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Statement of
The Honorable Robert R. Glauber
Under Secretary of the Treasury for Finance
Before the
Committee on Agriculture
U.S. House of Representatives

September 11, 1991

Good morning Chairman de la Garza, Mr. Coleman, and Members of the Committee:

I am pleased to appear before you today to discuss the pressing need to strengthen and modernize our nation's banking and financial services laws. At your request, my testimony will concentrate on the potential effects of the "Financial Institutions Safety and Consumer Choice Act of 1991" (H.R. 6) on the nation's commodities exchanges and commodity futures markets over which this Committee has jurisdiction. Before discussing these issues, let me take a minute to discuss the need for comprehensive legislation and how it might address the concerns of state and local communities.

Need for Comprehensive Reform

Last winter the Administration proposed H.R. 1505 as a comprehensive approach to modernize our outdated banking laws to make our banking system stronger and safer. Our proposal was the legislative culmination of an 18-month study by the Treasury Department of the banking system, as mandated by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. We believe this comprehensive approach to banking reform is the only way to truly resolve the underlying problems in the banking system -- merely recapitalizing the Bank Insurance Fund, as some have suggested, will only put off the day of reckoning and increase the exposure of the taxpayer. As Secretary Brady has said many times, we need to fix the banking problem, not just fund it.

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We believe that comprehensive reform must accomplish three fundamental objectives:

-- First, we must make deposit insurance safe for taxpayers and depositors. That means stronger supervision, better capitalized banks, and the return of deposit insurance to its original purpose of protecting average depositors. It also means a better capitalized Bank Insurance Fund.

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

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

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

The plain fact is that the laws on the books no longer reflect the way financial companies do business. Until we recognize this and act, our financial system will be exposed to further decay. Our financial companies will become weaker; and taxpayers will face the prospect of losses as weak financial concerns turn to the government for help.

We must instead find ways to tap voluntary private capital from the marketplace to stand ahead of the taxpayer. That is the strategy at the heart of comprehensive banking and financial reform. It is the strategy behind H.R. 1505, and it is the strategy behind H.R. 6, which is now before this Committee for its consideration.

Taken as a whole, H.R. 1505 addresses the fundamental problems of the banking system -- rather than just funding them. We believe it is a carefully balanced, integrated approach, which is essential to meaningful reform. By contrast, a thin, 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 and financial system and better serve consumers.

In short, Mr. Chairman, comprehensive reform will serve the public well -- consumers, financial service providers, and each of us who benefits from a strong and competitive banking system.

Impact on States and Local Communities

At the same time, both H.R. 1505 and H.R. 6 recognize and address the legitimate concerns of states and rural communities that arise with any significant change to our banking laws. The issues of particular concern to the states include: (1) interstate branching, with its related issues of community reinvestment and state taxing authority; (2) preservation of the dual banking system; and (3) the implications of the so-called "too-big-to-fail" policy that today results in the routine protection of uninsured depositors in large banks.

Interstate Banking and Branching. Any legislation that authorizes nationwide banking and branching must recognize legitimate state and rural concerns, and the legislative proposals before Congress do just this. For example, although an Iowa bank could establish an initial branch inside Illinois, Illinois would retain the right to restrict further branching inside its own borders, regardless of whether the Iowa bank was state chartered or nationally chartered. Illinois would also retain control over the ability of its own state banks to branch into other states. Finally, a host state would have the right to limit the activities of in-state branches of banks chartered in other states to the activities permitted for its own in-state banks -- a bank that obtained a charter from a state that permits expanded activities could not "export" these activities into a different state that prohibits these same activities for its own state banks.

Of course, the activities of national banks would not be so limited since Congress, not the states, has always maintained the exclusive authority to determine the scope of activities of national banks. Nevertheless, all of the proposals appear to require branches of out-of-state national banks to comply with a state's laws to the same extent as a national bank located in that state. This would specifically apply to state taxation and community reinvestment laws.

There is a popular misconception that the legislation's authorization of interstate branching will deprive states of the ability to tax local banking activities to the same extent they are taxed today. This is just not true. States will have broad authority to tax branches of interstate banks, just as they have broad authority to tax separately incorporated banks operating in that state. This goal is strongly shared by both the Administration and Congress, and to the extent that technical language in any bill does not accomplish this goal, it should be changed. In clarifying this point, however, it is critical to avoid any inference that any other taxing ability of the states is called into question.

Another popular myth is that interstate branching will undermine community reinvestment and lead to a "siphoning off" of funds from rural and local markets. Again, this is just not the case. First, the Community Reinvestment Act, a federal law, will continue to apply to the expansion of all interstate branches. Second, state community reinvestment and consumer protection laws will apply to interstate branches of state and national banks to the same extent that they apply to state and national banks today. Third, and most important, there is simply no evidence that interstate branching will siphon off funds from rural communities. To the contrary, numerous studies have shown that banks in states with liberal intrastate branching laws have provided more loans to local customers than banks in states with restrictive branching laws. At the same time, the movement toward interstate banking through holding companies has not resulted in any decline in local credit; there is simply no reason to believe that interstate branching would create any different result. The plain fact is that a bank or branch that does not serve the local community will not prosper, no matter who owns it.

The Dual Banking System. Another general area of concern for the states is the continued viability of the dual banking system, which has provided important benefits to consumers of banking services over the years. Critics claim that banking legislation will spell the end of the dual banking system, but again, the facts just do not support this assertion.

All versions of the legislation continue to permit states to authorize their banks to engage in a broader range of activities than national banks. This is the key ingredient of the dual banking system. For example, there are absolutely no federal limits on the types of agency activities in which state banks would be permitted to engage within their state borders; this is a matter left entirely up to the states.

There are, however, some new federal limitations on other types of state bank activities because of the direct risk to the U.S. taxpayer through federal deposit insurance. With one exception, these are not rigid statutory prohibitions but rather a grant of flexible safety and soundness authority to the FDIC. The general rule is that a state bank may engage in non-agency activities that are prohibited for national banks, but only if it meets its capital requirements and gets permission from the FDIC. This modest and prudent federal authority is appropriate, given the massive federal exposure to the taxpayer that has been painfully experienced with savings and loans.

The only exception to the general rule is the flat prohibition on direct equity investments by state banks in real estate and other commercial enterprises -- investments not permissible for national banks. Again, as was evidenced only too

well from the S&L experience, these risky ventures are simply inappropriate for federally insured deposits. The risk of loss to every taxpayer is just too great.

Rollback of the "Too Big To Fail" Policy. Finally, the states as well as many others have raised strong concerns about the current FDIC policy of routinely protecting uninsured depositors in bank failures, particularly large bank failures -- the so-called "too big to fail" policy. This practice has sometimes been magnified by the Federal Reserve's occasional practice of extended lending to troubled institutions through its discount window.

The Administration's original proposal to address the FDIC's too-big-to-fail policy has been improved by amendments in H.R. 6 that address the related Federal Reserve issue. The final legislative product should eliminate the routine protection of uninsured deposits, and, with certain exceptions noted below, we believe this outcome merits strong support.

First, the legislation for the first time will require the FDIC to adopt the failed bank resolution method that is least costly to the deposit insurance fund. This will result in fewer instances of protection for uninsured depositors.

Second, in order for the Federal Reserve to lend to undercapitalized institutions for a period exceeding 60 days, it must obtain a "certificate of viability" from the primary regulator of that institution. Furthermore, the Federal Reserve must reimburse the FDIC for certain costs attributable to withdrawals of uninsured deposits if it lends to undercapitalized institutions without a certificate of viability. While this provision goes too far -- it shifts too much cost from the FDIC to the taxpayer -- it is a sound idea to discourage routine discount window lending to troubled banks.

Third, while the government will and should retain the flexibility to protect even uninsured depositors in cases of systemic risk, the legislation ensures that the systemic risk must be genuine. This exception could only be invoked if the highest levels of government determine that systemic risk exists -- creating true and fair accountability for such extraordinary determinations.

Fourth, the legislation includes several proposals that will directly decrease the likelihood that the failure of a bank, even a large bank, will create the kind of systemic risk that forces protection of uninsured depositors. New provisions relating to the strength of correspondent banks, the interbank clearing system, and improved liquidity mechanisms will all help reduce the occasions of systemic risk.

In the end, however, the best way to eliminate even the rare instances of systemic risk is to fix the underlying system. Other countries rarely confront the "too big to fail" problem because they rarely have bank failures that raise the issue. There simply must be fewer costly bank failures and fewer threats to the economy.

Other Provisions Favorable to Community and Rural Banks

Other provisions of H.R. 1505 and H.R. 6 would clearly serve to bolster the community banks that are the backbone of the dual banking system. These provisions include the implementation of risk-related premiums, capital-based supervision, the removal of insurance for brokered deposits, reduced regulatory burdens, and certain miscellaneous provisions.

Risk-related Premiums. Premiums based on the degree of risk an institution poses to the deposit insurance fund will reward generally smaller banks for their typically higher levels of capital. Both the Administration's proposal and H.R. 6 would authorize the FDIC to develop an assessment system based on the ratio of capital to risk-weighted assets. Because small banks typically engage in less risky activities and have a higher percentage of capital than larger institutions, risk-related premiums will benefit these banks by creating a more equitable and relatively less costly assessment system.

Capital-based Supervision. Capital-based supervision will also reward small banks for their high capital levels. Under H.R. 1505, well-capitalized banks would be permitted to expand their financial activities to include insurance, securities, and mutual funds through the formation of financial services holding companies. State banks, in particular, would be permitted to engage in any agency activity permitted by the states, including distribution of mutual funds; and well-capitalized state banks would be permitted to engage in non-agency activities beyond those permitted national banks subject to FDIC approval. Under H.R. 6, these new financial activities would be limited to well-capitalized institutions, and insurance activities would have to be conducted under the diversified holding company rather than the financial services holding company.

Brokered Deposits. Small banks will benefit from the elimination or reduction of deposit insurance coverage for brokered deposits. Insured brokered deposits compete with local bank deposit rates in ways that can hurt community lending institutions.

Reduced Reporting Burdens. The exemption from the reporting requirements of the Home Mortgage Disclosure Act would apply to banks with less than $50 million in assets. Currently, only banks with assets of less than $10 million are exempt.

A regulatory burden study would examine the feasibility of reducing the number of items required to be disclosed on the Report of Condition by banks with less than $50 million in assets. The regulatory burden study would also examine the impact of the Regulatory Flexibility Act and the Paperwork Reduction Act on banks. And, the reporting burdens under the Fair Housing Act and the notification burdens of the Expedited Funds Availability Act would be reduced.

Both Houses of Congress have additional helpful provisions to reduce the burden on community banks.

Effects on Futures Markets and Exchanges

I would like to focus now on some relatively technical issues involving the bill's effects on futures markets and futures exchanges. The Commodity Futures Trading Commission has expressed concern about three specific issues. Let me begin with the netting provisions in Title VI, Subtitle A, about which you have expressed particular interest.

1. Netting Arrangements and Definition of "Futures Commission Merchant"

The bill's netting provisions are designed to reduce risk to the payment system by promoting more efficient processing of financial transactions through netting and clarifying the validity of netting procedures in the event of the closing of a financial institution participating in such netting.

Financial institutions and members of clearing organizations are organized under the laws of numerous jurisdictions, which may differ. These laws may establish a variety of preferences and priorities among creditors in the event of bankruptcy, receivership, or insolvency, many of which are not codified and the implications of which are not fully developed.

Consequently, it cannot be determined with certainty whether the netting procedures provided in private contracts would be honored under these various laws. Because certainty of settlement on a net basis is essential to the safety and soundness of the banking system and financial markets, Section 605 of H.R. 6 preempts any injunction or similar order issued by a court or agency that would interfere with the netting procedures governed by the Act. This preemption is, however, explicitly limited to orders that are inconsistent with the netting procedures and are not intended to affect any other priorities or preferences established by other laws.

In addition, Section 603 provides with respect to bilateral netting that, in accordance with the terms of the contractual arrangements between two financial institutions, the mutual

obligations of such institutions shall be netted and set off, without regard to whether the obligations are matured or unmatured. Although it is believed that a similar result would occur under existing law, some uncertainty exists. The daily volume of trillions of dollars of payments through clearing organizations requires that this uncertainty be eliminated.

Section 604 addresses the additional concern that, in the event of a clearing member's bankruptcy, its receiver or liquidator might attempt to negate the multilateral settlement rules of the clearing organizations. This section provides statutory validation of netting to the extent provided by the clearing organization rules. If a member fails, its claim with respect to payment orders received through the clearing organization would be limited to the excess, if any, of the amount of payment orders transmitted.

The CFTC has expressed concern that these three provisions might validate netting arrangements otherwise prohibited under the Commodity Exchange Act (or other laws). For example, the CFTC views the Commodity Exchange Act as prohibiting netting of proprietary and customer obligations. In addition, futures clearing organization rules, which may constitute netting contracts under Section 602(14) of the bill, are generally subject to CFTC review under the Commodity Exchange Act. Among other things, these rules could affect how such net payments are calculated, and the CFTC is concerned that the rules might be superseded. To remedy this problem, the CFTC has suggested including language to make it clear that the bill's new netting provisions are subject to and are not intended to supersede other applicable legal requirements of the Federal banking, securities, or commodities laws.

We understand the Senate Banking Committee version of the bill would fix this problem by excluding netting contracts that are precluded by Federal banking, securities, or commodities laws. We have no objection to this language in the Senate bill. If it is not acceptable to the Committee, we will work with CFTC and Committee staff to develop other, mutually agreeable language.

The CFTC also has pointed out a technical problem with the definition of "futures commission merchant" (FCM). H.R. 6 defines an FCM to mean a company that is registered or licensed under "Federal or State" law to engage in the business of selling futures and options in commodities. We concur with the CFTC's suggestion to delete reference to state law, inasmuch as an FCM would not be able to conduct business unless registered under federal law.

2. Deposit Insurance Coverage of FCM and Clearing Organization Accounts

The CFTC has expressed particular concern that the bill's deposit insurance provisions, if applied broadly, may supersede the current practice of "passing-through" deposit insurance coverage to funds of individual customers maintained in accounts with futures commission merchants and deposited on an omnibus basis in FDIC-insured institutions. The CFTC is seeking report language to the effect that any modification of deposit insurance coverage would not affect coverage of segregated customer accounts carried on an omnibus basis.

Coverage of Brokered Deposits, BICs, and Pension Plans. Section 101 of H.R. 1505 provides that deposit insurance would no longer apply to deposits obtained directly or indirectly from so-called "deposit brokers." H.R. 6 would permit brokered deposit coverage only for the best-capitalized institutions.

In addition, Section 101 of our bill eliminates "pass-through" insurance coverage of deposits of certain defined benefit and defined contribution pension plans that are not "self-directed." Currently, the FDIC provides insurance coverage on a "pass-through" basis to certain fiduciary accounts maintained for the benefit of others. This means that despite the explicit $100,000 limit on federal deposit insurance for any one deposit account, a single fiduciary account well in excess of $100,000 may be fully protected by passing through coverage to each of the beneficiaries.

The CFTC is concerned that if these sections are read broadly, they may prohibit pass-through treatment of FCM segregated accounts that the FDIC has permitted as a matter of practice since 1984. More specifically, the CFTC is seeking report language clarifying that FCMs do not fall within the definition of "deposit broker" -- to avoid triggering the elimination of insurance coverage for deposits made by FCMs. Although the bill's definition of "deposit broker" is identical to the current definition in the Federal Deposit Insurance Act, we would be willing to explore with CFTC staff the possibility of adding report language to the effect that FCMs are not intended to be covered. We note that the FDIC has not allowed pass-through coverage of clearing organization accounts, as indicated in a 1986 FDIC Advisory Opinion.

Pass-Through Coverage. The CFTC also is concerned about the bill's new rules for determining pass-through insurance coverage. The Administration's bill, but not H.R. 6, establishes new rules for determining pass-through treatment. They specifically allow pass-through coverage if each of four conditions are met, including that the account not be maintained for investment

purposes. The CFTC is concerned that this "non-investment" test may be difficult to meet in the case of FCM customer accounts.

Pursuant to CFTC interpretation FCMs can deposit customer funds in depository institutions only in non-interest bearing demand deposit accounts without withdrawal restrictions (to ensure liquidity). Therefore, it does not appear to us that the "non-investment purpose" test is a problem.

We recognize that this is a complex subject, and new rules always raise the possibility of unintended consequences and interpretations. Thus, the CFTC's concerns are understandable. The Treasury Department did not intend the deposit insurance provisions of the bill to change existing practice with respect to segregated customer accounts deposited in insured institutions on an omnibus basis for other than investment reasons. To the extent there is any ambiguity in this regard, we will work with the CFTC and Committee staff to develop mutually agreeable report language to resolve these concerns.

H.R. 6 also authorizes the FDIC to adopt rules clarifying deposit insurance coverage. In the spirit of interagency cooperation, we support the CFTC's suggestion that language be included in the legislative history of this provision directing the FDIC to consult with the CFTC, SEC, and other appropriate federal agencies with respect to any rulemaking concerning pass-though insurance coverage.

3. Definition of "Functional Regulator"

Finally, the CFTC has noted that various sections of the bills provide for coordination with or notice to the "functional regulator" -- the federal or state agency that has supervisory authority over a diversified holding company, financial services holding company, or nonbank subsidiary (section 401(a)(5) of H.R. 6). Because report language for H.R. 1505 and H.R. 6 refer to the Securities and Exchange Commission, the Federal Reserve Board and state insurance commissioners as examples of a "functional regulator", there is concern that the CFTC and other agencies not specifically mentioned were intended to be excluded from the definition. This certainly was not our intent, and we would be happy to support report language clarifying that the CFTC is a "functional regulator" of firms registered under the Commodity Exchange Act that are engaged in futures-related activities.

Conclusion

In conclusion, let me emphasize once again the need for comprehensive legislation. Congress has an historic opportunity to address the reality of the modern financial marketplace and create a U.S. banking and financial system that is

internationally competitive, that will protect depositors and taxpayers, serve consumers, and strengthen the economy. We hope the Committee will join us in seeking enactment of this far-reaching legislation this year.

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Mr. Chairman, that concludes by prepared remarks. I would be pleased to answer any questions the Committee may have.

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STATEMENT OF
MICHAEL J. GRAETZ
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss the recent withdrawal of proposed regulations concerning the treatment under State ratemaking proceedings of consolidated tax savings under the normalization provisions of the Internal Revenue Code (the "Code"). These proposed regulations, which were published in November 1990 and withdrawn in April 1991, attempted to address the question whether the Internal Revenue Code should be interpreted to restrict the ability of State regulators to take into account certain tax savings realized by an affiliated group of corporations ("consolidated tax savings") in setting the rates that they permit public utilities to charge their customers.

<u>Background</u>

Public utility rates generally are set under State law to compensate the utility for the costs of providing utility services and to provide the utility's bondholders and shareholders with a fair return on the capital they invest in utility assets. The "cost of service" component of rates is based on the operating costs incurred by the utility during the year (such as fuel, salaries, postage, etc.), the depreciation of fixed assets during the year (generally allowed on a straight-line basis over a 25 to 40 year life), and Federal and State income tax expense for the year. The "return on capital" component of rates is based on the product of the "rate base"

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(generally the regulatory book value of assets employed to provide utility services) and a weighted average rate of return on debt and equity capital that bondholders and shareholders have invested in those assets.

Since 1969 the Internal Revenue Code has conditioned a public utility's ability to use accelerated depreciation for public utility property on specified ratemaking treatment of the tax savings due to the utility's use of accelerated methods of depreciation or shortened depreciation lives. In general, the Code provides that a public utility may not use accelerated depreciation for public utility property in computing its Federal income tax liability unless the regulators use a "normalization method of accounting" in calculating the utility's tax expense for ratemaking purposes.

There are two general ways a utility regulatory commission can account for the benefits of accelerated depreciation, shorter depreciation lives, and investment credits for public utility property in setting utility rates. One way, flowthrough accounting, treats these benefits as a current reduction in Federal income tax expense in computing the utility's cost of service. Under this method, current operating expenses are reduced, and the Federal tax benefit is immediately flowed through to current utility customers. A second way, normalization accounting, treats these benefits as a reduction in the utility's capital costs.

In general, normalization accounting requires a utility to compute its tax expense in determining its cost of service for ratemaking purposes as though it used the same method and period of depreciation that it uses in calculating its depreciation expense for purposes of setting its rates. This typically will be the straight-line method over a much longer life than is used for tax purposes. Thus, under this method, which the Code requires for a utility to be able to use accelerated depreciation on public utility property, regulators must calculate the utility's cost of service in a manner that permits the utility to collect from customers an amount for tax expense that exceeds the utility's actual current tax liability by the amount of the tax savings from accelerated depreciation.

Under normalization accounting, however, regulators may treat the tax savings as cost-free capital. It is not a violation of the normalization rules of the Code for regulators to reduce a utility's "rate base" -- generally the total amount of capital invested in the utility on which stockholders and bondholders are allowed to earn a return -- by the cumulative tax savings from using accelerated depreciation. A utility using normalization accounting may be thought of as treating the reduction in its current tax liability that results from using accelerated depreciation as an interest-free loan from the Treasury; this is accomplished by treating the utility as though it were required to pay to the Treasury the tax that would be due

if accelerated depreciation were not allowed, and the Treasury loaned back to the utility -- without interest -- the excess of this amount over the utility's actual tax liability calculated using accelerated depreciation. In effect, normalization accounting operates to determine a utility's rate of return on a reduced rate base, thereby flowing through to customers over the service life of the asset the benefits of reduced capital expenses due to accelerated depreciation. The normalization rules are intended to ensure that the Federal tax savings provided through accelerated depreciation provide cost-free capital to utilities to promote investment and are not used to subsidize current consumption.

The History of the Normalization Requirement

A requirement that utilities use the normalization method of accounting was first added to the Internal Revenue Code in 1969. In 1964, Congress had foreshadowed the 1969 normalization rules by prohibiting Federal regulatory agencies from flowing through the 3 percent investment tax credit then available on public utility property more rapidly than ratably over the useful life of the asset and prohibiting Federal regulators from flowing through any part of the 7 percent investment credit on nonpublic utility property.[1] The Tax Reform Act of 1969 added section 167(l) to the Code to limit the use of flowthrough accounting, and, in general, to require utilities that claimed accelerated tax depreciation to use a normalization method of accounting.

Congress did not completely prohibit flowthrough accounting in 1969, however. At that time, about half of all State ratemaking authorities were requiring utilities to flow through to current customers the benefits of accelerated tax depreciation.[2] Congress was concerned about causing a widespread increase in rates paid by customers of those

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[1]Pub. L. No. 88-272, § 203(e) (1964). When Congress enacted a 7 percent investment tax credit (ITC) in 1962, regulated utilities were granted a credit of only 3 percent. The reduced rate was a compromise between those who argued that utilities should receive the same investment incentives as other businesses and those who argued that, because of their monopoly status, utilities did not need incentives to invest and that flowthrough accounting by ratemakers would defeat the purpose of making investment incentives available to utilities.

[2]Indeed, some ratemakers were insisting that utilities, such as the major telephone companies, which had been claiming straight-line depreciation, claim accelerated tax depreciation so that the Federal tax savings could be flowed through to ratepayers. Certain ratemakers were reducing rates by the available Federal tax savings even if a utility did not claim accelerated tax depreciation.

utilities, and the 1969 legislation was designed to stop the spread of flowthrough accounting to utilities not already using it; utilities using flowthrough were "grandfathered."

In structuring the 1969 prohibition, Congress did not attempt directly to prohibit State ratemaking authorities from using flowthrough accounting. Because of federalism concerns and suggestions that such a direct prohibition would raise constitutional issues, Congress instead conditioned a utility's ability to use accelerated depreciation on its use of normalization accounting.[3] The 1969 Act granted Treasury broad authority in section 167(1)(5) to issue regulations as needed to carry out the purposes of the normalization rules.

In 1971, Congress increased the investment tax credit on public utility property to 4 percent and required utilities to use a normalization method of accounting for the credit as a condition of claiming it with respect to public utility property.[4] In 1981, in connection with the adoption of the ACRS system of depreciation, Congress extended the normalization rules to all utilities by repealing the 1969 grandfather rules. In 1982, Congress expanded Treasury's regulatory authority to prevent the use of ratemaking techniques that are inconsistent

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[3]The 1969 normalization requirement grew out of H.R. 6659, which would have prohibited flowthrough accounting by State ratemakers. This direct prohibition was rejected in favor of imposing a loss of accelerated depreciation on utilities because the bill's opponents raised doubts about the constitutionality of prohibiting State regulators from using flowthrough accounting. See, e.g., Statement of Fred P. Morrissey, Commissioner, California Public Utilities Commission, before the Committee on Ways and Means on March 27, 1969, summarized in Summary of Testimony on Treatment of Tax Depreciation by Regulated Utilities, JCS 47-69 at 8 (July 11, 1969). The Treasury Department opined on May 5, 1969, that the direct prohibition was constitutional. See letter from Paul W. Eggers, General Counsel of the Treasury, submitted in response to a question from Congressman Utt to Assistant Secretary Cohen and reprinted in Hearings before the Committee on Ways and means, Ninety-first Congress, First Session on the Subject of Tax Reform, Part 15 of 15 at 5672 (April 24, 1969).

[4]Although the new ITC normalization rules in section 46(e) (which later became section 46(f)) allowed ratemakers to "share" part of the credit with current and future ratepayers, the rules were not identical to the section 167(l) normalization rules that were prescribed for accelerated depreciation in 1969. Under the 1971 rules, ratemakers were permitted to reduce the rate base by the amount of the investment tax credit or to flow through the credit over the life of the property.

with the statutory normalization requirement.[5] In 1986, Congress extended normalization accounting to cover the ratemaking treatment of the reduction in corporate income tax rates.[6] Notice 87-82, 1987-2 C.B. 389, 391, requires normalization of contributions in aid of construction (CIACs) received subsequent to the 1986 Act's changes in the method of tax accounting for most CIACs.[7]

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[5]The California regulatory commission had created a technique called the Average Annual Adjustment ("AAA") method, which creatively used certain "estimates and projections" to mimic the effects of a flowthrough method in a way that arguably did not violate the statutory normalization rules. In sections 168(e)(3)(C) (which later became section 168(i)(9)(B)) and 46(f)(10), Congress stated that the normalization requirements are not met if the taxpayer uses procedures and adjustments that are inconsistent with the normalization rules. Congress described the AAA method as one procedure or adjustment that violated the new statutory "consistency requirement," and authorized Treasury to prescribe by regulation other procedures and adjustments that would be treated as inconsistent with the normalization rules. See H.R. Rep. No. 97-827, 97th Cong. 2d Sess. at 7-10 (1982). The 1982 legislation also granted relief to eliminate the substantial tax liability of several California utilities that would have been assessed for prior years due to the disallowance of accelerated depreciation and investment credits on the grounds that the State regulatory commission's rules violated the Code's normalization requirements.

[6]By lowering the top marginal income tax rate for corporations from 46 percent to 34 percent, the 1986 Act produced an "excess deferred tax reserve" because the deferred tax reserve for accelerated depreciation that was set aside at a rate of 46 percent could now be paid back at the 34 percent rate. Section 203(e) of the 1986 Act provided that under a normalization method, the excess deferred tax reserve could not be flowed through to reduce the cost of service component of current rates more rapidly than over the remaining regulatory lives of the utility's assets. In 1987 and again in 1989, this Committee revisited the decision to require normalization of the effect of the 1986 change in income tax rates, and on both occasions Congress left in place its 1986 decision that the excess deferred tax reserves should be normalized.

[7]A typical CIAC is a utility line that a customer constructs and contributes to the utility, or pays the utility to construct, as a condition of receiving utility services. Prior to 1986, CIACs were generally excluded from the utility's income as nonshareholder contributions to capital under Code section 118(a). The 1986 Act added section 118(b), which provides that CIACs received from a customer or potential customer are not covered by section 118(a). Thus, these CIACs must be included currently in the utility's gross income under section 61.

In summary, Congress has enacted normalization requirements with respect to the regulatory treatment of three tax benefits: accelerated depreciation and investment tax credits claimed for public utility property and the 1986 reduction in corporate tax rates. Prior to the publication of the proposed regulations concerning consolidated tax savings -- which are the subject of this hearing -- the Internal Revenue had published normalization requirements for only one additional item: post-1986 CIACs.

Consolidated Tax Savings

In recent years, the Treasury and Internal Revenue Service have been asked whether the normalization requirements of the Code apply to restrict the regulatory treatment of the reduction in Federal income taxes resulting from utilities filing a consolidated return with unregulated affiliates. Utilities, like other corporate taxpayers, are permitted to file a consolidated tax return with other commonly controlled corporations. When a consolidated return is filed, the tax liability of the affiliated group generally is determined as if the members of the group were a single corporation. A utility, for example, may thereby shelter its income from current taxation by offsetting tax losses (or excess credits) of other affiliated corporations engaged in unregulated businesses (for example, leasing and gas exploration). If the affiliated corporations did not file a consolidated return, the losses of the unregulated companies generally would not be used to reduce taxes until the later years in which the loss companies become profitable.

State ratemaking authorities generally have used two different approaches to determine the tax expense of a utility that files a consolidated return. Under an "actual taxes paid" approach, the tax savings that result from filing a consolidated return are flowed through to utility customers through lower rates that result from including only the utility's share of actual taxes paid in the utility's cost of service. The United States Supreme Court upheld the Federal Power Commission's use of such an "actual taxes paid" approach in 1967, two years before the depreciation normalization rules were first added to the

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However, notwithstanding the 1986 change in the tax law, most utilities disregard the receipt of a CIAC for ratemaking purposes. Thus, the 1986 Act created a timing difference between ratemaking and tax accounting for CIACs, and Notice 87-82 required that difference to be normalized so that the prepayment of tax on CIACs would be shared between current and future ratepayers. The Notice requires a utility to increase its rate base by the amount of the CIAC or treat the CIAC as a loss of zero-cost capital in computing the return on capital component of current rates. We are not aware of any utilities or ratemakers who have complained about Notice 87-82.

Internal Revenue Code. Federal Power Commission v. United Gas Pipe Line Co., 386 U.S. 237 (1967).

Under an alternative "stand-alone" approach, the ratemaking authority determines the utility's tax expense for purposes of setting rates as if the utility had filed a separate return. Thus, for example, under stand-alone accounting, if a utility that has taxable income files a consolidated return with an affiliate whose losses completely shelter that income from current taxation, the utility's cost of service for ratemaking purposes reflects the tax that the utility would have paid if it had filed a separate return. The United States Court of Appeals for the District of Columbia Circuit upheld the Federal Energy Regulatory Commission's use of such an approach in City of Charlottesville v. Federal Energy Regulatory Commission, 774 F.2d 1205 (D.C. Cir. 1985), cert. denied, 475 U.S. 1108 (1986).[8]

In the 1980s, the Internal Revenue Service issued several private letter rulings holding that the normalization provisions of the Code require regulatory authorities to use a stand-alone approach. One of these rulings was issued to Contel, a utility doing business in Pennsylvania. Notwithstanding this ruling, the Pennsylvania Public Utility Commission set Contel's rates using an "actual taxes paid" approach. Contel then appealed the Commission's decision to the Commonwealth Court of Pennsylvania, which affirmed the Commission's position. Continental Telephone Company of Pennsylvania v. Pennsylvania Public Utility Commission, 548 A.2d 344 (Pa. Commw. 1988), appeal denied, 557 A.2d 345 (Pa. 1989). The Pennsylvania court rejected the conclusion of the private letter ruling that Contel would be in violation of the normalization rules if it followed the Commission's rate order.[9]

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[8]The Federal Power Commission (FERC's predecessor) decided in 1972 to abandon consolidated tax savings adjustments in favor of a stand-alone approach. Dismissing as dicta the Supreme Court's statements in United Gas Pipeline about FPC's "duty" to limit the cost of service component of rates to real expenses, Judge Scalia rejected Charlottesville's argument that the "actual taxes paid" doctrine prevented FERC from using a stand-alone method. 774 F. 2d at 1216. In essence, the court held that it was within FERC's ratemaking authority to require either a flowthrough or stand-alone method of accounting for consolidated tax savings.

[9]According to the Pennsylvania court, the letter ruling did not rest upon compelling law or logic, and "in itself cannot provide a legal basis for invalidation of a PUC order." 548 A.2d at 351. The court relied instead upon the holdings of the Pennsylvania Supreme Court in Barasch v. Pennsylvania Public Utility Commission, 493 A.2d 653 (Pa. 1985)(the commission was not entitled to include in rates "hypothetical" Federal and State income taxes that were not actually incurred), and in Barasch v.

Following the Pennsylvania Court's decision, decisionmakers at the Internal Revenue Service were forced to consider whether to maintain the position taken in the private letter ruling, which would have treated Contel as violating the normalization requirement, thereby requiring disallowance of accelerated depreciation on its public utility property that would produce large tax deficiencies against Contel. In May 1989, the Service published Notice 89-63, 1989-1 C.B. 720, to inform utilities and ratemakers that it was developing proposed regulations to address whether the use of consolidated tax adjustments violates the normalization requirements of the Code. At that time, the Service also withdrew two of the private rulings -- including the one issued to Contel -- that had addressed the issue.

Issuance and Withdrawal of Proposed Regulations

On November 27, 1990, the Service proposed regulations attempting to apply the general policies of the normalization method of accounting to consolidated tax savings. These proposed regulations would have prohibited current flowthrough of consolidated tax savings by denying a utility the use of accelerated depreciation on its public utility property -- the only sanction permissible under the statute -- unless the utility's tax expense in determining its cost of service for ratemaking purposes is determined on a stand-alone basis. Thus, the proposed regulations would have prohibited regulatory commissions from taking consolidated tax savings into account in computing ratemaking tax expense. However, the proposed regulations would not have prohibited a commission from adjusting the utility's rate base to treat the affiliated group's 14 tax savings from filing a consolidated return as cost-free capital until the loss affiliate becomes profitable.

This approach generally regards the taxable income generated by the utility as serving to permit current use of the offsetting losses (or credits) of unregulated affiliates and treats the benefits of filing a consolidated return as a deferral, rather than a permanent reduction, of tax liability. The normalization requirements of the proposed regulations were similar to those under the Code for the tax savings from accelerated depreciation. As with statutory normalization of accelerated depreciation, the proposed regulations would not have required ratemakers to adjust the rate base by a utility's share of the affiliated group's consolidated tax savings, but would have permitted them to do so. The proposed regulations specified a method, based on the

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Pennsylvania Public Utility Commission and Pennsylvania Power Co., 491 A.2d 94, 103 (Pa. 1985)("hypothetical" taxes could only be included in rates if the failure to normalize would result in the loss of accelerated depreciation deductions and leave current ratepayers even worse off than they are under normalization).

consolidated return regulations, for determining the utility's share of the affiliated group's consolidated tax savings.

Subject to specific exceptions for cases where consolidated tax savings had previously been flowed through to customers, the proposed regulations would not have permitted any tax savings from prior years to be flowed through to customers or to be treated by regulatory commissions as cost-free capital. These provisions were intended to minimize the effect of the proposed regulations by limiting any sudden changes in utility rates.

The Internal Revenue Service received about 100 written comments on the proposed regulations and held a public hearing on February 8, 1991, at which about 30 witnesses testified. Not one commenter endorsed the basic approach of the proposed regulations.

Representatives of public utility commissions argued that the Service lacked authority under the normalization rules to issue regulations to require use of a stand-alone approach in computing cost of service, because the normalization rules of the Code apply only to accelerated depreciation of public utility property. Ratemakers contended that the Service exceeded its regulatory authority by attempting to dictate the ratemaking treatment of an item, such as consolidated tax savings, that does not necessarily involve either accelerated depreciation or public utility assets. The ratemakers maintained that if Congress had intended to treat consolidated tax adjustments as a violation of normalization, it would have done so explicitly and would have adopted a different statutory penalty for violating normalization -- something other than the loss of accelerated depreciation on utility property. State regulatory authorities indicated that they intended to challenge in court the validity of the regulations if finalized.

Representatives of public utilities opposed the proposed regulations on the grounds that the normalization rules of the Code do not permit any reduction of rate base due to consolidated tax savings. They argued that any reduction of rate base inappropriately allows utility customers to enjoy the tax benefits associated with losses of an unregulated affiliate when the customers did not bear the burden of those losses.

On March 29, 1991, the Office of Management and Budget ("OMB") informed the Treasury Department that it had designated any final regulations in this area as a "major rule" under Executive order 12291. That designation requires the Department to submit the text of the final regulations, along with a Regulatory Impact Analysis of the costs and benefits of the rule and of any alternative regulatory approaches, for review by OMB

before the final rule can be published in the Federal Register.[10]

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[10]As provided in section 3(d) of Executive order 12291, the Analysis is required to contain the following information:

1. A description of the potential benefits of the rule, including any beneficial effects that cannot be quantified in monetary terms, and the identification of those likely to receive the benefits;

2. A description of the potential costs of the rule, including any adverse effects that cannot be quantified in monetary terms, and the identification of those likely to bear the costs;

3. A determination of the potential net benefits of the rule, including an evaluation of effects that cannot be quantified in monetary terms;

4. A description of alternative approaches that could substantially achieve the same regulatory goal at lower cost, together with an analysis of their potential benefits and costs and a brief explanation of the legal reasons why such alternatives, if proposed, could not be adopted; and

5. Unless covered by the description required under item 4. above, an explanation of any legal reason why the rule can not satisfy the requirements set forth in section 2 of the Executive order:

   - Administrative decisions shall be based on adequate information concerning the need for and consequences of regulatory action;

   - Regulatory action shall not be undertaken unless the potential benefits to society from the regulation outweigh the potential costs to society;

   - Regulatory objectives shall be chosen to maximize the net benefits to society;

   - Among alternative approaches to any given regulatory objective, the alternative involving the least net cost to society shall be chosen; and

   - Agencies shall set regulatory priorities with the aim of maximizing the aggregate net benefits to society, taking into account the condition of the particular industries affected, the condition of the national economy, and other regulatory actions contemplated for the future.

Furthermore, the designation of the final regulations as a "major rule" under Executive order 12291 automatically makes any final regulations a "significant regulatory action" under Executive order 12498. That designation would have required the final regulations to be described in the published Regulatory Program of the U.S. Government.[11]

The Treasury Department is not aware of another circumstance when OMB has designated a tax regulation as a "major rule" under Executive order 12291. Performing the kinds of cost-benefit analyses required by these Executive orders would be difficult in any circumstances, but in the instant context such analyses would be particularly forbidding. First, the factual variations are manifold. For example, tax savings resulting from the filing of consolidated tax returns by affiliated groups that include a regulated utility may or may not be due to the use of specific tax incentives, such as accelerated depreciation or deduction of intangible drilling costs, and may vary in their relationship to the provision of utility services. Second, the costs and benefits may be different in different sections of the country and will depend, at least in part, on the State regulatory process relating both to consolidated tax savings and other issues.[12] Third, this issue raises important issues of both Federal-State relations and utility ratemaking regulatory policy

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[11]That description must include:

1. An identification of the problem to be solved;

2. A statement of the need for a Federal solution to the problem;

3. A summary of the approach taken by the rule; and

4. A tabular presentation of the currently projected monetary costs and benefits of the rule, as well as that of potential alternative approaches to the rule, including transfer costs and benefits resulting from the rule. (OMB has indicated to the Treasury Department that a narrative description of costs and benefits associated with a final regulation might be acceptable in lieu of a tabular monetary analysis in certain cases.)

[12]As Emil Sunley, Deputy Assistant Secretary of Treasury, reported to this Committee more than a decade ago: "While the [normalization] tax rules prescribe accounting rules, they do not authorize an inquiry into the motivation for regulators choosing a particular rate of return. This means there are limits as to how far the tax rules can be enforced in the regulatory process." Hearings before the Subcommittee on Oversight of the House Committee on Ways and Means, 96th Cong., 1st Sess., 515 (March 28, 1979).

that are difficult, if not impossible, to quantify and about which the Internal Revenue Service and the Office of Tax Policy claim no special expertise. Finally, the adverse commentary on the proposed regulations made it clear that neither the State regulatory authorities nor the affected utilities approved of the approach of the regulations and for opposite reasons: The State commissions regarded the proposed regulations as overreaching and illegal, while the utilities complained that the proposed regulations did not sufficiently constrain the regulators' discretion. In these circumstances, we had little reason to believe that any cost-benefit analysis we performed would be convincing to the affected parties. On April 25, 1991, the Internal Revenue Service withdrew the proposed regulations pending congressional guidance.

Current State of the Law

Attached as an Appendix to this statement is a memorandum to me from Abraham N.M. Shashy, Jr., Chief Counsel, Internal Revenue Service, that describes the Service's current ruling policy concerning whether a consolidated tax adjustment by a regulated utility violates the normalization requirements of the Internal Revenue Code. It is the position of the Service that, in the absence of regulations specifically prohibiting consolidated tax adjustments, these adjustments can be made without violating the normalization requirements of the Code. Therefore, if requested in an appropriate circumstance, the Service would rule that these adjustments do not violate the normalization requirements of the Code, provided that the adjustments are applied only to the extent of current ratemaking tax expense and not to the deferred tax reserve applicable to accelerated depreciation on public utility property.

Conclusion

We did not view the proposed regulations as a complete or final product. We saw them as a general rule and a framework within which a number of more specific issues could be resolved. We had expected that as a result of comments by the affected parties, the proposed regulations might be revised. For example, comments suggested that the rules for determining the utility's deemed share of the consolidated tax savings of the affiliated group merited change, such as by taking into account, where appropriate, tax sharing arrangements among the regulated and unregulated affiliated corporations. The comments we received on the proposed regulations also identified other issues to be considered, such as situations where there are several unregulated affiliates and situations where regulated and unregulated activities are performed within a single corporation.

Notwithstanding contentions to the contrary in comments on the proposed regulations, the Internal Revenue Service and the

Treasury concluded that the Code authorizes, but does not require, the Service to issue regulations prohibiting ratemaking procedures -- such as adjusting tax expense to reflect consolidated tax savings -- that it finds to be inconsistent with the policies behind the normalization rules. Section 168(i)(9)(B)(iii) authorizes Treasury by regulations to "prescribe procedures and adjustments" that "are to be treated as inconsistent" with the normalization rules. See also Section 167(l)(5).[13] Thus, we determined that we had adequate legal authority to issue these regulations.

Obviously, the Treasury and the Internal Revenue Service also regarded the basic approach of the proposed regulations as appropriate as a matter of policy when they were issued. On balance, we decided to propose regulations that would limit regulators' discretion in accounting for consolidated tax savings, notwithstanding Congress's failure to address explicitly the issue of consolidated tax adjustments in 1969 or thereafter, and even though the Supreme Court in 1967 had approved such ratemaking offsets.

As I have indicated, the proposed regulations were designed to follow the general structure of normalization requirements for accelerated depreciation. In essence, this approach views consolidated tax savings resulting from the combination of losses of unregulated affiliates with the income of the regulated

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[13]Certain comments argued that the kind of rate base reduction permitted in the proposed regulations violates the statutory consistency rules of section 168(i)(9)(B)(i). That paragraph provides that the normalization requirements are not met "if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with" the requirements of section 168(i)(9)(A). In particular, these comments argued that rate base reduction effectively allows losses of affiliates to be taken into account for purposes of computing rate base when they are not taken into account in computing depreciation expense, tax expense, and deferred tax expense, and that this violates the "estimate or projection" consistency rule of section 168(i)(9)(B)(ii).

We do not find this reading of the statute persuasive. The practice of taking affiliates' losses into account does not involve an "estimate or projection" of rate base as Congress used those words in section 168(i)(9)(B)(ii). The term "estimate or projection" as used in the statute clearly was intended to be narrower than the term "procedure or adjustment," and to refer to assumed changes in a particular account or item between a test year and the subsequent years covered by a rate order. See S. Rep. No. 643,, 97th Cong., 2d Sess. 7 (1982). Indeed, there is no evidence that the enactment of the consistency rules in 1982 was intended to extend normalization requirements to consolidated tax savings.

utility as enabling the consolidated group to use the losses sooner than if the affiliate were to file its tax return on a stand-alone basis. This measure of the utility's contribution may be captured in a rate base adjustment, which provides the utility's ratepayers with a benefit reflecting the time value of the more rapid use of the unregulated affiliates' losses or excess credits made possible by the utility's taxable income or tax liability.[14] Under the proposed regulations, the unregulated affiliates would have been no worse off than they would be had the utility not been part of the consolidated group. Since the utility's cost of capital reflects the activities of its unregulated affiliates, there seemed to be no reason to allocate the benefits resulting from the accelerated use of their losses or excess credits entirely to the unregulated affiliates, as would be the result if rate base reductions were prohibited. Thus, we concluded that we should not attempt to prohibit regulatory commissions from permitting utility customers to share in the benefit produced by consolidated tax savings through a rate base adjustment. However, because the assets that generated the tax loss are not utility property, we concluded that the losses generated by those assets should not be used to adjust the utility's current tax expense. If they were so used, the shareholders would be subsidizing the cost of the service provided by the utility. For this reason, the proposed regulations held that the current tax expense of the utility should be calculated as if it had filed a separate return.

Even when the statutory language is directly applicable and congressional policy is clear, the normalization requirements of the Code have proved to be something of a blunt instrument. On the prior important occasion when a State regulatory authority refused to accede to the statutory structure, Congress ultimately was forced to legislate to clarify the rules and forgave over $2 billion in tax liability that would have been due had the Service disallowed accelerated depreciation deductions as contemplated by the statute.[15] In the current context, certain State regulatory commissions made clear their intention to challenge the validity of these regulations if finalized and may well have disregarded them in the interval. The Service's ability to sustain disallowances of accelerated depreciation deductions in circumstances where the State commissions refuse to adhere to the proposed regulations is far from certain, and the failure to do so might erode the Service's ability to enforce normalization

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[14]Even when the tax savings are generated from a transaction that does not automatically "reverse" (i.e., where the tax loss incurred by the unregulated affiliate does not simply represent a timing difference), the component of no-cost capital in the utility's rate base will be reduced when the unregulated affiliate earns income.

[15]_See_ H. Rep. No. 97-987, 97th Cong., 2d Sess.(1982) and the discussion at note 5, supra.

requirements where the Code speaks clearly as to the congressional policy.

Finally, if Congress wishes to limit State regulatory commissions' discretion with respect to their treatment of consolidated tax losses by specifying normalization or other ratemaking treatment, disallowing the filing of a consolidated return by the utility would be a more focused and appropriate remedy than the only sanction available by regulation -- the disallowance of accelerated depreciation on public utility property. We are prepared to work with this Committee should it decide legislation is appropriate on the consolidated tax savings issue.

This concludes my prepared remarks. I will be happy to answer any questions that the Committee may have.

APPENDIX

OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

SEP 09 1991

MEMORANDUM FOR: **Michael Graetz**
Deputy Assistant Secretary (Tax Policy)

FROM: **Abraham N.M. Shashy, Jr.**
Chief Counsel

Abraham N.M. Shashy, Jr.

SUBJECT: **Internal Revenue Service Ruling Position on the Treatment of Consolidated Tax Adjustments Under the Normalization Rules**

You have asked for a statement of the Internal Revenue Service ruling policy concerning whether a consolidated tax adjustment by a regulated utility violates the normalization requirements of the Internal Revenue Code. In the absence of regulations specifically prohibiting consolidated tax adjustments, it is the position of the Service that these adjustments can be made without violating the normalization requirements of the Code. Therefore, if requested in an appropriate circumstance, the Service would rule that these adjustments do not violate the normalization requirements of the Code.

Background

Over the last several years, the Service has faced the question of whether the calculation of ratemaking tax expense on a consolidated group basis is inconsistent under section 168(i)(9)(B)(i) with the normalization requirements, or, if not, whether it should be treated as inconsistent by exercise of the Service's broad regulatory authority under section 168(i)(9)(B)(iii) and former section 167(l)(5). When computed on a consolidated group basis, ratemaking tax expense is reduced to reflect the savings from filing a consolidated return with affiliated companies. These savings might arise, for example, from the credits, losses, or deferred transactions of affiliated companies.

Under one variation - the "consolidated tax savings adjustment" - the ratemaker first determines the utility's total tax expense on a separate return basis and then reduces it by the utility's share of the consolidated tax savings. Under another variation, the ratemaker computes an "effective tax rate" by dividing the tax liability of the group by the sum of the taxable

incomes of all members with positive taxable incomes. The ratemaker then applies this "effective tax rate" to the utility's taxable income to compute its current tax expense.

Between 1983 and 1988, the Service issued a series of private letter rulings holding that these practices ("consolidated tax savings adjustments" or "effective tax rates") violate the normalization requirements of Section 168(i)(9) and its predecessors. After the refusal of the Pennsylvania Public Utility Commission and the state courts to follow one of these rulings in 1988, the Service began to reexamine the issue. See Continental Telephone Co. of Pennsylvania v. Pennsylvania Public Utility Commission, 120 Pa. Commw. 25, 548 A.2d 344 (1988), appeal denied, 521 Pa. 613, 557 A.2d 345 (1989). In May 1989, the Service issued Notice 89-63, 1989-1 C.B. 720, announcing that regulations would be issued providing the extent to which consolidated tax adjustments violate the normalization rules and that these regulations generally would not provide that rate orders made final before July 1989 violate normalization merely because they involve such adjustments. Accordingly, several of the normalization rulings were revoked, including the one issued to Continental Telephone of Pennsylvania that was the subject of the litigation referred to above. On November 27, 1990, the Service published proposed regulations in the Federal Register addressing the issue. 55 Fed. Reg. 49294 (Nov. 27, 1990). Under the proposed regulations, a consolidated tax adjustment was treated as a violation of the Code's normalization requirements, pursuant to the authority of Section 168(i)(9)(B)(iii). On the other hand, an adjustment to rate base was permitted for tax amounts not actually paid to the federal government. Following public comment and a hearing, the proposed regulations were withdrawn in April 1991. 56 Fed. Reg. 19825 (Apr. 30, 1991).

We believe that existing law, as reflected in statutory language, legislative history, and current regulations, leads to the conclusion that consolidated tax adjustments do not violate normalization, provided that the adjustments are applied only to the extent of current ratemaking tax expense and not to the deferred tax reserve applicable to accelerated depreciation on public utility property. In the absence of a change in that law, our ruling policy must conform to that conclusion.

Analysis: Statutory Requirement of Section 168(i)(9)(A)

Section 168(i)(9)(A) requires that, in order to be eligible for accelerated depreciation on "public utility property" (as defined in section 168(i)(10)) a public utility must compute its

tax expense for ratemaking purposes using the same method and period for such property as it uses for computing its depreciation expense for ratemaking purposes. Under section 168(i)(9)(A)(ii), the difference between the tax expense so computed and the utility's actual current tax liability must be treated as a deferred tax expense, which is considered a cost-free source of capital. This cost-free capital may be used to reduce the rate base on which the utility is permitted to earn a return.

Section 168(i)(9)(A) does not impose any other restriction on the computation of tax expense for ratemaking purposes. Thus, if a utility computes its ratemaking tax expense on a consolidated basis, taking into account the losses of its affiliates (and thus taking into account the tax savings resulting from those losses), but also computes its tax expense as though it used its book method and period for determining depreciation deductions on public utility property, it would not be in violation of the literal requirements of section 168(i)(9)(A).

It has been argued that the statutory requirement that "the taxpayer must, in computing its tax expense . . ." necessarily contemplates determination of ratemaking tax expense on a "stand-alone" basis. We do not believe, however, that Congress intended to address this issue by using those words. At the time that the words were first added to the Code in 1969, consolidated tax adjustments (or equivalent procedures) were a widespread and accepted ratemaking practice and had been upheld by the Supreme Court as within the authority of the Federal Power Commission. See FPC v. United Gas Pipeline Co., 386 U.S. 237 (1967). We do not believe that it is plausible that Congress would have deliberately prohibited or discouraged such a widespread practice without a more explicit reference in the statute or legislative history.

Consistency Requirement of Section 168(i)(9)(B)

Section 168(i)(9)(B) prohibits (or authorizes Treasury to prohibit by regulation) ratemaking practices that undermine the purpose of the normalization rules while complying with their literal terms. This provision was enacted in 1982 in response to a specific ratemaking practice called the "averaged annual adjustment" or "AAA" method. See S. Rep. No. 1038, 96th cong. 2d Sess. 11 (1980). The AAA method purported to comply with the literal statutory requirements of the normalization rules, while at the same time undermining the requirement to provide for

deferred taxes; the method did so by making an unreasonable adjustment to current tax expense, explainable only by an intent to circumvent the normalization rules.

Although the Service, in PLR 7838038 and PLR 7838048, ruled that the AAA method violated normalization, some utility commissions and courts refused to follow these rulings. In 1982, Congress concluded that the AAA method was inconsistent with normalization and that a clarifying statutory change was appropriate. Accordingly, section 168(i)(9)(B)(i) was enacted, providing that "[o]ne way in which the requirements of [section 168(i)(9)(A)] are not met is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with the requirements of [section 168(i)(9)(A)]." The phrase "inconsistent with the requirements" of normalization apparently was taken from regulations in effect at the time (section 1.167(1)-1(h)(4)(ii)), upon which the Service had relied in ruling that the AAA method violated normalization.

In order to make clear that the AAA method was "inconsistent with the requirements" of normalization, Congress also enacted section 168(i)(9)(B)(ii), which provided that "[t]he procedures and adjustments which are to be treated as inconsistent for purposes of [section 168(i)(9)(B)(i)] shall include any procedure or adjustment for ratemaking purposes which uses an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under [section 168(i)(9)(A)(ii)] unless such adjustment or projection is also used, for ratemaking purposes, with respect to the other 2 such items and with respect to the rate base."

PLR 8711050 (subsequently revoked) reasoned that section 168(i)(9)(B)(ii) prohibits consolidated tax adjustments because it requires that, if depreciation on property owned by an affiliate is not taken into account in setting rates (which it is not), the losses of that affiliate attributable to depreciation on such property cannot be taken into account in computing the utility's ratemaking tax expense.

We do not believe that this reasoning is persuasive for two reasons. First, the practice of taking affiliate losses into account does not involve an "estimate or projection" of tax expense as Congress used those words in section 168(i)(9)(B)(ii). The term "estimate or projection" as used in the statute clearly was intended to be more narrow than the term "procedure or adjustment", and it was intended to refer to assumed changes in a particular account or item between a test year and the subsequent

years covered by a rate order. See S. Rep. No. 643, 97th Cong., 2d Sess. 7 (1982); H.R. Rep. No. 827, 97th Cong. 2d Sess. 7 (1982). Therefore, we do not believe that consolidated tax adjustments constitute an "estimate or projection" of depreciation expense within the meaning of section 168(i)(9)(B)(ii).

Second, this reasoning implies that the normalization rules prohibit flow-through of the tax benefit of accelerated depreciation on any property if depreciation expense on that property is not taken into account in computing utility rates. The normalization provisions are, by their terms, limited to accelerated depreciation on public utility property. There is no evidence in the legislative history of section 168(i)(9)(B)(ii) indicating that Congress contemplated that this provision would have the effect of applying the normalization rules to non-public utility property.

In any event, even if the reasoning of this ruling were to be accepted, it would not support the view that no affiliate losses can be taken into account in computing ratemaking tax expense; it would only support the view that losses attributable to accelerated depreciation deductions on affiliate property can not be taken into account. Thus, this reasoning would not prohibit as being inconsistent with the normalization requirements the flow-through of affiliate losses attributable to intangible drilling costs, for example. In any case, we do not believe Congress intended the literal scope of the normalization requirements to extend beyond accelerated depreciation on public utility property.

These arguments do raise a concern that a consolidated tax adjustment might be used to offset a utility's deferred tax reserve from normalization or might be used to flow through the accelerated depreciation benefit of another regulated utility in the same consolidated group. These concerns are worthy of further study. Until they are resolved we can only say with confidence that consolidated tax adjustments do not violate normalization, provided that the adjustments are applied only to the extent of current ratemaking tax expense and not to the deferred tax reserve applicable to accelerated depreciation on public utility property, and provided that the taxable income of any other regulated utilities used in the calculation of the adjustments is computed on a normalized basis.

Regulatory Authority of Section 168(i)(9)(B)(iii)

In 1982, Congress also authorized Treasury to prohibit procedures and adjustments other than the AAA method by enacting the predecessor to section 168(i)(9)(B)(iii). It provides that the "Secretary may by regulations prescribe procedures and adjustments (in addition to those specified in [section 168(i)(9)(B)(ii)]) which are to be treated as inconsistent for purposes of [section 168(i)(9)(B)(i)]." The preamble to the now-withdrawn proposed regulations explicitly states that the regulations were issued pursuant to this authority. In the absence of such a regulatory provision, however, the normalization requirements do not prohibit consolidated tax adjustments as a general rule.

Therefore, it is the current ruling position of the Internal Revenue Service that consolidated tax adjustments, as a general rule, are not inconsistent with the normalization requirements of the Code. (Similarly, it is the current ruling position of the Internal Revenue Service, that, in the absence of any reduction of cost of service for consolidated tax savings, an appropriate reduction of rate base for consolidated tax savings is also not inconsistent with the normalization requirements of the Code.)

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STATEMENT OF THE HONORABLE
JEROME H. POWELL
ASSISTANT SECRETARY OF THE TREASURY
FOR DOMESTIC FINANCE
BEFORE THE
SUBCOMMITTEE ON SECURITIES
COMMITTEE ON BANKING, HOUSING, AND
AND URBAN AFFAIRS
UNITED STATES SENATE
SEPTEMBER 11, 1991

I am pleased to have this opportunity to explain the Treasury security auction process, the oversight and regulation of the Government securities market, Salomon Brothers' recently admitted violations of auction rules, and that firm's possible violations of securities laws, antitrust laws, general fraud statutes, SEC regulations, and New York Stock Exchange rules. I also am pleased to be able to address some specific issues you have raised concerning government securities market regulation.

While regulation of the government securities markets can be improved, the responsibilities of the various regulators are reasonably well-defined. With respect to the auctions, Treasury determines the amounts and maturities of the securities to be auctioned and sets the auction rules. The Federal Reserve conducts the auctions as Treasury's agent, and together the Treasury and the Federal Reserve review bids for compliance. Both the Treasury and the Federal Reserve have powerful, but limited, sanctions available to them to punish violators of these rules. The Treasury, for example, has forbidden Salomon Brothers to bid in auctions in behalf of its customers. Securities fraud in the form of deliberate violations of auction rules accompanied by false statements to the Treasury and antitrust violations are more generally the enforcement responsibility of the self-regulatory organizations, the SEC, and the Justice Department. In addition, price manipulation and other types of secondary market fraud are also the enforcement responsibility of the SEC and the Justice Department.

We believe that these agencies' legal authority to prosecute fraud and antitrust violations in Treasury auctions is beyond question. However, at a minimum, Treasury would support

modifications to current law to strengthen enforcement of Treasury auction rules by providing that violations of these rules would also constitute violations of the securities laws.

All government securities brokers and dealers, including those that are financial institutions, are subject to regulation pursuant to the Government Securities Act of 1986. Under that Act, the Treasury was given the role as the rulemaker for government securities brokers and dealers. In its rulemaking capacity, Treasury issued rules for government securities brokers and dealers that adopted many of the existing SEC regulations that already applied to registered brokers and dealers. The responsibility for enforcing these rules was given to the SEC and the self-regulatory organizations for non-financial institution brokers and dealers and to the appropriate Federal banking agencies for financial institutions.

Salomon Brothers is, therefore, subject to comprehensive regulation. As a registered broker/dealer and member firm of the New York Stock Exchange, it is subject to all SEC and NYSE rules, as well as Treasury rules under the Government Securities Act. Based on the recent admissions by Salomon Brothers, it is possible that the firm violated recordkeeping and customer confirmation requirements, as well as other requirements that the SEC and the NYSE have full authority to enforce. Moreover, any allegations of market manipulation or securities fraud, if true, would be a violation of securities laws that the SEC has the authority to enforce. Like all persons and entities, Salomon Brothers and its employees are subject to the antitrust laws and general fraud statutes. Violations of these provisions could result in criminal prosecution by the Justice Department.

As a general matter, the current regulatory structure has usually worked well. And yet the recent revelations of intentional wrongdoing have raised legitimate concerns about the integrity of the marketplace and about the adequacy of regulation and supervision. The ongoing investigations of misconduct are broad ranging. We believe that it is appropriate to conduct an equally careful review of the adequacy of current regulation, with the goal of maintaining the highest standards of integrity while also preserving the liquidity, efficiency, and depth of the government securities market.

We would expect to complete such a review and to report its results to Congress within 90 days. In the interim period, we believe that all parties involved -- including the regulators, market participants, and the Congress -- should exercise restraint. The market for U.S. government securities is the largest, most liquid, and most important financial market in the world. It is the means by which we finance the national debt. Moreover, it is the bedrock of the world financial system. It is essential that the integrity of this market be beyond question

and that there be adequate regulation to ensure that integrity. But it is also essential that hasty action not impair the liquidity and competitiveness of U.S. financial markets. A one basis point increase in the interest cost on outstanding marketable Treasury securities amounts to approximately a $230 million increase in annual interest costs.

In my testimony today, I will first discuss Treasury auctions, including the role of the primary dealers and significant auction rules, then present a chronology from Treasury's perspective of developments concerning the February and May auctions, and conclude with a discussion of policy and regulatory issues.

I. Background on Treasury Issuance of Marketable Securities

Treasury Auctions

As the chart accompanying my testimony shows, the Treasury Department has auctioned large amounts of marketable Treasury securities in the past ten years. In 1981, Treasury sold over $600 billion of marketable Treasury securities; by 1990, this figure had increased to over $1.5 trillion. As long as there is a budget deficit, the amount of securities Treasury is required to sell will tend to increase, not only to raise funds to cover the shortfall between receipts and expenditures, but also to refinance maturing debt.

The massive Treasury financing requirements have been accomplished in an extraordinarily smooth and efficient manner. In the face of the government's large demands on financial markets, interest rates, nevertheless, have trended down over the last ten years. Treasury believes that the best way to achieve the goal of minimizing borrowing costs to the U.S. taxpayer is to minimize surprises to the market while having in place procedures to ensure the fairness and integrity of the market for Treasury securities.

The Treasury Department has a regular and predictable schedule for offering marketable securities, which is well known to market participants. The Treasury makes an announcement as far in advance as is practical any time there is a change in the usual pattern, so that the market can digest the information and prepare for the offerings.

The Treasury Department provides a large amount of information to the public that helps investors estimate the amount that the Treasury will borrow and the types of securities that the Treasury will offer. At the end of the first month of each calendar quarter, the Treasury holds a press conference to announce the securities to be offered in the regular mid-quarter financing operation. At the press conference, the Treasury also

announces estimates of the Treasury's borrowing needs for the current calendar quarter and the succeeding three months.

Currently, the Treasury sells 13- and 26-week bills every week and 52-week bills every four weeks. Two-year and five-year notes are auctioned every month for settlement at the end of the month. Seven-year notes are issued in the middle of the first month of each calendar quarter. The quarterly financings, which settle on the 15th of February, May, August, and November, typically consist of three- and ten-year notes and a thirty-year bond. These regularly scheduled issues amount to about 157 separate securities auctions each year.[1]

The details concerning an offering of marketable securities are announced about one week prior to the auction, and the auction occurs from a few days to about one week prior to the settlement date, depending upon holidays and other vagaries of the calendar.

In a Treasury auction, competitive bidders submit tenders stating the yield (discount rate for bill auctions) at which the bidder wants to purchase the securities. The bids are ranked from the lowest yield to the highest yield required to sell the amount offered to the public. Competitive bidders whose tenders are accepted pay the price equivalent to the yield that they bid.

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[1] The Treasury also offers cash management bills from time to time to raise funds to cover low points in the Treasury cash balance. The maturity dates for cash management bills usually coincide with the regular Thursday maturities of regular weekly and 52-week bills. Short-term cash management bills maturing in a few days or a few weeks may be issued when the Treasury's cash balance is seasonally low. For example, cash management bills may be issued in early April, before the April 15 tax payment date, and mature later in April, when cash balances are at seasonal highs. Short-term cash management bills may be announced, auctioned, and settled in a period as short as one day, if necessary, to ensure that the government does not run out of cash. To shorten the time for the auction and reduce the cost of issuing short-term cash management bills, they usually are issued only in large minimum purchase amounts -- $1 million or more -- and noncompetitive tenders are not accepted.

Longer-term cash management bills are also issued from time to time. For example, the Treasury's borrowing requirement in the final calendar quarter of the year is typically larger than for the April-June quarter, when seasonally high tax payments are due. Cash management bills maturing after the April 15, 1991 tax date were issued in November 1990 to manage Treasury borrowing in light of this seasonal pattern.

In an auction of Treasury notes or bonds, the coupon rate is determined after the deadline for receipt of competitive tenders, based on the average yield of accepted competitive bids.

Noncompetitive bids for up to $1 million from the public are awarded in full at the weighted average yield of accepted competitive bids. The ability to bid on a noncompetitive basis ensures that smaller investors, who may not be able to obtain current market information, can purchase securities at a current market yield. Noncompetitive bidding eliminates the risk that a prospective investor might bid a yield that is too high and not obtain the securities desired or too low and pay too much for the securities. Noncompetitive bidding also benefits the Treasury, since the larger the amount awarded noncompetitively, the less needs to be awarded to competitive bidders at successively higher yields. It also serves the goal of achieving a broad distribution of Treasury securities.

To participate in the auction, any potential investor may submit tender forms to any Federal Reserve Bank or branch, which act as Treasury's agent in the auction, or to the Treasury's Bureau of the Public Debt. The tenders must be received before 12:00 noon, Eastern time, for noncompetitive bids and 1:00 p.m., Eastern time, for competitive bids. Currently, tenders are received at 37 sites. Typically, between 75 and 85 bidders submit competitive tenders in Treasury's auctions for securities to be held in the commercial book-entry system.[2] Additionally, between 850 and 900 bidders submit noncompetitive tenders in Treasury auctions for securities to be held in the commercial book-entry system. Also, on average there are about 19,000 noncompetitive tenders per auction for securities to be held in the Treasury Direct system.[3]

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[2] The commercial book-entry system for Treasury securities is operated by the Federal Reserve Banks, acting as Treasury's fiscal agents. The Federal Reserve maintains book-entry accounts for depository institutions and other entities such as government and international agencies and foreign central banks. In their book-entry accounts at the Federal Reserve, the depository institutions maintain their own security holdings and holdings for customers, which include other depository institutions, dealers, brokers, institutional investors, and individuals. In turn, the depository institution's customers maintain accounts for their customers. Broker-dealers are currently not permitted to maintain securities accounts directly with the Federal Reserve.

[3] The Treasury Direct system is designed primarily for those who wish to hold Treasury securities to maturity; no custodial or transaction fees are charged. At the end of 1990, 979,522 investors held 2.2 million security accounts in Treasury Direct

Depository institutions and primary dealers may submit either competitive or noncompetitive tenders for their own account and for the account of customers. All other entities or individuals may submit either competitive or noncompetitive tenders only for their own accounts. Depository institutions and primary dealers are required to submit customer lists when submitting bids for the accounts of customers. Customer lists for competitive bids must be submitted either with the tender or by the close of the auction. Customer lists for noncompetitive tenders must be received prior to the issue date.

The Federal Reserve Banks review the tenders for accuracy, completeness, and compliance with Treasury's rules and guidelines. The Federal Reserve Banks consult with the Treasury Department prior to taking any action on questionable tenders which could materially affect the results of the auction. The Treasury reserves the right to reject any tender.

Once it has been determined that the tenders have complied with Treasury's rules, the Federal Reserve Banks compile the auction summaries. The noncompetitive summary shows the total amount of noncompetitive bids received by each Federal Reserve district. The competitive bid summary shows the total amount bid at each yield. The summaries include information on specific bidders only when needed to apply the 35% limitation on the amount awarded or bid at a given yield by a single bidder or when specific bids appear irregular. This information is forwarded to the Treasury's Bureau of the Public Debt.

The Bureau of the Public Debt accepts noncompetitive bids in full and then determines the yields that are to be accepted on competitive bids. The amount awarded at the high yield is prorated based on the amount bid at that yield to obtain the offering amount.

Auction results are released to the public around 2:00 p.m., Eastern time, on the auction day.

Role of the Primary Dealers

In order to conduct monetary policy, the Federal Reserve buys and sells government securities in the secondary market. The Federal Reserve determines with which dealers it will trade, and these designated dealers, currently 39 in number, are called primary dealers. Despite the name, designation as a "primary dealer" refers to a secondary market relationship with the Open Market Desk of the Federal Reserve System, not a relationship with the Treasury. The Treasury does not determine which dealers

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with a par value of nearly $59 billion.

can be primary dealers, nor does it set any criteria for this designation.

The relationship between the Federal Reserve Bank of New York and the primary dealers is a business relationship, not a formal regulatory one. In order to assure itself of the creditworthiness of the primary dealers, the Federal Reserve Bank of New York requires that primary dealers submit reports to it and that they permit FRBNY staff to inspect their operations and books and records.

In addition to requirements that the primary dealers make markets in all maturity sectors of Treasury securities and that their share of the market meet certain minimums, the Federal Reserve expects that primary dealers demonstrate their continued commitment to the market for government securities by participating in Treasury auctions.

Because of their importance to the government securities market, their consistent participation in Treasury auctions, and the monitoring of their creditworthiness by the FRBNY, primary dealers share with depository institutions two privileges in the auctions. As mentioned, only primary dealers and depository institutions can submit bids for customers as well as for themselves. In addition, tenders from primary dealers are accepted without deposit, as is also the case for depository institutions, States, political subdivisions or instrumentalities thereof, public pension and retirement and other public funds, international organizations in which the United States holds membership, and foreign central banks and foreign states. Others must pay in full at the time the tender is submitted or, in the case of notes and bonds, present a guarantee from a commercial bank or primary dealer of 5 percent of the par amount applied for.[4]

That there is a group of dealers with a commitment to the government securities market is a benefit to the Treasury, which offers securities every week of the year. However, it needs to be emphasized that the auction process is open; and that others besides primary dealers can and do participate, either directly, or if they choose, through primary dealers or depository institutions.

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[4] Treasury also permits tenders to be received without deposit if there is a preexisting agreement with a depository institution on file at the Federal Reserve Bank that authorizes the Federal Reserve Bank to debit the reserve account of the depository institution on the issue date for the securities purchased by the bidder.

The 35% Rule

For the past 29 years, the Treasury has limited the maximum amount of securities awarded to a single bidder in a Treasury offering. The primary reasons for the limitation are to ensure broad distribution of Treasury securities and to make it less likely that ownership of Treasury securities becomes concentrated in a few hands as a result of the auction.

The limitation has evolved over the years. It was first set at 25 percent of the total offering amount and applied only to 3-month and 6-month Treasury bills. Today, for bills, notes, and bonds, the limitation is 35 percent of the <u>public</u> offering. The application of the 35 percent limit to any bidder includes consideration of positions in the futures, forward, and when-issued markets. The same limitation is also applied to the maximum amount Treasury will recognize as having been tendered at any particular yield.

The genesis of the maximum award limitation was the unusual occurrence of a single bidder tendering what would have been a successful bid for an exceptionally high proportion of the 13-week bills auctioned on August 27, 1962 and issued on August 30, 1962. On that occasion, Secretary of the Treasury Douglas Dillon invoked his right to reject any or all tenders, in whole or in part, because of concern about a possible market disturbance that could have resulted from the disproportionate allotment. On August 28, 1962, the Treasury announced that "no single bidder would be awarded more than one quarter of the total supply of bills offered in either the 3- or 6-month bill maturities." Subsequently, it became generally understood and accepted throughout the market as applying to all Treasury offerings of marketable securities.

The rule remained unmodified until May 14, 1979, when two rule changes were announced. First, the maximum award to any single bidder in Treasury security offerings was limited to 25 percent of the total combined amounts of the competitive and noncompetitive awards <u>to the public</u>. This rule excluded from the 25 percent calculation those Treasury securities allotted to the Federal Reserve in exchange for maturing securities for its own account and for the accounts of foreign official institutions. It also excluded Treasury securities allotted to foreign official institutions through the Federal Reserve for new cash.

This change was necessary because, by 1979, the size of bids from foreign official accounts through the Federal Reserve, had grown markedly. As a consequence, the amount of an offering remaining for the "public" had shrunk significantly, despite the general increase in the size of Treasury offerings.

The second modification announced on May 14, 1979, was the requirement, in effect today, that, beginning on June 18, 1979, all bidders in bill auctions report on the tender form the amount of any net long position in excess of $200 million in the bills being offered. This net long position is taken into account to compute whether awards to any single bidder would exceed the award limit. Such positions include when-issued, futures, and forward positions in the bill and holdings of the outstanding bill with the same maturity date as the new offering. Also, a primary dealer bidding on behalf of a customer was required to submit a separate tender for the customer whenever the customer's net long position in the bill being offered exceeded $200 million. This new rule recognized the growing importance of when-issued trading and trading in Treasury bill futures. A similar rule for notes and bonds became effective on December 30, 1981.

The Treasury announced on September 8, 1981, an increase in the limit on the maximum amount any one bidder may purchase in a bill, note, or bond auction to 35% from 25% of the combined amounts of competitive and noncompetitive securities available to the public. This was done to lessen the restrictive effect of the modification made in 1979.

A further modification to the 35% rule was made on July 12, 1990. While continuing to permit bidders to tender for securities at multiple yields, the Treasury announced that at any one yield the Treasury will not recognize amounts tendered in excess of 35 percent of the public offering. This rule change was made necessary because several dealers began to place very large bids, even greater than the total size of the offering, at what turned out to be the high or stop-out yield. Because the Treasury used the amount bid to prorate the securities awarded at the highest yield among all bidders at that yield, a dealer who guessed right about the stop-out yield and submitted a very large bid could obtain a large proportion of the auction at the most favorable yield. The rule change put a stop to this practice and resulted in a more equitable distribution for bids awarded at the highest accepted yield.

This abuse of the proration methodology occurred in the June 27, 1990, auction of four-year notes by a primary dealer who was directly requested not to repeat the practice. This same dealer, along with another bidder, however, placed bids for extremely large amounts at a July 10 auction of Resolution Funding Corporation bonds. This time the amounts were cut back for purposes of proration at the stop-out yield. Two days later, in order to put an end to this practice, Treasury announced the rule change limiting the amount recognized as bid at any one yield to 35% of the public offering.

Other Treasury Auction Rules

Single Bidder Guidelines. On June 1, 1984, the Treasury issued guidelines concerning the definition of a single bidder for the purpose of the $1 million limitation on noncompetitive bids. These guidelines are also used to determine what constitutes a single bidder for purposes of the 35 percent limitation.

When-Issued Trading Prior to Auction. Pre-auction trading in Treasury notes and bonds was effectively prohibited from 1941 to 1975. Pre-auction activity in Treasury bills has never been prohibited, except in the case of noncompetitive bidders. Until 1975, regular Treasury announcements of note and bond auctions included a clause banning from the auction any participants who engaged in purchasing, selling or making agreements on an issue before the auction time and date.

Between February 1975 and July 1977, however, Treasury announcements no longer carried this clause as it was thought to be unnecessary. This allowed a temporary when-issued market in Treasury notes and bonds prior to auction to develop. With the 2-year note auction of July 1977, however, Treasury once again included the provision against pre-auction trading, citing "undesirable speculative activity." This prohibition was effective only for coupon securities.

Treasury decided to allow auction participants to engage in pre-auction trading in order to "eliminate an unnecessary regulation" beginning with the August 1981 issue of two-year notes. Since then, when-issued trading has come to be considered an important and efficient mechanism for reducing the uncertainties surrounding Treasury auctions.

The only significant rule change subsequent to 1981 was an October 1983 Treasury announcement prohibiting when-issued trading on the part of noncompetitive bidders. This prohibition applies to all Treasury securities and was intended to prevent participants from garnering disproportionate shares of an issue through noncompetitive auction bidding.

Bidder Certifications. Bidders are required to certify on the tender form that their net long position in the security being auctioned is not in excess of $200 million, or, if it is in excess, the amount of the long position. Depository institutions and primary dealers must certify that any bids submitted on behalf of customers have been entered under the same conditions, agreements, and certification set forth in the tender form.

II. Chronology of Recent Events Involving Salomon Brothers

The February 1991 Five-Year Note Auction

The Treasury's Bureau of the Public Debt received a call at approximately 1:30 p.m. February 21, 1991, from the Federal Reserve Bank of New York concerning the application of the 35% limitation at a single yield in connection with the five-year note auction that day. The FRBNY requested that a determination be made regarding two separate bid submissions from what appeared to be a single bidding entity -- S.G. Warburg & Co., Inc. (S.G. Warburg).

Salomon Brothers had submitted a tender for a customer identified on the tender as Warburg Asset Management. S.G. Warburg separately submitted a tender at the same yield for its dealer account. Combined, the two bids exceeded 35% of the public offering amount at a single yield by one bidder.

Prior to calling the Treasury, the Federal Reserve Bank of New York had called Salomon Brothers concerning the Warburg Asset Management bid. Salomon Brothers stated that they had made a mistake and that Warburg Asset Management was actually Mercury Asset Management.

The Treasury decided to accept both tenders. However, in an effort to prevent future auction delays and any potential for confusion, uncertainty, and inequity in the handling of bidders, the Treasury, in consultation with the Federal Reserve Bank of New York, decided to investigate the relationship of Mercury Asset Management and S.G. Warburg to determine whether these bidders constituted separate and distinct entities for bidding purposes.

The Treasury discussed the issue with Tom Murphy of Salomon Brothers and with an officer of S.G. Warburg. It was determined that Mercury Asset Management, a British company, is majority owned by the same holding company that owns the British subsidiary that owns the U.S. firm of S.G. Warburg.

After reviewing the facts of the case, the Treasury decided that S.G. Warburg and Mercury Asset Management would be treated as a single bidder for purposes of applying the 35% limitation rule in future auctions. The decision was based primarily on the fact that the Treasury's guidelines for determining a single bidding entity are based on the principle that bidders that share common investment advice and management control are viewed as a single entity.

The Treasury's Bureau of the Public Debt sent a letter dated April 17, 1991 to Mercury Asset Management which provided details concerning the two bids submitted in the February five-year note

auction and Treasury's decision to treat the two entities as a single bidder for purposes of the 35% limitation rule. Copies of this letter were sent to officers of S.G. Warburg, S.G. Warburg, PLC (the British parent company), and the Federal Reserve Bank of New York. In addition, a copy of the letter was sent to Mr. Paul Mozer of Salomon Brothers.

As Salomon Brothers has now admitted, the bid from Mercury Asset Management was unauthorized. The securities in question were in fact purchased by Salomon Brothers. It appears from Salomon Brothers' public statements that the letter from Treasury played an important role in Mr. Mozer's decision to inform senior management of the fraudulent bid. Salomon Brothers did not inform the government of this violation until August 9.

Although both Mercury and S.G. Warburg replied to the Treasury's April 17 letter on April 25 and May 22, respectively, they did not inform the Treasury that the Mercury bid was unauthorized. Treasury first learned of this fact from Salomon Brothers on August 9. The Treasury and the Federal Reserve have arranged to meet with Warburg officials this week to discuss this matter.

The May Two-Year Note Auction

The May two-year note auction also attracted attention at the Treasury.

It soon became apparent after the auction of $12.25 billion of two-year notes on May 22, 1991, that a squeeze had developed in the issue. The yield on the two-year notes was out of line with market rates and the notes were "on special" in the repurchase agreement market. (In other words, market participants desiring to borrow temporarily the two-year notes had to accept a significantly lower interest rate on funds they deposited with their counterparties in effect as collateral than the prevailing repo rate.)

A number of market participants contacted the Treasury Department to point out this situation. Treasury Department officials also had details concerning the bids received and awarded to primary dealers and their customers. It appeared from this information that the squeeze had developed because Salomon Brothers and some of its customers had bid more aggressively than others and had been awarded the bulk of the securities. Treasury Department officials thought the situation serious enough to warrant investigation by the Securities and Exchange Commission. In late May, the Treasury told the Division of Market Regulation and the Division of Enforcement of the SEC about the problems stemming from the May auction and provided the SEC information concerning auction awards. The SEC promptly began investigating the matter. In addition, the Antitrust Division of the Justice

Department requested information pertinent to its own investigation of the squeeze.

On June 4, a Treasury Department official discussed Treasury's concerns with Mr. Paul Mozer. On June 10, Mr. John Gutfreund, chairman of Salomon Brothers, met with Treasury officials to explain the firm's point of view with respect to the May two-year notes. He did not mention the fraudulent bid in the February auction.

The Treasury was concerned about the squeeze in the May two-year note for several reasons. First, any such squeeze goes against the goal of achieving a broad distribution of securities. If dealers are not reasonably comfortable that they can obtain and deliver securities that they have sold prior to the auction, they will be less likely to participate in pre-auction distribution of new issues. Second, while squeezes can occur for reasons other than market manipulation, squeezes in Treasury securities that appear to be deliberately engineered would likely cause some market participants to question the fairness and integrity of the government securities market. If doubt concerning the fairness of Treasury auctions persists over the longer term, the number of active participants in the government securities market could be reduced. The resulting decline in participation in Treasury auctions and in the liquidity of the secondary market could raise Treasury borrowing costs. Finally, Treasury was concerned that there may have been possible violations of securities and other laws in the government securities market.

Subsequent Developments

On August 9, Mr. Gutfreund, in a telephone call to Under Secretary Robert R. Glauber, informed him of the unauthorized Mercury bid and his knowledge of this since April.

Also, on August 9, Treasury officials were provided an advance copy of Salomon Brothers' announcement released later that day, in which the firm admitted committing violations of the 35% rule in the December 1990 auction of four-year Treasury notes, the February 1991 auction of five-year notes, and the May 1991 auction of two-year notes and announced the suspension of two managing directors responsible for Treasury securities trading and two other employees.

On August 14, Treasury staff, along with staff from other concerned government agencies, attended meetings at the Justice Department and at the SEC with the law firm of Wachtell, Lipton, Rosen & Katz, which was representing Salomon Brothers in this matter. The Wachtell, Lipton lawyers detailed the results of their investigation of the irregularities and rule violations in Treasury auctions as well as related matters. Also, on August

14, Salomon Brothers publicly announced further details of rule violations in Treasury auctions and the fact that the senior management had been informed in late April of an unauthorized bid in the February 1991 auction but had not informed the appropriate government officials of this.

After consulting with the Federal Reserve and the SEC, the Treasury Department announced on the morning of Sunday, August 18, that, in light of Salomon Brothers' auction rule violations, it would for an indeterminate time not allow the firm to participate in auctions of Treasury securities. This penalty was modified later in the day after Salomon Brothers' board meeting resulted in the immediate resignation of three senior officials of Salomon Brothers, the firing of the two suspended managing directors, and the placing of effective management control of the firm in the hands of Mr. Warren E. Buffett. Mr. Buffett assured Secretary Brady that appropriate controls were being put in place to assure that there would be no future rule violations in Treasury auctions. Consequently, Secretary Brady decided to allow Salomon Brothers to bid in auctions for its own account but not to allow it to submit bids for its customers.

The Treasury was subsequently provided specific information concerning the procedures and controls Salomon Brothers has put in place to ensure that there would be no violation of auction rules. The new procedures and controls appear to be a good faith effort to prevent future rule violations.

The Treasury Department is assisting the SEC and the Justice Department in their continuing investigations of Salomon Brothers' activities in the government securities market. While the Treasury Department has no enforcement authority in the area of securities or antitrust law, the Treasury can help these two agencies with its expertise concerning the market for Treasury securities.

III. Policy and Regulatory Issues

The admissions that Salomon Brothers has made have caused us to reexamine various policy issues concerning both the issuance of Treasury securities and regulation of the government securities markets. I am pleased to share with the Subcommittee the Treasury Department's current thinking with respect to changes in the auction process, including automation, large customer certification, and "Dutch auctions," the Treasury Borrowing Advisory Committee, and Government Securities Act issues.

Changes in the Auction Process

Automated bidding. We believe that automation of the auction process will make it more efficient, result in fewer

errors, facilitate broader participation, and assist in monitoring of compliance with auction rules. Consequently, the Treasury and the Federal Reserve have made the development of a system to permit automated bidding a high priority.

A project is underway at the Federal Reserve Bank of Kansas City that will allow medium and smaller depository institutions and other institutional bidders to submit their bids to the Federal Reserve Banks electronically. We expect this project to be completed by the second quarter of 1992.

There is also a project underway at the Federal Reserve Bank of New York that will enable electronic bidding by large bidders. This project is currently in the design phase.

Large customer certifications. The Treasury and the Federal Reserve Bank of New York will develop a system to require customers who make large winning bids through primary dealers or depository institutions to verify in writing their bids prior to the settlement date. This will prevent firms from putting in unauthorized bids in order to circumvent the 35 percent rule.

Already, the Federal Reserve Bank of New York has begun making spot checks with customers of primary dealers to verify the legitimacy of bids submitted for customer accounts.

"Dutch" auctions. The Treasury currently uses a sealed-bid "discriminatory price" auction to sell its securities. The auction is "discriminatory" because different bidders pay different prices for the same security, based on their bids. In other words, competitive bidders whose tenders are accepted pay the price equivalent to the yield that they bid.

In a sealed-bid uniform price auction, sometimes called a "Dutch" auction, all bidders whose tenders are accepted pay the same price for a given security. This price is the <u>lowest</u> of the <u>accepted</u> prices bid (or highest of the accepted yields). As a result, in a Dutch auction, some of the bidders whose tenders are accepted pay a lower price than they actually bid. At first glance, this appears to be a revenue loser, because "money is left on the table." On the other hand, it is commonly argued by economists that participants in a Dutch auction can be expected to bid higher prices than they would in a discriminatory price auction. As a result, the relative revenue effects of a Dutch auction versus current practice are uncertain.

In 1976, two Treasury economists prepared a study on Dutch auctions using Treasury tender data from the six uniform price auctions Treasury conducted earlier in the 1970s and from discriminatory price auctions of Treasury bonds during the same general time period. The study indicated that there was some evidence that Dutch auctions resulted in somewhat reduced costs

to the Treasury. From 1976 to 1980, two consecutive Deputy Assistant Secretaries for Debt Management refused permission to the authors to have the study published. Finally, in early 1980, their successor decided that the study could be published with the usual disclaimer that it represented the views of the authors and not necessarily the views of the Treasury Department. The study was to have been included in a book edited by Professor Vernon Smith of the University of Arizona; however, in 1981, at which time both authors were no longer with the Treasury, the authors discovered discrepancies in the data used in the study. Neither author had the interest, the time, or easy access to the raw Treasury data to investigate this problem and put the article into publishable form. It is not certain whether any of the authors' conclusions would have changed if they had continued to study the issue and identified the reasons for the data discrepancies.

The perceived advantages of Dutch auctions are that they eliminate the primary dealers' advantage over less informed participants, since all buyers pay the same price. This could broaden auction participation and induce more non-specialist investors to bid directly for their own account rather than through primary dealers. This should naturally lead to less concentration of ownership at auction.

A potential disadvantage of Dutch auctions relative to the current auction method is the concern that primary dealers may be somewhat less willing to participate in Treasury auctions. This could cost the Treasury, and taxpayers, in the long run. In addition, the use of Dutch auctions does not itself eliminate the opportunities for collusion among major participants for purposes of underbidding on securities or cornering a particular issue. Finally, Dutch auctions could increase the number of bids from non-dealers and thereby complicate auction administration and possibly slow down the auction process. However, automation of the auction process would substantially reduce these costs.

Treasury is reviewing all of its auction procedures. We believe that changes should be made only after careful consideration, given the large volume of securities we issue and the potential costs to the taxpayers of ill-conceived or hastily implemented changes.

Borrowing Advisory Committee

In light of the concerns that have recently been expressed concerning the Treasury Borrowing Advisory Committee, I would like to address this issue.

The Treasury Department receives advice on debt management from government securities market participants formally through the Treasury Borrowing Advisory Committee of the Public

Securities Association, chartered under the Advisory Committee Act of 1972. Prior to 1972, Treasury had been receiving advice on debt management from informal committees since World War II. The Treasury meets with the advisory committee, at the request of the Secretary, the Tuesday before the regularly scheduled Wednesday announcement of 3-, 10-, and 30-year Treasury securities in the mid-quarter refunding. The committee is given a specific list of items on which its advice is sought.

The membership of the committee currently consists of senior level officials from ten primary dealer firms and eight institutional investor firms. The committee makes a unique contribution by providing informed advice in a forum that requires the members to form consensus recommendations, or at least majority recommendations, that the Treasury would be unable to get in any other way. Free and open discussion among the committee members during meetings prior to making recommendations has served to minimize any problems of evaluating conflicting recommendations due to such factors as the specific business interests of the various members' employers.

In addition to receiving recommendations of the advisory committee, Treasury representatives meet with primary dealers at the Federal Reserve Bank of New York before each quarterly refunding operation. Moreover, we receive advice from market participants who call or write to the Treasury on an ad hoc basis.

At the beginning of each meeting, the Committee receives Treasury's latest estimate of Treasury market borrowing needs and historical background information related to Treasury borrowing and debt outstanding. Members are not permitted to contact their firms from the time the meetings with the Treasury begin until the Treasury financing announcement appears on the news wire services the next afternoon.

The Treasury Department provides a large amount of information to the public that helps investors estimate the amount that the Treasury will borrow and the types of securities that the Treasury will offer. Treasury regularly makes information that is provided to the advisory committee available to the public during the press conference announcing each mid-quarter refunding. Beginning with estimates to be used in connection with the November refunding, scheduled for announcement on October 30, 1991, we will release the latest estimates of Treasury borrowing requirements to the public prior to convening the committee.

Government Securities Act Issues

We believe that the basic regulatory structure of the Government Securities Act of 1986 (GSA) is sound. It recognizes

that Treasury is in the best position to set rules for all brokers and dealers, including financial institutions, that are consistent, assure fairness and integrity in the government securities market, but that do not result in inordinate cost to the taxpayer by not allowing the government to finance itself efficiently. However, some changes need to be made, particularly in the sales practice area. We support the modifications to the Government Securities Act of S.1247.

Sales Practice Rules. Treasury believes that legislation applying 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 broker-dealers now must comply with sales practice rules for their corporate and municipal securities activities, while banks that conduct a business in municipal securities must comply with sales practice rules of the Municipal Securities Rulemaking Board. We believe that sales practice rules should apply to all government securities brokers and dealers -- both bank and non-bank broker-dealers.

The GSA was enacted to correct only those areas of documented abuse and weakness in the government securities market (e.g., unregistered broker-dealers and hold-in-custody repos) that existed at the time, 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 National Association of Securities Dealers (NASD) that prohibits it from applying its sales practice rules to the government securities transactions conducted by its members.

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 government securities market is the only regulated securities market in the United States that does not have sales practice rules. 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. Treasury believes it is necessary to prevent unscrupulous brokers and dealers, who may have operated in these other markets until the advent of sales practice rules, from moving to the government securities market.

Sales practice rules for the government securities market would also enhance protection of smaller, less sophisticated investors, who are attracted to the market because of their desire for safe investments. Additionally, since the government securities market increasingly encompasses instruments that can pose considerably greater price risk than traditional Treasury or agency securities, sales practice rules have become increasingly important.

Any proposed regulatory structure for government securities sales practice rules must retain a prominent oversight role for Treasury, consistent with the regulatory approach set out in the GSA. Such a role is necessary and appropriate given Treasury's strong interest in minimizing the cost to the taxpayer of financing the public debt by maintaining the liquidity, efficiency, and integrity of the government securities market. Treasury is also in a unique position to evaluate the actual or potential impact of sales practice rules on the liquidity and efficiency of the market. Accordingly, Treasury supports S.1247, which would grant authority to regulatory agencies and the NASD to issue government securities sales practice rules, if the Treasury has not determined that the rules would "adversely affect the liquidity and efficiency of the market for Government securities" or "impose any burden on competition not necessary or appropriate" in furtherance of the purposes of the GSA.

Electronic Dissemination of Pricing and Trading Information. Treasury supports expanded disclosure of and access to government securities price and volume information. The expanded availability of such information would serve the public interest. When a broad spectrum of market participants can obtain current, accurate information on market conditions, the competitiveness, liquidity and efficiency of the government securities market should improve, as should the auction process. Moreover, 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. Access to more accurate price and volume information also enhances the ability of regulatory authorities and independent auditors to verify that securities transactions and positions have been properly valued.

In its 1987 report, the GAO recommended that the private sector be given time to develop systems that would provide market participants increased access to government securities pricing information. In its follow-up report issued in September 1990, the GAO recommended that Congress legislatively mandate that government securities price and volume information be made available on a real-time basis to anyone willing to pay the appropriate fees and that Treasury be assigned authority to

prescribe regulations as needed to ensure that such transaction information is available.

Recently, private sector initiatives such as GOVPX and EJV have become operational and have made significant steps toward disseminating the type of government securities price and volume information that would serve the public interest. Consequently, we fully support the efforts undertaken by these private sector groups in this area. We also recognize that these initiatives are just beginning, and it is uncertain how successful they will ultimately be. In addition, these private sector systems to date do not encompass the market for government securities that are not direct Treasury issuances.

Even with these concerns, we believe these initiatives are an encouraging indication that adequate private sector solutions can be found without the need for additional federal regulation. They should be allowed additional time to develop before any rulemaking authority is determined necessary. Treasury supports S. 1247, which provides for a joint Treasury/SEC/Federal Reserve Board evaluation of private sector initiatives regarding the dissemination of price and volume information that will permit further development of these efforts, while providing for continued scrutiny.

IV. Conclusions

Salomon Brothers' recent admissions are a major development that are bringing the government securities market close scrutiny.

Treasury auctions. Since the May auction and the squeeze in two-year notes, Treasury has been considering changes in its auction rules. We stated in a letter to Congressman Markey dated July 1: "Treasury is concerned that there have been several recent auctions resulting in a concentration of ownership at original issue...Treasury is considering changes in its auction rules that would make this concentration of ownership less likely."

With respect to the information advantage that it is perceived gives primary dealers an edge in Treasury auctions, the information that has recently been made available on interdealer broker screen quotes through GOVPX has made for much broader dissemination of market prices. We expect that in the future even more price and volume information will be made generally available. This will make for a more level playing field for all participants in the government securities market and in Treasury auctions.

Finally, with respect to the Salomon Brothers matter, we currently have no evidence that other firms have engaged in the

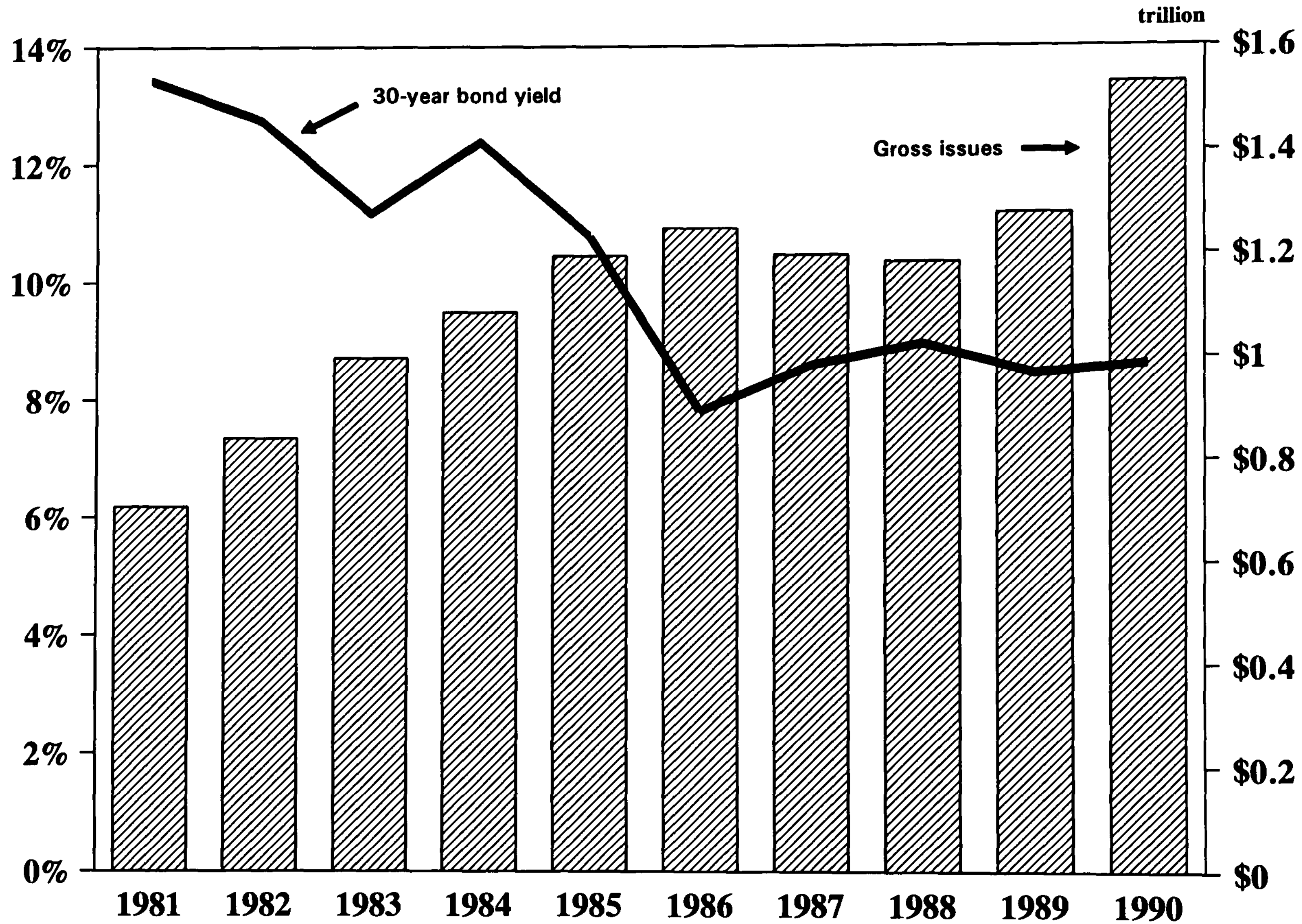
specific types of auction practices admitted to by Salomon Brothers. We do, however, believe it is salutary that major market participants are reviewing their own procedures for participating in the auctions.

Regulation. Until recently, it had been our view that existing legal authority was sufficient to deal with misconduct in the government securities markets. However, Salomon Brothers' recent admissions of wrongdoing are deeply troubling, as are the allegations of more widespread misconduct in the markets. The entire situation warrants, and is receiving, a sweeping, thorough investigation by the appropriate regulatory authorities.

Until that investigation is reasonably complete, we would prefer to withhold judgment as to the adequacy of existing laws and regulations, as well as existing enforcement capabilities and practices. The market for U.S. government securities is the largest and most important securities market in the world, and any changes in its regulation should only be made after careful collection and review of the facts.

We also recognize the urgency of this matter and the desire of Congress to take prompt and appropriate corrective action. The Treasury, in consultation with the Federal Reserve and the SEC, therefore undertakes to report back to the Congress within 90 days as to any recommended legislative or regulatory changes. We anticipate that this review will address in some depth the adequacy of existing legal authority and enforcement practices to detect and punish wrongdoing in the government securities markets, while also maintaining the extraordinary liquidity and depth of our marketplace.

Questions have also arisen as to the status of the Treasury's rulemaking authority under the Government Securities Act, which will lapse unless reauthorized by October 1. In the view of the Treasury, the Federal Reserve, and the SEC, it is important that there be no such lapse in rulemaking authority. We therefore urge that the reauthorization take place on schedule or that Treasury's rulemaking authority be temporarily extended beyond the October 1 "sunset" date.



Bond yield is annual average Treasury constant maturity 30-year bond yield.
Gross issues are total marketable securities sold.

TREASURY NEWS

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FOR IMMEDIATE RELEASE
September 11, 1991

Contact: Cheryl Crispen
202-566-2041

The Department of the Treasury Announces Changes to the Treasury Auction Process

The Treasury Department today announced actions aimed at ensuring continued integrity in the government auction process. In announcing the actions, Secretary of the Treasury Nicholas F. Brady said, "The U.S. government securities market is the largest, most efficient and liquid market in the world. We are taking these steps to ensure its continued integrity. In addition to these actions, the Treasury Department will continue to review the auction process to determine what other changes may be appropriate."

The following changes will be instituted:

Written Verification of Bids

- The Treasury Department and the Federal Reserve Bank of New York will develop a system to require customers to provide written verification of large, winning bids prior to the settlement date and receipt of the security being purchased. This change is aimed at ensuring the authenticity of large, winning bids placed on behalf of a customer by a primary dealer.

Public Release of Borrowing Needs

- Effective immediately, data on Treasury quarterly borrowing needs will be released two days prior to each quarterly refunding announcement and prior to the meeting of the Public Securities Association (PSA) Treasury Borrowing Advisory Committee Meeting.

Information on borrowing needs is now provided to the PSA Advisory Committee at the beginning of its meetings, which are the day prior to each Quarterly Refunding Announcement. The PSA Advisory Committee uses this information to make recommendations on what securities it feels would be most cost effective for the Treasury to issue. Senior officials in the Office of Domestic Finance at the Treasury Department use the PSA recommendations, Treasury staff recommendations and calculations, other private sector recommendations, technical data and historical data to decide what securities to issue.

<u>Permanent Operating Group on Information Sharing Formed</u>

- The Treasury has created a permanent Operating Group on Market Surveillance to formalize and expand information sharing among the government regulators. Members of the group will be representatives from Treasury, SEC and the Fed.

<u>Working Group Expanded to Speed Auction Automation</u>

- The Treasury/Fed Working Group on Auction Automation has been working to automate the government auction process to improve efficiency and accuracy and to enhance supervision and compliance. These efforts will be strengthened and accelerated with completion of the first phase of automation expected in the first half of 1992. In addition, the existing Treasury/Fed Working Group on Auction Automation will be expanded to include the SEC.

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TREASURY NEWS

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EMBARGOED UNTIL GIVEN
EXPECTED AT 10:00 A.M.
SEPTEMBER 12, 1991

STATEMENT OF THE HONORABLE JOHN ROBSON
DEPUTY SECRETARY OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS SUPERVISION,
REGULATION AND INSURANCE
SEPTEMBER 12, 1991, 10:00 A.M.
2128 RAYBURN HOUSE OFFICE BUILDING

Mr. Chairman, members of the Subcommittee, I am pleased to appear today on behalf of Secretary Brady, the Chairman of the Oversight Board of the Resolution Trust Corporation. Accompanying me is Peter Monroe, President of the Oversight Board. As your invitation asks, I will discuss the Board's request for additional funding for the RTC, RTC asset disposition, and RTC restructuring.

We are pleased that the Subcommittee is giving attention to the important, indeed urgent matter of providing additional funds to close failed thrifts and protect their depositors in fulfillment of our government's insurance commitments. At the end of August, more than 16 million deposit accounts had been protected. Five hundred and twelve thrifts had been closed in 42 states, and about 135 thrifts were pending in conservatorship in these and another three states. People all over the country - more than 16 million of them - have had their deposits saved by the money Congress has voted for this effort. I cannot stress too strongly the point that these people could have lost their savings, and that they did not because our government honored its deposit insurance obligations. Our commitment to these depositors has meant continued public confidence in the banking system.

More remains to be done, however, and both additional loss funds and working capital are needed to complete the task. Loss funds are the monies needed to fill the "hole" between an institution's deposits and the value of its assets. This is the money that savings and loans have lost through bad investments, mismanagement and fraud, and the effects of weak real estate markets even on reasonably well-managed thrifts.

Working capital, on the other hand, is used to finance RTC's acquisition of the assets of failed thrifts until they are sold. It is borrowed by the RTC from the Federal Financing Bank (FFB), and these borrowings are backed by seized assets. The RTC expects to repay its working capital borrowings from the proceeds of the sales of these assets.

NB-1450

Loss Fund Request

To date Congress has authorized $80 billion in loss funds for depositor protection: $50 billion in FIRREA and $30 billion in the RTC Funding Act of 1991. The RTC estimates that it will complete the resolution of approximately 569 thrifts by the end of this fiscal year, and by the end of October or shortly thereafter will have used all $80 billion.

How much is necessary to complete the task? Secretary Brady has repeatedly warned that the ultimate cost of the S&L cleanup is very difficult to estimate because it is driven by unpredictable real estate markets, interest rates, and the state of the economy. However, 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.

Our request for an additional $80 billion in budget dollars is based upon the conservative assumption that all institutions currently designated by the Office of Thrift Supervision (OTS) as Group IV, IIIC and IIIB would require resolution by the RTC. While OTS now designates only Group IV institutions as in probable need of government assistance, we have taken a more conservative approach for three reasons. First, OTS designations represent a snapshot in time. Some institutions currently in Group III could be downgraded in the future, and past experience indicates that this is likely. Second, our forecast of thrift failures should make allowance for the current uncertainty in real estate markets and the economy. Third, no one can predict with any degree of certainty what the final cost of the thrift clean-up will be, so we have elected to assume a somewhat pessimistic scenario to ensure that sufficient funds are available for the prompt, orderly resolution of institutions that are found to be operating in an unsafe and unsound condition.

The Oversight Board therefore asks that Congress provide the RTC with sufficient funds to complete the job, which we estimate could be up to $80 billion. This would recognize -- as the budget does -- that deposit insurance is a mandatory obligation of the government, and that having pledged to protect depositors, the government must honor that pledge.

This action would also recognize that delays in funding simply add to taxpayers' costs. As the Congressional Budget Office points out in its most recent Budget Outlook, "limiting ... funds does nothing to reduce eventual spending. In fact, it can drive up costs if it slows the pace of resolutions and enables ailing institutions to stay in business. These costs of delay can be formidable." It is worth adding that a CBO study found that forbearance - that is, delaying resolution - during 1980-1991 of institutions known to be insolvent, cost an extra $66 billion in 1990 dollars.

The point is, Mr. Chairman, that failure to provide RTC with additional funds before the session ends would require the RTC to delay its closure of insolvent thrifts. The longer the period of delay the higher the extra cost of the cleanup to the taxpayer. That is why we believe the only sensible course is to provide now sufficient funds to get this enormous, unprecedented task behind us.

Adding our request for $80 billion to the previously authorized $80 billion would total $160 billion budget dollars, which converts to approximately $130 billion in 1989 dollars.

The Oversight Board has estimated in past testimony that the total cost of the savings and loan cleanup would be in the range of $90 to $130 billion in 1989 dollars. As Secretary Brady has testified, because of economic conditions and deterioration in real estate markets, the most likely cost scenario has moved to the higher end of this range, but it remains within it. We continue to believe that the estimate remains valid.

Working Capital Request

By the end of this fiscal year, RTC expects to have $70 billion in working capital borrowings outstanding, an amount well within the borrowing limitation 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 outstanding FFB balances will begin to decline.

Because both loss funds and working capital funds are required to complete 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 would just as surely prevent the RTC from resolving thrifts and protecting depositors as delays in funding do.

It has been suggested that RTC asset sales can be used to fund losses. This cannot be done because these assets are the only source of repaying FFB borrowings. If proceeds from asset sales are used to fund losses, FFB borrowings cannot be repaid. As I said earlier, both Congressionally authorized loss funds and FFB borrowings are necessary to continue the cleanup and protect depositors.

Extension of OTS Transfer Authority

Although 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. However, current law provides that OTS may transfer thrifts to RTC for closing only until August 9, 1992. Therefore we request an extension of OTS transfer authority until September 30, 1993, for the following reasons:

- The caseload is larger than anticipated. The number of failed thrifts requiring resolution by the RTC has grown beyond our estimates at the time FIRREA was written.

- By adhering to the current deadline we could create an incentive for rushing borderline thrifts to the RTC, and that could mean forcing a large number of thrifts into conservatorship for a long period, during which they would lose franchise value.

- RTC was designed to clean up the insolvent sector of the thrift industry. The intent of FIRREA was that the SAIF would begin with a healthy industry. Therefore were thrifts to be transferred to SAIF starting August 9 next year, SAIF would have to gear up for a task that is already being performed by the RTC.

For all these reasons we believe it makes good sense to provide the extension until September 30, 1993. We do not believe this will have any effect on the 1996 deadline for terminating the RTC.

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 this 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 or how much of a contribution Treasury will need to make to SAIF.

Secretary Brady has stressed that we cannot predict ultimate costs and borrowing needs with certainty. 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.

PROGRESS IN MEETING CLEAN-UP GOALS

The RTC is making progress. It is doing so by adhering to the four guiding objectives established by President Bush when he proposed his solution to the savings and loan crisis soon after taking office.

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 19 million people with deposit accounts averaging less than $10,000 will have been protected.

Second, restore the safety and soundness of the industry so that another crisis will not occur. New, FIRREA mandated capital standards are being phased in. OTS reports that more than 1,700 institutions now meet, or expect to meet, these capital standards. Further, the private segment of the thrift industry reported net income of about $997 million in the first half of 1991, compared to about a $675 million loss in the first half last year.

Third, clean up the overhang of insolvent S&Ls 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 569 insolvent thrifts, one about every 33 hours.

Fourth, aggressively pursue and prosecute the crooks and fraudulent operators who helped create the problem. As of July 31, over 800 individuals have been charged criminally, of whom 100 have been thrift CEO's, board chairmen, or presidents. To date, approximately 600 individuals have been convicted for thrift crimes, with about 80 percent of those sentenced receiving prison terms.

PROGRESS IN IMPROVING RTC MANAGEMENT

Improving the management of the RTC has been an important objective of the Oversight Board and the RTC because strong internal controls and effective management practices are essential to sound decision-making and, ultimately, to saving taxpayer dollars. The Wylie Amendment to the 1991 Funding Act mandated specific improvements in management practices. Following is a summary of the RTC's progress on each of the improvements required by the amendment. A more complete description of progress toward these reforms appears in Appendix I.

RTC has implemented standardized procedures for conservatorships, and has required all regional RTC offices to adhere to a uniform Conservatorship Operations Manual;

- RTC has reduced the average time institutions remain in conservatorship. By September 30 it appears that the statutory goal of 9 months will have been surpassed.
- RTC projects that its Information Resources Management strategic plan to be issued by September 30, identifying goals and systems needs at operation levels;
- RTC expects its computerized securities portfolio management system to be operational by September 30;
- RTC has developed a system to track and inventory real-estate-owned assets and it is becoming operational as data is entered into the system;
- RTC has developed standard loan sales documents for one-to-four family mortgages and has begun using new standards for due diligence;
- RTC has standardized contracting policies and procedures among all regions by developing standardized directives, standardized solicitation and contract documents, training modules, and a comprehensive policy manual; and
- RTC has implemented a quarterly asset valuation system.

I would like to expand on this last point because RTC asset valuation is directly related to important issues raised by the GAO's 1990 audit of the RTC.

GAO will soon be issuing its opinion on RTC's 1990 financial statements. One issue we anticipate they will note is RTC's problems in reconciling its general ledger accounts for receivership assets with the records maintained at receivership sites and by loan servicers. GAO may cite unreconciled differences as part of a justification for issuing a disclaimer, or no opinion, on RTC's financial statements. The primary reason for a disclaimer most likely will be overall uncertainty in asset recovery values, which will likely persist until RTC has had substantially longer experience in selling its illiquid assets. Nonetheless, the reconciliation problems represent a situation which the Oversight Board and RTC believe must be remedied.

As Secretary Brady described to the full Committee in his July 11 testimony, HUD Deputy Secretary Alfred DelliBovi and I have been leading an Oversight Board working group charged with monitoring RTC's progress in the accounting and financial management area and making recommendations for corrective actions where needed. The Oversight Board and its staff have been concerned with these issues and have been discussing them with the GAO since early March, when the Board staff asked the RTC Inspector General to expedite an asset valuation review.

The Oversight Board working group has been actively exploring these issues with RTC, GAO and the RTC Inspector General since it was named by Secretary Brady on May 15. Recently, it met with representatives of RTC, the Inspector General, and Price Waterhouse, which was retained by RTC to review its loss estimation methodology. Price Waterhouse told us that RTC's methods for estimating losses are both "reasonable and conservative," but they did note the asset accounts reconciliation problems during the 1990 period covered by the GAO audit. Price Waterhouse agreed that such problems add to the uncertainty of the asset valuation process, but that it was doubtful that such differences would have a material impact on RTC's 1990 financial statement of condition.

The RTC informs us that, while reconciliation will continue to be a major challenge, a number of steps have been taken to minimize such problems.

1. The RTC established its own Office of Corporate Finance in January to assume responsibility from the FDIC's Division of Accounting and Corporate Services for the integrity of financial reports. The staffing of this office is nearly complete and has resulted in a significantly greater allocation of resources dedicated to resolving accounting related issues such as reconciliation.

2. The RTC has initiated a program for periodic comprehensive audits of receivership by independent accounting firms.

3. The RTC has instructed regional offices to retain outside accountants where necessary to facilitate the reconciliation of receivership records.

4. The RTC has established a standardized process for reporting the progress of the reconciliation program on a monthly basis.

5. The RTC is in the process of implementing a mainframe system to further automate the reconciliation of subsidiary records with the general ledger.

6. The RTC has also instructed its regional offices to proceed more aggressively in consolidating and reducing the number of asset servicers that support the general ledger accounts. This will greatly simplify the reconciliation process.

With this six-point program well under way, RTC has told us that any future unexplained differences discovered during accounts reconciliation should not significantly affect the representation of RTC's financial position.

The RTC has nearly completed its June 30, 1991 reconciliation. Based on preliminary estimates, the RTC believes that the magnitude of items which are not reconcilable will not be material. Nonetheless, the RTC intends to establish a reserve for any unexplained, unreconciled financial position.

It is our firm belief that this reconciliation initiative should permit the GAO to issue an opinion on RTC's financial statements.

In addition to this very intensive effort vis a vis RTC's financial audit, the Oversight Board also adopted a policy on July 25 which encourages RTC to establish and adhere to internal control standards, including evaluation and reporting standards, that are no less stringent than those required by the Federal Managers' Financial Integrity Act of 1982. RTC's first report on material weaknesses and corrective action plans is due to the Oversight Board in October. This policy is attached as Appendix II.

PROGRESS IN ASSET SALES

Asset disposition remains the most important task facing the RTC today. As of June 30, 1991 the RTC had seized assets with a book value of $328.3 billion and had sold or collected a net amount of $168.2 billion or 51 percent of the total. Cumulative asset sales and collections are shown in Appendix III. Sales and collections by asset categories are shown in Appendix IV.

The RTC has had most success in its sales of securities and mortgages - its most readily marketable assets. RTC reports that 73 percent of its book value of securities has been sold or collected with only a three percent loss on these sales. With respect to mortgages, the RTC has sold or collected 46 percent of its inventory and incurred only a three percent loss. The mortgage sale results as of June 30 do not reflect the recent success of the securitization program which will further reduce the RTC's inventory of residential mortgages. In general, RTC's losses on assets sold or collected have so far been very low, as shown in Appendix V, reflecting the fact that it has been selling its more readily marketable assets.

The pace of asset sales has increased since the beginning of 1991. For example, the expected holding period of RTC's current $20.7 billion REO inventory - its hardest to sell assets - is currently 42 months based on the asset sales and collection pace of April, May and June, as shown in Appendix VI. By contrast, in March 1991, the expected holding period for REO was 72 months.

In its operating plan for the nine months from January through September this year, RTC projected net book value asset sales of $65 billion. As of June, the RTC had achieved 74 percent of its projections, as shown in Appendix VII. RTC expects to exceed its projections by September 30, 1991.

Developing effective programs to dispose of RTC assets quickly and at the best possible prices will save taxpayer dollars. Accordingly, the Oversight Board has directed the RTC to use securitization to the widest extent possible, has authorized an $8 billion pilot program for portfolio sales, and has taken steps to implement and enhance the affordable housing program.

Securitization

RTC's securitization of mortgage-backed securities is well underway. Immediately following the enactment of the Funding Act, which provided director and officer immunity from liability, the RTC filed a $4 billion shelf registration with the Securities and Exchange Commission covering the issuance of mortgage-backed securities. Through August, the RTC had already sold approximately $2.5 billion of these securities, including $2.1 billion backed by single-family mortgages and nearly $400 million backed by multi-family mortgages.

Securitization has permitted the RTC to sell mortgages for a higher return than would have been possible had they been sold on a whole loan basis. We estimate that this additional return to the taxpayer has already been substantial, and that it could total $1 billion as a result of the securitization of single-family mortgages alone.

The RTC is also considering the securitization of commercial loans, which could both increase returns to taxpayers and increase the pace of sales of those assets.

Portfolio Sales

In light of mounting inventories of real estate and other hard-to-sell assets, the RTC has introduced the portfolio sales program as one strategy to accelerate the pace of, and return from, asset sales.

Under this new program, large portfolios (typically containing at least $100 million of assets) will be sold to buyers qualified to purchase such large packages of property. The policy gives the RTC the flexibility to custom-tailor transactions in a manner consistent with private sector practice. By so doing, the RTC hopes to elicit greater investor interest, and ultimately higher prices.

The program also addresses an acute marketing problem the RTC has experienced -- that of inducing prospective investors to perform costly and time-consuming due diligence before they have any assurance that they will be able to purchase assets. The

portfolio sales policy encourages buyer investment in due diligence by making the sales process more predictable.

To facilitate such sales RTC has indicated that participating cash flow seller financing may be made available. In exchange the RTC will receive upside participation in the financed assets.

One transaction under this program -- the sale of between $300 million and $500 million of office and hotel properties to the Patriot Group -- has been entered into, and two other large transactions involving commercial real estate are currently being negotiated.

The Oversight Board has approved this RTC policy on a pilot basis up to a total of $8 billion. At Oversight Board request, the RTC has amended its policy to ensure that the RTC will publicly disclose the details of all completed transactions on a timely basis.

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 and multi-family properties to low- and moderate- income families with increasing success.

With regard to single-family homes, RTC reports that 17,293 properties have been marketed in the affordable program at June 30, 1991. Of these, sales have closed on 3,882 and offers have been accepted on 5,895. Another 4,833 are in clearinghouses being offered for sale. Another 2,683 or 16 percent were offered for sale in clearinghouses but remain unsold. These are eligible for donation to nonprofit organizations under the reasonable recovery value program. For example, RTC recently announced that it has donated for public use about 260 properties with no recoverable value to 18 cities and 25 nonprofit groups in Texas.

Since the passage of the Funding Act in March this year, the number of single-family accepted offers began to increase sharply, as demonstrated in Appendix VIII.

The success of the program in reaching its target income group is demonstrated by the fact that the average income of purchasers is $23,000, 61 percent of the national median household income. FIRREA requires only that buyers have income less than 115 percent of local median income.

With regard to multi-family properties, RTC reports that 485 have been marketed at June 30, 1991. Of these, 49 sales have closed and offers have been accepted on 62. Another 138 are in clearinghouses, and 236, or 49 percent, were not sold and have left the clearinghouse stage. This program has been difficult to implement but sales have recently begun to increase.

The 1991 Funding Act provided that single-family homes be made available to qualified buyers in conservatorship. This provision has proven helpful. RTC advises that, at June 30, 1,332 homes had been sold in conservatorship.

STRUCTURE OF THE CLEANUP

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 of an organization that is responsible for expending as much as $160 billion of taxpayer funds, this separation of management and operations from oversight makes sense.

We have functioned under this structure for two years. Admittedly there have been problems in addressing this giant, unprecedented cleanup task. It would have been unrealistic not to expect them.

Some have suggested that they have been caused by the structure of the cleanup, notably the two-board structure, and there have been calls for eliminating the Oversight Board, creating a single board dominated by independent members, and splitting the RTC and the FDIC.

As the Board has testified, it does not believe that the problems stem from the organizational structure. Rather, they are operational in nature. The Board believes that the most important step that can be taken toward making the RTC more effective is to appoint a new RTC Chief Executive Officer with the experience and the operating latitude to get this job done.

Secretary Brady and Chairman Seidman have formed a search committee and a search is actively in progress for an RTC Chief Executive Officer.

We do not believe that changing the organizational structure of the cleanup now is necessary or desirable. Changes of the magnitude suggested in bills introduced in the Senate and House would entirely revamp the executive structure of the RTC, would cause disruption of ongoing resolution and asset disposal activities, and thus would create expensive delays in an effort that in any case is by law scheduled to terminate at the end of 1996.

CONCLUSION

In conclusion, Mr. Chairman, I repeat the Oversight Board's request for legislation this session that will provide sufficient additional funds to complete the cleanup, which we estimate at $80 billion; an increase in RTC borrowing authority to $160 billion; and an extension from August 1992 until September 1993 of the period in which the Office of Thrift Supervision may transfer thrifts to the RTC for closing.

I must underscore Chairman Seidman's opinion that additional loss funds will be needed by the end of October or shortly thereafter. If loss funds run out and the RTC is unable to close money-losing thrifts and pay off their depositors, the costs of the cleanup will simply grow, and we would risk alarming depositors that their deposits are not safe, thus creating runs on already weak institutions. Ultimately, Congress must provide the funds, simply in order to fulfill our government's deposit insurance commitments.

If the funds requested are provided and the cleanup can continue without the disruption that would inevitably be caused by a major reorganization, RTC can continue to close thrifts and save depositor's accounts, and the unnecessary additional costs resulting from funding delays can be avoided.

At the same time the RTC and Oversight Board will continue to work to improve RTC's asset disposition performance and to improve its management practices under the leadership of a new Chief Executive Officer.

For the longer term, when the backlog of insolvent thrifts is resolved and these institutions are closed or merged, we can look forward to a stronger industry with improved profitability.

Certainly, Mr. Chairman, I am sure that you and the members of the Subcommittee share our goal of getting this immense, complex task behind us as quickly and economically as possible. I hope you would also agree that we should do nothing - such as a major reorganization - to make the cleanup more difficult and more expensive. For I believe that if we are permitted to stay the course we can get the job done with increasing efficiency.

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RTC Management Initiatives: Current Status

Oversight Board
Resolution Trust Corporation
Washington, D.C.

August 27, 1991

Preface

This report is intended to document the current status of management initiatives being undertaken at the RTC which address: (i) criticisms by the GAO; and (ii) requirements set forth in the RTC Funding Act of 1991.

Each page in this document is organized according to the following categories:

Operating Area	Segments RTC's major operating areas as follows: 1. Resolution Process 2. Asset Sales 3. Information Resources Management (IRM) 4. Contracting 5. 1989 Financial Statements
GAO Criticisms	Summarizes major issues and findings of GAO extracted from: 1. Testimony of Comptroller Bowsher on February 20, 1991 before The House Committee on Banking, Finance, and Urban Affairs 2. GAO's Audit of RTC's 1989 Financial Statements
RTC Funding Act of 1991	Details Management Reform Initiatives called for in the RTC Funding Act of 1991
IG Comments	Provides a summary, prepared by the IG, on any related audit work in each of the five operating areas
RTC Comments	Provides status update, prepared by RTC staff, on initiatives which address both GAO criticisms and Congressionally mandated Management Reform Initiatives.

Operating Area	GAO Criticisms[1]	RTC Funding Act of 1991	IG Comments	RTC Comments
1. Resolution Process				
A. Conservatorship	• Regional oversight inconsistent	• By 9/30/91, RTC must develop and implement standardized procedures with respect to: — auditing conservatorships — ensuring/monitoring compliance with policies and procedures — ensuring/monitoring Managing Agent performance	• An audit of the region's and consolidated offices' oversight of conservatorship operations is in process. Audits of individual conservatorships also being conducted to assess the hiring and supervision of managing agents. (5/9/91 Report) • Headquarters oversight and procedure-setting for conservatorship operations under review. (6/10/91 Report)	• A Managing Agent Oversight and Training Task Force was established in March 1991 to address the standardization of conservatorship audits and Managing Agent oversight and training. The Task Force has concluded its mission. A directive titled "Standardization of Conservatorship Review Programs" establishing national standards for the oversight of conservatorships was issued on 7/12/91. RTC also issued directive titled "Training Standards for Conservatorship Operations" on 6/11/91, establishing national standards for training. • RTC needs operational regional flexibility • All regions follow uniform Conservatorship Operations Manual • Headquarters staff meets with regions quarterly • Ambiguous phrasing of questions on GAO survey of Managing Agents makes survey's reliability questionable.

Notes:

(1) All GAO comments taken from the testimony of Comptroller Bowsher on February 20, 1991 before the House Committee on Banking and Finance and Urban Affairs, with the exception of comments on RTC's 1989 financial statements, which are taken from the GAO Audit of the RTC's 1989 financials.

Operating Area	GAO Criticisms[1]	RTC Funding Act of 1991	IG Comments	RTC Comments
I. Resolution Process				
B. Resolutions	• Average length of time that thrifts have been in conservatorship was over 52 weeks at the end of 1990.	• Increase pace of resolutions with the goal that no institution remains in conservatorship longer than 9 months	• On January 15, 1991, IG issued audit report on four major resolutions. Deficiencies were not found relative to the cost test used in resolutions.	• At inception in August 1989, the RTC took control of 262 conservatorships. Many of these institutions had been under government control for as much as seven months by the time the RTC came into existence. • Resolution pace was slowed down by uncertainty over funding. Now that funding has been provided, older conservatorships are being given priority for resolution. By 9/30/91, substantially all institutions that were in conservatorship as of 3/15/91 will have been resolved. • Thrifts held the longest are expected to be resolved first.
			• Audit work is also in process relative to the award of appraisal contracts and asset valuation methods. (5/9/91 Report) • Report being finalized on review of resolution of a thrift in New Jersey conducted in response to Congressional complaint. (6/10/91 Report)	

Operating Area	GAO Criticisms	RTC Funding Act of 1991	IG Comments	RTC Comments
2. Asset Sales				
A. Financial Assets (i) Securities				
	• Develop comprehensive securities portfolio management system	• Develop and implement securities portfolio management system by 9/30/91	• IG overseeing activities in this area generally. Specific audit scheduled to review the sale of junk bonds and hedging instruments. Continuing involvement in and review of RTC systems development and implementation will include input to controls needed in the system. (6/10/91 Report) Fiscal Year 1992 audit planned.	• SOS titled "Securities Inventory/Operations Support System" was issued on April 29, 1991. Contract was awarded on 8/16/91. System is to be operational by 9/30/91.

Operating Area	GAO Criticisms	RTC Funding Act of 1991	IG Comments	RTC Comments
2. Asset Sales				
A. Financial Assets (i) Securities (cont'd.)	• Centralize all securities sales in capital markets group	• N/A		• The RTC is in the process of centralizing the sale of all RTC-owned securities through a single "desk" in the Capital Markets Branch in Washington. On 7/12/91, the Capital Markets Branch moved to a state-of-the-art sales "desk" for securities sales located at RTC headquarters in Washington. Final steps will be completed and implemented at the time the securities portfolio management system comes on line. • The Capital Markets Branch is currently preparing a policies and procedures manual as part of the effort to centralize the sale of all RTC-owned securities.

Operating Area	GAO Criticisms	RTC Funding Act of 1991	IG Comments	RTC Comments
2. Asset Sales				
A. Financial Assets (ii) Portfolio Sales	• Develop standardized packages conforming to market requirements	• Develop a program for performing due diligence of 1-4 family mortgages and marketing such loans on a pooled basis	• Activities in this area are generally being monitored for potential audit coverage. IG recommendations regarding bulk sales and other major asset disposition efforts made in May 13, 1991 report on the cancelled real estate auction.	• Developed and completed representations and warranties in standard loan sales documentation for adjustable and fixed-rate 1-4 family mortgages.
				• Standardized loan sales agreements for commercial/multi-family mortgage, student, vehicle, credit card, manufactured housing and home equity loans incorporating industry standard representations and warranties are in final stage of completion.
	rdize due ce process	• See above		• Due diligence firms began using new standards for single family mortgages on 4/15/91.
				• Standardized due diligence for commercial/multi-family mortgages and for various forms of consumer loans is near completion.

Operating Area	GAO Criticisms	RTC Funding Act of 1991	IG Comments	RTC Comments
2. Asset Sales				
A. Financial Assets				
(iii) Securitization	• Securitize as many loans as possible; resolve liability issue	• Special legislative exemption for liability under Securities Act of 1933 for RTC directors, officers and employees	• To the extent necessary, IG will monitor solicitation and award of contracts for underwriters, etc. • Audit report on alternatives to repaying FHLBank Advances (selling of excess collateral) issued July 3, 1991. • Audit work was started in May 1991 on RTC's Selection of Brokers to assess the criteria for and selection of brokers and whether planned processes will maximize sale proceeds. (6/10/91 Report) Audit terminated after survey work disclosed no significant problems.	• RTC filed a shelf registration statement with the SEC for issuance of $4 billion of investment-grade securities. Initial securitization of $430 million of adjustable-rate mortgages closed on 6/27/91. Second issuance of approximately $580 million occurred on July 15. Three additional securitization offerings are planned for August.

Operating Area	GAO Criticisms	RTC Funding Act of 1991	IG Comments	RTC Comments
2. Asset Sales A. Financial Assets (iii) Securitization (cont'd.)				• RTC currently pursuing securitization for junk bonds, multi-family and second mortgages, and mobile home loans. • A master selling and servicing contract was negotiated between the RTC and Fannie Mae, and Freddie Mac in October 1990. RTC has sold or swapped $1.6 billion in mortgages that conform with the standards of above agencies. • On 5/10/91, RTC issued a directive requiring that all agency-eligible loans be swapped with above agencies. • RTC negotiating with Ginnie Mae to begin securitization program.

Operating Area	GAO Criticisms	RTC Funding Act of 1991	IG Comments	RTC Comments
2. Asset Sales				
A. Financial Assets				
(iii) Securitization (continued)	• Centralize marketing efforts	• N/A		• Agency swaps and securitization are being coordinated in Washington. • RTC, Freddie Mac, and Fannie Mae have prepared a "Swap Guide" Manual that sets forth standardized procedures for securitizations. In June, 1991, the RTC, Freddie Mac, and Fannie Mae began visiting Consolidated Field Offices to train asset marketing specialists and asset technicians in manual procedures.

Operating Area	GAO Criticisms	RTC Funding Act of 1991	IG Comments	RTC Comments
2. Asset Sales				
A. Financial Assets				
(iv) Overall	• Develop and implement loan asset inventory system	• N/A	• IG generally monitoring systems development in this area.	• Loan and Other Asset Inventory System (LOAIS) currently implemented in 23 states of North Central Region. It is expected to be implemented nationwide by 9/30/91.
	• Consolidate loan sales	• N/A	• Audit work relative to compliance with delegations of authority will cover decision-making process in asset sales.	• Standardized due diligence documentation procedures and development and implementation of LOAIS will facilitate greater control and coordination of loan sales.

Operating Area	GAO Criticisms	RTC Funding Act of 1991	IG Comments	RTC Comments
2. Asset Sales				
B. Real Estate				
(i) General	• GAO has not validated asset valuation/appraisal process	• Develop process for quarterly valuation or updating of valuations of receivership assets incorporating, to the extent possible, RTC disposition experience	• Audit work is in process relative to asset valuation methods and the award and administration of appraisal contracts. These audits are specifically assessing the establishment of asset valuations including estimated cash recoveries/loan loss reserves and estimated recovery values used in various cost calculations.	• RTC has implemented a quarterly valuation system, based on on-site reviews by contractors of a sample of RTC assets. This process includes consideration of asset values, holding and operating costs. RTC completed a valuation of receivership assets as of 12/31/90 and submitted it to the GAO on 5/31/91 for review. In addition, RTC's Inspector General is reviewing the process. RTC is refining valuation process to fully integrate on-site reviews, data from SAMDA contractors, statistical sampling, RTC disposition experience, and empirical modeling. An enhanced automated system will be developed to support these efforts.

Operating Area	GAO Criticisms	RTC Funding Act of 1991	IG Comments	RTC Comments
2. Asset Sales				
B. Real Estate				
(i) General (continued)	• Clarify asset sales strategy	• N/A	• Final audit report on the cancelled auction (Auction Company of America) issued May 13, 1991. Review of first bulk sales (Alamo & Commonwealth assets) started in July 1991.	• Sales strategies and standards are in place. Through June 1991, the book value of RTC sales and collections totaled $179 Billion, including 29% (book value) of the real estate that has come under RTC control.
	• Eliminate confusion/duplication surrounding sales centers and SAMDA contractors	• N/A		• National/regional sales centers and SAMDA contractors each have clear non-duplicative role. Sales centers serve as central point of contact and referral to appropriate private sector managers, and as focal point for portfolio sales.
	st practices (sales nents, offer respon- ss) in line with pri- ector	• N/A		• Standard format due diligence procedures implemented on 4/15/91. Standard format bid packages and sales documents will reach investors by late August.

Operating Area	GAO Criticisms	RTC Funding Act of 1991	IG Comments	RTC Comments
2. Asset Sales				
B. Real Estate				
(ii) Affordable Housing	• Improve operational consistency among regions	• N/A	• Audit work is scheduled in IG audit plan for the 4th Quarter of FY 1991. Work will probably begin in FY 1992.	• Held national affordable housing staff meeting 4/9-4/11 to provide training and standardize program implementation. Moved Affordable Housing Program to consolidated and regional sales centers to improve marketing and sales consistency. Hired contractor to develop training program for staff, contractors, and brokers. Contractor attended first quarterly meeting with Affordable Housing staff on 7/31-8/2.
	• Develop marketing net- [illegible] and inventory dis- [illegible] tructure in the [illegible] est region	• N/A		• Hired 42 Technical Assistance Advisors ("TAAs") as of June, 1991 to assist eligible single family purchasers. Recruiting effort to hire additional TAAs is continuing.
				• Developing automated property information system to serve as a clearinghouse.

Operating Area	GAO Criticisms	RTC Funding Act of 1991	IG Comments	RTC Comments
2. Asset Sales				
B. Real Estate				
(ii) Affordable Housing (continued)	• N/A	• RTC may sell eligible single family property to qualified buyers without regard to any minimum purchase price		• Directive titled "Guidelines for Selling single Family Properties Under the Affordable Housing Disposition Program" providing for no minimum purchase price (and expanding the affordable housing program to conservatorships) was issued on 4/10/91. • Mass advertising campaign underway to promote sale of affordable housing through auction and sealed-bid marketing campaigns. Auctions for properties sold "absolute", without minimum reserve price, are underway nationwide.

Operating Area	GAO Criticisms	RTC Funding Act of 1991	IG Comments	RTC Comments
3. Information Resources Management (IRM)	• Complete strategic plan and systems architecture	• Strategic plan to include translation of program goals into necessary hardware, software and staffing required to accomplish such goals	• A number of audits in process relative to IRM, including assessments of solicitations and awards for Real Estate Owned Management System, Interim Contractor Activity Reporting System, Contractor Activity Reporting System, and review of activities with respect to the Asset Inventory System and the Asset Management System. IG participating on an ongoing basis providing input on systems development. (5/9/91 Report)	• Version 2 of the IRM Plan that incorporates the information architecture concept has been completed. Version 3, enhancing treatment of data integrity, integration, and detailed information requirements, is to be issued 9/30/91.
		• Systems architecture to include: (i) securities portfolio management system;		• See 2.A.(i)
		(ii) REO inventory and tracking system; to be developed and implemented by 9/30/91		• REO Management System (REOMS) development completed. In process of loading data onto system. On target for 9/30/91 implementation. In addition, Loan and other Assets Inventory System (LOAIS) and Asset Manager System (AMS) are expected to be implemented nationally by 9/30/91.

Operating Area	GAO Criticisms	RTC Funding Act of 1991	IG Comments	RTC Comments
3. Information Resources Management (IRM) (continued)	• Identify information and systems needs at all organization levels	• Identify system needs at all operation levels		• Established Office of Corporate Information to integrate and oversee development of a comprehensive management information system • User task forces have been formed for all major applications • User working groups have been formed to define overall requirements • Inclusion of field office review of Information Resource Management strategic plan. • Monthly meeting between Office of Corporate Information and Regional/Consolidated Information System Administrators

Operating Area	GAO Criticisms	RTC Funding Act of 1991	IG Comments	RTC Comments
4. Contracting				
(i) Policies/procedures	• Insufficient recognition given to contracting process and procedures	• N/A	• Many of the IG audits discussed herein assess contracting activity. In addition, IG has provided specific input on proposed policies and procedures for suspension and exclusion of contractors and complaint processing guidelines. IG reviewed and consulted with the RTC on the establishment of a separate independent contracting office as focal point of contracting activity. • Nearly 70% of IG audit resources are devoted to issues which include contract management or asset management including: – SAMDA – Appraisals – Brokers – Bidder Selection – Legal Services	• Established independent contracting office to develop, monitor and enforce compliance with contract procurement standards and procedures • Office of Contractor Oversight and Surveillance established in 1990 to deter/detect fraud

Operating Area	GAO Criticisms	RTC Funding Act of 1991	IG Comments	RTC Comments
4. Contracting				
(i) Policies/procedures (continued)		• Develop directive describing roles and responsibilities of all parties involved in the contracting process; progress report by 9/30/91	• See comment at 4(i) above	• RTC has developed and disseminated policy directives and standard contractual documents to standardize RTC policies and procedures. The most recent of which is titled "RTC Contracting Roles and Responsibilities" and was issued 5/6/91
		• Develop standardized solicitation and contract documents for use by all RTC officers; progress report by 9/30/91	• SAMDA documents are being reviewed from a number of standpoints including audits and quality assurance oversight	• Standardized solicitation and contract documents for asset management engagements completed, and issued to all RTC field offices on 4/15/91, and are currently in use
		• Develop comprehensive policy manual; progress report by 9/30/91	• OIG has reviewed and provided comments on draft manual	• Manual is in final draft and will be issued by 9/30/91.
		• Develop standardized training modules; progress report by 9/30/91	• OIG has met with contractor to discuss training needs.	• Private contractor has been engaged to develop 6 standard contract training modules that will be used by all RTC offices. The first training class will be held the week of 8/26-8/30. The training manual is in process and is currently being reviewed by RTC contracting and legal departments.

Operating Area	GAO Criticisms	RTC Funding Act of 1991	IG Comments	RTC Comments
4. Contracting				
(ii) Management	• Improvements needed in areas of contractor selection and performance monitoring	• N/A		• RTC has provided standardized documents, training, and directives on roles and responsibilities of contractor management.
				• Pre-award certification reviews
				• Database to include potential contractors' performance history with government agencies and any involvement with federal/state law enforcement authorities
			• Audit report on cancelled real estate auction contained specific recommendations for improving and better controlling background checks and investigations of contractors and potential contractors	• Comprehensive review of current RTC background check policies complete. Improving background checks, including whether entities meet the fitness and integrity standards established by FIRREA and have the financial strength to endure the term of the contract

Operating Area	GAO Criticisms	RTC Funding Act of 1991	IG Comments	RTC Comments
4. Contracting				
(ii) Management (continued)				• Fraud awareness training to educate contracting and asset management staff on the early warning signs of fraud and abuse is being developed. First course took place during July 1991. The Office of Contractor Oversight and Surveillance has issued a "Contract Fraud Training Manual" and embarked on an extensive series of training seminars on fraud awareness. The training program, intended to sensitize all RTC employees involved in the contracting process, has already been given in several field locations. The current schedule will result in fraud awareness training for all field personnel by year end.

Operating Area	GAO Criticisms	RTC Funding Act of 1991	IG Comments	RTC Comments
4. Contracting				
(ii) Management (continued)				• Contract audit program to review financial reports, verify services performed, and assess contractor's internal controls, compliance with laws and regulations, subcontractor selection and engagement practices and overall performance is operational. Since January 1991, Office of Contractor Surveillance and Oversight conducted over 60 inquiries and referred 12 matters to IG. RTC policy on suspension and exclusion of contractors has been issued. • Evaluation and monitoring of contractor performance against contractor business plans; rating system to evaluate overall performance under development; guidelines prepared for review of SAMDA contractors internal controls, conduct audits of SAMDA contracts to identify potential weaknesses; and develop comprehensive RTC contract audit program.

Operating Area	GAO Criticisms	RTC Funding Act of 1991	IG Comments	RTC Comments
4. Contracting				
(ii) Management (continued)			• IG has started an audit, Review of the OM Program, which will include assessment of the performance rating system (6/10/91 Report)	• RTC policy regarding Oversight Manager Program defined in directive dated 11/28/90
				• RTC policy regarding Asset Manager Performance Ratings defined in directive dated 4/16/91, which establishes uniform criteria to measure performance of RTC Asset Management Contractors
			• IG working closely with contractor Oversight and Surveillance staff to coordinate investigative activity and formulate complementary contractor review and monitoring program to maximize coverage	• Washington and field staff participate in project compliance review teams which perform site visitations to ensure that operations and contractor management oversight is being implemented according to RTC policy. Field office staff participate in a contractor oversight visitation program to monitor policy implementation by asset managers.

Operating Area	GAO Criticisms	RTC Funding Act of 1991	IG Comments	RTC Comments
4. Contracting				
(iii) Minority Contracting		• Semi-annual reports due 4/30 and 10/31 on steps taken by the RTC to implement the minority and women outreach program required by section 1216(c) of FIRREA	• Consideration to minority contracting activity is covered in all IG contract audits including: – Legal Services – Bidder Selection – SAMDA	• 4/30/91 Semi Annual report submitted. Five national Outreach seminars and over 100 regional outreach efforts have been initiated, with ethnic, minority, and female trade and professional associations and special interest groups. 8A agreement with SBA has been signed. Proposed final regulations on MWOB contracting were forwarded to Oversight Board on 4/8/91. Oversight Board comments were received on 6/3/91. Interim final regulations, except those related to minority preferences which are being held back pending Justice Department review, as requested by the Oversight Board, were approved by RTC Board on 7/30/91.

Operating Area	GAO Criticisms	RTC Funding Act of 1991	IG Comments	RTC Comments
4. Contracting (iii) Minority Contracting (continued)				• To encourage more contracting with minority, women-owned and small businesses, RTC is downsizing asset portfolios and making them more geographically concentrated. RTC is also enhancing normal solicitation actions with local and national advertising that is specifically directed at such firms. Alternate proposal evaluation approaches are being developed by an RTC task force in order to improve the participation of minority, women-owned and smaller firms in RTC's contracting process. One such approach would qualify technical proposals within a given acceptable range (without scoring by absolute points) and then award the contract based on the cost side of the proposal.

Operating Area	GAO Criticisms	RTC Funding Act of 1991	IG Comments	RTC Comments
4. Contracting				
(iii) Minority Contracting (continued)				• The RTC has signed an agreement with The Minority Business Development Agency (MBDA) to establish an interagency cooperative effort to assist in minority business development. The MBDA will assist in publicizing and promoting the RTC's outreach to minority businesses and will participate in joint efforts with RTC staff in training activities; allowing the input of MBDA staff and resources in areas in which RTC has not had an opportunity to develop customized workshops targeting specific concerns of the minority businesses, thus enhancing contracting opportunities for the minority business community.

Operating Area	GAO Criticisms	RTC Funding Act of 1991	IG Comments	RTC Comments
5. 1989 Financial Statements				
(i) Audit Report	• Qualified opinion, scope limitation due to uncertainties re: — estimated recoveries on claims paid (asset valuation) — estimated liability for unresolved cases to be transferred from OTS (remaining cost of cleanup)	• N/A	• IG has met with GAO and provided information from its reviews to expedite completion of 1990 statements	• RTC has implemented a quarterly valuation system to estimate recoveries on claims. See 2.B.(i). • The estimated liability for unresolved cases is based on the best available information from OTS. • RTC acknowledges that there is inherent uncertainty as to asset values and the remaining cost of the thrift clean-up.
(ii) Internal Controls	• General concerns regarding adequacy*	• N/A	• All IG audits assess internal controls of the activity reviewed and provide recommendations relative to deficiencies noted. The IG is also participating as a technical advisor in RTC activities to establish an Internal Control Task Force.	• Site reviews of Consolidated Offices have been initiated by the Offices of Corporate Finance and Program Analysis to flowchart and document transactional flows and associated control points in various processing cycles. • See Attachment #1 entitled "RTC Internal Control Environment"

*GAO has identified specific instances of internal control weaknesses. RTC's review of internal controls revealed internal control procedures in place subject to possible audit exceptions which have subsequently been corrected. These audit exceptions included

910719.0

Policy Statement Number 18
RTC Internal Controls

1. Objectives.

The objectives of this Policy Statement are:

(A) to encourage the Resolution Trust Corporation ("RTC") to establish and adhere to internal control standards, including evaluation and reporting standards, that are no less stringent than those required of certain agencies pursuant to the Federal Managers' Financial Integrity Act of 1982 ("FMFIA");

(B) to encourage the RTC to vest in its Chief Financial Officer powers substantially similar to those provided in the Chief Financial Officers Act of 1990 ("CFO Act").

2. Purpose.

(A) The purpose of this Policy Statement is to ensure that the RTC, in its corporate and receivership capacities, has in place a comprehensive set of internal accounting and administrative controls, which can provide reasonable assurance that:

1) obligations and costs are in compliance with applicable law and Oversight Board resolutions;

2) all transactions are executed in accordance with management's general or specific authorization, and in accordance with established policies and procedures;

3) funds, property, and other assets are properly accounted for and safeguarded against waste, loss, unauthorized use, or misappropriation; and

4) revenues and expenditures are properly recorded and accounted for in a timely manner to

(a) permit the preparation of accurate and reliable accounts, financial statements, and management reports and

(b) maintain accountability over assets

3. Internal Control Standards. *

It is the policy of the Oversight Board that the RTC should establish and maintain a system of internal accounting and administrative controls which, at a minimum, meet the standards prescribed by the Comptroller General pursuant to FMFIA.

4. <u>Internal Control Evaluation</u>. *

It is the policy of the Oversight Board that the RTC should establish and maintain an internal control evaluation system which, at a minimum, meets the requirements prescribed by the Office of Management and Budget pursuant to FMFIA. In establishing that system, the RTC should, to the extent practicable, study the evaluation systems used by Executive agencies and adopt the most effective elements of those systems. The RTC should also incorporate in such system specific mechanisms to evaluate compliance with relevant Oversight Board resolutions, policy statements, principles, and other guidance.

5. <u>Designation, Authority, and Function of the Chief Financial Officer</u>.

It is the policy of the Oversight Board that the RTC should provide its Chief Financial Officer with authority and functions substantially similar to those set forth in 31 U.S.C. Sections 902(a)(1)-(3), (5)(B)-(E), (7) and (8), and Section 902(b), as amended by the CFO Act.

6. <u>Reports to the Oversight Board</u>. *

(A) The RTC shall submit to the Chairman of the Oversight Board the annual management report required by the CFO Act at least 30 days before the report is due to be submitted to Congress.

(B) The RTC shall prepare and submit to the Chairman of the Oversight Board a statement and report on internal administrative and accounting controls substantially similar to that annually required of Executive agencies under FMFIA. Such report is due 90 days after the end of the reporting period. The reporting period is the RTC's fiscal year unless the Chairman of the Oversight Board determines otherwise. On a one time basis only, however, the RTC shall submit a statement and report by October 30, 1991, covering the RTC's fiscal year ended December 31, 1990, and covering, to the extent possible, the period from January 1 through September 30, 1991.

7. <u>Immediately Effective</u>.

This Policy Statement shall be immediately effective.

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* With regard to Section 3 of this Policy Statement, RTC should develop appropriately rigorous internal control standards for the internal controls of those of its contractors who act on behalf of the RTC (<u>e.g.</u>, SAMDA contractors and Interim Servicing Agreement contractors). The internal control evaluation system referred to in Section 4 of this Policy Statement should be employed by RTC to evaluate the internal controls of such RTC contractors in accordance with such standards. Reports required under Section 6 of this Policy Statement should include the results of such evaluations of the internal controls of such RTC contractors.

Since inception, the RTC has achieved net asset reductions of $168.2 Billion. Most of these asset reductions have taken place in conservatorship.

Cumulative Net Asset Reductions
($ Billions)

Inception through June 30, 1991

Acquired Assets*	$328.3
Reduction in Conservatorships	$103.4
Reduction in Resolutions	$36.7
Reduction in Receiverships	$26.7
Other Changes	$1.4
Current RTC Inventory	$160.0

$168.2 Net Reduction

* Conservatorship and receivership
Source: RTC Review; OB Analysis

The RTC has made the most progress in sales of its securities inventory.

Asset Sales and Principal Collections – Conservatorship and Receivership

($ Billions)

Inception through June 30, 1991

■ % Book Value Sold ☐ % Remaining Inventory

	% Book Value Sold	% Remaining Inventory	Total Assets in Inventory
Securities	73%	27%	100% = $108.7
Mortgages	46%	54%	100% = $151.7
Other Loans	55%	45%	100% = $27.8
Real Estate	26%	74%	100% = $28.0
Other Assets	33%	67%	100% = $23.0
Total Assets*	53%	47%	100% = $339.2

* Total Assets include new loans and assets purchased by RTC Conservatorships prior to resolution.
Source: RTC; OB Analysis

The RTC has incurred the highest loss rate on sales of REO.

Loss on Asset Sales and Principal Collections

Conservatorship and Receivership
($ Billions)

Inception through June 30, 1991

■ % Collected □ % Loss

	% Collected	% Loss	Total Assets Sold & Collected
Securities	97%	3%	100% = $79.8
Mortgages	97%	3%	100% = $69.2
Other Loans	95%	5%	100% = $15.2
Real Estate	74%	26%	100% = $7.3
Other Assets	95%	5%	100% = $7.6
Total	96%	4%	100% = $179.3

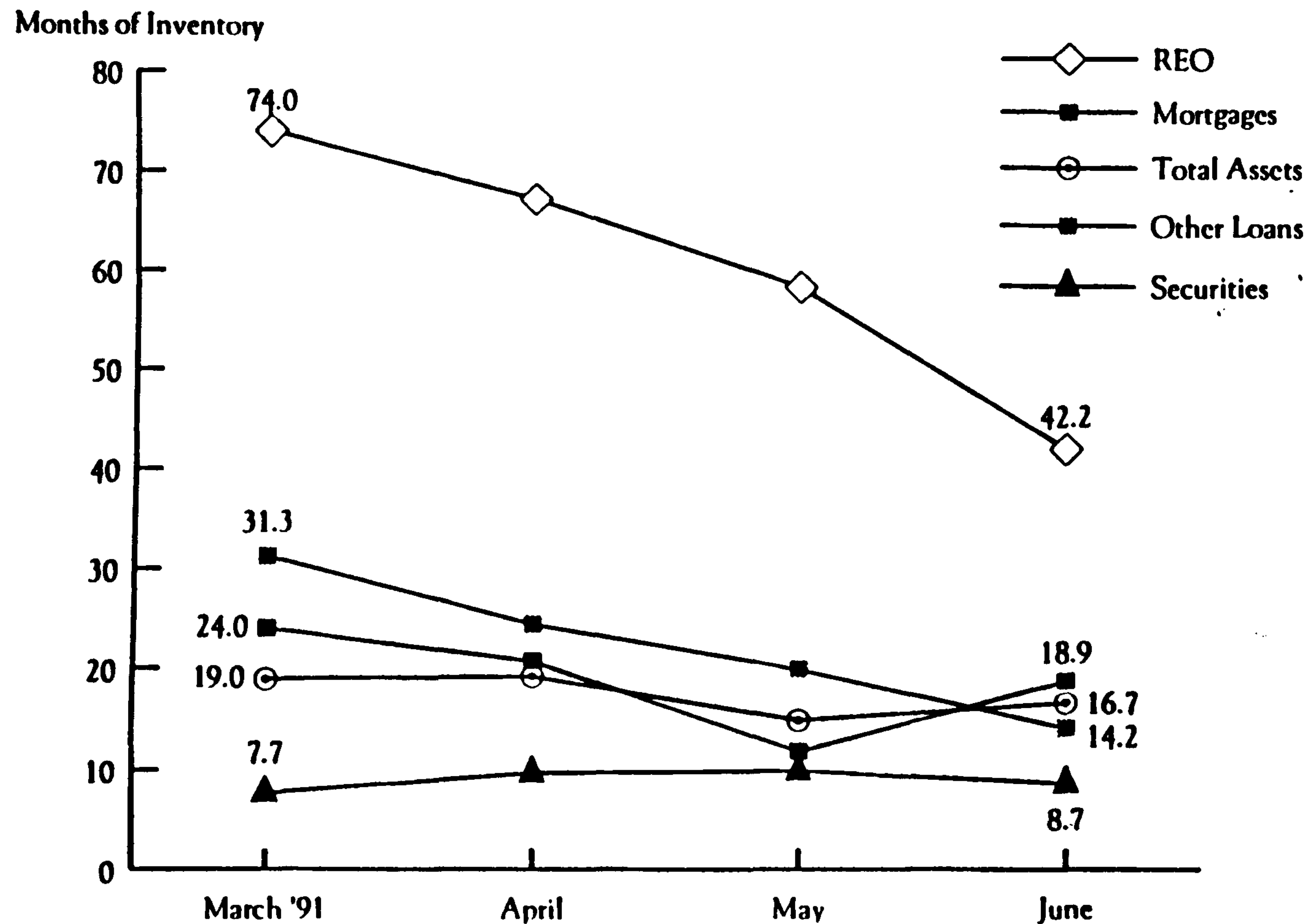
Note: Loss percentages generally reflect the sale of higher quality assets in conservatorship and those passed at resolution.
Source: RTC; OB Analysis

The holding period of RTC assets based on three month moving average of sales and collections has declined since March for all asset categories except Securities.

Total RTC Inventory* - Months of Inventory

Three Month Moving Average

Based on January-June, 1991 Sales



* Includes conservatorship assets, assets passed at resolution and receivership assets.

Note: Three Month Moving Average is the average sales and collections for the preceding 3 month period. The 42.2 month REO figure for June indicates that all REO will be sold after a holding period of 42.2 months, based on sales and collections in April, May & June.

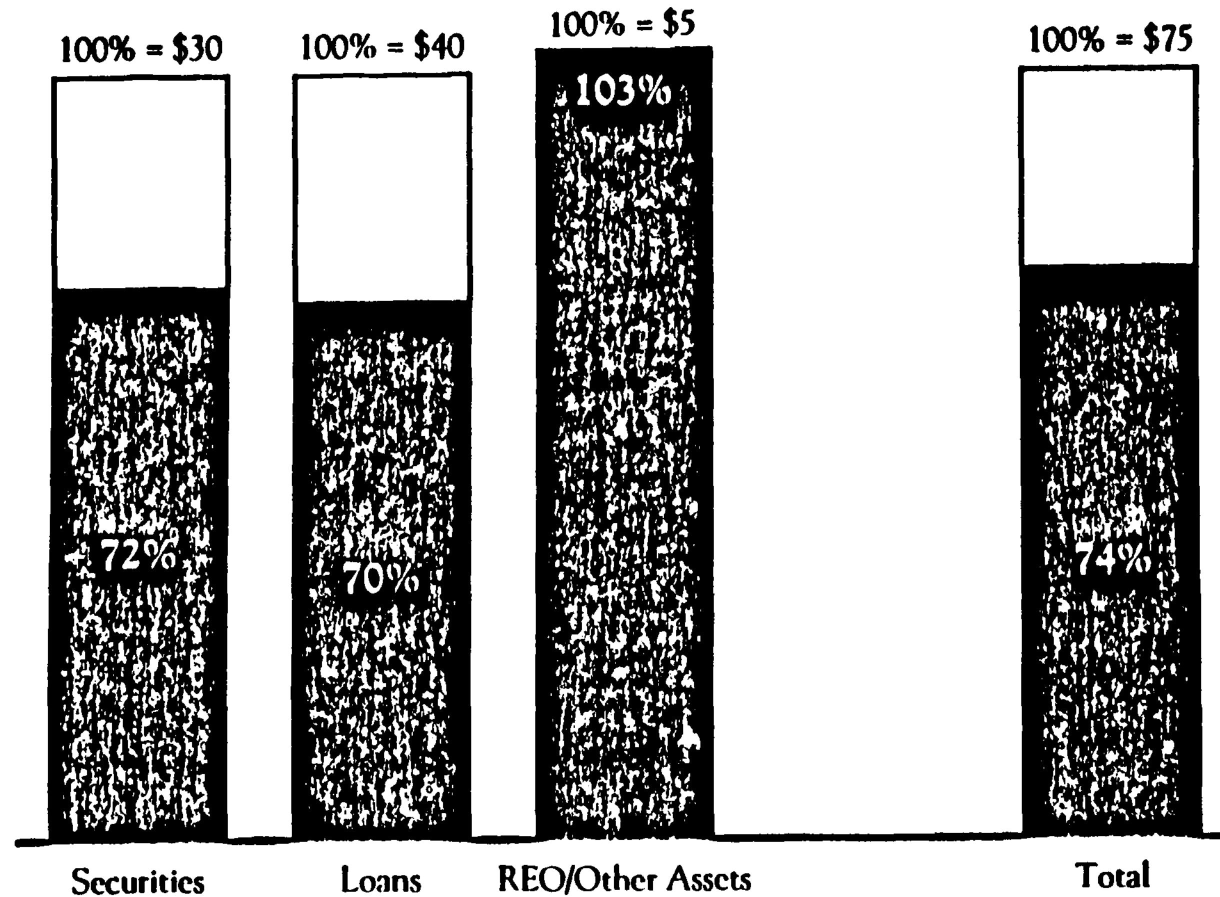
Source: RTC Monthly Historical Information; OB Analysis

The RTC has achieved 74% of its January-September asset sales projections.

RTC Asset Sales and Principal Collections Pace Against Projections*

Book Value Reductions
($ Billions)

As of June 30, 1991



* Sales and collections projections include assets passed at resolution and sales and collections from receiverships and conservatorships.

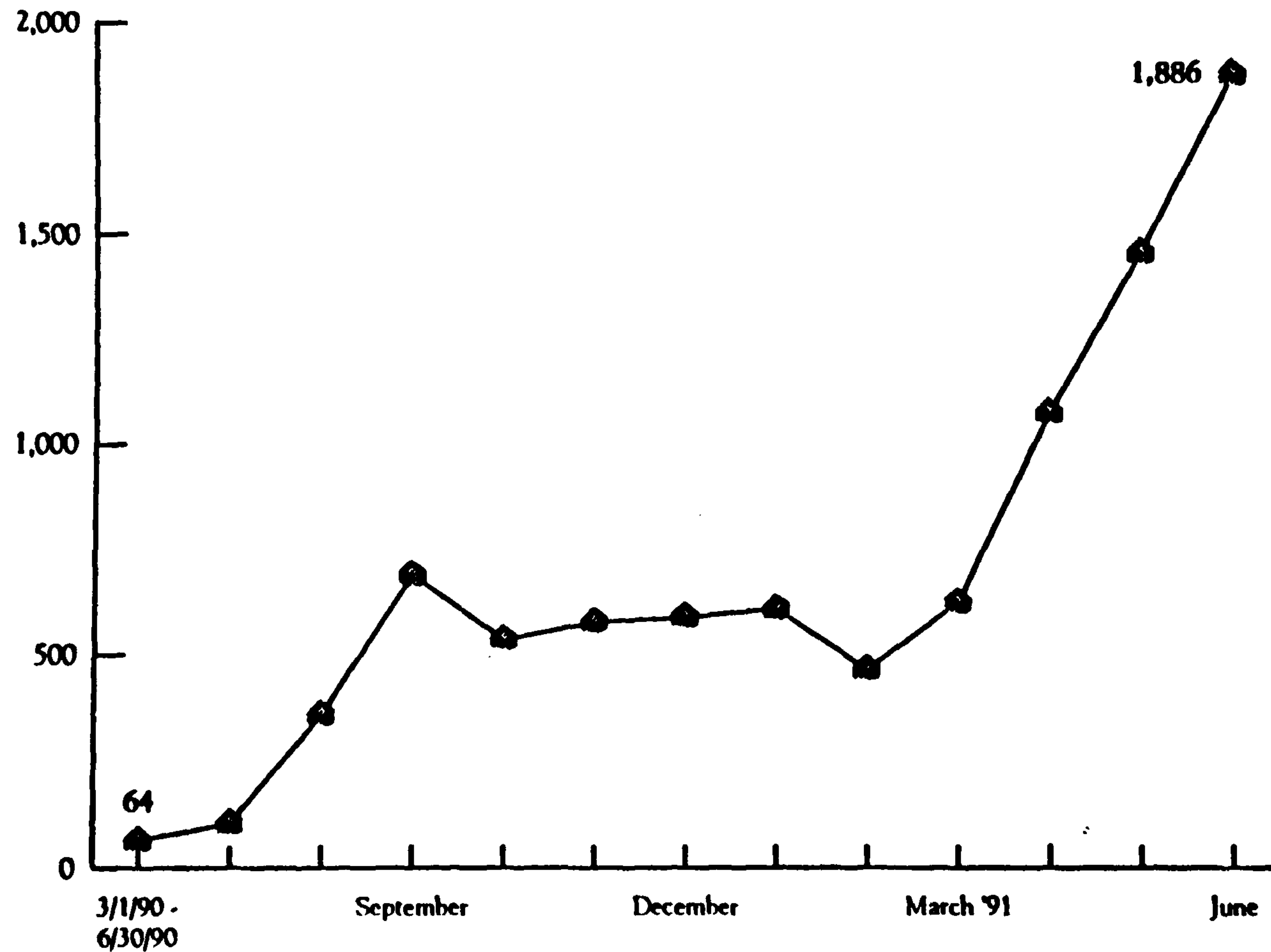
Source: February 1 Operating Plan; RTC Monthly Historical Information; OB Analysis

Single family affordable housing accepted offers have continued to increase in June.

Affordable Housing - Single Family Monthly Accepted Offers

(# of Properties)

As of June 30, 1991



Note: The number of properties in RTC's eligible inventory is unknown. The RTC has hired a contractor to determine its inventory.
Source: RTC; OB Analysis

TREASURY NEWS

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FOR IMMEDIATE RELEASE
September 13, 1991

Contact: Andy Montgomery
(202) 874-6750

RUSSELL D. MORRIS
Appointed Commissioner
Financial Management Service

Secretary Nicholas F. Brady today announced the appointment of Russell D. Morris as the commissioner of the Financial Management Service (FMS), a bureau within the Department of the Treasury.

As commissioner of the Financial Management Service, Mr. Morris has responsibility for over $2 trillion a year in collections and disbursements, and for the investment of the government's multibillion-dollar trust funds. The Financial Management Service also has program responsibilities for cash management, credit administration, and debt collection activities throughout the government.

Mr. Morris has served since 1988 as the deputy commissioner of the FMS, participating in policy and planning decisions, overseeing the day-to-day management of the 2,200 person bureau, and serving as the chairman of the Executive Resources Board. From 1984 to 1988, Mr. Morris served as the assistant commissioner for federal finance at the FMS. Previously, Mr. Morris served as the assistant commissioner for banking and cash management at the FMS, from 1980 to 1984.

Prior to his eleven years of service at the Financial Management Service, Mr. Morris worked as a general manager at the U.S. Postal Service; and as an analyst with the Board of Governors of the Federal Reserve. Since 1985 he has taught as an adjunct professor in financial markets and institutions at Georgetown University.

Mr. Morris received his B.S. in finance (1963), and an M.B.A. (1964) from Ohio State University. He went on to receive a Ph.D. in business administration (1973) from Ohio State University. He is married to the former Rebecca Rainer, and has one son, Justin. Mr. Morris and his family reside in Severna Park, Maryland.

oOo

NB-1451

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FOR IMMEDIATE RELEASE
September 13, 1991

Contact: Desiree Tucker-Sorini
202-566-8191

Statement by
Nicholas F. Brady
Secretary of the Treasury

We welcome the move by the Federal Reserve Board to lower the discount rate. I hope this will be followed by similar moves by the Fed to assure it meets its own money supply growth targets.

The economy is on track and it appears that inflation has slowed markedly this year. It is extremely important that Fed policy support the economic recovery.

NB-1452

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FOR RELEASE AT 2:30 P.M.
September 13, 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 September 26, 1991, and to mature September 24, 1992 (CUSIP No. 912794 YY 4). This issue will provide about $1,875 million of new cash for the Treasury, as the maturing 52-week bill is outstanding in the amount of $10,630 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, September 19, 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 September 26, 1991. In addition to the maturing 52-week bills, there are $18,263 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 $1,784 million as agents for foreign and international monetary authorities, and $5,977 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 $230 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.

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

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

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

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

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

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

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

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

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

8/89

AUCTION RESULTS

PUBLIC DEBT NEWS

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

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FOR IMMEDIATE RELEASE
September 16, 1991

CONTACT: Office of Financing
202-219-3350

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Tenders for $10,604 million of 13-week bills to be issued September 19, 1991 and to mature December 19, 1991 were accepted today (CUSIP: 912794WX8).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.17%	5.33%	98.693
High	5.19%	5.35%	98.688
Average	5.19%	5.35%	98.688

Tenders at the high discount rate were allotted 47%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	36,475	36,475
New York	31,965,340	9,320,025
Philadelphia	25,290	25,290
Cleveland	48,565	48,565
Richmond	241,555	49,435
Atlanta	31,220	30,690
Chicago	2,998,155	304,005
St. Louis	13,860	13,860
Minneapolis	7,135	6,715
Kansas City	38,905	38,905
Dallas	25,185	25,185
San Francisco	650,775	73,875
Treasury	631,055	631,055
TOTALS	$36,713,515	$10,604,080
Type		
Competitive	$32,227,490	$6,118,055
Noncompetitive	1,343,645	1,343,645
Subtotal, Public	$33,571,135	$7,461,700
Federal Reserve	2,010,980	2,010,980
Foreign Official Institutions	1,131,400	1,131,400
TOTALS	$36,713,515	$10,604,080

NB-1454

AUCTION RESULTS

PUBLIC DEBT NEWS

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FOR IMMEDIATE RELEASE
September 16, 1991

CONTACT: Office of Financing
202-219-3350

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Tenders for $10,607 million of 26-week bills to be issued September 19, 1991 and to mature March 19, 1992 were accepted today (CUSIP: 912794YE8).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.19%	5.42%	97.376
High	5.22%	5.45%	97.361
Average	5.22%	5.45%	97.361

Tenders at the high discount rate were allotted 88%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	33,555	33,555
New York	25,863,995	9,497,155
Philadelphia	13,190	13,190
Cleveland	28,880	28,880
Richmond	44,365	43,525
Atlanta	29,165	29,045
Chicago	1,137,500	147,500
St. Louis	14,625	14,625
Minneapolis	5,590	5,590
Kansas City	35,720	35,720
Dallas	15,965	15,965
San Francisco	629,060	255,060
Treasury	487,065	487,065
TOTALS	$28,338,675	$10,606,875
Type		
Competitive	$24,223,500	$6,491,700
Noncompetitive	1,015,975	1,015,975
Subtotal, Public	$25,239,475	$7,507,675
Federal Reserve	2,300,000	2,300,000
Foreign Official Institutions	799,200	799,200
TOTALS	$28,338,675	$10,606,875

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For Release Upon Delivery
Expected at 10:00 a.m.
September 17, 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 present the views of the Administration on H.R. 2735, which would make three changes relevant to regulated investment companies (RICs).

First, H.R. 2735 would repeal the "30 percent" test of section 851(b)(3). Second, H.R. 2735 would generally require a shareholder who sells shares in an open-end RIC to use a prescribed method to determine the basis and holding period in the shares sold. This proposal would also require open-end RICs and other brokers to track and report shareholder basis and holding period in shares in open-end RICs. Finally, H.R. 2735 would amend the "90 percent" test of section 851(b)(2) to clarify the treatment of reimbursements of RIC expenses.

The Office of Tax Analysis estimates that each provision of H.R. 2735 loses revenue and hence that overall the bill will lose revenue over the 1992-1996 budget period. Our support for the repeal of the so-called "short-short" restriction is, therefore, conditioned upon the enactment of an acceptable revenue offset with repeal.

1. Repeal of the 30 Percent Test of Section 851(b)(3)

Current law. Under the 30 percent test of section 851(b)(3), in order to qualify to be taxed as a RIC, a corporation must derive less than 30 percent of its gross income for the year from the sale or disposition of certain investments (including stock, securities, options, futures, and forward contracts) held for less than three months.

Following an earlier effort to repeal section 851(b)(3), section 851(g) was added in 1986 to provide some relief from the 30 percent test for a RIC's hedging activities. Under section 851(g), both the hedged and the hedging positions are essentially

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treated as a single investment (any increase in value of a position that is part of a hedge is offset by any decrease in value on any other position that is part of the hedge).

Proposal. The bill would repeal the 30 percent test of section 851(b)(3).

Administration position. We support repeal of the 30 percent test of section 851(b)(3) if an acceptable revenue offset is provided. Repeal of section 851(b)(3) would significantly reduce tax compliance cost for RICs without sacrificing any legitimate tax policy objective.

The predecessor to the 30 percent test was originally enacted in 1936. The legislative history, however, is silent on the purpose of the 30 percent test. It has subsequently been rationalized as necessary either (1) to restrict the availability of RIC treatment to entities that are not engaged in an active business or (2) to protect shareholders by limiting speculative trading or portfolio "churning." The Treasury Department has long held the view that neither of these rationales justifies retaining the 30 percent test.

While we believe that RIC treatment should be available only to entities that are not engaged in an active business, we do not believe a restriction based on the holding period of securities sold is helpful in achieving this policy. For Federal income tax purposes, the trading of portfolio securities is generally treated as less "active" than other business activities. A distinction based on sales of securities held for a short period as opposed to sales of securities held for a longer period is of little utility in making this distinction.

Subsequent to the enactment of the 30 percent test in 1936, the Investment Company Act of 1940 was adopted and the Code was amended generally to require a RIC to register as an "investment company" under the 1940 Act. This requirement imposes an independent limitation on the permissible activities of a RIC and restricts the ability of an active business corporation to qualify as a RIC. Registration with, and regulation by, the Securities and Exchange Commission under the 1940 Act obviates the need for the 30 percent test as an investor protection device. We believe that the 1940 Act provides the appropriate vehicle for the regulation of the relationship between such corporations and their shareholders; such regulation, if desirable, should be achieved through the securities laws, rather than the tax laws.

Finally, the 30 percent test imposes substantial costs on RICs and their shareholders, both by requiring investment decisions to be made on noneconomic grounds and by forcing RICs to monitor their compliance with the rule.

2. RIC Shareholder Basis

Current law. Under section 1012, a taxpayer who sells shares in a RIC may use one of four methods to determine the basis and holding period of the shares sold. These methods are (1) specific identification, (2) first-in, first-out (FIFO), (3) single category average cost, and (4) double category average cost. Under the single category average cost method, a single average basis is computed for all shares and holding period is determined using FIFO. Under the double category average cost method, an average basis is computed for those shares held for not more than one year and for those shares held for more than one year and the taxpayer can choose the category from which the shares were sold.

In applying FIFO and the two average cost methods, a taxpayer must take into account all shares he holds in a single RIC. For example, if a taxpayer has more than one account in a single RIC, in using the single category average cost method, he must determine a single average basis for all of the shares in all of the accounts.

The single and double category average cost methods generally do not apply to shares that were acquired by gift if the basis of the shares to the donor exceeded their fair market value at the time of the gift. Such shares have a "split" basis under section 1015(a) (i.e., they have one basis for determining gain and another for determining loss), which makes computing an average impossible.

Under section 6045, brokers must send information returns, both to the Internal Revenue Service and to the investor, reporting the gross proceeds from sales of securities during the year. For this purpose, open-end RICs that stand ready to redeem their shares are treated as brokers.

Proposal. Under the bill, section 1012 would be amended to require a taxpayer who sells shares in an open-end RIC generally to use the single category average cost method to determine basis and holding period in the shares sold.

All computations would be made on an account-by-account basis. Thus, if a taxpayer has two separate accounts in the same RIC, the basis and holding period would be computed separately for each account.

The taxpayer would be permitted to elect not to use the single category average cost method and instead to use either the specific identification or FIFO method. The election would be made on an account-by-account basis. The election would have to be made in the taxpayer's return for the year in which he first

sells shares from the account. The proposal would not apply to any account which includes any stock not acquired by purchase.

Section 6045 would also be amended to require open-end RICs and other brokers to issue information returns reporting, in addition to the gross proceeds from any sale of shares in an open-end RIC, the basis of the shares sold and the portion of the gross proceeds attributable to shares held for more than one year and to shares held for not more than one year. Under the proposal, basis would be determined by using an average and holding period would be determined by using FIFO (i.e., the single category average cost method). The proposal would require the average basis and FIFO holding period to be computed on an account-by-account basis (thus, it would not be necessary to determine whether a shareholder has multiple accounts and compute an overall average or FIFO holding period).

If a taxpayer's account is transferred from one broker to another, the transferor broker would be required to provide the transferee broker with sufficient information regarding the account to enable the transferee to comply with the new reporting requirements.

The proposal grants Treasury authority to prescribe regulations regarding the manner in which this information is to be reported. These regulations would be necessary to provide guidance regarding the categories of basis and holding period adjustments (e.g., return of capital distributions) that must be taken into account in preparing the new information returns.

The proposal would be effective beginning January 1, 1993 (i.e., for accounts opened after December 31, 1992 and for information returns regarding sales during calendar 1993). The proposal would not apply to accounts established before January 1, 1993, even if additional investments were made through the account.

Administration position. We question whether this proposal will achieve significantly enhanced compliance or provide meaningful simplification in its current elective form; therefore, we would suggest modifying the proposal to make it mandatory. Congress must ultimately make a judgment as to whether the obvious convenience which an elective proposal could provide for many small mutual fund shareholders outweighs the difficulties described below and the revenue loss an elective proposal will entail. We would also note that we and the Internal Revenue Service believe that the proposal would improve compliance significantly if it were mandatory. The Office of Tax Analysis estimates that a mandatory provision would raise a modest amount of revenue.

Many taxpayers investing in open-end RICs engage in a large number of transactions in the RICs shares. For example, some taxpayers purchase shares periodically through participation in dividend reinvestment plans or in payroll deduction or other types of investment plans. Other taxpayers may frequently sell shares to pay living expenses. Because of the many purchases or sales or both in different amounts, at different times, and at different prices, taxpayers can have difficulty accurately reporting sales of open-end RIC shares.

In most cases, the proposed reporting requirement would provide taxpayers selling shares in open-end RICs with the information necessary to report those sales. However, the information returns received by at least some taxpayers would not provide the information required to file properly.

The size of the group for which the information would be inaccurate would depend, in part, on how many taxpayers elect not to use the single category average cost method. For taxpayers who "elect out", the new information returns would simply be irrelevant. While such taxpayers place themselves in this position by voluntary action and therefore may be reasonably required to assume any additional burdens imposed by their action, this permissive election will seriously limit the value of such information to the Internal Revenue Service for enforcement purposes and may even be counterproductive to compliance.

Even for taxpayers who do not elect out of the single category average cost method, the information returns may not provide the appropriate information either because brokers may not be able to apply all of the rules regarding basis and holding period or because those rules are applied improperly. For example, a taxpayer could hedge his investment, which could suspend his holding period or create a new holding period. Similarly, a taxpayer could incur costs (e.g., legal fees) that must be capitalized into the basis of his investment. Also, a taxpayer's basis could be affected by events occurring long after he has sold some or all of his investment. For example, a taxpayer selling shares in an open-end RIC in December of one year could have his basis in those shares reduced as a result of a distribution made in November of the following year if the distribution is a return of capital. As another example, section 852(f), relating to the treatment of certain load charges, could affect a taxpayer's basis long after the shares are sold. It is open to question whether these caveats affect a large number of mutual fund shareholders.

Some taxpayers for whom the returns are inaccurate for reasons specified above may nonetheless use the information. Some would do so unknowingly; others, however, may be tempted to use the inaccurate information when doing so would be to their

advantage. They might be tempted to do so because they believe that reporting the amounts shown on the information returns provides a form of audit protection.

The fact that taxpayers would be permitted to elect not to use the single category average cost method is an obvious source of complexity in the proposal. Taxpayers would be required to determine whether to make the election and then to take the steps necessary to make the election. In addition, because the information returns would be wrong for any taxpayer that makes the election, the information returns would be less useful for the Internal Revenue Service. While removing the election from the proposal would deprive RIC investors of basis computation options allowed to other securities investors, we believe that the proposal should not be enacted unless it is mandatory. Given the ability of RIC shareholders to control significant basis allocations by the simple expedient of opening new accounts, we question whether the loss of flexibility inherent in a mandatory rule would impose any meaningful disadvantage.

It may be difficult to develop procedures for transferring information regarding an account when the account is transferred from one broker to another. For example, it is a common practice for a taxpayer who holds RIC shares directly or through an account with one broker to use a different broker to sell part or all of his investment. In such a case, although the account (and the related information) has not been transferred, the selling broker has the reporting obligation. It should also be noted that the rules on transfers of accounts, by requiring both brokers to be acting as nominees, is too narrow. It should be expanded to cover situations in which an account held directly with an open-end RIC is transferred to a broker who will act as a nominee or where an account that is held through a broker acting as a nominee is transferred to one held directly with the RIC.

Congress should be aware of the need for adequate lead time both for the Internal Revenue Service to prescribe rules and procedures and for mutual funds to develop compliance programs implementing those rules. Accordingly, the effective dates proposed should be reviewed carefully to ensure that adequate time for implementation is provided after enactment.

The Internal Revenue Service has also expressed concern about the exclusion of existing accounts from the proposal. We and the Internal Revenue Service recognize the difficulties associated with gathering the information required to bring existing accounts into the reporting system and understand that additional time would be required to implement a system for existing accounts. However, we believe Congress should consider granting the Secretary regulatory authority to require reporting for existing accounts without specifying a deadline for implementation of such authority. Such a structure would allow

evaluation of the experience with new accounts and rulemaking on a proposed basis, allowing time for comments and industry consultations.

Until such regulations are implemented, we suggest that the proposal be clarified to make clear that an account established before the effective date does not become subject to the proposal as a new account simply because it is transferred from one broker to another after the effective date. The rationale for excluding existing accounts is that the necessary information regarding basis and holding period is not as readily available as it would be for a new account. This continues to be true where the account is merely transferred. It should also be clarified that the proposal will be applied separately to part-sale, part-gift transactions.

3. Reimbursements of RIC Expenses

Current law. Under the 90 percent test of section 851(b)(2), a RIC must derive at least 90 percent of its gross income for the year from certain specified sources. These sources are dividends, interest, payments with respect to securities loans, gains from the sale or other disposition of stock, securities, or foreign currencies, or other income (including gains from options, futures, and forward contracts) derived with respect to its business of investing in stock, securities, or currencies.

Proposal. The proposal would provide that, for purposes of the 90 percent test of section 851(b)(2), amounts included in gross income by reason of any reimbursement (or other payment) with respect to any expenses of the RIC will be disregarded.

Administration position. We do not support the proposal.

Prior to the Tax Reform Act of 1986, the sources of qualifying income for purposes of section 851(b)(2) were limited to dividends, interest, payments with respect to securities loans, and gains from the sale or disposition of stock or securities. The Internal Revenue Service, however, administered the prior version of section 851(b)(2) in a manner which avoided inappropriate application of the requirement. For example, the Service ruled that certain gains from options and futures contracts were qualifying income for purposes of the 90 percent test. See e.g., Rev. Rul. 83-69, 1983-1 C.B. 126 (options); GCM 38994 (May 27, 1983) (futures contracts); and GCM 39447 (December 5, 1984) (futures contracts). The Service also ruled that the 90 percent test was not violated by recovery of excess management fees, Rev. Rul. 64-247, 1964-2 C.B. 179; recovery of damages from an investment advisor for breach of fiduciary duty, Rev. Rul. 74-248, 1974-1 C.B. 167; refund of state franchise taxes, Ltr. Rul. 8530016 (April 24, 1985); or recovery of damages

arising from the purchase of securities in reliance on a misleading prospectus or through fraud, Ltr. Rul. 7838135 (June 26, 1978), Ltr Rul. 8837085 (June 24, 1988).

In 1986, section 851(b)(2) was amended to expand the sources of qualifying income. The amendment, in part, codified the administrative positions of the Service. In addition, the amendment expanded section 851(b)(2) to treat as qualifying income other income derived with respect to a RICs business of investing in stock, securities, or currencies. By adding this residual category of qualifying income, the amendment provides the Treasury Department and the Service clear authority to apply section 851(b)(2) in a manner consistent with its underlying purposes. No regulations or rulings interpreting this residual category have thus far been issued.

We are concerned by the breadth of the proposed amendment which could allow payments to a RIC to be structured as reimbursements without restriction. We fear that aggressive use of the provision might undermine investment restrictions designed to insure that RICs do not engage in active business. While we would be willing to consider a more narrowly targeted exception limited to particular problems associated with the commencement of fund operations, we do not believe that a case has been made for the broad change here proposed given prior administration of the provision.

Mr. Chairman, that concludes my formal statement. I will be pleased to answer any questions that you or other Members may wish to ask.

TREASURY NEWS

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

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FOR IMMEDIATE RELEASE September 17, 1991

Monthly Release of U.S. Reserve Assets

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

As indicated in this table, U.S. reserve assets amounted to $73,514 million at the end of August 1991, down from $74,816 million in July 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					
July	74,816	11,062	10,360	44,664	8,730
August	73,514	11,062	10,479	43,247	8,726

1/ Valued at $42.2222 per fine troy ounce.

2/ Beginning July 1974, the IMF adopted a technique for valuing the SDR based on a weighted average of exchange rates for the currencies of selected member countries. The U.S. SDR holdings and reserve position in the IMF also are valued on this basis beginning July 1974.

3/ Includes allocations of SDRs by the IMF plus transactions in SDRs.

4/ Valued at current market exchange rates.

NB-1457

Report to Congress on the

Depreciation of Business-Use Light Trucks

Department of the Treasury
September 1991

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

September 1991

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Section 7612(f) of Public Law 101-239, the Omnibus Budget Reconciliation Act of 1989, directs the Secretary of the Treasury or his delegate to conduct a study of the proper class life for cars and light trucks and submit a report to the Congress within one year of enactment. The Omnibus Budget Reconciliation Act of 1990 extended the date for submission of the report to April 15, 1991.

Pursuant to those directives, a study entitled "Report to Congress on the Depreciation of Business-Use Passenger Cars" was submitted to Congress in April. In completion of this mandate, I hereby submit the companion study "Report to Congress on the Depreciation of Business-Use Light Trucks."

I am sending a similar letter to Representative Bill Archer.

Sincerely,

Kenneth W. Gideon
Assistant Secretary
(Tax Policy)

Enclosure

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

September 1991

The Honorable Lloyd Bentsen
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

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Pursuant to those directives, a study entitled "Report to Congress on the Depreciation of Business-Use Passenger Cars" was submitted to Congress in April. In completion of this mandate, I hereby submit the companion study "Report to Congress on the Depreciation of Business-Use Light Trucks."

I am sending a similar letter to Senator Bob Packwood.

Sincerely,

Kenneth W. Gideon
Assistant Secretary
(Tax Policy)

Enclosure

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Chapter I. Introduction and Principal Findings

A. Mandate for This Study

This study of the depreciation of business-use light trucks has been prepared by the Office of Tax Analysis (OTA) in response to a Congressional mandate in the Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239). Section 7612(f) of the Act, which became effective December 19, 1989, directed Treasury to conduct a study on the proper class life for cars and light general purpose trucks and to report its findings to the Congress within one year. The Omnibus Budget Reconciliation Act of 1990 extended the due date for the report to April 15, 1991. A report on the depreciation of business-use passenger cars was submitted to Congress in April 1991; this report completes the task requested in P.L. 101-239.

OTA conducts studies of the depreciation of assets, including assets not expressly requested for study by the Congress, as part of its general mandate under Section 168(i)(1)(B) of the Internal Revenue Code, as modified by the Tax Reform Act of 1986. (See Exhibit 1 of Appendix A.) This Code provision directed the Treasury to "monitor and analyze actual experience with respect to all depreciable assets", and granted Treasury explicit authority to change the classification and class lives of assets. The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) repealed Treasury's authority to alter asset classes or class lives, but the revised Section 168(i) continued Treasury's responsibility to "monitor and analyze actual experience with respect to all depreciable assets." (See Exhibit 2 of Appendix A.)

B. Methodology and Classification Issues

The General Explanation of the Tax Reform Act of 1986 indicates that the determination of the class lives of depreciable assets should be based on their anticipated useful lives and the anticipated decline in their value over time, after adjustment for inflation. (See Exhibit 3 of Appendix A.) Under current law, the useful life of an asset is taken to be its entire economic life span over all (business) users combined, and not just the period it is retained by a single owner. The General Explanation also indicates that, if the class life of an asset is derived from the decline with age of its market value, such life (which, to avoid confusion, is hereafter referred to as its "equivalent economic life") should be set so that the present value of straight-line depreciation over the equivalent economic life equals the present value of the decline in value of the asset (both discounted at an appropriate rate of interest).

In its study of the depreciation of business-use passenger cars, OTA accounted for not only the decline in the vehicles' market values with age, but also for their conversion from business to non-business use and the tax gains and losses that arise from their sale at different ages. This treatment was necessary because of a particular characteristic of business-use passenger cars. Unlike most other business equipment, passenger cars are typically sold before the end of their useful life as vehicles. Moreover, unlike a number of other business assets for which an established resale market exists, used passenger cars are nearly always acquired for household or other non-business use.

Like passenger cars, business-use light trucks are also frequently sold before the end of their useful life as vehicles. However, in contrast to passenger cars, business-use light trucks are often sold to other businesses. This feature of the business-use light truck market required OTA to modify the methodology used for passenger cars to account for business-use light trucks that are capitalized and depreciated for tax purposes by more than one owner. Moreover, because the period of time light trucks are held by business owners (either the initial owners or subsequent purchasers) can be comparable to their total useful life, it was also necessary to take account of the retirement pattern with age of light trucks, a factor which was not as important for passenger cars.

Revenue Procedure 87-56, which lists the depreciable asset classes and their corresponding class lives, indicates that "light general purpose trucks" have an actual unloaded weight of less than 13,000 pounds, and are to be distinguished from automobiles, buses, heavy general purpose trucks (with an actual unloaded weight of 13,000 pounds or more), over-the-road tractor units, and trailers and trailer-mounted containers. Under current law, light general purpose trucks are assigned to Asset Class 00.241, and have a class life of four years, regardless of whether they are owned, leased, or rented by their business users. Under section 168(e)(3)(B)(i) of the Internal Revenue Code, however, light general purpose trucks are expressly assigned to the (modified) accelerated cost recovery system's five-year property recovery class, regardless of their class life. Likewise, under section 168(g)(3)(D), the alternative depreciation system recovery period for light trucks is five years, independent of their current class life.

Trucks are not generally classified according to their unloaded weight for other legal purposes, including aspects of tax law, motor vehicle safety standards, and fuel economy standards. Classification is commonly based on the vehicle's gross vehicle weight rating (GVWR) and other factors. The GVWR is the value specified by the manufacturer as the vehicle's maximum design loaded

weight; a GVWR must be assigned to each domestically produced truck.[1] Two vehicles possessing similar empty weights may have dramatically different GVWRs. This is because the GVWR depends upon the vehicle's specific characteristics: suspension system, shock absorbers, axle strength, transmission, tires, seating capacity, etc. These characteristics determine, in part, a truck's intended use, and therefore can play an important role in establishing the truck's expected economic life. Moreover, each vehicle's GVWR class is incorporated in the vehicle's identification number (VIN), which is often included in the data used in this study; the unloaded vehicle weights are not so readily available. For these reasons, trucks were classified in this study by their GVWR, rather than by their unloaded weight.

More specifically, "light general purpose trucks" are defined in this report as those trucks having a GVWR of less than 33,000 pounds. The trucks examined are classified into four weight classes: trucks with a GVWR of 6,000 pounds or less (referred to in this report as Class 1 trucks); trucks with a GVWR in the range of 6,001 to 10,000 pounds (Class 2); trucks having a GVWR in the range of 10,001 to 19,500 pounds (Class 3); and trucks with a GVWR of more than 19,500 pounds but less than or equal to 33,000 pounds (Class 4).

An investigation was conducted into the relationship between unloaded truck weights and loaded weight measures. Using the Census' 1987 Truck Inventory and Use Survey, it was found that over 98 percent of business-use trucks with a reported empty weight of less than 13,000 pounds also reported an average loaded weight of 33,000 pounds or less. Thus, virtually all available observations on "light general purpose trucks" as defined by Asset Class 00.241 were included in the analysis. Of those business-use trucks with a reported empty weight of 13,000 pounds or more, 55 percent reported an average loaded weight of more than 33,000 pounds, while 38 percent had an average loaded weight of 19,500 to 33,000 pounds, and 7 percent had an average loaded weight of under 19,500 pounds. Trucks with an empty weight of 13,000 pounds or more constituted about 7 percent of the total number of business-use trucks in Class 3 and about 33 percent of business-use

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[1] In submitting information to the National Highway and Traffic Safety Administration (NHTSA), manufacturers must use the following GVWR classes: Class A: 3,000 pounds or less; Classes B through H: 3,001 to 10,000 pounds, at 1,000 pound increments; Class 3: 10,001 to 14,000 pounds; Class 4: 14,001 to 16,000 pounds; Class 5: 16,001 to 19,500 pounds; Class 6: 19,501 to 26,000 pounds; Class 7: 26,001 to 33,000 pounds; Class 8: 33,001 pounds and over. The U.S. Bureau of the Census, in its Truck Inventory and Use Survey, classifies trucks into either four or fourteen weight categories for reporting purposes. These categories are groupings of the NHTSA classes, although they refer to average loaded weights as reported by survey respondents rather than the assigned GVWRs.

trucks in Class 4. A significant probability thus exists that some "heavy general purpose trucks" belonging to Asset Class 00.242 were also included in the data examined in this study, particularly trucks with a GVWR above 19,500 pounds.[2]

C. Principal Findings and Recommendation

The principal findings of this study are that trucks with a GVWR of 6,000 pounds or less have an equivalent economic life of 4.1 years and a useful life of 7.1 years. Trucks with a GVWR of 6,001 to 10,000 pounds have an equivalent economic life of 4.4 years and a useful life of 10.9 years. Trucks with a GVWR of 10,001 to 19,500 pounds have an equivalent economic life of 4.8 years and a useful life of 16.5 years. Trucks with a GVWR of 19,501 to 33,000 pounds have an equivalent economic life of 6.6 years and a useful life of 16.5 years. As stated above, these categories cover virtually all trucks included in Asset Class 00.241. Based on the adjusted relative annual investment in trucks in each weight class, an overall equivalent economic life for all trucks in Asset Class 00.241 is estimated to be 4.6 years, with a useful life of 9.4 years. If Congress wishes to retain the existing definition of light general purpose trucks, it is recommended that the class life for Asset Class 00.241 be changed from 4 years to 4.5 years.

Buses, heavy general purpose trucks with an unloaded weight of more than 13,000 pounds, tractor units, trailers and trailer-mounted containers, (i.e., vehicles defined in Asset Classes 00.23, 00.242, 00.26, and 00.27) were not expressly examined in this study, and no inference can be made of their equivalent economic lives from the findings of this report.

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[2] This fact was taken into account by adjusting the investment weights used to generate a single overall economic equivalent life for "light general purpose trucks" in Asset Class 00.241. The possible inclusion of heavy trucks belonging to Asset Class 00.242 in the analysis of Classes 3 and 4, however, was unavoidable.

Chapter II. Industry Background

Trucks are important business assets. According to the Bureau of Economic Analysis (BEA), in 1989 U.S. business spent $36.5 billion on the purchase of new trucks, trailers, and buses. While BEA does not identify trucks separately from buses and trailers, OTA estimates that nearly 80 percent of the BEA total ($28.9 billion) was spent on trucks alone (including tractor-trailer combinations). Slightly more than half (52.2 percent) of this latter figure was spent on trucks with a gross vehicle weight of 10,000 pounds or less. Business new truck purchases accounted for nearly one-half of total domestic new private truck sales, and about seven percent of total business investment in new equipment. Table 1 shows 1989 investment in new business-use trucks by gross vehicle weight class.

Table 1. Investment in Business-Use Trucks by GVWR Class, 1989
(Weight in Pounds, Units in Thousands, Dollars in Billions)

GVWR Class	Number of Vehicles	Acquisition Cost	Percentage Distribution	
			Number	Cost
6,000 or less	693	10.3	48.3	35.6
6,001-10,000	436	4.8	30.4	16.6
10,001-19,500	51	0.7	3.6	2.4
19,501-33,000	123	4.5	8.6	15.6
More than 33,000	130	8.6	9.1	29.9
Total	1,434	28.9	100.0	100.0

Sources: OTA estimates based on data from Bureau of Economic Analysis, Motor Vehicle Manufacturers Association, and U.S. Bureau of the Census.

As noted in Table 1, trucks with a GVWR of 10,000 pounds or less dominate the number of business purchases of new trucks. Within this weight class are a wide variety of body styles that are designed for carrying passengers, cargo, or both. Such vehicles include four-wheel drive utilities (e.g., Ford Bronco, Chevrolet Blazer, etc.), vans, mini-vans, station wagons built on a truck chassis (e.g., GMC Suburban, Jeep Wagoneer, etc.), compact and conventional pick-up trucks, and other light-duty trucks. Most of these truck types are used by both households and businesses. According

to the Census Bureau's 1987 Truck Inventory and Use Survey (1987 TIUS), in terms of aggregate mileage driven, utility vehicles, vans, and pick-up trucks as a group were used about one-third for business purposes and about two-thirds for household purposes.

In OTA's study of the depreciation of business-use passenger cars, a significant difference in economic lives was found among cars held in fleets of 10 or more and all other ("non-fleet") business-use passenger cars. This difference was attributed primarily to differences in intensity of use, since fleet cars appeared to be driven on average nearly twice as many miles per year as non-fleet passenger cars.[1] While evidence from the 1987 TIUS suggests that business-use light trucks in fleets are driven somewhat more intensively than non-fleet trucks, the difference does not appear to be as significant as for passenger cars.[2] Thus, no distinction was made in this study between fleet and non-fleet status.

Trucks are distinguished from automobiles in this study primarily on the basis of information contained in vehicle identification numbers (VINs). In general, any vehicle identified in its VIN as a truck (whether complete or incomplete) or a multipurpose vehicle is regarded as a "truck." This definition generally includes sport utility vehicles and mini-vans, which are considered by some to be more similar in function to passenger automobiles than to trucks. These vehicles constitute about 10 percent of the business-use trucks in Classes 1 and 2, although their shares of current investment may be higher.[3]

Under safety standard regulations issued by the National Highway and Traffic Safety Administration (NHTSA), "multipurpose passenger vehicles" are distinguished from "passenger cars" by being constructed either on a truck chassis or with special features for occasional off-road operation. "Trucks" are defined as being designed for the transportation of property or special purpose equipment (49 CFR, sec. 571.3). Most passenger vans and sport utility vehicles would be considered as "passenger automobiles" under NHTSA's fuel economy standards regulations.

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[1] It was found that fleet vehicles (passenger cars held by owners of 10 or more cars) were driven on average about 25,000 miles per year, while non-fleet vehicles were driven on average only 15,000 miles per year.

[2] According to the 1987 TIUS, business-use trucks in Classes 1 and 2 held in fleets of 20 or more were driven on average about 16,000 miles per year; those held by businesses owning less than 20 trucks were driven on average 13,000 miles per year.

[3] Vans (excluding mini-vans and multi-stop or step vans) and pick-up trucks constitute roughly 80 percent of business-use trucks having a GVWR of 10,000 pounds or less. Pickups, vans, mini-vans, station wagons on a truck chassis, and sport utility vehicles constitute almost 97 percent of Class 1 business-use trucks. These data come from an analysis of the 1987 Census Truck Inventory and Use Survey.

However, those regulations cover most pick-up trucks as well. "Listed property" under section 280F and "passenger vehicles" subject to the luxury tax under section 4001 of the Internal Revenue Code generally include trucks, vans, and utility vehicles, as long as they have a gross vehicle weight of 6,000 pounds or less and are manufactured primarily for use on public streets, roads, and highways. Regulations proposed under section 4001 explicitly state that the term "truck or van" includes sport utility vehicles and mini-vans. The section 4064 gas "guzzler tax" does not cover sport utility vehicles and pick-up trucks, but does cover "passenger automobiles" as defined under the NHTSA fuel economy standards regulations.

Chapter III. Data Collection and Estimation Methods

A. Public meetings

Public meetings were held at the Treasury Department in January and March of 1990 to determine the scope of the passenger car and light truck study, discuss the study design and general methodology, and describe the kind of data needed for the study. The first public meeting was announced in the Federal Register on December 21, 1989, and invitations were extended to each of the major trade associations representing different sectors of the business-use car and light truck industry. Invitations were also sent to executives of the largest leasing and rental firms in the United States.

At these meetings, it was determined that the scope of the study should include all automobiles and light- and medium-duty trucks designed for use over-the-road and used in a trade or business. This coverage was generally understood by Treasury and industry participants to include both fleet and non-fleet vehicles, and vehicles that are either leased or owned by their users. Although no attempt was made to formally define "light trucks", data collection for trucks was limited to all those with a GVWR of 33,000 pounds or less.

Unlike many of the previous depreciation studies conducted by OTA, no survey of the industry was conducted or proposed. Instead, data were solicited directly from a limited number of owners of business-use vehicles based on vehicle specifications that were proposed and developed at the public meetings. This procedure was adopted because of the relatively short time frame granted by the Congress for completion of this study, and because of the availability of machine-readable data from several of the firms that agreed to participate in the study.

B. Description of the Data

Firms participating in the study were asked to provide OTA with detailed data on certain characteristics of cars and light general purpose trucks either disposed of during the last few years or remaining in their inventory at the time the data were provided. Each observation in each data set was to include, at a minimum, the vehicle's Vehicle Identification Number (VIN), original acquisition cost, the month and year of acquisition, and, in the case of dispositions, the proceeds (net of refurbishing costs), and the month and year of disposition. Some data sets also included the type of disposition and the mileage of the vehicles at disposition. All of the data were received by OTA from May through August of 1990.

Table 2. Distribution of Data Observations By Type of Firm and Analytical Purpose

Type of Firm	Analytical Purpose: Estimation of Age-Price Profile	Analytical Purpose: Estimation of Sales Distribution
Leasing Firms	97.2%	97.3%
Private Fleets	2.7%	2.7%
Non-Fleet Trucks	0.1%	0.0%
Total Observations	33,470	189,283

Data for light general purpose trucks were received from five leasing firms and four truck fleet owners.[1] A data set covering a small number of independent owner-operators was also made available to OTA. In addition, a few observations were also obtained from an analysis of a small sample of IRS returns covering non-fleet truck dispositions. Truck data from three of the leasing firms, from two of the private fleets, and from the non-fleet sources were used.[2] In total, there were about 112,000 total usable observations. Table 2 shows the distribution of observations by type of firm and analytical purpose. It is apparent that data from the leasing companies dominate the usable data, and thus significantly influence the results presented. Nevertheless, the available data do not

[1] Except for three of the leasing firms and one fleet owner who provided data directly to OTA, the data were first collected from the participating firms and examined by Price Waterhouse, which in turn provided the data, together with a paper summarizing the results of their preliminary analysis, to OTA. This mechanism was chosen by the industry in order to maintain the confidentiality of several of the companies participating in the study, which were not revealed to OTA.

[2] Data provided by one of the leasing firms and one of the private fleet firms were not analyzed because the data were incomplete. However, due to the large sample of complete data, these firms were not asked to resubmit their information.

provide any strong evidence in favor of the view that leasing firm data differ in a systematic manner from the data obtained from non-leasing firms. Table 2 also shows that estimates based on data from non-leasing firms would reflect almost exclusively the prices and retirements from truck fleets.[3]

C. Structuring the Data

Although the depreciation of trucks may vary by vehicle type and whether the vehicle is designed for passengers or cargo, preliminary analysis of the data suggested that aggregation of the data into four GVWR classes would make the analysis more manageable, and yet capture the more significant differences in intensity of usage. Trucks were classified to the following categories: Class 1 - trucks having a GVWR less than or equal to 6,000 pounds; Class 2 - trucks with a GVWR of more than 6,000 but less than or equal to 10,000 pounds; Class 3 - trucks with a GVWR of more than 10,000 pounds but less than or equal to 19,500 pounds; and Class 4 - trucks with a GVWR of more than 19,500 pounds but less than 33,000 pounds.

Equivalent economic lives, taking into account truck prices, retirements, and sales by age, were derived (as described below and in Appendix B) for trucks in each weight class. A light truck retirement probability distribution was obtained from a previous study of vehicle scrappage rates observed over the period 1978 to 1988.[4] These rates were available through age 25. At that age, about 22 percent of trucks were still registered. For the purpose of this study, all of those remaining trucks were assumed to be retired in year 26. This truncation of the retirement curve does not affect the final estimate of equivalent life, because of the additional assumption that the value of those remaining trucks reaches zero at 26 years of age. The retirement curve used indicates a median retirement age of 16.0 years and a mean age at retirement of 16.5 years.[5]

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[3] According to the 1987 TIUS, less than three percent of trucks in business use with a GVWR of 33,000 pounds or less are operated in fleets of more than 100 trucks. About 10 percent are operated in fleets of more than 20 trucks, while one-half of business-use trucks are operated in small fleets containing between 2 and 19 trucks. About 39 percent belong to firms operating only a single truck. Fleets of ten or more trucks, however, account for about 50 percent of new investment in business-use light trucks.

[4] Scrappage rates by age were produced by Shaw-Pin Miaou, "Study of Vehicle Scrappage Rates," Oak Ridge National Laboratory, Oak Ridge, TN, August 1990. These rates were reported in Stacy C. Davis and Patricia S. Hu, *Transportation Energy Data Book: Edition 11*, Oak Ridge National Laboratory, Oak Ridge TN, January 1991.

[5] The estimate of mean age at retirement is affected by the assumption that all trucks are retired at age 26. The median retirement age, however, is independent of that assumption.

Observations from all data sources were pooled in order to estimate the age-price curve and age-sales probability curve for each weight category. Data for these curves were generally available to about age ten for each GVWR class. Only observations representing bona fide arms-length sales were used to produce estimates of the age-price curves. Sales to lessees or trade-in prices were disregarded. The price curves were obtained by first adjusting observed prices for the effects of inflation; the overall consumer price index for urban workers was used in this regard. Sales prices were then expressed as ratios of the original acquisition costs, and these normalized prices were averaged at each age to obtain a curve showing the mean relative price as a function of age. These mean prices were extrapolated in a linear fashion for ages where price observations were insufficient, reaching zero (by assumption) at age 26.[6] The arbitrary nature of this extrapolation is not important, however, due to the discounting and the small value changes involved at ages above ten years.[7]

All sales data were used in estimating the probability of truck sales at each age. This curve was obtained by dividing the number of sales at each age by the number of assets in the sample examined that had remained in business use to at least that age. The probability of truck sales was set equal to zero for the years where fewer than five observations were available. No further smoothing of either the price curve or sales distribution curve was employed.

All sales of trucks in Classes 3 and 4 were assumed to be to other businesses. For trucks in Class 2, 75 percent of sales were assumed to be to other businesses, while 25 percent of sales were assumed to be to households. For trucks in Class 1, 50 percent of sales were assumed to be to other businesses and 50 percent to households. These repurchase percentages were assumed to be independent of the age of the truck.[8]

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[6] For each truck class at each age, the observed mean price was adopted as long as long as at least five observations were available at that age. This criterion generally could not be met for ages beyond ten or eleven years. Normally, the standard deviations of the mean price estimates were well under one percent, although higher values were often experienced at age one and at ages above eight years.

[7] Assuming that prices trail off to a five percent minimum salvage value, instead of a zero value, increases the estimated equivalent economic life for all light trucks by less than one-tenth of a year.

[8] Analysis indicated that the estimates of equivalent economic lives are only mildly sensitive to these assumptions. For example, raising the percentage of sales assumed to be made to other businesses from 50 percent to 75 percent for Class 1 trucks, or from 75 percent to 100 percent for Class 2 trucks, increases the estimated equivalent economic lives for these trucks by about one-tenth of a year. Assuming that all truck sales in these two classes are to households decreases the estimated equivalent economic life for Class 1 by one-tenth of a year but leaves the equivalent economic life for Class 2 trucks unchanged. However, assuming that no Class 1 trucks are sold to households increases the estimated equivalent economic life by four-tenths of a year (to 4.5 years) for Class 1 trucks.

A single weighted average equivalent economic life for all light general purpose trucks was obtained by weighting the observed characteristics (price-age and sales-age distributions and the probability of business-to-business sales) for each weight class with the observed share of 1989 investment in new general purpose light trucks for the class. The observed investment shares were adjusted to reflect the fact that some trucks in classes 3 and 4 were possibly heavy general purpose trucks with empty weights in excess of 13,000 pounds. The weighted-average characteristics were then used to obtain an overall equivalent economic life for trucks in Asset Class 00.241.[9]

D. Equivalent Economic Lives

As suggested in the General Explanation of the Tax Reform Act of 1986, the class life of an asset is to be determined from the decline in its value with age. This life (which for clarity has been referred to as the asset's equivalent economic life) can be either longer or shorter than its useful life (i.e., the period over which the asset provides service to business users).

For each weight category, an equivalent economic life was derived by equating the present value of the average loss in economic value over time for those trucks that remain in business use with the present value of tax deductions for those trucks in business use. The loss in economic value includes both the decline in the value of assets which remain in business use and the economic losses that are incurred upon the retirement of trucks from business use. The relevant tax deductions taken into account include both the depreciation allowances available to taxpayers, as determined by applying a straight-line schedule over the equivalent economic life, and the recognized losses resulting from sales of trucks in business use and from retirements of trucks from business use. Gains on sales and retirements are treated as negative losses.[10] Both change-in-value curves are discounted at a four percent annual discount rate.[11]

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[9] These average characteristics are shown in Appendix B, where they are used to illustrate the methods employed to compute equivalent economic lives.

[10] In the analysis, salvage values available upon the retirement of trucks are assumed to be zero. This assumption is immaterial. Salvage value affects the recovery of capital equally under economic depreciation accounting and under tax accounting. It therefore has no direct impact on the value of the estimated equivalent economic life. Salvage can have an indirect impact through an influence on used asset prices, however.

[11] The estimated equivalent economic lives are only mildly dependent upon the actual discount rate chosen. For example, halving the discount rate to two percent raises the estimated equivalent economic life for all trucks by less than one-tenth of a year. Doubling the rate to eight percent lowers the estimated equivalent economic life by two-tenths of a year.

The straight-line tax depreciation allowances are calculated over a recovery period equal to the equivalent economic life, starting with the year of acquisition, with the same recovery period for both new and used trucks. However, both straight-line and economic depreciation are considered only up to the truck's date of sale or retirement. See Appendix B for a more detailed description of the analysis.

Chapter IV. Results of the Analysis

This chapter presents the results of applying the methods described in Chapter III to obtain equivalent economic lives for trucks in each of the four weight categories and the economic life for all trucks in Asset Class 00.241. In addition, the estimated average useful life of trucks in each weight category and the method of depreciation used for financial accounting purposes by the participating firms are noted.

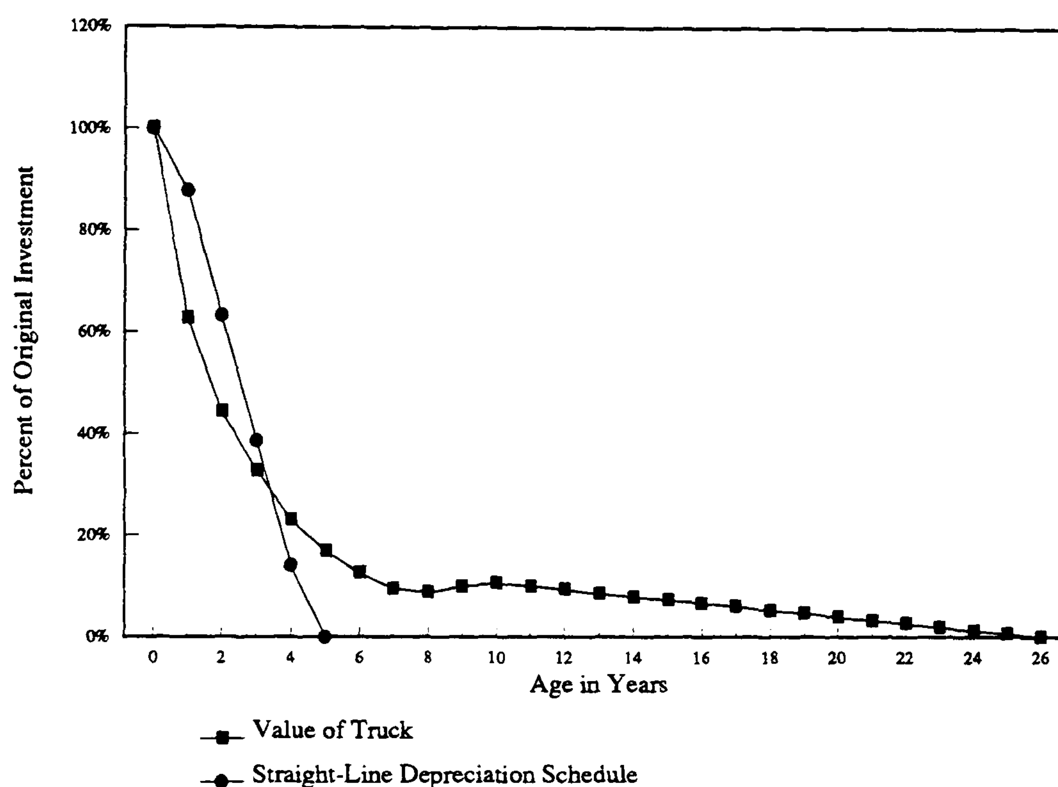

Figure 1. Age-price profile and straight-line depreciation schedule for trucks with a GVWR of 6,000 pounds or less (Class 1).

Figure 1 illustrates the relationship between the observed age-price profile and the adjusted basis obtained from the use of a straight-line depreciation schedule with a recovery period of 4.1 years (the estimated equivalent economic life) for trucks with a GVWR of 6,000 pounds or less. The age-price profile drops rapidly over the first year of service, and then at successively slower rates over ages two through eight. A small increase in the average price occurs between ages eight

and ten, but the absolute amount of economic depreciation is constant thereafter by assumption.[1] The straight-line depreciation schedule underlying the tax basis curve in Figure 1 allows for a half-year allowance in the first taxable year, and reaches zero during the fifth taxable year.

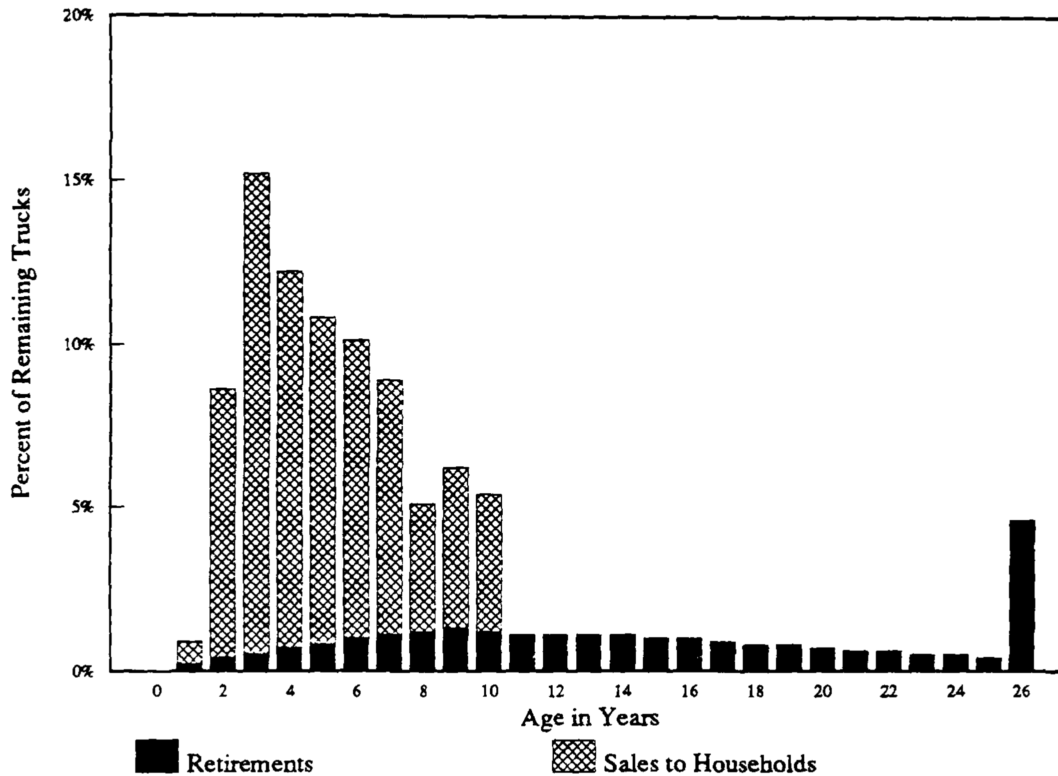

Figure 2. Disposition probabilities (retirements and sales to households), by age of truck, for trucks with a GVWR of 6,000 pounds or less (Class 1).

The depreciation of trucks remaining in business use does not reflect the total source of economic loss; losses incurred upon retirement of trucks in business use must also be considered in determining the equivalent economic life. Also, since sales of trucks also trigger the recognition of tax losses or gains, these must also be taken into account.[2]

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[1] Price observations were either few or nonexistent for ages above ten years for trucks in this weight class.

[2] Because the adjusted economic basis equals the market value when economic depreciation is used, under this method of accounting no gains or losses are realized when trucks are sold.

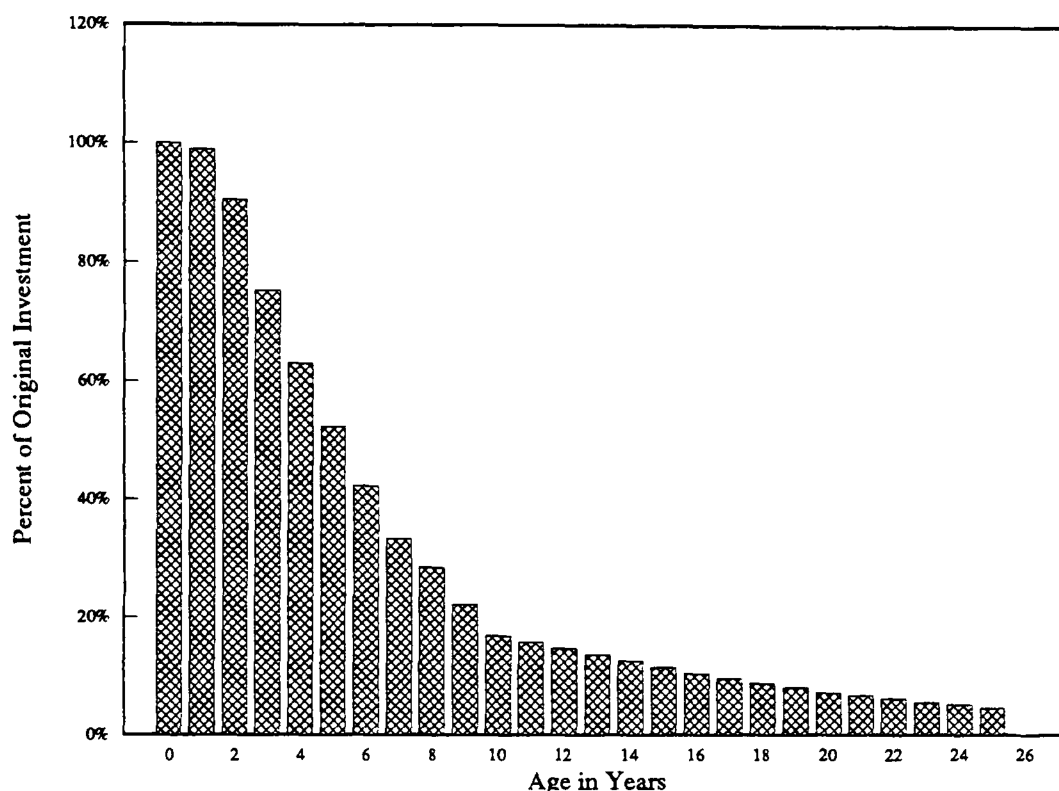

Figure 3. Fraction of initial investment in trucks that remains in business use, by age of truck, for trucks with a GVWR of 6,000 pounds or less (Class 1).

The estimated disposition frequencies (the fraction of remaining business-use Class 1 trucks at each age that are either retired or sold to households) are shown in Figure 2.[3] As described in Chapter 3, no sales are assumed to occur after age 10 (the oldest age at which the number of observations was five or more), and all trucks remaining in business use at age 25 were assumed for convenience to be retired at age 26. The resulting fraction of trucks with a GVWR of 6,000 pounds or less remaining in business use at each age are shown in Figure 3.

As is discussed more fully in Appendix B, investment may be recovered in several ways in addition to depreciation allowances. These include losses upon retirement of business-use trucks, gain or loss realized when trucks are sold, salvage value received upon the retirement of trucks, and payments received from the sale of trucks to households. Figure 4 shows the unrecovered

[3] Since one-half of business sales of Class 1 trucks are assumed to be to households, the values in Figure 2 for sales to households merely need to be doubled in order to obtain the probability of total truck sales at each age.

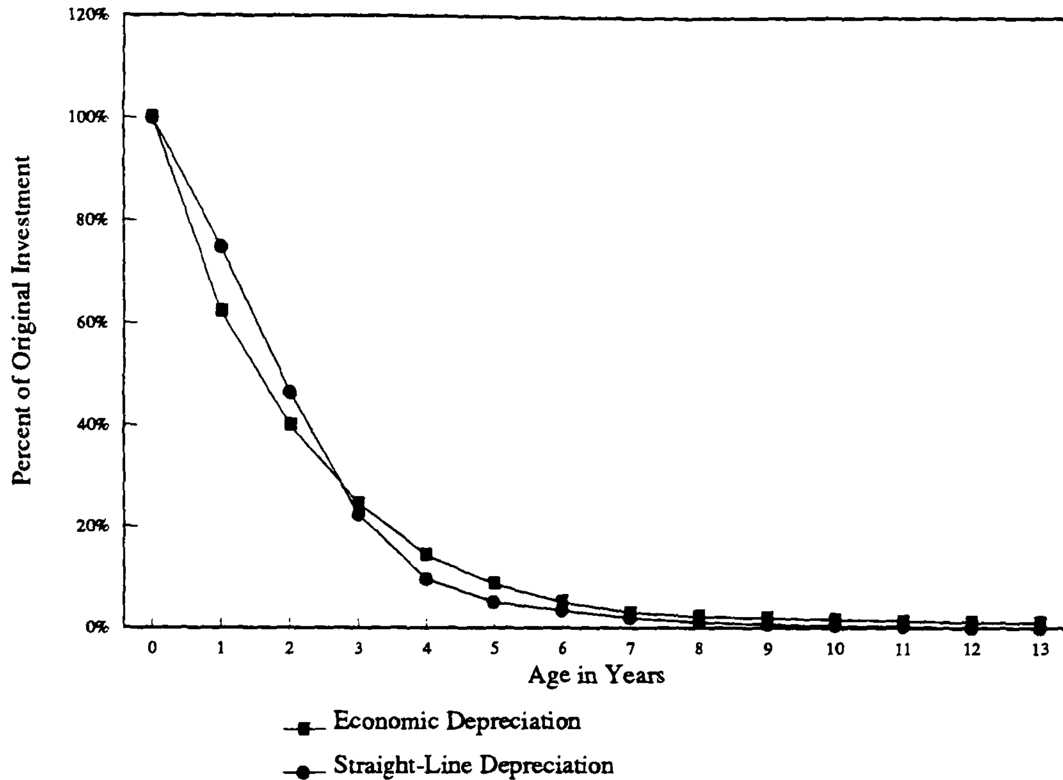

Figure 4. Unrecovered investment value as a fraction of the original investment, by age of truck, based on economic depreciation and on straight-line depreciation, for trucks with a GVWR of 6,000 pounds or less (Class 1).

investment, measured as a fraction of the original investment in new trucks, by age of truck, based on the use of economic depreciation and straight-line depreciation (and the recognition of losses and gains) for trucks in this weight category. The two curves coincide at zero at age 26, when the last trucks are assumed to be retired. The equivalent economic life is determined by equating the present values (discounted at a 4 percent rate) of the annual increase in recovered investment under the two methods shown in Figure 4.

Table 3 lists the estimated equivalent economic lives by weight class, as well as the overall equivalent economic life for trucks in Asset Class 00.241. These results show a positive relationship between the estimated equivalent economic lives and gross vehicle weight; the equivalent economic lives range from 4.1 years for Class 1 trucks to 6.6 years for Class 4 trucks. This is partly due to differences in price profiles and sales distributions and partly due to the fact that lighter trucks are

Table 3. Equivalent Economic Lives and Useful Lives For Trucks By GVWR Class
(Weight in Pounds, Lives in Years)

GVWR Class	Economic Equivalent Life	Average Useful Life
6,000 or less	4.1	7.1
6,001-10,000	4.4	10.9
10,001-19,500	4.8	16.5
19,501-33,000	6.6	16.5
Asset Class 00.241	4.6	9.4

also sold to households. It may also reflect the fact that observations used for analyzing Classes 3 and 4 may include some heavy general purpose trucks.[4] An overall equivalent economic life for trucks in Asset Class 00.241 was estimated to be 4.6 years.

In addition to the equivalent economic lives, Congress has expressed an interest in the useful lives of the assets studied. If the useful life is taken to be the period the trucks are used for business purposes (regardless of the number of owners), the answer obtained is somewhat dependent upon the assumed fraction of trucks sold that are purchased by households. It also is somewhat sensitive to the assumption that all trucks remaining in use at age 25 are retired during the following year. Based on the values of the repurchase percentages assumed for each weight class, useful lives for trucks in each weight class, as well as an overall weighted average useful life for trucks in Asset Class 00.241, may be obtained. These useful lives are noted in Table 3.[5] Since no sales for personal use are presumed to occur for trucks with a GVWR greater than 10,000 pounds, the useful life equals the mean retirement age for trucks in Classes 3 and 4.

[4] In addition to the categories shown in Table 3, an equivalent economic life was computed separately for multipurpose vehicles with a GVWR of less than 6,000 pounds. These vehicles are comprised mainly of sport utility vehicles and mini-vans; they constitute about 51 percent of the sample of Class 1 trucks. Their equivalent economic life was estimated to be 4.1 years, indicating little difference between multipurpose vehicles and light pickups and vans.

[5] The useful life for Class 1 multipurpose vehicles was estimated to be 6.3 years.

Congress was also interested in the method used to depreciate the assets for financial accounting purposes. All of the companies which reported their methods of accounting for trucks used the straight-line method of depreciation. The recovery periods ranged from 3 to 8 years, with an investment-weighted average recovery period of 4.4 years.

Chapter V. Conclusions and Recommendation

The principal findings of this study are that trucks with a GVWR of 6,000 pounds or less have an equivalent economic life of 4.1 years, while trucks with a GVWR of between 6,000 and 10,000 pounds have an equivalent economic life of 4.4 years. Trucks with a GVWR between 10,000 and 19,500 pounds have an equivalent economic life of 4.8 years, and those with a GVWR of between 19,500 and 33,000 pounds have an equivalent economic life of 6.6 years. These categories cover virtually all vehicles included in Asset Class 00.241 (trucks having an unloaded weight of less than 13,000 pounds). The values for truck classes 3 and 4 may also reflect the influence of some heavy general purpose trucks with an unloaded weight of 13,000 pounds or more, which are currently classified to Asset Class 00.242. The useful lives of the trucks ranged from 7.1 years (for Class 1 trucks) to 16.5 years (for Class 3 and Class 4 trucks). The overall useful life for light general purpose trucks is 9.4 years.

When the estimated equivalent economic lives for each weight class are combined by weighting the results for each class by the adjusted share of business investment in new trucks in that class, a single overall equivalent economic life of 4.6 years is obtained. Treasury thus recommends that, if the current definition of light general purpose trucks is retained, the class life for Asset Class 00.241 be changed from 4 years to 4.5 years. Tractor units, trailers, trailer-mounted containers, tractor-trailer combinations, and heavy general purpose trucks with an unloaded weight of more than 13,000 pounds (i.e., trucks in Asset Classes 00.242, 00.26, and 00.27) were not expressly examined in this study, and no recommendation is thus made in this report regarding the appropriate class life for such trucks.

Under current law, this recommendation, if adopted, would have no effect on the depreciation deductions claimed by taxpayers for light general purpose trucks. Section 168(e)(3)(B)(i) assigns automobiles and light general purpose trucks to the five-year property recovery class, regardless of their class lives. If this provision were repealed, light trucks would be assigned to the MACRS three-year property recovery class if the recommended change in the class life were not enacted, and to the MACRS five-year property recovery class if the recommendation were enacted.[1] Likewise, under Section 168(g)(3)(D), the alternative depreciation system recovery period for automobiles and light general purpose trucks is currently five years, regardless of their class lives.

[1] The three-year property recovery class generally includes property with a class life of four years or less. The five-year property recovery class includes property with a class life of greater than four years but less than ten years.

If this provision were repealed, taxpayers using the alternative depreciation system could depreciate their light trucks over four years (based on the current law class life) or over 4.5 years (based on the recommended class life).

Appendix A. The Mandate for Depreciation Studies

Exhibit 1.

Section 168(i)(1)(B) of the Internal Revenue Code as Revised by the Tax Reform Act of 1986

(i) Definitions and Special Rules.

For purposes of this section--

(1) **Class Life.**

(B) Secretarial authority. The Secretary, through an office established in the Treasury--

(i) shall monitor and analyze actual experience with respect to all depreciable assets, and

(ii) except in the case of residential rental property or nonresidential real property--

(I) may prescribe a new class life for any property,

(II) in the case of assigned property, may modify any assigned item, or

(III) may prescribe a class life for any property which does not have a class life within the meaning of subparagraph (A).

Any class life or assigned item prescribed or modified under the preceding sentence shall reasonably reflect the anticipated useful life, and the anticipated decline in value over time, of the property to the industry or other group.

Exhibit 2.

Section 168(i)(1) of the Internal Revenue Code as Revised by the Technical and Miscellaneous Revenue Act of 1988 and the Revenue Reconciliation Act of 1990.

Definitions and Special Rules.

For purposes of this section--

(1) **Class Life.** Except as provided in this section, the term "class life" means the class life (if any) which would be applicable with respect to any property as of January 1, 1986, under subsection (m) of section 167 (determined without regard to paragraph (4) and as if the taxpayer had made an election under such subsection). The Secretary, through an office established in the Treasury, shall monitor and analyze actual experience with respect to all depreciable assets. The reference in this paragraph to subsection (m) of section 167 shall be treated as a reference to such subsection as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1990 [11/5/90].

Exhibit 3.

Provisions for Changes in Classification from the General Explanation of the Tax Reform Act of 1986 (pp. 103-104)

The Secretary, through an office established in the Treasury Department is authorized to monitor and analyze actual experience with all tangible depreciable assets, to prescribe a new class life for any property or class of property (other than real property) when appropriate, and to prescribe a class life for any property that does not have a class life. If the Secretary prescribes a new class life for property, such life will be used in determining the classification of property. The prescription of a new class life for property will not change the ACRS class structure, but will affect the ACRS class in which the property falls. Any classification or reclassification would be prospective.

Any class life prescribed under the Secretary's authority must reflect the anticipated useful life, and the anticipated decline in value over time, of an asset to the industry or other group. Useful life means the economic life span of property over all users combined and not, as under prior law, the typical period over which a taxpayer holds the property. Evidence indicative of the useful life of property, which the Secretary is expected to take into account in prescribing a class life, includes the depreciation practices followed by taxpayers for book purposes with respect to the property, and useful lives experienced by taxpayers, according to their reports. It further includes independent evidence of minimal useful life -- the terms for which new property is leased, used under a service contract, or financed -- and independent evidence of the decline in value of an asset over time, such as is afforded by resale price data. If resale price data is used to prescribe class lives, such resale price data should be adjusted downward to remove the effects of historical inflation. This adjustment provides a larger measure of depreciation than in the absence of such an adjustment. Class lives using this data would be determined such that the present value of straight-line depreciation deductions over the class life, discounted at an appropriate real rate of interest, is equal to the present value of what the estimated decline in value of the asset would be in the absence of inflation.

Initial studies are expected to concentrate on property that now has no ADR midpoint. Additionally, clothing held for rental and scientific instruments (especially those used in connection with a computer) should be studied to determine whether a change in class life is appropriate.

Certain other assets specifically assigned a recovery period (including horses in the three-year class, qualified technological equipment, computer-based central office switching equipment, research and experimentation property, certain renewable energy and biomass properties, semi-conductor manufacturing equipment, railroad track, single-purpose agricultural or horticultural structures, telephone distribution plant and comparable equipment, municipal waste-water treatment plants, and municipal sewers) may not be assigned a longer class life by the Treasury Department if placed in service before January 1, 1992. Additionally, automobiles and light trucks may not be reclassified by the Treasury Department during this five-year period. Such property placed in service after December 31, 1991, and before July 1, 1992, may be prescribed a different class life if the Secretary has notified the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate of the proposed change at least 6 months before the date on which such change is to take effect.

Appendix B. Determination of Equivalent Economic Lives

This appendix describes the calculations used in this study to estimate an equivalent economic life for light general purpose trucks. As an aid to the reader, the set of data used to determine the overall equivalent economic life for light trucks has been presented here in order to illustrate the more formal algebra. Results of the calculations using these data are reported in the tables at the end of this appendix.

The computations described assume the availability of certain data. These data include the expected relative prices for trucks remaining in business use by age (the age-price profile), the expected salvage values of retired trucks by age, the probability of retirement of business-use trucks by age (the retirement distribution), the probability of business-use truck sales by age (the gross sales distribution), and the probability that business-use trucks sold will be purchased for business purposes (the repurchase percentage). In this study, the age-price profile and the gross sales distribution are obtained from data provided by the participating firms. The retirement probability is taken from Davis and Hu (1991), while a zero salvage value and fixed repurchase percentage (which vary by weight class) are assumed. In keeping with the dictates of the General Explanation of the Tax Reform Act of 1986, the observed truck prices are adjusted for general inflation prior to their incorporation into the analysis.

The analysis of the depreciation of passenger cars focused on the relative number and relative value of business-use passenger cars as continuous functions of a single variable -- the age of the cars. Because used trucks as well as new trucks are acquired by businesses, in this study a second variable -- the age of the truck at acquisition -- is needed. For convenience, a discrete rather than continuous time framework is used. Thus, the analysis in this study utilizes matrices which specify, among other things, the number of trucks remaining in business use, business-use truck retirements, and business-use truck sales for trucks of a given age that were acquired at the same or an earlier age.

OTA has interpreted the General Explanation as defining the equivalent economic life as that life which, when used as the recovery period for depreciation purposes (in association with the straight-line depreciation method, a half-year depreciation timing convention, and other applicable tax rules), equates the present value of the tax deductions associated with the business use of a group of assets with the present value of the loss in the group's economic value while in business use. This definition takes as given the current law treatment of asset retirements and sales; in particular, it relies on the principle that tangible asset sales and retirements are recognized as taxable events,

and that any gains or losses associated with these taxable events enter together with depreciation allowances into the taxable income of the asset owner.[1] It also relies on the principle that a truck sold from one business to another does not carry over its adjusted tax basis. Instead, the new owner adopts his or her own cost as the new depreciable basis of the truck; the depreciation schedule for the used truck is the same as that for new trucks. Thus, a truck that is sold once or twice during its lifetime will have a different pattern of tax deductions associated with it than would an identical truck that has been held entirely by a single owner.

Constructing the Data Matrices

The number of trucks in business use at the beginning of an accounting period is designated as $N(t,v)$, where t refers to the actual physical age of the trucks in the account, and v refers to the age at which the trucks were most recently acquired.[2] Thus, $N(0,0)$ refers to an initial investment in new trucks at the beginning of some given time period. $N(1,0)$ refers to those trucks purchased as new assets in the prior period that were neither retired from use nor sold before the end of that period. $N(1,1)$ refers to one-period old trucks that were sold at the end of the initial period and purchased by another business.

Using this notation, the business-use history of the initial truck investment, $N(0,0)$, can be represented by the following matrix:

$$N(t,v) = \begin{pmatrix} N(0,0) & 0 & \cdots & \\ N(1,0) & N(1,1) & 0 & \cdots \\ N(2,0) & N(2,1) & N(2,2) & \cdots \\ \cdot & \cdot & \cdot & \cdot \\ \cdot & \cdot & \cdot & \cdot \\ \cdot & \cdot & \cdot & \cdot \\ N(m,0) & N(m,1) & N(m,2) & \cdots \end{pmatrix}.$$

[1] This assumes that taxpayers account separately for each truck, rather than use general asset accounts.

[2] Trucks are assumed to be placed in service in the middle of the taxable year. Accounting periods for the analysis, therefore, run from the middle of each taxable year to the middle of the following taxable year. Economic depreciation, sales, and retirements are assumed to occur uniformly over each accounting year. Tax depreciation allowances were are assumed to occur uniformly over each taxable year.

The passage of time implies a movement from one row to the next in $N(t,v)$. Movement down a particular column traces the number of trucks held in established depreciation accounts. The transfer of a truck from one owner to another means a shift of a truck to the diagonal element lying in a column to the right. For example, the sale of a truck from cell $N(1,0)$ implies that $N(2,0)$ will be at least one less than $N(1,0)$ and that $N(2,2)$ will be increased by one. In this matrix, m designates the maximum age that a business-use truck may reach. Consequently, the order of the matrix is $(m+1 \times m+1)$. The last row (and column) of this matrix will be comprised of all zeros.

Given the diagonal elements of $N(t,v)$, the probabilities of truck retirements and sales will determine the values taken by the lower left-hand off-diagonal elements.[3] Let $R(t,v)$ and $S(t,v)$ designate the number of trucks expected to be retired and sold, respectively, during the t'th period and which were most recently acquired at age v. Then,

$$N(t,v) = N(t-1,v) - R(t,v) - S(t,v), \quad t > v.$$

The incidence of truck retirements and sales are assumed to be a function solely of their age. Let $r(t)$ be the probability that a truck of age $t-1$ will be retired before reaching age t. Then,

$$\begin{aligned} R(t,v) &= r(t) \times N(t-1,v), && t > v \\ &= 0, && t \le v. \end{aligned}$$

Similarly, let $s(t)$ represent the probability that an asset of age $t-1$ which is not retired before age t will be sold during the following period. Then,

$$\begin{aligned} S(t,v) &= s(t) \times [1-r(t)] \times N(t-1,v), && t > v \\ &= 0, && t \le v. \end{aligned}$$

It follows that

$$N(t,v) = [1-s(t)] \times [1-r(t)] \times N(t-1,v), \quad t > v.$$

[3] The matrix elements above the diagonal are zero by definition.

The diagonal elements, $N(t,t)$, are determined by the probabilities associated with the purchase of used trucks by business. The analysis assumes that (i) used trucks purchased for business purposes are bought only from other businesses, and (ii) the probability of a business-to-business sale is dependent only upon the age of the truck.[4] Let the fraction of trucks sold that are purchased for business use be represented by $b(t)$. Then,

$$N(t,t) = b(t) \times S(t),$$

where $S(t)$ is the total number of sales of trucks of age t (i.e., the sum over v of $S(t,v)$ for $v < t$). Thus, given the initial number of new trucks, $N(0,0)$, and the distributions, $r(t)$, $s(t)$, and $b(t)$, the complete $N(t,v)$, $R(t,v)$, and $S(t,v)$ matrices can be computed.

The number of trucks remaining in business use at each age, $N(t)$, may be obtained by calculating the row sums of $N(t,v)$, i.e., by taking the sum over v of $N(t,v)$. Similarly, the number of business truck retirements by age, $R(t)$, and of gross business truck sales by age, $S(t)$, are obtained from the row sums of $R(t,v)$ and $S(t,v)$, respectively. Used truck purchases by age, $U(t)$, are zero for $t = 0$ and equal to the diagonal elements, $N(t,t)$, for $t > 0$, while net truck sales to households, $H(t)$, are equal to the difference between $S(t)$ and $U(t)$. The first column of $N(t,v)$ represents the number of remaining trucks that were purchased as new trucks, while the number of trucks remaining at each age that were purchased used, $W(t)$, can be obtained by subtracting $N(t,0)$ from $N(t)$.

The data used here to construct $N(t,v)$, $R(t,v)$, and $S(t,v)$ are displayed in columns (2) through (4) of Table A-1. The percentages shown are $r(t)$, $s(t)$, and $[1 - b(t)] \times s(t)$, respectively. The maximum age is assumed to be 26, so that $r(26)$ equals 100 percent. Table A-2 shows a number of the results referred to in the previous paragraph. All numbers have been rounded to the nearest integer for easier reading.

Calculation of Economic Loss

The calculation of the loss in economic value requires knowledge of the number of remaining trucks at each age, $N(t)$, and the number of retirements at each age, $R(t)$. Since no gains or losses are incurred on a truck sale when economic depreciation is used, sales are important in calculating the economic loss only insofar as they determine the number of used trucks of the given vintage that remain in business use. The calculation of economic loss also requires knowledge of the expected price of remaining business assets, $P(t)$, and of the salvage value, $V(t)$, that can be expected

[4] A constant repurchase percentage is actually used in the analysis for this report.

to be received from a truck retirement. The hypothetical end-of-year values used in the numerical example for these variables are shown in columns (5) and (6) of Table A-1. These prices have been normalized so that the price of a new truck is unity.

The total loss in economic value is the sum of the loss in value that occurs while a truck is employed in a trade or business (economic depreciation) and the loss in value occurring when trucks are retired from business use. Economic depreciation, $EDP(t)$, is a straightforward function of the average number of trucks that are in business use during the prior period, times the depreciation for a representative truck:

$$EDP(t) = \frac{[N(t-1)+N(t)]}{2}[P(t-1)-P(t)], \quad t = 1\ldots m$$

$$= 0, \qquad t = 0.$$

Economic loss on retirement, $ELR(t)$, is the product of the number of truck retirements during each period and the difference between the average expected price of trucks remaining in use and the average expected truck salvage value at that time:

$$ELR(t) = R(t) \times [P_a(t) - V_a(t)], \qquad t = 1\ldots m$$

$$= 0, \qquad t = 0,$$

where,

$$P_a(t) = \frac{P(t)+P(t-1)}{2}$$

and

$$V_a(t) = \frac{V(t)+V(t-1)}{2}.$$

Total loss in economic value, $ELV(t)$, is simply $EDP(t) + ELR(t)$. Its present value, $PVELV$, can be calculated directly as

$$PVELV = \sum_{t=0}^{m} \beta(t) ELV(t),$$

where $\beta(t)$ is the relevant discount factor.[5] Note that the loss in economic value at time zero, $ELV(0)$, is equal to zero and that the loss in value occurring at the beginning of period one, $ELV(1)$, is discounted by a single period discount factor.

Values of economic depreciation, losses upon retirement, and total losses in value for the data set are shown in columns (2) through (4) of Table A-3. *PVELV* is shown at the bottom of column (4) in the row labeled "PV."[6] The final column of that table displays the remaining economic value at each age, $REV(t)$. This value declines to $148, rather than zero, and represents the revenues obtained through sales to non-business entities.[7] Since there are 594 such sales, these sales have an average price equal to about 25 percent of the initial investment value. The average age of trucks sold at the time of such sales is 5.3 years.

Calculation of Tax Deductions and the Equivalent Economic Life

With the present value of the loss in economic value calculated, the equivalent economic life can be computed through an iterative procedure. In this procedure, a trial value is chosen, and the total tax deductions associated with the use of that life for depreciation purposes are calculated. The present value of those tax deductions is computed and compared to the present value of the loss in economic value that was previously calculated. The initial trial value is then adjusted, based on the algebraic sign of the difference in the two present values. The iteration ends when the absolute value of this difference fails to exceed some small preset tolerance value.

The first step in deriving the tax deductions associated with any given trial equivalent economic life is the calculation of the tax depreciation schedule, $A(t)$. In this regard, a half-year convention is employed; thus, the initial taxable year's deduction per dollar of investment, $A(0)$, is

[5] A four percent annual discount rate was employed in the example. The resulting discounting function, $\beta(t)$, is shown in the last column of Table A-1.

[6] The present values shown in Tables A-3 and A-4 are expressed on a per asset basis; that is, they have been divided by the initial investment value, $N(0,0)$.

[7] If positive salvage values were assumed in the analysis, this would be another source of capital cost recovery.

held to be $0.5/L$, where L is the class life. Scheduled allowances for subsequent taxable years are set at $1/L$ per dollar of investment, and the final nonzero scheduled deduction is established so as to make the sum of the $A(t)$ equal unity.[8]

The resulting schedule is applied separately to each column of $N(t,v)$, weighted by the average price element, $P_a(t)$. The initial deduction is available to taxpayers with respect to the initial investment in new trucks and with respect to each subsequent investment in used trucks. Thus, the diagonal elements, $P_a(t)N(t,t)$, are each multiplied by $A_a(0)$, whereas the elements one period removed from the diagonal, $P_a(t)N(t+1,t)$, are each multiplied by $A_a(1)$, the second element from the averaged depreciation schedule. The remaining off-diagonal elements are similarly constructed. The depreciation allowances are represented by the elements of the tax depreciation matrix, $D(t,v)$. The sum over v of the elements of this matrix provide the total depreciation allowances available by age, $TDP(t)$.

Losses or gains on sales are computed from the basis matrix, $Z(t,v)$ (whose elements indicate the remaining tax basis), the previously computed sales matrix, $S(t,v)$, and the retirements matrix, $R(t,v)$, along with the price function, $P(t)$, and the salvage value function, $V(t)$. These calculations take into account the following facts: (i) the basis of each asset differs according to when the asset was last placed in service, and (ii) since a truck's tax basis does not, in general, equal its market value, asset sales as well as retirements result in the recognition of loss or gain for tax purposes.

To compute the remaining tax basis for each truck category, the depreciation matrix, $D(t,v)$, is divided element-by-element by the asset matrix, $N(t,v)$. This result expresses the depreciation allowances on a per asset basis. Cumulative sums for each column of this result are computed and then subtracted from the column's applicable per asset average cost, $P_a(v)$, resulting in a matrix showing the beginning-of-period basis per truck, $Z(t,v)$. In algebraic form, $Z(t,v)$ is equal to

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[8] The tax basis curve shown in Figure 1 of the main text shows values at the end of each taxable or calendar year. However, tax depreciation allowances are averaged in order to correspond to the accounting periods used in the analysis. Thus, for example, the initial accounting year's tax depreciation per dollar of investment consists of the first taxable year's depreciation allowance (equal to 0.5/L, where L is the equivalent economic life) plus one-half of the second taxable year's allowance ($0.5 \times 1/L$) for total depreciation in the first accounting year of 1/L. This averaging effect is not reflected in the tax basis curve shown in Figure 1. The averaged depreciation allowances are referred to as $A_a(t)$

$$Z(t,v) = P_a(v) - \sum_{i=v}^{T-1} \frac{D(i,v)}{N(i,v)}, \qquad t > v$$

$$= P_a(v), \qquad t = v.$$

In this expression, T is the minimum of t and τ, where τ is the smallest value of t for which $N(t, v) = 0$.

The tax loss (gain) matrix, $TLG(t, v)$, is calculated as

$$TLG(t,v) = [Z(t,v) - P_a(t)] \times S(t,v) + [Z(t,v) - V_a(t)] \times R(t,v).$$

Sums over the columns of this matrix yield the total net tax loss (gain) by age, $TLG(t)$. Summing $TDP(t)$ and $TLG(t)$ yields total tax deductions by age, $TDD(t)$. The present value, *PVTDD*, is calculated with a formula identical to that used in calculating *PVELV*.

The final results from the iterative procedure for the numerical example are shown in Table A-4. The life which yields a *PVTDD* of equal value to *PVELV* is 4.6 years.[9] The straight-line depreciation schedule associated with this life is shown in column (2) of Table A-4.[10] The depreciation allowances, loss deductions, and total deductions are shown in columns (3)-(5).

Column (6) reports the remaining tax basis, $RTB(t)$, associated with the initial investment of $1,000. As with the remaining economic value column in Table A-3, this series ends with $148 of remaining value. This value represents capital investment that is recovered not through tax deductions, but through sales to non-business truck users.[11] The remaining tax basis is initially above the remaining economic value curve, but drops below it by year four. This implies that, after that point, truck sales will generate reportable taxable gains.[12]

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[9] The average period of business use for a truck in the example is 9.4 years, while the average retirement age for a truck is 16.5 years. Use of either the average holding period or the average retirement age as a useful life for straight-line depreciation purposes would yield a present value of tax deductions that differs, perhaps substantially, from *PVELV*.

[10] The present value of the depreciation schedule is 0.8980, well above 0.7796, the present value of the total economic loss in value. However, these values are not comparable. Only about 85 percent of the original investment outlay in the example is recovered in the form of tax deductions, and reported taxable gains offset a good portion of the depreciation deductions.

[11] The unrecovered investment values shown in Figure 4 in the main text reach zero at age twenty-six. Those curves were obtained by subtracting the proceeds from sales of trucks to households from the remaining values shown in the final columns of Tables A-3 and A-4.

[12] In the early years, the remaining tax basis exceeds the remaining economic value of the original investment. In this period, a sale generates a tax loss. It is assumed that transaction costs are significant enough to inhibit tax-motivated wash sales in tangible depreciable assets, so that the probability of sales remains unchanged.

Table A-1

Truck Prices and Retirement and Sale Probabilities by Age

Initial Investment: $1,000
Period Discount Rate: 4.0 percent

	Probability Distributions (Percent)			Prices (Normalized)		
Age t	Retirements $r(t)$	Gross Sales $s(t)$	Net Sales $[1-b(t)]s(t)$	Remaining Assets $P(t)$	Salvage $V(t)$	Discount Factors $\beta(t)$
(1)	(2)	(3)	(4)	(5)	(6)	(7)
0	0.0	0.0	0.0	1.000	0.000	1.000
1	0.2	1.0	0.3	0.655	0.000	0.981
2	0.4	10.3	3.5	0.467	0.000	0.943
3	0.6	21.5	7.3	0.344	0.000	0.907
4	0.9	26.5	9.0	0.280	0.000	0.872
5	1.3	41.5	14.0	0.241	0.000	0.838
6	1.9	43.0	14.5	0.172	0.000	0.806
7	2.6	36.5	12.3	0.118	0.000	0.775
8	3.5	25.6	8.7	0.106	0.000	0.745
9	4.5	28.4	9.6	0.109	0.000	0.717
10	5.4	33.7	11.4	0.103	0.000	0.689
11	6.3	15.4	5.2	0.093	0.000	0.662
12	7.0	0.0	0.0	0.087	0.000	0.637
13	7.6	0.0	0.0	0.081	0.000	0.612
14	8.0	0.0	0.0	0.075	0.000	0.589
15	8.3	0.0	0.0	0.068	0.000	0.566
16	8.4	0.0	0.0	0.062	0.000	0.544
17	8.6	0.0	0.0	0.056	0.000	0.524
18	8.7	0.0	0.0	0.050	0.000	0.503
19	8.7	0.0	0.0	0.044	0.000	0.484
20	8.7	0.0	0.0	0.037	0.000	0.465
21	8.8	0.0	0.0	0.031	0.000	0.448
22	8.8	0.0	0.0	0.025	0.000	0.430
23	8.8	0.0	0.0	0.019	0.000	0.414
24	8.8	0.0	0.0	0.012	0.000	0.398
25	8.8	0.0	0.0	0.006	0.000	0.383
26	100.0	0.0	0.0	0.000	0.000	0.368

Table A-2

Retirements, Sales, and Assets Remaining in Business Use by Age of Trucks

	Remaining Business Assets			Business Asset Sales		
Age t	Total Assets $N(t)$	Used Assets $W(t)$	Business Asset Retirements $R(t)$	Gross Sales $S(t)$	Household Purchases $H(t)$	Business Purchases $U(t)$
(1)	(2)	(3)	(4)	(5)	(6)	(7)
0	1000	0	0	0	0	0
1	994	7	2	10	3	7
2	956	74	4	102	35	68
3	881	193	6	204	69	135
4	795	294	8	232	78	153
5	675	385	10	326	110	216
6	566	404	13	285	96	188
7	483	383	15	201	68	133
8	426	354	17	119	40	79
9	368	319	19	115	39	76
10	308	277	20	117	40	78
11	274	249	19	44	15	29
12	255	232	19	0	0	0
13	235	214	19	0	0	0
14	217	197	19	0	0	0
15	199	181	18	0	0	0
16	182	166	17	0	0	0
17	166	152	16	0	0	0
18	152	138	14	0	0	0
19	139	126	13	0	0	0
20	127	115	12	0	0	0
21	116	105	11	0	0	0
22	105	96	10	0	0	0
23	96	88	9	0	0	0
24	88	80	8	0	0	0
25	80	73	8	0	0	0
26	0	0	80	0	0	0
Sum	-	-	406	1756	594	1162

Table A-3

Loss in Economic Value by Age of Trucks

Age t	Economic Depreciation $EDP(t)$	Economic Losses on Retirements $ELR(t)$	Total Loss in Economic Value $ELV(t)$	Remaining Economic Value $REV(t)$
(1)	(2)	(3)	(4)	(5)
0	0	0	0	1000
1	344	2	346	654
2	183	2	185	468
3	113	2	115	354
4	54	2	56	297
5	29	3	31	266
6	43	3	45	221
7	29	2	31	190
8	5	2	7	183
9	-1	2	1	182
10	2	2	4	178
11	3	2	5	173
12	2	2	3	170
13	2	2	3	167
14	1	1	3	164
15	1	1	3	161
16	1	1	2	159
17	1	1	2	157
18	1	1	2	155
19	1	1	2	154
20	1	0	1	152
21	1	0	1	151
22	1	0	1	150
23	1	0	1	149
24	1	0	1	149
25	1	0	1	148
26	0	0	0	148
Sum	817	36	852	
PV	0.7536	0.0260	0.7796	

Table A-4

Tax Deductions and the Resulting Equivalent Economic Life

Equivalent Economic Life: 4.6 years

Age t	Depreciation Schedule $A(t)$	Depreciation Allowances $TDP(t)$	Loss Deductions $TLG(t)$	Total Tax Deductions $TDD(t)$	Remaining Tax Basis $RTB(t)$
(1)	(2)	(3)	(4)	(5)	(6)
0	0.0	0	0	0	1000
1	10.9	218	1	219	781
2	21.8	216	3	219	562
3	21.8	201	-9	193	369
4	21.8	169	-32	137	232
5	21.8	84	-54	30	202
6	2.0	29	-28	1	201
7	0.0	22	-8	14	187
8	0.0	17	-3	14	173
9	0.0	13	-5	7	166
10	0.0	9	-7	2	164
11	0.0	6	-2	4	160
12	0.0	4	1	5	155
13	0.0	3	0	3	151
14	0.0	2	0	2	149
15	0.0	1	0	1	148
16	0.0	0	0	0	148
17	0.0	0	0	0	148
18	0.0	0	0	0	148
19	0.0	0	0	0	148
20	0.0	0	0	0	148
21	0.0	0	0	0	148
22	0.0	0	0	0	148
23	0.0	0	0	0	148
24	0.0	0	0	0	148
25	0.0	0	0	0	148
26	0.0	0	0	0	148
Sum	100.0	995	-143	852	-
PV	0.8980	0.8969	-0.1173	0.7796	-

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Report to The Congress on The Tax Treatment of Bad Debts by Financial Institutions

Department of the Treasury
September 1991

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

September 1991

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

The Conference Report for the Tax Reform Act of 1986 directed the Treasury Department to study and report on the appropriate criteria to be used in determining whether a debt is worthless for Federal income tax purposes, and specifically to consider the circumstances under which it would be appropriate to provide a conclusive or rebuttable presumption of worthlessness (H.R. Conf. Rep. No. 841, 99th Cong. 2d Sess. II-316 (1986)).

Pursuant to that directive, I hereby submit this "Report to the Congress on the Tax Treatment of Bad Debts by Financial Institutions."

I am sending a similar letter to Representative Bill Archer.

Sincerely,

Kenneth W. Gideon
Assistant Secretary
(Tax Policy)

Enclosure

ASSISTANT SECRETARY

DEPARTMENT OF THE TREASURY
WASHINGTON

September 1991

The Honorable Lloyd Bentsen
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

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Assistant Secretary
(Tax Policy)

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I. INTRODUCTION

The Internal Revenue Code (the Code) has from its inception permitted holders of business debts to deduct the losses resulting from the nonpayment of those debts. Historically, the Code has prescribed two alternative methods for determining the amount of the business bad debt deduction allowed for any taxable year. Taxpayers generally could choose to compute their bad debt deduction either by determining on a loan-by-loan basis the debts that had become uncollectible (the specific charge-off method of accounting for bad debts)[1] or by determining the amount of the addition for the taxable year to a reserve for bad debts required to cause that reserve to equal the debts held by the taxpayer that are expected to become worthless (the reserve method of accounting for bad debts).[2] Once a taxpayer properly selected a method, the consent of the Commissioner was generally required to change it.[3]

The Tax Reform Act of 1986 (the 1986 Act) repealed the reserve method for all taxpayers other than thrift institutions and commercial banks that are not "large" banks.[4] Accordingly, large banks, non-depository financial institutions, and taxpayers generally may use only the specific charge-off method for determining their bad debt deduction. When it repealed the reserve method for most taxpayers, Congress directed the Treasury Department to study and report on the appropriate criteria to be used in determining whether a debt is worthless for Federal income tax purposes and specifically to consider the circumstances under which it would be appropriate to provide a conclusive or rebuttable presumption of worthlessness.[5]

A. Bad debt deductions

The two methods that have historically been used to compute the bad debt deduction under section 166 of the Code are the specific charge-off method and the reserve method.

---

[1] I.R.C. § 166(a); Treas. Reg. §1.166-1(a)(1).

[2] See Treas. Reg. § 1.166-1(a)(2). Prior to its repeal in 1986, section 166(c) provided statutory authority for the reserve method. Special rules have governed the reserve methods available to commercial banks and savings and loan institutions (hereinafter "thrift institutions" or "thrifts"). See, e.g., I.R.C. §§ 585 and 593.

[3] Treas. Reg. § 1.166-1(b)(2).

[4] Pub. L. No. 99-514, § 805(a) (1986). A bank is a large bank if the average adjusted bases of its assets exceed $500 million or if it is a member of a controlled group the average adjusted bases of all assets of which exceed $500 million. I.R.C. § 585(c)(2). For purposes of this report, all banks not meeting the definition of a large bank are referred to as "small" banks.

[5] H. R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-316 (1986).

1. Specific charge-off method

A debt that is completely worthless may be deducted only in the year it becomes worthless.[6] Thus, the bad debt deduction claimed for any year must be supported by a showing that the debt had some value at the beginning of the year and that some change in the debtor's condition occurred during the year.[7] In determining whether a debt is worthless, "all pertinent evidence," including the adequacy of the collateral and the financial condition of the debtor, will be considered.[8] An inherent difficulty in identifying the year of deduction is that worthlessness often results from a gradual deterioration in the debtor's financial condition rather than an easily identified event. A special 7-year statute of limitations applicable to refund claims based on worthless debts mitigates the hardship that may arise when a debt is determined to have become worthless in a year earlier than the one in which the taxpayer claimed it as a bad debt deduction.[9]

If it can be determined that only part of a debt is recoverable, the worthless portion may be deducted in the year in which the taxpayer charges it off for book purposes.[10] Unlike the case of a wholly worthless debt, the taxpayer need not show that the partial worthlessness occurred in the year of deduction, thereby permitting the taxpayer a certain amount of flexibility in the timing of such deductions.[11] Another important way in which deductions for partially worthless and wholly worthless debts differ is that Congress has delegated to the Commissioner discretion to allow the deduction for a partially worthless debt.[12] As a result, the taxpayer may bear a heavier burden in establishing the correctness of the partial worthlessness write-off, because the issue in litigating a taxpayer's disallowed partial worthlessness deduction is not whether the debt is partially worthless, but whether the Commissioner's denial of the deduction is arbitrary or unreasonable.[13]

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[6]I.R.C. § 166(a)(1).

[7]See Denver & R.G.W.R.R. Co. v. Commissioner, 279 F.2d 368 (10th Cir. 1960).

[8]Treas. Reg. § 1.166-2(a). Except in the case of the special rule applicable to regulated financial institutions described below, there is no specific requirement that a wholly worthless debt be charged off for book purposes in the year it becomes worthless.

[9]I.R.C. § 6511(d)(1).

[10]I.R.C. § 166(a)(2).

[11]The extended statute of limitations under I.R.C. § 6511(d) does not apply to deductions claimed for partially worthless debts. Treas. Reg. § 301.6511(d)-1(c).

[12]I.R.C. § 166(a)(2); Treas. Reg. § 1.166-3(a)(ii).

[13]See Brimberry v. Commissioner, 588 F.2d 975 (5th Cir. 1979).

Special rule applicable to depository institutions

Treasury regulations provide a special rule that allows regulated financial institutions a conclusive presumption that debts that are properly charged off for regulatory purposes are worthless for purposes of applying section 166 if certain conditions are met.[14] This conformity of tax and regulatory accounting generally applies only to loans classified under regulatory standards as loss assets, which are evaluated according to criteria comparable to those applied under section 166.[15] Therefore, the conclusive presumption does not apply where the institution writes down real estate or other property obtained in foreclosure in compliance with regulatory requirements that such assets be carried at the lower of net book or current market value.[16] The history and current operation of the conformity rule is discussed in greater detail at pages 16-19, below.

Amount of allowable bad debt deduction

Generally, a deduction for a wholly worthless debt is allowed to the extent of outstanding principal and previously reported but uncollected interest.[17] The amount of the deduction can therefore not exceed the taxpayer's adjusted basis in the debt, computed in the manner used for determining the loss from the sale or other disposition of the property. In the case of repossessions and foreclosures, the amount of the deduction is equal to the amount by which the taxpayer's basis in the debt exceeds the fair market value of the repossessed or foreclosed property.[18] If a bad debt deduction is allowed for a partially worthless debt, the basis of the debt is reduced by the amount of the deduction. If the taxpayer recovers an amount on a debt after having deducted it as a bad debt, the amount recovered is taxable income to the taxpayer in the year of recovery.[19]

2. Reserve method

Prior to the repeal of section 166(c) in 1986, the reserve method generally permitted a bad debt deduction for a year equal to an amount determined to be a reasonable addition to the

---

[14]Treas. Reg. § 1.166-2(d).

[15]Regulators may occasionally require institutions to charge off loans that are very weak but not yet deserving of loss classification.

[16]Rev. Rul. 84-95, 1984-2 C.B. 53.

[17]I.R.C. § 166(b); Treas. Reg. § 1.166-1(d)(1).

[18]Treas. Reg. § 1.166-6; I.R.C. § 595(a).

[19]Treas. Reg. § 1.166-1(f).

taxpayer's reserve for bad debts for that year.[20] The reasonable addition to the reserve for any year was that amount necessary to bring the beginning bad debt reserve balance, adjusted for actual bad debt losses and recoveries during the year, to the permitted ending reserve balance, which had to be computed under an approved method.[21] The most widely used formula for determining the ending reserve balance was based on a six-year moving average, determined by dividing the sum of the bad debts actually charged off for tax purposes[22] (net of actual recoveries) for the most recent six years (including the current year) by the sum of the debts owed the taxpayer at the end of each year of the same six-year period. This average bad debt ratio was multiplied by the sum of the debts outstanding at the close of the year to produce the permitted ending reserve balance for the current year.[23] This method (the experience method) produces an ending reserve balance based on past experience that approximates the bad debt charge-offs expected to occur in a single taxable year.

The 1986 Act severely limited the use of the reserve method for computing bad debt deductions. It is now available only for thrifts and small banks. Small banks using the reserve method are limited to the experience method described above.[24] Thrifts eligible to use the reserve method under section 593 may use either the experience method or the percentage of taxable income method.[25] Under the percentage of taxable income method, the addition to the

---

[20]See Treas. Reg. § 1.166-1(a)(2).

[21]Treas. Reg. § 1.166-4.

[22]In determining the amount of debts actually charged off, depository institutions using the reserve method were permitted to apply the conclusive presumption of worthlessness described at p. 5, above.

[23]This formula is based on the decision in Black Motor Company v. Commissioner, 41 B.T.A. 300 (1940), aff'd, 125 F.2d 977 (6th Cir. 1942).

[24]I.R.C. § 585(b)(2).

[25]I.R.C. § 593(b)(2). Until 1951, thrifts were exempt from federal income tax. Although they became subject to the corporate income tax in 1952, thrifts were generally allowed a bad debt reserve deduction for a taxable year equal to 100 percent of taxable income for the year. In 1962, Congress reduced the percentage of taxable income that could be claimed as a bad debt reserve deduction to 60 percent. This amendment was designed to produce some level of tax from thrifts and at the same time to encourage the residential real estate loans that constituted the bulk of thrifts' lending activities. Between 1969 and 1979, the allowable percentage of taxable income reserve method fell gradually from 60 percent to 40 percent. The 1986 Act reduced the allowable percentage to the present 8 percent.

reserve for a year is generally equal to 8 percent of the institution's taxable income for that year.[26] In any given year, thrifts may use either the experience method or the percentage of taxable income method, whichever is more advantageous.[27]

B. Nonaccrual of interest

An accrual method taxpayer generally takes amounts into income when the right to the income is fixed and the amount of the income can be determined with reasonable accuracy.[28] Under an exception to this general rule, income must not be accrued if, at the time the right to the income arises, the income is uncollectible.[29] In the case of interest on a loan, uncollectibility is determined based on not only whether the debtor is currently delinquent but also whether there is evidence that the income will never be paid. Therefore, mere untimeliness of payment is not necessarily substantial evidence of uncollectibility and will not alone support nonaccrual of the income.[30] Other factors, such as the solvency of the debtor and the course of dealings between the debtor and the creditor, must be taken into account. There is no special rule applicable to regulated institutions permitting a presumption of uncollectibility for interest on loans that are placed in nonaccrual status under financial institution regulatory standards.

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[26]The excess of the deduction produced by the percentage of taxable income method over the taxpayer's actual loss experience is a preference item for purposes of the corporate alternative minimum tax. I.R.C. § 57(a)(4).

[27]Treas. Reg. § 1.593-6A(a)(1); Rev. Rul. 79-123, 1979-1 C.B. 215.

[28]Treas. Reg. §§ 1.446-1(c)(ii), 1.451-1(a).

[29]Corn Exchange Bank v. United States, 37 F.2d 34 (2d Cir. 1930).

[30]See Georgia Schoolbook Depository v. Commissioner, 1 T.C. 463 (1943)(inadequacy of amounts held in state beer tax fund to be used as sole source for payment of amounts owed to taxpayer not sufficient basis for nonaccrual of income where source of funds would increase in subsequent years); Koehring Company v. United States, 421 F.2d 715 (Ct. Cl. 1970)(unpaid royalties owed to taxpayer constituted accrued income because business reverses causing nonpayment were temporary and ultimately full payment could be expected); and Union Pacific Railroad Co. v. Commissioner, 14 T.C. 401 (1950)(taxpayer's failure to receive interest income on bonds it held did not justify nonaccrual because issuer's business reverses, although protracted, were temporary).

II. COMPARISON OF THE CHARGE-OFF AND RESERVE METHODS

A. Reasons for repeal of the reserve method

The legislative history of the 1986 Act cites two interrelated reasons for the general repeal of the reserve method. First, Congress believed that in permitting current tax deductions for statistically computed losses that will occur in the future, the reserve for bad debts was inconsistent with the treatment of other deductions, which may generally not be taken into account for tax purposes until the event to which the deduction is economically related has occurred. Second, because the deduction for the increase in the tax bad debt reserve represents a current deduction for the full amount of losses to be incurred in the future, the reserve method results in overstated deductions.[31]

In seeking to conform the treatment of bad debt deductions to other types of deductions, Congress was revisiting certain time value of money issues it had first addressed in the Tax Reform Act of 1984, when it enacted the "economic performance" requirement of section 461(h). Section 461(h) governs the time at which accrual method taxpayers may take liabilities into account for tax purposes. Prior to 1984, accrual method taxpayers could generally deduct the amount of a liability if the fact of the liability was fixed and the amount of the liability could be determined with reasonable accuracy (the all-events test). Because the rule permitted a current deduction for amounts that might be paid far into the future and made no adjustment in the amount of the deduction to take account of the time value of money, the rule produced overstated deductions. In crafting a remedy for the overstated deduction problem in 1984, Congress recognized that the correct deduction could be reached in one of two ways -- either by allowing a deduction for the present value of the deduction at the time the all-events test is satisfied or by deferring the deduction until the liability giving rise to the deduction is satisfied. Congress opted to defer the deduction, in view of the administrative complexities that would accompany the discounting approach.[32] In repealing the reserve method and requiring most taxpayers to use the specific charge-off method for bad debts, Congress in 1986 approached the time value of money issue much as it had in 1984 -- by deferring the deduction until the event giving rise to the loss had occurred.[33]

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[31]See H.R. Rep. No. 426, 99th Cong., 1st Sess. 640 (1985) and S. Rep. No. 313, 99th Cong., 2d Sess. 155 (1986).

[32]H.R. Rep. No. 432, Pt. 2, 98th Cong., 2d Sess. 1254-1255 (1984).

[33]In the case of bad debts, the discounting approach would be even more administratively unwieldy than in the case of other deductions, since the time at which the default will occur cannot be known with certainty at the time the loan is originated.

B. Accounting for loan losses

A loan is a financial contract stipulating a stream of payments to be made by the borrower to the lender. The value of the contract at any point in time is the present value of its future cash flows, discounted at a market rate of interest that represents the return on alternative uses of the lender's funds. This discount rate usually is not the contract rate of interest.[34] The value of a loan contract in any period during the life of the loan may differ from the value implied by the stated terms of the contract at the time of origination because of the possibility that those terms may not be fully satisfied. The borrower may default on the loan, producing a loss for the lender that reduces the implied value of the contract.[35] Because the lender recognizes the possibility of borrower default when he makes the loan, the terms of the lender's cash advance to the borrower will take into account the lender's expectation of future losses.

A common method of pricing a contract to account for a lender's expected loan losses is to compute for a given nominal principal a contract interest rate that incorporates a "risk premium." The addition of the risk premium yields a discounted present value for the contract's expected future payments that is equal to the nominal principal. This approach builds a cushion into the contractual payment stream to absorb the expected losses.

The effect of the charge-off and reserve methods on the value of a loan portfolio depends upon the timing of the recognition of the income associated with the risk premium and the deduction associated with the loan loss. If the timing of the income recognition does not match the timing of the loss deduction, income and tax liability will be either deferred or accelerated. The following section describes the effects of the charge-off and reserve methods on the value of a loan portfolio and compares those methods to an economically efficient income tax system in which tax is imposed on economic income.

C. The taxation of income from a portfolio with loan losses

Under an economically efficient income tax system, the imposition of tax does not distort an investor's choices among assets, because it does not change the price of the asset relative to

---

[34]The market interest rate may fluctuate in response to changes in economic conditions, whereas the contract rate may be fixed for the term of the loan. Assuming that market conditions and hence interest rates do not change, the contract rate and the discount rate are expected to be equal only when there is no risk of default and the price paid for the contract is the nominal contract principal.

[35]The effect of an expected failure of the borrower to honor the terms of a financial contract generally cannot be distinguished from the effect of an unexpected increase in market interest rates during the term of the loan. In either case, the value of the contract becomes less than that implied by the terms of the loan. References in this discussion to changes in the value of loans include only changes effected by borrower defaults.

the price that would exist in the absence of the tax. In the case of investment in depreciable assets, economic efficiency requires a deduction for tax depreciation that is equal to the decline in the value of an asset, so that tax is imposed on economic income. In the case of a physical asset, such a decline in value is referred to as economic depreciation, which must be deducted from gross income to arrive at economic income.[36] Similarly, the efficient allocation of investment in financial assets also requires taxation of economic income.[37]

To determine the economic income produced by the ownership of an asset, it is necessary to track the asset's value over its life. In the case of a loan portfolio that includes debts that will become uncollectible, the value of the portfolio generally changes over time in a manner that depends upon the timing of the expected nonperformance. In each period, economic income earned on the portfolio equals the net cash flow received in that period plus the changes in the value of the portfolio. Since conceptually the current value of an asset is the present value of its expected future income stream, the decline in the value of the loan portfolio is the reduction in the present value of its expected future income stream.[38]

The present tax treatment of loan losses generally mismeasures economic income, because neither the charge-off nor reserve methods accurately reflects changes in the market value of the loan portfolio. Under both the charge-off and reserve methods, the timing of the recognition of income attributable to the risk premium differs from the timing of the recognition of the associated loss, which may result in a deferral or acceleration of income. If the present value of unrecognized income is positive, income and tax liability are deferred and the value of the portfolio increases relative to its pre-tax value. Alternatively, if the present value of the unrecognized income is negative, the after-tax value of the portfolio is less than its pre-tax value.

1. The effect of early loan losses

The effect of the charge-off and reserve methods on the value of a loan portfolio depends upon the timing of the losses during the life of a loan.[39] When losses occur early in the life

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[36]See Paul A. Samuelson, "Tax Deductibility of Economic Depreciation to Insure Invariant Valuations," Journal of Political Economy (December 1964), pp. 604-6.

[37]See Arnold C. Harberger, "Tax Neutrality in Investment Incentives," in The Economics of Taxation, H. J. Aaron and M. J. Boskin, eds., Washington, D.C.: The Brookings Institution (1980), pp. 303-6.

[38]When economic income is taxed, the effective tax rate (the percentage reduction in the internal rate of return attributable to taxes) is equal to the statutory tax rate.

[39]The Appendix illustrates the effect of the timing of debtor nonperformance using two hypothetical loan portfolios in which losses occur early and late in the life of the loans, respectively. It analyzes the economic accrual of the loan losses and compares such accrual to the tax accounting for the loan losses. These hypothetical examples assume that the timing of

of a loan, both the charge-off and reserve methods increase the value of a loan portfolio because they defer the recognition of income attributable to the risk premium relative to the deduction for the associated loss. The present value of after-tax cash flows from the loan portfolio will exceed the present value of before-tax cash flows, because the lender has deducted defaulted amounts before he has taken into income payments reflecting the risk premium charged on all loans. Because the pre-tax and after-tax portfolio values differ, investment decisions are likely to be distorted.

The disparity between the after-tax value of the loan portfolio and its pre-tax value is greater under the reserve method than under the charge-off method, because the mismatch between the time the deductions attributable to loan losses are taken and the time the risk premium is included in income is more extreme under the reserve method. Under the charge-off method, declines in the value of the loan portfolio are recognized when loans are charged off. The reserve method anticipates future loan losses. Neither method reflects unrealized changes in the market value of the loan portfolio.

Under the charge-off and reserve methods taxable income is lower than economic income in the early years of the contract and higher in the later years. This pattern occurs because the recognition of income attributable to the risk premium covering expected losses tends to be deferred relative to the deduction for the associated loss. As a result, both methods defer income and tax liability. Under the reserve method, however, the deferred income and tax liability are larger, because the reserve method tends to accelerate deductions relative to the economic decline in the value of the portfolio to a greater extent than the charge-off method.

2. The effect of late loan losses

When loan losses occur late in the life of a loan, the charge-off and reserve methods may favor or disadvantage the loan portfolio. The charge-off method disadvantages the portfolio because it defers the recognition of loan losses relative to the recognition of income attributable to the risk premium. The reserve method favors the portfolio because it allows deductions for losses before they accrue.

Compared with economic income, taxable income under the charge-off and reserve methods is higher in the early years of the contract and lower in the later years. The charge-off method defers deductions for declines in the value of a loan portfolio attributable to defaults until the default occurs. The reserve method permits a deduction in the year of origination for defaults that occur late in the life of the contract in addition to deductions allowed under the charge-off method. As a result, taxable income under the reserve method is lower than under the charge-off method. Whereas the charge-off method reduces the value of the portfolio by deferring

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debtor nonperformance and the rate of return the lender would receive on alternative investments are known with certainty (i.e., that all "losses" are expected). These factors are difficult to ascertain in practice.

losses (the present value of deferred tax liability is negative), the reserve method increases the value of the portfolio by accelerating deductions (the present value of the deferred tax liability is positive.)

D. Conclusion

An economically efficient income tax system would measure accurately the lender's economic income, which consists of principal and interest payments and changes in the value of the portfolio. The market value of the portfolio is based on the portfolio's expected cash flow and the expected return on alternative investments. To measure economic income correctly, the value of a portfolio of loans would have to be adjusted annually to reflect changes in its market value. In practice, such adjustments would be problematic, because they would require annual price quotes or knowledge of the lender's expectations of future loan losses and rate of return on alternative investments.

Neither the charge-off nor reserve methods measure economic income accurately. The charge-off method may favor or disadvantage a loan portfolio, depending upon the timing of the loan losses. When losses occur early in the life of the contract, the charge-off method will increase the value of the portfolio by deferring income and tax liability. When losses occur late in the life of the contract, the charge-off method will disadvantage the portfolio by deferring losses. Although neither method correctly measures economic income, the reserve method tends to accelerate deductions relative to the true economic decline in the value of the portfolio, and thus favors the portfolio regardless of the timing of the losses. The best practical alternative to taxing economic income is the consistent taxation of realized income. In achieving this purpose, the charge-off method is preferable to the reserve method, because it is less distortionary for a wide variety of fully anticipated loan default characteristics.

III. CONFORMITY OF TAX TO REGULATORY STANDARDS OF WORTHLESSNESS

As described at page 3, above, there has long been a rule that debts held by depository institutions that are charged off for regulatory purposes are conclusively presumed to be worthless for purposes of the bad debt deduction if certain conditions are met. This section of the report describes the federal regulatory framework applicable to commercial banks and thrift institutions, outlines the system for classifying assets for regulatory purposes, and analyzes the history and policy considerations underlying the conformity of tax and regulatory treatment of loss assets.

A. Regulatory framework

Under the present regulatory framework, federal supervisory authority over depository institutions is exercised by several regulatory bodies that are charged with the oversight of particular groups of institutions. The distribution of supervisory responsibilities is summarized below.

1. Commercial banks

Responsibility for the regulation of commercial banks is distributed among the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve (FRB) and the Federal Deposit Insurance Corporation (FDIC). The OCC charters, regulates and supervises national banks.[40] It carries out its supervisory functions through both on-site examinations and off-site review of regular reports and other relevant information that banks are required to supply.[41]

The FRB was created in 1913 to provide stability and uniformity to the banking system through a system of regional Federal Reserve Banks. All national banks are required to be members of the Federal Reserve System (FRS), and state-chartered banks may elect to become members.[42] The FRB also has sole jurisdiction over bank holding companies.[43] The FRB plays the same regulatory role with respect to its state-chartered members and their affiliates as the OCC plays with respect to national banks.[44]

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[40]12 U.S.C. § 1.

[41]Comptroller of the Currency, Handbook for National Bank Examiners -- Commercial, International (hereinafter "Handbook") § 1.1 (1979).

[42]U.S.C. §§ 222, 321.

[43]12 U.S.C. § 1844(b).

[44]12 U.S.C. §§ 325, 338, 248(a) and 483.

The FDIC was established in 1933 to insure the deposits of all FRS member banks as well as state nonmember banks.[45] It performs examination functions analogous to those of the OCC and the FRB with respect to state banks that are not members of the FRS.

2. Thrift institutions

Prior to the passage of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA),[46] the Federal Home Loan Bank Board (FHLBB) operated the Federal Home Loan Bank System, a central bank system for the thrift industry, chartered and supervised federal thrifts, and insured the deposits of member institutions through the Federal Savings and Loan Insurance Corporation (FSLIC). FIRREA abolished the FHLBB and the FSLIC and redistributed their responsibilities.[47] Under the current structure, the Office of Thrift Supervision (OTS) supervises all federal and state thrift institutions;[48] the Federal Housing Finance Board is the principal overseer of the credit operations of Federal Home Loan Banks;[49] and the FDIC insures the deposits of member S&Ls and manages defaulted savings associations.[50]

Despite the division of regulatory responsibilities involved in the supervision of financial institutions, a high degree of consistency in the application of regulatory standards is provided by the Federal Financial Institutions Examination Council (FFIEC). The FFIEC, which was created in 1978, is an interagency entity composed of representatives of each of the federal regulatory bodies and is charged with promoting the uniform examination and supervision of banks. The FFIEC achieves this by prescribing uniform principles, standards, and reporting forms.[51] The FFIEC also provides schools for training federal examiners and makes the schools available to state regulators as well.[52]

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[45]12 U.S.C. § 1811 et. seq.

[46]Pub. L. No. 101-73, 103 Stat. 183 (1989).

[47]FIRREA § 301.

[48]FIRREA § 301.

[49]FIRREA § 702(a).

[50]FIRREA § 211, 12 U.S.C. § 1821(a)(1)-(7).

[51]12 U.S.C. § 3305(b).

[52]12 U.S.C. § 3305(d).

B. Regulatory classification of assets for determining loss asset charge-offs

Under the uniform standards adopted by the federal regulatory bodies, assets that are suspect are placed in one of the four following classifications:

1. Other assets especially mentioned (OAEM). These assets are currently protected by the paying capacity of the obligor or the pledged collateral but there are signs that the asset has the potential to become a loss asset.

2. Substandard. These assets are inadequately protected by the current sound worth and paying capacity of the obligor or the collateral securing the assets. Substandard assets in the aggregate represent some loss potential, but this classification does not necessarily reflect loss potential in any individual asset.

3. Doubtful. These assets show all of the characteristics of substandard assets and, in addition, the facts and circumstances are such that collection or liquidation of the assets is highly questionable or improbable. Nevertheless, their classification as loss assets is deferred because of other factors that may strengthen the assets. An asset generally does not remain in the doubtful category for successive examinations.

4. Loss. These assets are considered uncollectible and, despite some potential for salvage or recovery, that potential is not sufficient to justify continued treatment as bankable assets. These assets are charged off as worthless for regulatory purposes.

An additional regulatory classification applies to loans to foreign borrowers. When the quality of an institution's international loans becomes impaired by a protracted inability of foreign borrowers to make payments on their external indebtedness, regulators require either that the institution establish an allocated transfer risk reserve (ATRR) in the amount of the portion of the loans affected or charge-off the requisite amounts as a loss.[53]

The specific regulatory criteria for determining whether a loan should be placed in loss status depend on the type of credit the institution has extended. Generally, the status of commercial and real estate loans is considered in light of the value of the collateral securing the loan or other factors affecting the current creditworthiness of the borrower.[54] Other types

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[53]Handbook, § 215.1. Although citations throughout this section III.A. will be to the OCC Handbook, comparable standards apply to institutions supervised by the FRS, the FDIC, and the OTS.

Amounts required to be added to the ATRR are treated as charge-offs to which the conclusive presumption of Treas. Reg. § 1.166-2(d) applies. Rev. Rul. 84-94, 1984-1 C.B. 34.

[54]Handbook, §§ 206.3 and 213.3.

of high-volume loans, such as consumer installment loans, credit card plans, and check credit plans, are subject to more mechanical, automatic charge-off procedures. Consumer installment paper that is delinquent 120 days or more and credit card or check credit debt that is delinquent 180 days or more are considered loss assets for regulatory purposes.[55]

Regulators determine the financial condition of institutions under their jurisdiction on the basis of quarterly reports (Call Reports) furnished by the institution[56] and on-site examinations that may occur as frequently as more than once a year or as infrequently as once every three years.

The on-site examination generally includes a review of the institution's own internal loan review and loss classification standards.[57] An institution's loan officers are responsible for ensuring that each asset is properly classified according to its current risk status. As a result, institutions typically adopt an internal loan rating system that is designed to provide senior management with an accurate current assessment of the quality of the loan portfolio. Federal examiners review the methods institutions use to evaluate the quality of their loans and test the extent to which an institution's internal loan review procedures conform to federal regulatory standards by reviewing a sampling of the institution's commercial and real estate loans and by confirming that the proper automatic charge-off procedures have been adopted for installment and credit card loans.[58]

C. Relationship of regulatory loss standard to deductibility of bad debts under section 166

For 70 years, the tax treatment of bad debts by depository institutions has been linked to the treatment of such debts for regulatory purposes. This section of the study traces the evolution of this tax/regulatory relationship and the policy considerations underlying the conformity of tax to regulatory treatment under certain circumstances.

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[55]Handbook, §§ 209.1, 211.1 and 212.1.

[56]The FFIEC has developed for use by the bank regulatory agencies uniform "Reports of Condition and Income" (Call Reports), which contain extensive information regarding the classification of the institution's assets and the condition of its income. Uniform rules set forth the proper treatment of assets and income items.

[57]Handbook, § 205.1, pp. 8-9.

[58]Handbook, § 900.205.1.

1. History of the presumption of worthlessness for regulated financial institutions

The ability of banks and other supervised corporations to use their regulators' evaluation in determining whether debts are worthless for purposes of the bad debt deduction originated in 1921. Treasury Decision 3262, which promulgated regulations under the bad debt provisions of the 1921 Revenue Act, provided a rebuttable presumption that debts charged off in whole or in part "in obedience to the specific orders or in accordance with the general policy of" bank supervisors were worthless for purposes of the bad debt deduction. As interpreted by the Board of Tax Appeals in Murchison National Bank, this presumption did not provide banks with any particular advantage over unsupervised taxpayers, because the bank examiner's treatment did not conclusively determine the appropriate tax treatment.[59]

The Murchison approach set the tone for almost a decade. But in a 1935 case, the Fourth Circuit held that a charge-off made in obedience to a regulatory order justified a bad debt deduction, regardless of the reason for the regulatory charge-off.[60] The court's rationale was that "[t]here should be at least some semblance of co-ordination between the several branches of government in dealing with the taxpayer . . . . Otherwise the banks would be compelled to keep two sets of books, one, as directed by the bank examiner, and the other for purposes of making a tax return."[61]

Despite the opinion of the Fourth Circuit, the Board of Tax Appeals held to its earlier opinions and continued to interpret the tax regulation as providing only a rather easily rebutted presumption.[62] The conflicting interpretations were resolved in favor of the Fourth Circuit's view by a 1936 amendment to the regulation that unambiguously changed the rebuttable

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[59] 1 B.T.A. 617 (1925). The Board stated its views as follows:

> "The fact that the entire amount of the debt was charged off in accordance with what was assumed to be the policy of the national bank examiners, seems to us to have no bearing on the question presented here. It is well known that national bank examiners, in accordance with sound banking and good business methods, often times require banks to charge off overdue paper. This action cannot be construed as indicating in any way that the paper so charged off is worthless, but only that its value is doubtful and it is desirable that banks shall include in their balance sheet only such assets as have unquestioned value." Id. at 621.

[60] Citizens National Bank of Orange v. Commissioner, 74 F.2d 604 (4th Cir. 1935).

[61] Id. at 605.

[62] See Second National Bank of Philadelphia v. Commissioner, 33 B.T.A. 750 (1935) and Citizens National Bank of Orange v. Commissioner, 33 B.T.A. 758 (1935), rem'd, 87 F.2d 999 (4th Cir. 1937).

presumption to a conclusive presumption of worthlessness.[63] The amended regulations provided that debts charged off, in whole or in part, in obedience to the specific orders of bank supervisors were conclusively presumed to be worthless for purposes of the bad debt deduction.

At the request of the Comptroller of the Currency, the conclusive presumption of worthlessness was amended in 1973 to expand the presumption to include charge-offs made in accordance with the established policies of the institution's regulatory authority, so long as the authority confirms in writing in connection with the first examination following the charge-off that the charge-off would have been specifically ordered if the examination had been made on the date of the charge-off.[64] Instructions for bank examiners were issued concurrently with the amendment to the regulations. Those instructions required that, in making the necessary review prior to issuing the confirmation letter required under the amended regulations, the loans voluntarily charged off by the institution be considered individually.

At the time of the 1973 amendment to the regulations, it was the policy of the Comptroller's office that installment loans for which no payment had been received for 90 days should be charged off. Without the amendment, banks were not entitled to the conclusive presumption of worthlessness for such loans because their charge-off was not in obedience to a specific order but rather in voluntary compliance with a regulatory policy. The regulations were amended specifically to allow banks adopting this procedure to enjoy the benefit of the conclusive presumption with respect to installment debt.

In 1980, the FDIC published a statement that ultimately became a new interagency standard for the classification of consumer installment credit as loss assets. It lengthened the 90-day delinquency period to 120 days for closed-end consumer installment loans and to 180 days for open-end consumer credit card loans. The change in the loss classification standard included the following guidance to examiners: "[t]he general classification policy recognizes that evaluating the quality of a consumer credit portfolio on a loan-by-loan basis is inefficient and unnecessary."[65]

The shift from loan-by-loan review to greater reliance on statistical surveillance made the confirmation letter procedure more difficult to administer. The Treasury Department recently proposed that its bad debt regulations be amended to take account of these changed conditions. Under the proposed regulation, a depository institution is permitted to make a "conformity election" under which a debt that is charged off in whole or in part on the bank's books is conclusively presumed to be worthless for tax purposes if either (1) the charge-off results from a specific order by the regulator or (2) the charge-off corresponds to the institution's

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[63]T.D. 4633 (XV-1 C.B. 118).

[64]T.D. 7254, 1973-1 C.B. 77.

[65]FDIC, "Uniform Policy for Classification of Consumer Installment Credit Based on Delinquency Status" (1980).

classification of the debt, in whole or in part, as a loss asset. The second requirement is deemed to be met only if the institution's regulators have expressly determined in connection with the most recent examination of the institution's internal loan review process that the institution maintains and applies loan review and loss classification standards that are consistent with the regulatory standards of the supervisory authority.[66]

2. Policy considerations related to tax/regulatory conformity

As is evidenced by the early disagreement between the Board of Tax Appeals and the Fourth Circuit, the development of tax/regulatory conformity has been informed by two competing views. First, there is a sense that a regulated entity should not be subject to inconsistent treatment by different regulatory agencies. Although the Fourth Circuit's concern for the burdens that may be imposed by requiring the taxpayer to keep two sets of books has become less compelling with the advent of sophisticated computerized recordkeeping systems, there remains a belief that the "semblance of coordination" it sought to achieve among government agencies remains desirable.[67]

At the same time, an OCC examiner's perspective in assessing the worthlessness of an institution's loan might well differ from that of the tax auditor. The conservatism that serves the government well in its role as regulator may not produce the result that best serves the proper protection of the fisc.

In addition to these competing considerations, there is the practical question of administration. Since the specific charge-off method under section 166 and the analysis of loan portfolios for regulatory purposes both require a determination of worthlessness on a loan-by-loan basis, the absence of some sort of conformity rule would require two independent investigations of the factual basis for a particular debt's worthlessness.

As Figure 1 shows, loans constitute more than half of all assets of insured commercial banks. Moreover, as shown in Figure 2, loans charged off by insured commercial banks for regulatory purposes have risen from approximately $5 billion, just over one-fifth of net income before tax in 1980 to more than $33 billion, more than half of net income before tax in 1990.[68] In light of the large volume of loans charged off annually for regulatory purposes, ease of administration is not enough to justify a regulatory/tax conformity rule. Such a conformity rule is, however, desirable to the extent that the regulatory criteria governing the charge-off of debts are similar enough to the criteria for worthlessness under section 166 to make regulatory criteria

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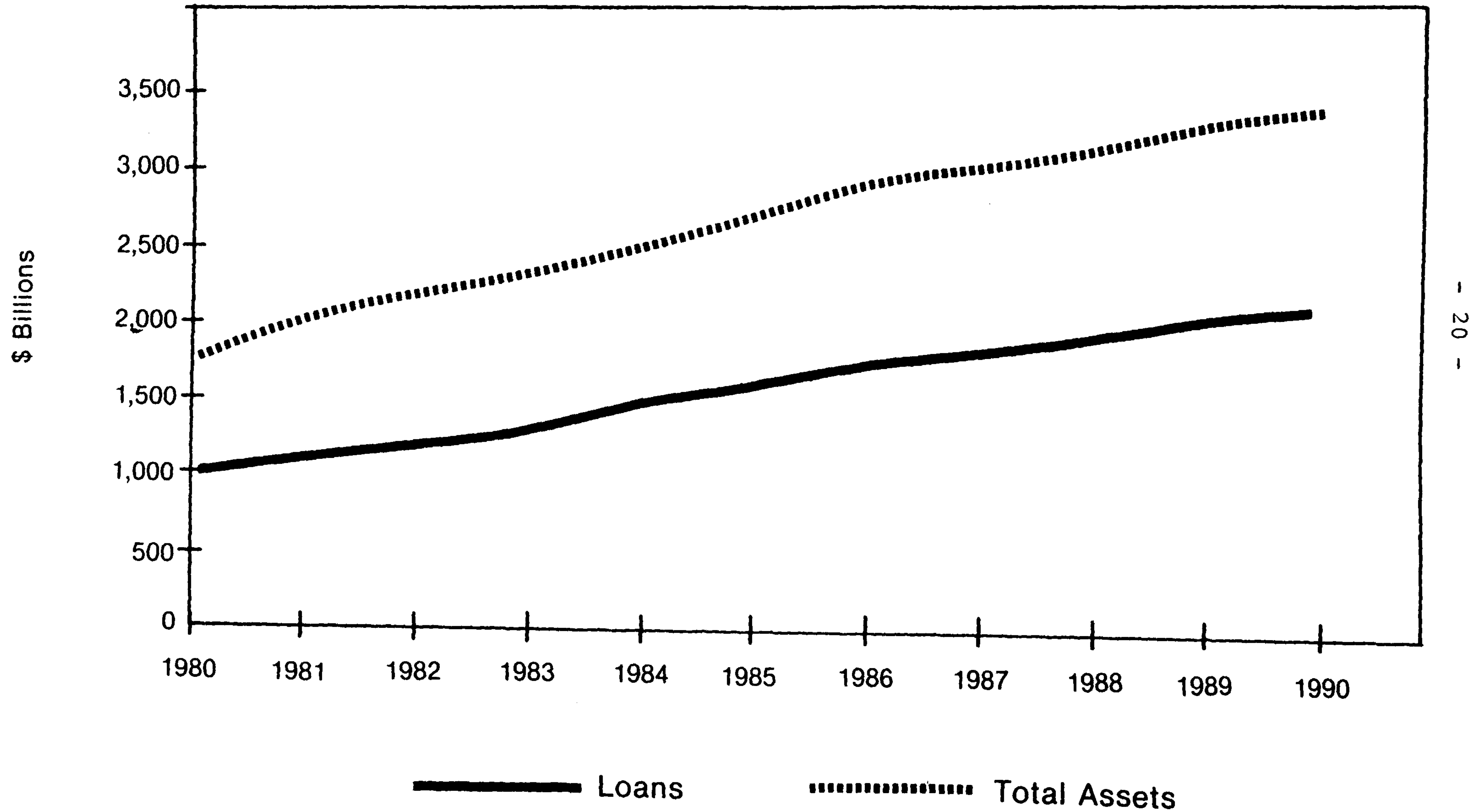
[66]56 Fed. Reg. 24,154 (1991).

[67]See Rev. Rul. 80-180, 1980-2 C.B. 66.

[68]Net income before tax includes net interest income, service charges, gains on securities not held in trading accounts and certain other income and excludes provisions for loan and lease losses.

Figure 1

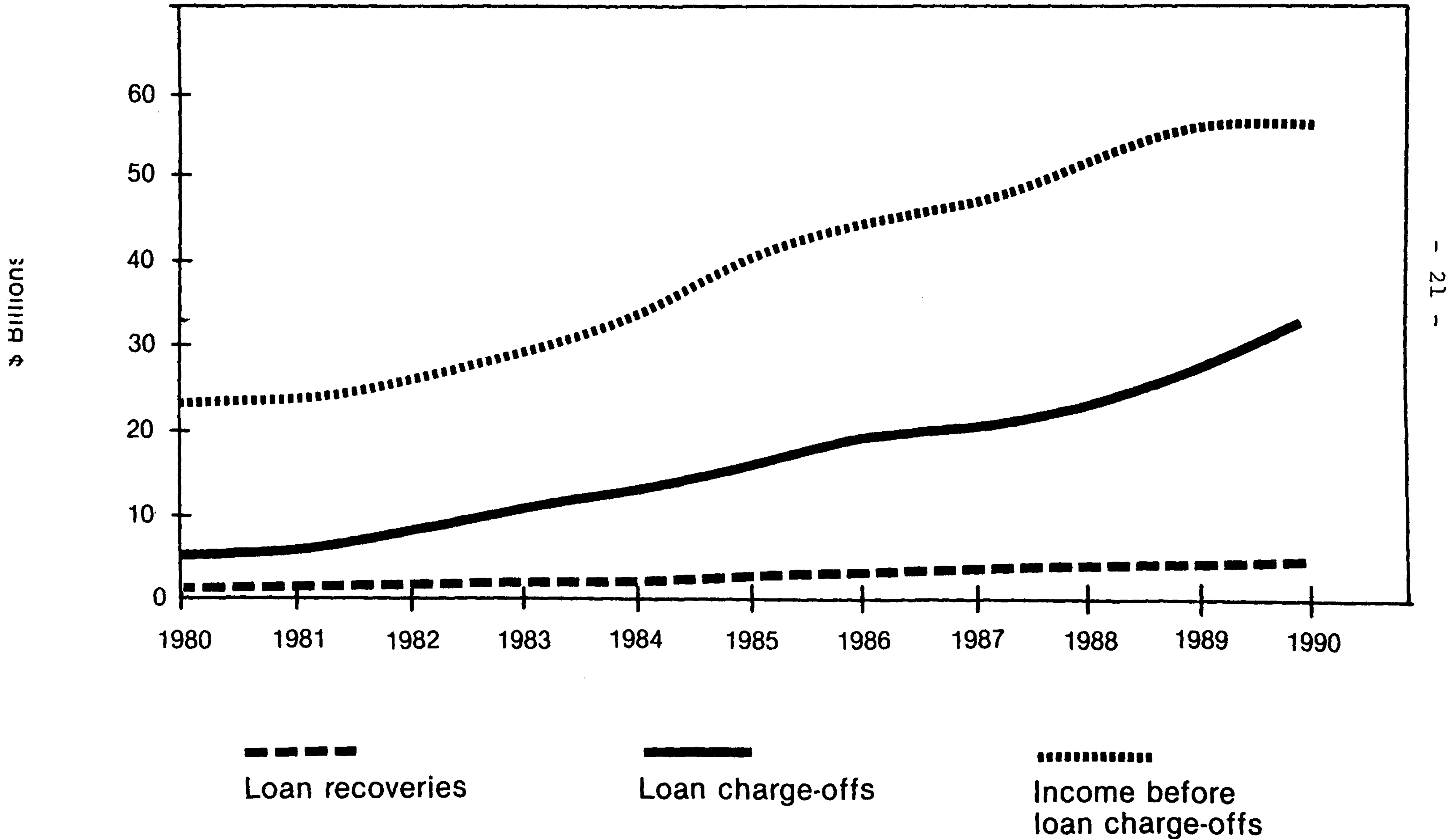
Loans and Assets · Insured Commercial Banks



Source: Federal Deposit Insurance Corporation

Figure 2

Loans Losses and Income - Insured Commercial Banks



Source: Federal Deposit Insurance Corporation

and examination by the regulatory authorities an acceptable surrogate for an independent investigation by the Internal Revenue Service.

As described above at page 13, federal regulatory standards classify an institution's problem loans along a prescribed descending scale of probable collectibility. Generally, an asset is charged off for regulatory purposes to the extent it is classified as a loss asset. Accordingly, in considering the appropriate scope of tax and regulatory conformity, we must compare the regulatory standards governing loss classification with the tax criteria for worthlessness. The proximity of these two standards of worthlessness can be analyzed at several levels. First, to what extent are the objective definitions of loss assets and worthless debts compatible? Second, is the factual basis on which a regulatory loss classification rests similar to that which would be required to support a deduction under section 166? Finally, is a bank examiner's assessment (or the assessment of a bank officer applying regulatory criteria) of whether an asset is a loss asset a satisfactory substitute for that of a tax auditor?

First, we turn to a comparison of the definitions of worthlessness employed for regulatory and tax purposes. For regulatory purposes, loss assets are those that, on the basis of specific factual criteria, are deemed "uncollectible" and of such little value that their retention as bankable assets is not warranted. Classification as a loss asset does not preclude the possibility of partial recovery, but deems the possibility too small to provide a sufficient reason for deferring a write-off.

Worthlessness for section 166 purposes has no succinct definition; it is determined on the basis of "all pertinent evidence." In making the determination of worthlessness, however, "the taxpayer must follow a rule of reason, avoiding alike the Scyllian role of the 'incorrigible optimist' and the Charybdian character of the 'stygian pessimist.' [Citations omitted.] . . . The taxpayer is not required to postpone his entitlement to a deduction in the expectancy of uncertain future events nor is he called to wait until some turn of the wheel of fortune may bring the debtor into affluence."[69] Thus, the regulatory and tax definitions of assets that should be charged off are quite similar in that they are both based on apparent uncollectibility, notwithstanding the possibility of partial recovery at some time in the future.

Given similar definitions, the next question is whether the factual basis that supports classification of an asset as a loss asset for regulatory purposes approximates the facts and circumstances that would support a finding of worthlessness under section 166. In general, institutions classify commercial and real estate loans on the basis of the borrower's financial statements, the borrower's condition compared to the industry average, whether a borrower has complied with the repayment terms of the loan, the adequacy of the collateral or income stream that secures repayment, the existence of contingent liabilities, the likelihood of the borrower's

[69] Minneapolis, St. P. & S. Ste. M. R.R. v. United States, 164 Cl. Ct. 226, 241 (1964).

business success, and the overall economic conditions affecting the borrower.[70] By contrast, high volume consumer installment loans and credit card plans are classified solely on the basis of the length of delinquency.

The breadth of circumstances taken into account in classifying commercial and real estate loans for regulatory purposes is comparable to the inquiry that would be appropriate for a finding of worthlessness for purposes of section 166. Although the classification of consumer installment loans and credit card plans depends on a single fact, length of delinquency, the unsecured (or as may be the case with consumer loans secured by household items, undersecured) nature of these loans may cause that single fact to be an adequate measure of worthlessness for tax purposes. In any event, the high volume of such loans and their comparatively low face value would make an in-depth inquiry into all relevant facts and circumstances a very burdensome task for the lending institution. In the absence of persuasive evidence, such as an unusually high recovery rate for such loans, that the automatic charge-off criteria for these types of high volume loans results in overstated losses, it is appropriate to permit the regulatory loss classification to determine the worthlessness of such debts for tax purposes.

The last issue is whether an examiner or a bank loan officer would find the loss asset definition satisfied at a time when the Internal Revenue Service auditor would consider a determination of worthlessness premature. There are inherent in the roles of the two agencies divergent inclinations with respect to the timing of a charge-off. A bank examiner charged with preserving the safety and soundness of a financial institution is more apt to lean toward the "stygian pessimist" view of a loan showing signs of weakness; the tax auditor, as the collector of revenue and protector of the fisc, should necessarily incline more to the "incorrigible optimist" role. Adoption of a regulatory conformity rule necessarily favors, however slightly, the more conservative approach.

It is unlikely, however, that regulated institutions generally would exploit the conservatism of the regulators to the serious detriment of the tax system. An institution could obtain excessive bad debt deductions by charging off loans only at the price of adverse consequences to its apparent financial soundness. The diminished earnings and capital that would result from excessive charge-offs could create adverse perceptions in the securities markets and, ultimately,

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[70] Handbook, §§ 206.3, 213.3, and 217.1.

weaken consumer confidence in the institution's stability. Failure to meet regulatory capital requirements would have similar adverse consequences.[71] These conclusions led the Treasury Department to issue the recent proposed regulations discussed at pages 18-19.

D. Regulatory standards for nonaccrual of interest

OCC guidance and FFIEC Call Report forms require that institutions not accrue on their required quarterly reports interest income on nonperforming loans. A loan is put into nonaccrual status if principal or interest payments are in default for 90 days or more, unless the loan is well secured and in the process of collection.[72] A debt is "well secured" if the principal and accrued interest are fully collateralized or guaranteed by a financially responsible person.[73] A debt is "in the process of collection" if collection is proceeding either through legal action, including judgment enforcement procedures, or other collection efforts that are reasonably expected to result in repayment of the debt or restoration to current status.[74] The treatment of previously accrued but uncollected interest and subsequent payments are governed by generally accepted accounting principles.[75] These principles do not require the write-off of previously accrued interest if principal and interest are ultimately protected by sound collateral values. Under OCC guidance, a nonaccrual loan may be returned to accrual status when (1) principal and interest are no longer due and unpaid or it otherwise becomes well secured and in the process of collection, and (2) prospects for future payment are no longer in doubt.[76]

The FFIEC standards for accounting for nonaccrual loans do not apply to consumer loans

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[71]In addition, the threat of impending bank failures has resulted in an increasingly important emphasis on capital. See FDIC, Differences in Capital and Accounting Standards Among the Federal Banking and Thrift Agencies; Report to Congressional Committees, 55 Fed. Reg. 34,339 (1990). New standards will require higher capital-to-asset ratios and will require the ratios to be computed on a risk-adjusted basis.

It appears therefore that the eagerness of regulated financial institutions to satisfy regulatory capital requirements and maintain the appearance of financial health would provide an adequate safeguard against abuse of a conformity rule.

[72]Handbook, § 205.1, p. 8.

[73]12 C.F.R. § 5.61(c)(2).

[74]12 C.F.R. § 5.61(c)(3).

[75]Handbook, § 205.1, p.8.

[76]Id. The FRB and the FDIC have adopted parallel accounting standards for institutions under their jurisdiction.

or residential real estate loans secured by one to four dwellings. OCC guidance directsinstitutions to formulate their own nonaccrual policies with respect to such loans to ensure that net income is not overstated.[77] Institutions file their required quarterly reports on the basis of the nonaccrual policy they have adopted.

The FFIEC has recently requested comment on a proposed change to the reporting standard applicable to nonaccrual loans.[78] The proposed standard would ease the ability of an institution to return a nonaccrual loan to accrual status without waiting for the loan to come into current payment status. Under this "loan-splitting" rule, institutions could charge off that portion of a nonaccrual loan that is not currently protected by pledged collateral or a dedicated income stream and return to accrual status the reduced loan balance that can be fully protected by the collateral or other security.[79] Only one such partial charge-off may be made with respect to a loan in nonaccrual status. If a loan restored to accrual status under the proposed standard is subsequently placed in nonaccrual status, the current criteria apply for returning the loan to accrual status.[80]

The proposed FFIEC rule in effect allows an institution to write off an asset that has not been classified as a loss asset. Under the conformity election of the proposed regulations under section 166, discussed above at pages 18-19, the conclusive presumption that generally applies to charge-offs made in conformity with regulatory treatment would not apply to charge-offs permitted under the proposed rule unless they were specifically ordered, because the conformity election extends only to the charge-off of assets classified as loss assets for regulatory purposes.[81] As a result, a bad debt deduction claimed in connection with a partial charge-off under the proposed FFIEC rule would generally have to be supported with the facts and circumstances required in connection with a claim of partial worthlessness under general tax principles.

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[77] Id. Similar guidelines apply for FRS- and FDIC-regulated institutions.

[78] Federal Financial Institutions Examination Council, Reporting Standard Concerning the Return of a Loan With a Partial Charge-off to Accrual Status, 56 Fed. Reg. 11,441 (1991).

[79] Id. at 11,442.

[80] Id. at 11,443.

[81] To permit a bad debt deduction for the partial charge-off of nonaccrual loans contemplated under the proposed FFIEC rule would be effectively to embrace market value accounting for diminutions in value. If there is to be some movement in the regulatory area from a realization based system to a market value accounting system, the tax treatment of assets can be tied to such a system only if it applies equally to augmentations and diminutions in value.

E. Relationship of regulatory nonaccrual standard to tax accrual rules

As described above at page 5, current law generally requires that an accrual method taxpayer include an accrued item in income unless it is uncollectible at the time the lender's right to it becomes fixed. Thus, unless there is no reasonable expectancy that the accrued but unpaid interest on a debt will be paid, an accrual basis lender must include it in income, notwithstanding the debtor's delinquency.[82]

The income accrual rules of section 61 and section 451 of the Code have historically been applied independently of the treatment of nonperforming loans for regulatory purposes. Accordingly, the Internal Revenue Service makes its own investigation of whether the standard for nonaccrual of interest is met regardless of whether the loan may have been placed in nonaccrual status for regulatory purposes.

The Treasury Department has been urged to adopt a conclusive presumption that interest on loans placed in nonaccrual status in accordance with Call Report rules be considered uncollectible for tax purposes and, therefore, not taken into account as income. In support of this proposal, advocates argue that such a policy would provide greater efficiency and uniformity in the administration of the relevant tax laws and reduce disputes and litigation; would substitute the experience of bank examiners, who are credit experts, for what advocates assert may be the less specialized judgment of Internal Revenue Service agents; would relieve the tax managers of banking institutions of the burden of a loan-by-loan review for compliance with what may be vague Internal Revenue Service criteria; and would allow banking institutions to determine their tax liability with greater certainty.

Current law does not provide for any conformity of the regulatory and tax treatment of interest on nonaccrual loans that have not been classified as loss assets.[83] Indeed, as the proposed conformity election amendment to the bad debt regulation makes clear, absent a specific charge-off order, the conclusive presumption under section 166 does not extend even

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[82]See Georgia Schoolbook Depository v. Commissioner; Koehring Company v. United States; and Union Pacific Railroad Company v. Commissioner, note 30, supra.

[83]Rev. Rul. 81-18, 1981-1 C.B. 295, involved the charge-off of interest on a loan that was earned but uncollected for a period in excess of 90 days. At the time of the charge-off, FHLBB regulations required that such interest be classified and accounted for as uncollectible income. See 12 C.F.R. § 563c.11 (1978). The ruling found that the cited regulation established a policy to which the conclusive presumption of Treas. Reg. § 1.166-2(d) applied, and held that the interest charged off as uncollectible that had already been accrued was deductible under section 166 and that interest that had not yet been reported in income need not be accrued. No other federal regulator of depository institutions has promulgated such a regulation, and 12 C.F.R. § 563c.11 has been withdrawn, effective January 1, 1989. See 53 Fed. Reg. 337 (1988). Rev. Rul. 81-18 is therefore obsolete.

to regulatory charge-offs that are not made as a consequence of the classification of an asset as a loss asset.[84] In considering whether it would be desirable to depart from current law by providing a presumption that interest on loans placed in nonaccrual status for regulatory purposes be considered uncollectible for purposes of section 61 and section 451, we look to the policy basis on which rests our support of the conformity rule in the case of determining the worthlessness of debts.

Whether conformity of tax and regulatory accounting in the case of nonaccrual loans is desirable tax policy depends on the criteria used by regulators in determining that interest income should not be accrued for regulatory accounting purposes. These criteria should approximate the criteria that would be required under the Internal Revenue Code to conclude that interest income should not be included in taxable income.

In determining whether a conclusive presumption for nonaccrual loans is appropriate, the relevant questions are (1) whether the regulatory definition of a nonaccrual loan is compatible with the tax definition of interest that may be omitted from an accrual method taxpayer's income; (2) whether the factual basis for a regulatory finding that a loan should be in nonaccrual status comports with the facts and circumstances that justify the nonaccrual of interest for tax purposes; and (3) whether the regulator's assessment of the appropriateness of ceasing to accrue interest is a satisfactory substitute for the judgment of a tax auditor.

The definition of a nonaccrual loan for regulatory purposes is one that is delinquent in interest or principal payments for some stated period (unless it is fully secured or guaranteed or in the active process of collection). Bank examiners require loans to be placed in nonaccrual status to avoid overstatement of the bank's current income, not necessarily to reflect a judgment as to their ultimate collectibility. By contrast, the definition of interest that a lender may omit from accrued income for tax purposes is interest the ultimate collectibility of which is in doubt. Nonaccrual of interest in this context is a recognition that the value of the right to income held by the lender when the interest comes due may never be realized and therefore should not be taken into account for tax purposes. Thus, there is not the comparability of basic definitions that is present in the case of the conclusive presumption of worthlessness of debts under section 166.

Given the differences in the basic definitions, it is not surprising that the factual basis that underlies classification as a nonaccrual loan for regulatory purposes also differs from the facts required to support nonaccrual of interest for tax purposes. Loans are placed in nonaccrual status for regulatory purposes on the basis of delinquency in principal or interest payments that extends beyond a certain period, usually 90 days. The 90-day threshold does not apply, however, to consumer loans and certain residential mortgage loans. The formulation of a nonaccrual policy with respect to these types of loans is left to the individual institution. For

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[84]This is consistent with the principles of Rev. Rul. 84-95, cited at note 16, supra, holding that the presumption encompasses only those charge-offs that are based on bad debt criteria under section 166.

tax purposes, because ultimate uncollectibility is the standard for nonaccrual, delinquency alone would not justify the omission of unpaid interest from income.

Finally, it appears that the judgments made in accordance with the regulatory standards governing nonaccrual would not provide an adequate substitute for the judgment of a revenue agent regarding whether the interest from such a loan must be included in income. The regulatory standards governing the classification of nonaccrual loans lack the uniformity of standards that is present in the classification of loss assets. Because individual institutions are free to set their own nonaccrual policies with regard to consumer loans and certain residential mortgage loans, standards for such loans may vary from institution to institution. In those cases, a conformity rule would tie tax treatment to a regulatory standard that cannot be readily identified.

In light of these factors, the Treasury Department has concluded that it is not appropriate to adopt a conclusive presumption that accrued but unpaid interest on loans that are placed in nonaccrual status for regulatory purposes be considered uncollectible for tax purposes.

IV. STANDARDS FOR UNREGULATED INSTITUTIONS

In addition to the depository institutions that are the subject of Part III of this study, there are a great many nondepository providers of consumer financial services. These companies range from independently owned consumer finance offices to very large financial services and retail and automobile companies and hold approximately one quarter of all consumer credit debt outstanding in the United States.

These nondepository institutions resemble regulated lenders in a number of ways. They typically hold large portfolios of homogeneous loan receivables. Like large banks, they are not permitted to use the reserve method in computing the deduction for bad debts. As a consequence, they face similar difficulties in evaluating the quality of the assets in their portfolios on a loan-by-loan basis for purposes of determining their bad debt deductions. But because they are not subject to the regime of state and federal regulation that governs depository institutions, the conclusive presumption allowing conformity of tax and book treatment of worthless debts is not available to them. Therefore, in the absence of the reserve method, these taxpayers must use the specific charge-off method for deducting worthless debts and support such deductions with "all pertinent evidence" if challenged by the Internal Revenue Service.

In view of many similarities between these unregulated lenders and depository institutions and the burdens imposed by the loan-by-loan analysis required under the specific charge-off method, it is worthwhile to consider whether such lenders should have some sort of book/tax conformity rule comparable to the conformity rule now available to banks and thrifts.

As discussed at page 23 above, excessive charge-offs under the conformity rule are restrained by the very real tension that exists between the tax benefits resulting from the charge-offs and the adverse effects such charge-offs would have on an institution's regulatory rating and depositor confidence. In considering whether some type of conformity rule would be appropriate for the worthless debts of unregulated lenders, an important factor is whether, in the absence of federal regulatory requirements, there would be some comparable restraint on overly aggressive charge-off policies.

Recoveries on bad debts must be included in income, hence a lender's net deductions for bad debts over time will not exceed the amount of debts that are not repaid, regardless of how aggressive the taxpayer's charge-off policy may be. Nevertheless, a deduction taken in an early year on a loan on which recovery is realized (and taken into income) in some later year has the effect of deferring tax on the amounts recovered for the period between the year of charge-off and the year of recovery. This deferral can have serious revenue consequences. The effects of such deferral are exacerbated during periods of declining tax rates and high interest rates.

It has been suggested that unregulated lenders are effectively discouraged from taking an overly aggressive charge-off position by administrative and recordkeeping considerations, the disincentive effect that charge-offs have on collection efforts and the negative impact of charge-offs on book income. In many cases these concerns may not be an adequate substitute for the

oversight of federal and state regulators and the watchfulness of depositors. Accordingly, the Treasury Department does not believe that a conclusive presumption that would permit unqualified conformity of book and tax treatment is appropriate. Some additional governor on the timing of charge-offs is needed to protect the fisc.

Described below are several approaches that might be considered in developing a proxy for regulatory oversight that would address these concerns: (1) a "look-back" approach; (2) an "identical standards" approach; and (3) a "recovery rate safe harbor" approach.

The "look-back" approach

One way of assuring that the fisc is not disadvantaged by taxpayers' charge-off policies is to permit charge-offs at any time, but to require that the government be made whole for any loss it suffers as a consequence of the erroneous (in hindsight) charge-off.[85] Under this look-back approach, recoveries would be taxed at no less than the marginal rates at which the deduction reduced tax in the year of the charge-off and an interest charge would be imposed on the taxes deferred from the year of deduction until the year of recovery.

Because the government would ultimately be receiving the "right" amount, regardless of the year of the charge-off, the look-back approach would effectively eliminate timing concerns regarding excessive charge-offs. Nevertheless, we are aware that the look-back approach would require lenders to track the vintages of their loans and perform interest and other tax calculations. For lenders holding large numbers of relatively small loans, the recordkeeping requirements of this approach could well outweigh the benefits.

The "identical standards" approach

The identical standards approach would look to the standards for worthlessness applied to consumer debt held by regulated institutions and would grant a conclusive presumption of worthlessness for similar debts of an unregulated lender that are charged off according to

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[85]For an analysis of this approach, see Committee on Income Management of the American Taxation Association, "A Time Value of Money Approach to Bad Debts," 40 Tax Notes 1075 (1988) and Crane, "Refining the Time Value Approach to Bad Debts," 42 Tax Notes 803. The look-back approach eliminates concerns relating to the timing of bad debt deductions. Although the discussion of the look-back approach appears in the section of the study dealing with the treatment of unregulated lenders, it would be equally efficacious if generally applied to all taxpayers, including regulated lenders.

The look-back approach would not solve the problem of premature charge-off of loans that ultimately become uncollectible. The Treasury Department believes that the combination of administrative efficiency and revenue protection that would result from the look-back approach would compensate for losses attributable to that problem.

identical standards. Under this approach, a consumer installment loan held by a finance company would be conclusively presumed to be worthless for purposes of section 166 if it (1) had been delinquent for 120 days or more in the case of a closed-end installment loan or 180 days or more in the case of an open-end installment loan, and (2) had been written off as uncollectible for financial reporting purposes in accordance with the taxpayer's established policy set forth in the taxpayer's audited financial statements. These thresholds for determining worthlessness mirror the regulatory standards applied by the OCC in determining whether consumer installment loans, credit card plans and check credit are loss assets.[86]

For purposes of the proposed presumption, "finance companies" would include companies that derive 80 percent or more of their gross income from the business of making consumer loans. "Consumer installment loans" would generally include loans or lines of credit calling for monthly payments of principal and interest that have been extended to individuals for household or personal expenditures. Loans or lines of credit either secured by collateral in the possession of the lender or secured by real estate would not be treated as consumer installment loans for this purpose because of the likelihood that the lender will recover a substantial portion of such loans even if amounts are uncollectible from the debtor.

The identical standards approach is appealing in that it adopts identifiable objective standards for determining worthlessness and seeks to create parity between the treatment of regulated and unregulated lenders with respect to similar types of loans. A drawback of this approach, however, is that any Internal Revenue Service audit of compliance with the conditions required for eligibility for the conclusive presumption would require the loan-by-loan review that the conclusive presumption is intended to eliminate. That is, there would be no way to confirm that the debts charged off satisfied the requisite delinquency periods short of a review of the individual debt histories. Administrative efficiency, one of the major benefits of conformity, could therefore be substantially reduced. Nevertheless, we believe the substance of this proposal may provide a promising basis for the development of a workable conformity rule and would have an insignificant revenue effect.[87]

The "recovery rate safe harbor" approach

The recovery rate safe harbor approach is based on the premise that the most reliable measure of the validity of a lender's charge-off policies is its own recovery rate on charged-off loans. This approach would take into account the fact that unregulated lenders, as a group, do not apply uniform criteria in charging off loans. Loans may be charged off at various stages of

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[86]See discussion at pages 13-14, above. To maintain the desired parity with regulated institutions, the criteria for worthlessness would have to be adjusted to take account of changes in the regulatory debt classification criteria.

[87]We estimate that this approach would produce a revenue loss of less than $50 million over five years.

delinquency (90 - 180 days), on the occurrence of certain events or conditions, on foreclosure or repossession, or upon the sale of repossessed or foreclosed collateral. Because such lenders may evaluate the effectiveness of their particular charge-off standards by monitoring the level of their bad debt recoveries, it has been suggested that a conclusive presumption limited by safe harbor recovery rates is appropriate.

Under this approach, holders of high-volume homogeneous receivables and loans would enjoy a rebuttable presumption that both partially and wholly worthless debts that are written off for book purposes are worthless debts for purposes of section 166. This presumption would become conclusive if a taxpayer met a safe harbor under which the taxpayer's average recoveries over the six-year period up to and including the taxable year of the claimed chargeoff did not exceed 25 percent of average charge-offs for the same six-year period. If the safe harbor were not met, the Service could rebut the presumption by applying a facts and circumstances test on a loan-by-loan basis. A pure facts and circumstances test would remain available for taxpayers whose particular circumstances may make book conformity inappropriate.

The effectiveness of this proposal depends very heavily on the precision with which the appropriate safe harbor percentage could be determined. Based on the experience of a sample of the unregulated lending industry, it appears that the determination of the proper percentage should take into account a number of factors. First, there are disparities in average recovery rates, depending on the type of loan outstanding. The average recovery rate on car loans for the 1985-1989 period, for example, has been approximately 12 percent. This is substantially lower than the average rate for unsecured personal loans (15.5 percent), which is lower than the average rate for consumer installment loans (17.4 percent). There are also disparities in recovery rates, depending on the size of the lender; companies with over $1 billion in assets have lower average recovery rates than companies under that threshold. Because large companies experience lower recovery rates, the averages stated above represent a very broad range of rates experienced by the industry as a whole. For example, although the average recovery rate on automobile loans is 12 percent, rates for some lenders on such loans are in the 50-60 percent range. Similar patterns are present in the case of personal loans and consumer installment loans.

Given the disparities in unregulated lenders' experience, the benefits of the adoption of a single 25 percent safe harbor rate would fall unevenly on lenders, depending on the type of debt they hold and their size. It would also provide significant flexibility in charge-off policies, and accompanying income management opportunities, for companies whose historical experience has been substantially below the 25 percent safe harbor rate. At the same time, fashioning and administering multiple safe harbor rates based on loan type would introduce unacceptable complexity into an approach designed to provide simplicity and administrability. Based on the available data, it appears that a 25 percent safe harbor recovery rate would provide a conclusive

presumption for a substantial majority of unregulated lenders. It would also have measurable revenue consequences.[88]

Although we are not persuaded that recovery rates alone provide an effective basis for a conformity rule, we believe they do provide a useful measure of the validity of charge-off policies. Accordingly, should Congress enact a conformity proposal for unregulated lenders, we believe that the benefit of the conformity rule that would be provided by the identical standards approach should be limited to those lenders whose recovery rates do not exceed a prescribed recovery rate ceiling. Were the recovery rate limit and identical standards approaches combined as suggested, the revenue loss arising from adoption of such a proposal would be negligible.[89]

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[88]We estimate that the proposal would produce a revenue loss of between $35-$100 million over five years. This revenue estimate includes consumer credit held by finance companies and excludes debt held by retailers and gasoline companies.

[89]The revenue loss for this proposal would be slightly less than the revenue loss resulting from the identical standards approach. See footnote 87.

V. CONCLUSION

As stated above, proposed regulations are pending to implement the Treasury Department's conclusions concerning needed changes in the longstanding regulatory conformity rules for banks. Extension of the conformity rules to unregulated lenders would be a significant departure from settled policy and practice. We believe that extension of the conformity rule to unregulated lenders is a question for the Congress and should not be resolved by unilateral regulatory action.

APPENDIX

Illustration of Economic and Tax Accounting for Loan Portfolios with Loan Losses

A. Accounting for loan losses

Table 1 illustrates the pricing of a loan portfolio which includes a risk premium in the contract interest rate to cover the lender's expected loan losses using a hypothetical portfolio of loans, each with the same contractual terms. Assume that the lender expects complete contract fulfillment -- receipt of four payments of $126.80 and one payment of $1,126.80 -- for 85 percent of the loans (Class A loans). The lender also expects that five percent of the contracts will pay $126.80 per year for Years 1 and 2, $25.36 per year for Years 3 and 4, and $1,025.36 for Year 5 (Class B loans); five percent of the loans will pay full interest in Year 1 and default at the end of Year 2, leading to a realization of $100 of principal (Class C loans); and five percent of the loans will default in Year 1 with $200 realized (Class D loans). With these expectations and a 10 percent market rate of interest, the lender would set the contract interest rate at 12.68 percent to be assured that he will earn 10 percent on a portfolio of loans, with 2.68 percentage points constituting his risk premium.[90] Table 1 shows the stream of payments for this portfolio. With this risk premium included in the contract, the lender would be willing to pay $1,000 for a portfolio with a $1,000 principal.

B. Taxation of income from a portfolio with early loan losses

Table 2 shows the calculation of economic income for the portfolio described in Table 1 and demonstrates that the taxation of economic income does not change the value of the portfolio and thus does not distort investment choices. The income of the lender is the sum of the payments received from the borrower, whether characterized as principal or interest, and the change in the market value of the portfolio. During the first holding period (Year 1), the economic income is $100 ($130.46 - $30.46). The value of the portfolio in each year is the present discounted value of the future expected cash flows.[91] As noted in Table 2, the present discounted value of the portfolio before and after taxes is the same ($1,000). The price of the portfolio is unaffected by taxation, because when the annual decline in the value of the portfolio is used to

[90]In order to identify the risk premium, it is assumed that there is no market risk attributable to changes in overall economic conditions, or changes over time in factors specifically related to the risk characteristics of the loans in the portfolio.

[91]The lender's after-tax discount rate (6.6 percent) is used to discount the after-tax cash flows.

Table 1

Illustration of the Pricing of a Loan Portfolio

Principal	$1,000.00
Contract Rate (percent)	12.68
Discount Rate (percent)	10.00

	Fraction of Loan Class in Portfolio	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Payments received on loans in each class per $1,000 of loan principal							
Class A Loans	0.85		$126.80	$126.80	$126.80	$126.80	$1,126.80
Class B Loans	0.05		126.80	126.80	25.36	25.36	1,025.36
Class C Loans	0.05		126.80	100.00	0.00	0.00	0.00
Class D Loans	0.05		200.00	0.00	0.00	0.00	0.00
Payments received on loan portfolio per $1,000 of portfolio principal[1]							
Class A Loans	0.85		107.78	107.78	107.78	107.78	957.78
Class B Loans	0.05		6.34	6.34	1.27	1.27	51.27
Class C Loans	0.05		6.34	5.00	0.00	0.00	0.00
Class D Loans	0.05		10.00	0.00	0.00	0.00	0.00
Total payments			130.46	119.12	109.05	109.05	1,009.05
Present value		$1,000					

[1]Payments shown are the weighted average of loan payments for each loan class, weighted by the share of each loan class in the portfolio.

Table 2

Illustration of Economic and Tax Accounting for the Loan Portfolio With Early Loan Losses[1]

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
1. Total payments[1]		$130.46	$119.12	$109.05	$109.05	$1,009.05
ECONOMIC ACCOUNTING:						
2. Before tax value[2]	$1,000.00	969.54	947.37	933.06	917.32	0.00
3. Decline in value[3]		30.46	22.17	14.31	15.74	917.32
4. Economic income [(1)-(3)]		100.00	96.95	94.74	93.31	91.73
5. Income tax [(4)x.34]		34.00	32.96	32.21	31.72	31.19
6. After-tax payments [(1)-(5)]		96.46	86.16	76.84	77.32	977.86
7. Present value after tax[4]	1,000.00					
TAX ACCOUNTING:[6]						
8. Beginning principal[7]		1,000.00	950.00	900.00	905.07	910.79
9. Interest accrued[8]		120.46	114.12	114.12	114.76	109.05
10. Interest received[1]		120.46	114.12	109.05	109.05	109.05
Charge-Off Method:						
11. Deduction[9]		40.00	45.00	0.00	0.00	10.79
12. Taxable income [(10)-(12)]		80.46	69.12	114.12	114.76	98.26
13. Income tax [(13)x.34]		27.36	23.50	38.80	39.02	33.41
14. After tax payments [(1)-(14)]		103.10	95.62	70.25	70.03	975.64
15. Present value after tax[4]	1,001.85					
Reserve Method:						
16. Ending reserve[10]	0.00	20.53	19.50	18.48	18.58	18.70
17. Deduction (addition to reserve)[11]		60.53	43.97	-1.03	0.10	10.90
18. Taxable income [(10)-(19)]		59.93	70.15	115.15	114.66	98.14
19. Income tax [(20)x.34]		20.38	23.85	39.12	38.98	33.37
20. After tax payments [(1)-(21)]		110.08	95.27	69.90	70.06	975.68
21. Present value after tax[4]	1,007.86					

Table 2 (continued)

[1]The amounts shown are based upon the loan portfolio shown on Table 1.

[2]Present value of remaining future payments shown on line (1).

[3]Difference between the before-tax value (line 2) for the current year and the previous year.

[4]Present value of after-tax payments (line 6) discounted at the lender's after-tax rate of return (6.6 percent).

[5]Ratio of the present value of the tax payments (lines 5, 13, or 19) to the present value of the economic income (line 4).

[6]Assumes that the taxpayer uses the accrual method of accounting.

[7]Nominal principal less loans retired plus additions to principal attributable to interest accrued but not received.

[8]Beginning principal (line 8) multiplied by the contract rate of interest (12.68 percent).

[9]Loss of principal defaults during the year.

[10]Reserve fraction multiplied by loans outstanding at end of prior year (line 8). The reserve fraction was estimated by dividing the sum of loan losses (line 11) by the sum of loans outstanding (line 8) for Years 1 through 5.

[11]The sum of the loss and the excess of the ending reserve the reserve for the prior year. Total deductions appear to exceed the losses shown in line 11 because deductions in excess of actual losses are not fully recaptured until all loans outstanding mature or default.

compute taxable income, the lower after-tax payments received are offset by the lower discount rate used to evaluate these reduced cash flows.

Under the specific charge-off method, a taxpayer may generally take a bad debt deduction with respect to a loan (or part of a loan) in the year that it becomes worthless. Table 2 demonstrates the application of the specific charge-off method by an accrual method taxpayer to the $1,000 loan portfolio described in Table 1. In Year 1, Class D loans default. The borrowers pay no interest and only $10.00 of the $50.00 principal owed. The lender deducts the $40.00 of unpaid principal. In Year 2, Class C loans default. The lender receives no interest, receives $5.00 of the $50.00 principal due, and deducts $45.00 of unpaid principal. For Years 3 through 5, Class B loans pay $1.27 of interest. The interest accrued but not received ($5.07) is included in the lender's income each year and added to the principal of the loan, in effect extending more credit to the borrower. In Year 5, the lender deducts the increase in principal attributable to accrued but unreceived interest.

In this example, the present value of the after-tax cash flows from the portfolio of investments exceeds the present value of the before-tax cash flows, because the lender has deducted defaulted amounts before he has taken into income payments reflecting the risk premium charged on all loans. As a result of this mismatch, the value of the loan contract increases from $1,000.00 (before tax) to $1,001.85 (after tax). Because the pre-tax and after-tax portfolio values differ, investment decisions are likely to be distorted.

Table 2 also illustrates the effect of the reserve method for an accrual method taxpayer. The reserve method allows a deduction for the amount necessary to produce the appropriate reserve balance. Based upon the lender's historical experience with loan losses, which is assumed to be identical to the expected losses for the portfolio illustrated in Table 1, the lender would maintain an end-of-year reserve equal to 2.053 percent of his outstanding loans at the beginning of the year.[92] In Year 1, the lender would be permitted a deduction of $60.53, the sum of the excess of the ending reserve ($20.53) over the ending reserve for the prior year ($0) and the loss incurred during the year ($40.00). In Year 2, the lender charges the loss of principal on Class C loans ($45.00) against the $20.53 reserve balance at the beginning of the year. The lender would be permitted a bad debt deduction of $43.97, the amount needed to restore the reserve balance to $19.50.[93] In Years 3 and 4, the lender adds the accrued but unreceived interest on Class B loans to the principal of the loan, in effect extending more credit to the borrower. In

[92]The reserve fraction was estimated by dividing the sum of loan losses determined under the charge-off method (line 11) by the sum of loans outstanding (line 8) for the five years shown on Table 2. In actual practice, a moving average rather than a fixed average is used, but this should not have an appreciable effect on the results shown.

[93]The tax deduction is the sum of the loss ($45.00) and the excess of the ending reserve ($19.50) over the ending reserve for the prior year ($20.53).

Year 5, the additional principal attributable to the accrued but unreceived interest payments are charged against the reserve.

Under the reserve method, the present value after-tax of the loan portfolio exceeds its pre-tax value ($1,007.86 v. $1,000.00). The disparity between the after-tax value of the loan portfolio and its pre-tax value is greater under the reserve method than under the charge-off method, because the mismatch between the time the deductions attributable to loan losses are taken and the time the risk premium is included in income is more extreme under the reserve method.[94]

Table 3 compares economic and taxable income for the loan portfolio shown on Table 1. The charge-off and reserve methods defer income and tax liability, because the recognition of income attributable to the risk premium covering the expected losses tends to be deferred relative to the deduction associated with the loss. Under the reserve method the present value of the deferred income and tax liability are larger than under the charge-off method--$7.87 under the reserve method and $1.86 under the charge-off method.[95] These deferred tax liabilities account for the increase in the after-tax values of the loan portfolio over its pre-tax value shown on Table 2.

C. Effect of loan losses late in the life of the contract

The example described above shows that both the charge-off and reserve methods favor a loan portfolio characterized by early defaults. This section illustrates the effects for an alternative portfolio where defaults occur late in the life of the loans. It shows that the taxation of economic income does not affect the price of the portfolio, whereas the charge-off and reserve methods may favor or disadvantage a portfolio with late loan losses.

In this example, shown on Table 4, Class A loans (85 percent of the total) fulfill the terms of the contract -- four payments of $122.73 and a fifth payment of $1,122.73. Class B loans five percent of the total) pay the full amount of interest $122.73 for Years 1 and 2 and $24.55

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[94]The calculations in Table 2 assume that the taxpayer continues to acquire in future years a loan portfolio with the same characteristics as the portfolio illustrated in Table 1, and thus was able to establish a loss reserve at the end of Year 5 of $18.70. Were it instead assumed that the taxpayer discontinues his lending operations and thus reduces the loss reserve to zero, the after-tax value of the portfolio would be $1,003.27. Even in this extreme case the reserve method is more distortionary than the charge-off method.

[95]Total deductions under the reserve method will appear to exceed total deductions under the charge-off method, because the excess deductions under the reserve method are not fully recaptured until all loans outstanding mature or default.

Table 3

Income and Tax Deferral for the Loan Portfolio With Early Loan Losses[1]

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
1. Economic income[2]		$100.00	$96.95	$94.74	$93.31	$91.73
Charge-Off Method:[3]						
2. Taxable income[4]		80.46	69.12	114.12	114.76	98.26
3. Deferred income [(1)-(2)]		19.54	27.83	-19.38	-21.46	-6.53
4. Deferred tax [(3)x.34]		6.64	9.46	-6.59	-7.30	-2.22
5. Present value of deferred tax[5]	$1.86					
Reserve Method:[3]						
6. Taxable income[6]		59.93	70.15	115.15	114.66	98.14
7. Deferred income [(1)-(6)]		40.07	26.81	-20.41	-21.35	-6.41
8. Deferred tax [(7)x.34]		13.62	9.11	-6.94	-7.26	-2.18
9. Present value of deferred tax[5]	7.87					

[1]The amounts shown are based upon the $1,000 loan portfolio shown on Table 1.
[2]Line 4 from Table 2.
[3]Assumes the taxpayer uses the accrual method of accounting.
[4]Line 12 from Table 2.
[5]Present value of the deferred taxes shown on the preceding line discounted at the lender's after-tax discount rate (6.6 percent).
[6]Line 18 from Table 2.

Table 4

Illustration of the Pricing of a Loan Portfolio With Late Loan Losses

	Fraction of Loan Class in Portfolio	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Payments received on loans in each class per $1,000 of loan principal							
Class A Loans	0.85		$122.73	$122.73	$122.73	$122.73	$1,122.73
Class B Loans	0.05		122.73	122.73	24.55	24.55	1,024.55
Class C Loans	0.05		122.73	0.00	0.00	295.00	0.00
Class D Loans	0.05		0.00	0.00	450.00	0.00	0.00
Payments received on loan portfolio per $1,000 of portfolio principal[1]							
Class A Loans	0.85		104.32	104.32	104.32	104.32	954.32
Class B Loans	0.05		6.14	6.14	1.23	1.23	51.23
Class C Loans	0.05		6.14	0.00	0.00	14.75	0.00
Class D Loans	0.05		0.00	0.00	22.50	0.00	0.00
Total payments			116.59	110.45	128.04	120.29	5.54
Present value		$1,000					

[1]Payments shown are the weighted average of loan payments for each loan class, weighted by the share of each loan class in the portfolio.

per year for Years 3 through 5, and the full principal ($1,000) in Year 5. Class C loans (five percent) pay the full amount of interest for Year 1, no interest for years 2 and 3, and default in year 4. The lender recovers $295 of the $1,000 principal owed. Class D loans pay no interest for Years 1 and 2 and default in Year 3. The lender recovers $450 of the principal in Year 3. Assuming that the lender would earn 10 percent on alternative investments, he would set the contract interest rate at 12.273 percent, for which 2.273 percentage points constitute the lender's risk premium. With this risk premium included in the contract, the lender would be willing to pay $1,000 for a portfolio with a $1,000 principal.

Table 5 shows the economic and tax accounting for the loan portfolio shown on Table 4. The taxation of economic income recognizes declines in the value of the portfolio in the early years attributable to accrued but unreceived interest and the late loan defaults. Under the charge-off method, such declines in the value of the portfolio are not recognized until the loans default (Years 3 and 4). Thus, under the charge-off method the value of the portfolio declines from a pre-tax value of $1,000.00 to an after-tax value of $998.25. Since the reserve method recognizes losses attributable to the late defaults in the year of origination, the value of the portfolio increases from $1,000.00 (before tax) to $1004.24 (after tax).

Table 6 shows the unrecognized income and losses under the charge-off and reserve methods for the portfolio with late loan losses. Taxable income under the charge-off and reserve methods is higher than economic income in the early years of the contract and lower in the later years. However, taxable income under the reserve method is lower than taxable income under the charge-off method. The reserve method permits a deduction in the year of origination for defaults that occur late in the life of the contract in addition to deductions allowed under the charge-off method. Thus, the present value of the deferred tax liability under the charge-off method reduces the value of the portfolio relative to its pre-tax value by $1.75. Under the reserve method, the present value of the deferred taxes increases the value of the portfolio by $4.24.[96]

[96]Table 5 assumes that the taxpayer continues to acquire a loan portfolio in the future that has the same characteristics as the portfolio shown on Table 4. Alternatively, if the taxpayer were assumed to discontinue his lending activities and thus reduce his ending reserve in Year 5 to zero, the after-tax value of the portfolio would be $999.70.

Table 5

Illustration of Economic and Tax Accounting for the Loan Portfolio With Late Loan Losses

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
1. Total payments[1]		$116.59	$110.45	$128.04	$120.29	$1,005.54
ECONOMIC ACCOUNTING:						
2. Before tax value[2]	$1,000.00	983.41	971.30	940.39	914.13	0.00
3. Decline in value[3]		16.59	12.11	30.91	26.25	914.13
4. Economic income [(1)-(3)]		100.00	98.34	97.13	94.04	91.41
5. Income tax [(4)x.34]		34.00	33.44	33.02	31.97	31.08
6. After-tax payments [(1)-(5)]		82.59	77.02	95.02	88.32	974.46
7. Present value after tax[4]	1,000.00					
TAX ACCOUNTING:[6]						
8. Beginning principal[7]		1,000.00	1,006.14	1,019.16	967.94	910.42
9. Interest accrued[8]		122.73	123.48	117.34	111.06	105.54
10. Interest received[1]		116.59	110.45	105.54	105.54	105.54
Charge-Off Method:						
11. Deduction[9]		0.00	0.00	40.53	48.28	10.42
12. Taxable income [(10)-(12)]		122.73	123.48	76.82	62.78	95.12
13. Income tax [(13)x.34]		41.73	41.98	26.12	21.34	32.34
14. After tax payments [(1)-(14)]		74.86	68.47	101.93	98.95	973.20
15. Present value after tax[4]	998.25					
Reserve Method:						
16. Beginning reserve[10]		0.00	20.23	20.36	20.62	19.59
17. Deduction (addition to reserve)[11]		20.23	0.12	40.79	47.24	9.26
18. Taxable income [(10)-(19)]		102.49	123.35	76.55	63.82	96.29
19. Income tax [(20)x.34]		34.85	41.94	26.03	21.70	32.74
20. After tax payments [(1)-(21)]		81.74	68.51	102.02	98.60	972.81
21. Present value after tax[4]	1,004.24					

Table 5 (continued)

[1]The amounts shown are based upon the loan portfolio shown in Table 4.

[2]Present value of remaining future payments shown on line (1).

[3]Difference between the before-tax value (line 2) for the current year and the previous year.

[4]Present value of after-tax payments (line 6) discounted at the lender's after-tax rate of return (6.6 percent).

[5]Ratio of the present value of the tax payments (lines 5, 13, or 19) to the present value of the economic income (line 4).

[6]Assumes that the taxpayer uses the accrual method of accounting.

[7]Nominal principal less loans retired plus additions to principal attributable to interest accrued but not received.

[8]Beginning principal (line 8) multiplied by the contract rate of interest (12.68 percent).

[9]Loss of principal defaults during the year.

[10]Reserve fraction multiplied by loans outstanding at end of prior year (line 8). The reserve fraction was estimated by dividing the sum of loan losses (line 11) by the sum of loans outstanding (line 9) for Years 1 through 5.

[11]The sum of the loss and the excess of the ending reserve the reserve for the prior year. Total deductions appear to exceed the losses shown in line 11 because deductions in excess of actual losses are not fully recaptured until all loans outstanding mature or default.

Table 6

Income and Tax Deferral for the Portfolio With Late Loan Losses[1]

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
1. Economic income[2]		$100.00	$98.34	$97.13	$94.04	$91.41
Charge-Off Method:[3]						
2. Taxable income[4]		122.73	123.48	76.82	62.78	95.12
3. Deferred income [(1)-(2)]		-22.73	-25.14	20.31	31.26	-3.71
4. Deferred tax [(3)x.34]		-7.73	-8.55	6.91	10.63	-1.26
5. Present value of deferred tax[5]	$-1.75					
Reserve Method:[3]						
6. Taxable income[6]		102.49	123.35	76.55	63.82	96.29
7. Deferred income [(1)-(2)]		-2.49	-25.01	20.58	30.22	-4.87
8. Deferred tax [(3)x.34]		-0.85	-8.50	7.00	10.28	-1.66
9. Present value of deferred tax[5]	4.24					

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[1]The amounts shown are based upon the $1,000 loan portfolio shown on Table 4.
[2]Line 4 from Table 5.
[3]Assumes the taxpayer uses the accrual method of accounting.
[4]Line 12 from Table 5.
[5]Present value of the amounts shown on the preceding line discounted at the lender's after-tax discount rate (6.6 percent).
[6]Line 18 from Table 5.

TREASURY NEWS

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DEPT. OF THE TREASURY

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

FOR RELEASE AT 2:30 P.M.
September 17, 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 $21,200 million, to be issued September 26, 1991. This offering will provide about $2,925 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $18,263 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, September 23, 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 $10,600 million, representing an additional amount of bills dated June 27, 1991, and to mature December 26, 1991 (CUSIP No. 912794 XS 8), currently outstanding in the amount of $10,459 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $ 10,600 million, to be dated September 26, 1991, and to mature March 26, 1992, (CUSIP No. 912794 YF 5).

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

The bills will be issued for cash and in exchange for Treasury bills maturing September 26, 1991. In addition to the maturing 13-week and 26-week bills, there are $10,630 million of maturing 52-week bills. The disposition of this latter amount was announced last week. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. For purposes of determining such additional amounts, foreign and international monetary authorities are considered to hold $1,529 million of the original 13-week and 26-week issues. Federal Reserve Banks currently hold $ 1,759 million as agents for foreign and international monetary authorities, and $6,002 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-1458

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

LIBRARY ROOM 5310

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

SEP 19 1991 112346

DEPT. OF THE TREASURY

FOR RELEASE AT 2:30 P.M.
September 18, 1991

CONTACT: Office of Financing
202/219-3350

TREASURY TO AUCTION 2-YEAR AND 5-YEAR NOTES TOTALING $22,250 MILLION

The Treasury will auction $13,000 million of 2-year notes and $9,250 million of 5-year notes to refund $18,061 million of securities maturing September 30, 1991, and to raise about $4,200 million new cash. The $18,061 million of maturing securities are those held by the public, including $1,527 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

The $22,250 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 $1,310 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.

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Attachment

NB-1459

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

September 18, 1991

Amount Offered to the Public ...	$13,000 million	$9,250 million
Description of Security:		
Term and type of security	2-year notes	5-year notes
Series and CUSIP designation ...	Series AF-1993 (CUSIP No. 912827 C4 2)	Series T-1996 (CUSIP No. 912827 C5 9)
Maturity date	September 30, 1993	September 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	March 31 and September 30	March 31 and September 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, September 24, 1991	Wednesday, September 25, 1991
a) noncompetitive	prior to 12:00 noon, EDST	prior to 12:00 noon, EDST
b) competitive	prior to 1:00 p.m., EDST	prior to 1:00 p.m., EDST
Settlement (final payment due from institutions):		
a) funds immediately available to the Treasury ...	Monday, September 30, 1991	Monday, September 30, 1991
b) readily-collectible check ...	Thursday, September 26, 1991	Thursday, September 26, 1991

TREASURY NEWS

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

FOR RELEASE AT 2:30 P.M.
September 18, 1991

CONTACT: Office of Financing
202/219-3350

TREASURY TO AUCTION 2-YEAR AND 5-YEAR NOTES TOTALING $22,250 MILLION

The Treasury will auction $13,000 million of 2-year notes and $9,250 million of 5-year notes to refund $18,061 million of securities maturing September 30, 1991, and to raise about $4,200 million new cash. The $18,061 million of maturing securities are those held by the public, including $1,527 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

The $22,250 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 $1,310 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-1459

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September 18, 1991

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Interest payment dates	March 31 and September 30	March 31 and September 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, September 24, 1991	Wednesday, September 25, 1991
a) noncompetitive	prior to 12:00 noon, EDST	prior to 12:00 noon, EDST
b) competitive	prior to 1:00 p.m., EDST	prior to 1:00 p.m., EDST
Settlement (final payment due from institutions):		
a) funds immediately available to the Treasury ...	Monday, September 30, 1991	Monday, September 30, 1991
b) readily-collectible check ...	Thursday, September 26, 1991	Thursday, September 26, 1991

PUBLIC DEBT NEWS

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

LIBRARY ROOM 5310

FOR IMMEDIATE RELEASE
September 19, 1991

CONTACT: Office of Financing
202-219-3350

SEP 23 91 112474
DEPT. OF THE TREASURY

RESULTS OF TREASURY'S AUCTION OF 52-WEEK BILLS

Tenders for $12,547 million of 52-week bills to be issued September 26, 1991 and to mature September 24, 1992 were accepted today (CUSIP: 912794YY4).

RANGE OF ACCEPTED
COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.25%	5.56%	94.692
High	5.26%	5.57%	94.682
Average	5.26%	5.57%	94.682

Tenders at the high discount rate were allotted 54%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	20,420	20,420
New York	32,086,380	11,709,980
Philadelphia	10,020	10,020
Cleveland	20,745	20,745
Richmond	18,860	18,860
Atlanta	19,045	17,125
Chicago	1,481,320	283,220
St. Louis	20,620	10,780
Minneapolis	4,005	4,005
Kansas City	23,065	23,065
Dallas	6,965	6,965
San Francisco	647,185	148,685
Treasury	272,810	272,810
TOTALS	$34,631,440	$12,546,680
Type		
Competitive	$31,641,300	$9,556,540
Noncompetitive	560,140	560,140
Subtotal, Public	$32,201,440	$10,116,680
Federal Reserve	2,300,000	2,300,000
Foreign Official Institutions	130,000	130,000
TOTALS	$34,631,440	$12,546,680

NB-1460

TREASURY NEWS

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

LIBRARY ROOM 5310
SEP ... 1991
DEPT. OF THE TREASURY

For Release Upon Delivery
Expected at 10:00 a.m. (12:00 EST)
September 20, 1991

REMARKS BY
JAMES H. FALL, III
DEPUTY ASSISTANT SECRETARY (DEVELOPING NATIONS)
DEPARTMENT OF THE TREASURY
BEFORE THE
U.S.-ROC ECONOMIC COUNCIL'S JOINT BUSINESS CONFERENCE
SALT LAKE CITY, UTAH

It is a pleasure to speak again to this distinguished audience, particularly in light of the lively discussion we had last year in Taipei. In my remarks, I will focus on the current state of financial relations between the United States and Taiwan. My emphasis will be on the need for further liberalization and internationalization in Taiwan's financial sector. These developments are in Taiwan's interests.

The comments of all participants at this conference are made against the backdrop of the historic events unfolding around the world. Former one-party states have moved toward democracy, borders and boundaries have been redrawn; newly-independent countries are being created, and centrally-planned, command economies are embracing capitalism. In short, freedom of choice and the role of the market are becoming the key features which characterize a major portion of the world economy.

These features are, of course, well-established in Taiwan. However, as Taiwan's economy becomes a growing force in the world, the nature of its economic and financial relations with the rest of the world will increasingly be shaped by changes elsewhere. New demands for capital and expanded investment and trade opportunities have emerged from economic restructuring in Eastern Europe and Latin America. These developments cannot be lost on economic policy-makers everywhere. For Taiwan, major opportunities, challenges, and sources of competition are emerging.

It is axiomatic that these rapid changes demand that industrialized and newly-industrializing economies assume increased responsibilities. They must pursue policies that will encourage growth and stability in the world economy, provide open markets, and shape domestic policies that foster global cooperation and openness. Economies with large imbalances in saving relative to investment can best assume these responsibilities by increasing investment in their infrastructure, liberalizing their financial sectors and exchange regimes, reducing barriers to trade and expanding the choices available to consumers.

Taiwan's Growing Role in the Global Economy

As its economic strength has grown, Taiwan has increasingly broadened the scope of its foreign economic policy. Taiwan's growing foreign aid program assists countries undertaking economic restructuring, and in so doing, modestly reduces its own global imbalances. Taiwan has offered assistance to countries attempting to improve relations with the international financial institutions. These efforts are helping certain developing nations regain access to IMF, World Bank and Inter-American Development Bank lending, which will set them more firmly on a path of economic reform.

Many developing countries are at a stage of development similar to Taiwan twenty years ago. The success that an outward-looking economic development strategy has brought to Taiwan should encourage other economies to move toward a more open, market-based growth and development strategy. We welcome the cooperation and example Taiwan has offered in this area.

However, the most constructive efforts Taiwan can make in advancing this cooperative strategy lie in a concerted effort to reduce its persistent trade and current account surpluses. Taiwan has made some progress over the past several years, but further improvement is still needed. The perennial imbalance in trade between our two economies seems to be easing slightly, although progress has come slowly. According to the most recent data from Taiwan, its trade surplus with the U.S. has fallen by more than 21 percent in the first eight months of this year against the comparable period last year. Nevertheless, the overall level of the bilateral imbalance is still unsustainable. In addition, over the same period, Taiwan's global trade surplus has actually increased by 0.4%. International reserves also remain at near-record levels. From the perspective of Taiwan's major trading partners, these developments will continue to generate increasing concern.

As we have long urged, the adjustment process will be facilitated if trade barriers are removed. Barriers such as excessively high tariffs on agricultural products, import licensing requirements, ineffective enforcement of intellectual property rights and restrictions on investment in the financial services and telecommunications sectors should be given priority attention. Likewise, as we have made known in our discussions with Taiwan's authorities and in reports to our Congress, exchange rate appreciation must continue to play a role in this process.

Limitations on capital flows, particularly on capital inflows, and on foreign exchange transactions restrain the adjustment process. These impediments to the full operation of market forces clearly effect the exchange rate. The U.S. will continue to watch closely the pace of adjustment in the overall and bilateral trade balance and the role of the exchange rate in that process.

To counter the continued global trade surplus, Taiwan's policy officials need to focus less on export promotion, and more on strengthening domestic demand. In this regard, Taiwan's encouraging proposals for a Six-Year National Development Plan offer an excellent opportunity to further reorient the economy away from its dependence on exports by stimulating investment through spending on infrastructure. This will help build the foundation for sustained economic growth and diversification of the domestic economy while reducing Taiwan's external surpluses. It will also provide increased opportunities for foreign firms in a variety of sectors. At the same time, it will require further internationalization of the economy, particularly in the financial sector, if the people of Taiwan are to benefit fully from the improvements in economic efficiency that the proposed National Development Plan is designed to achieve.

Internationalization of the Financial Sector

A more complete opening of the financial sector has become increasingly crucial when seen against the background of the competing demands for capital in other regions of the world. Global capital flows are most likely to achieve the desired results of improved trade, growth and development in Taiwan and other regions of the world when these flows are unencumbered.

Financial sectors in all countries must become deeper, more efficient, more flexible, and more stable. Policy-makers and businessmen in most global and regional financial centers have recognized the challenges and competition ahead and are increasing the pace of modernization. Taiwan cannot be separate from this process. It must press the pace of liberalization in order to avoid losing ground to well-established or emerging financial centers, including in Asia.

I stress this point because there is a widely-held view that the development of Taiwan's financial system has lagged behind that of the economy as a whole. To cite some examples, businessmen on Taiwan do not have access to certain sophisticated financial products available in advanced economies. Their access to international capital is restricted, and the cost of capital is probably higher than it might otherwise be, a daunting prospect to domestic businessmen wishing to participate in the National Development Plan.

While Taiwan's economy has grown and matured even in the absence of a truly modern and open financial sector, many would argue that the financial sector may serve as a drag on current growth and may retard the transformation to a more balanced and diversified economy with better prospects for steady and strong growth into the next century.

Taiwan's authorities appear to understand the problem the economy faces, and appear prepared to make the financial sector more efficient. However, efforts to date have also been accompanied by a substantial measure of caution. Treasury's general assessment is that Taiwan has made substantial progress towards reducing impediments to a market-determined exchange rate and the free flow of foreign exchange, while the pace of modernization on financial services issues has lagged.

The benefits to liberalization are many, and should be evident in the success of countries that have already followed this path. Most importantly, easing restrictions on both domestic and foreign investors will increase the efficiency of the financial market by increasing its depth and stability. Doing so will lower the cost of capital for all firms and provide domestic capital to fund the shift away from an export-oriented strategy. This will be especially important given the magnitude of public spending envisioned by the National Development Plan, which will require a more sophisticated financial sector if domestic and foreign resources are to be efficiently channeled to investment opportunities.

An effort to expand opportunities for foreign firms must be an integral part of the financial modernization program. Further opening to foreign participation will be necessary to link Taiwan into the network of global financial centers and increase access to global capital markets and worldwide financial services. Such linkages will assist domestic firms in their efforts to do business internationally, and will facilitate Taiwan's development as a regional financial center. Foreign expertise will also help Taiwan develop the technological infrastructure necessary to support an advanced financial sector. If sufficient opportunities are provided, foreign firms will provide these services to Taiwan. In return though, they will expect a firm commitment of a permanent role in Taiwan's economy. The present

uneven pace of liberalization is clearly sending mixed signals to foreign firms and detracting from the desirability of Taiwan as a regional financial center.

Taiwan can move boldly to incorporate itself into the new world, or it can be a cautious, tentative observer. Taiwan, we believe, can become a dynamic player in global markets, including financial markets. But it must think of markets not just in terms of goods, but in terms of services as well.

U.S. Interest in Further Liberalization

In that vein, Taiwan in recent years has taken some steps to modernize the financial sector and expand opportunities for foreign firms. However, the slow pace of these efforts will continue to frustrate Taiwan's trading partners, adding unnecessary friction to bilateral relations. It will continue to raise questions about Taiwan's commitment to further opening its economy. Ultimately, the lack of significant movement casts doubts on the feasibility of establishing Taiwan as a regional financial center.

The situation faced by foreign financial firms in Taiwan continues to concern the U.S. While modest improvements have been made, significant denials of national treatment continue. In many instances, there is outright discrimination against foreign firms. In the banking sector, for example, the number and location of additional foreign bank branches is still restricted. Special ceilings, over and above those faced by domestic banks, are imposed on loans made by a foreign bank to any single customer. Foreign banks also cannot deal directly in short-term money market instruments.

Foreign firms wishing to participate in the securities market also face significant denials of national treatment. For example, substantial restrictions are placed on foreign institutional investment in the stock market, while investments by foreign individuals are prohibited altogether. Foreign firms cannot manage private pension funds. These types of restrictions and barriers are increasingly difficult to justify to the Congress or to cast in a positive light.

As global competition in the financial services industry heightens, the Administration will face increased political pressure to open foreign markets to U.S. firms. Congress, the Administration, and the financial services industry all want to ensure that U.S. firms abroad are given national treatment, as well as the opportunity to offer a full range of financial services and products. This has not been the case in Taiwan. Treasury's last National Treatment Study report to Congress had to note that despite some improvements, important and significant denials of national treatment remain for U.S. firms in Taiwan.

Last year, the Administration introduced a far-reaching package of financial reform proposals. Under these proposals, we will continue to offer national treatment, as well as liberalization and expanded activities for foreign banks. In return, we will continue to seek national treatment and liberalization in foreign markets.

The final outlines of the financial services reform package are still being debated in the Congress. But it is clear that in return for granting new privileges to domestic and foreign banks, the Congress will continue to press for liberalization overseas. As Senator Garn will no doubt describe, there has been a continuing movement in Congress to shift away from national treatment and equality of competitive opportunity towards reciprocity of national treatment. Financial policy-makers abroad must recognize that it is politically unrealistic to assume that the U.S. can offer foreign banks opportunities that are not available to U.S. firms in foreign markets.

This sentiment is reflected in proposed legislation under consideration by the Congress. For example, under the Fair Trade in Financial Services Act sponsored by Senator Garn, the Treasury would be given additional leverage to assure fair treatment of U.S. financial firms in foreign financial markets. The bill essentially would give U.S. financial regulators, in consultation with the Secretary of the Treasury, the ability to deny applications to foreign financial firms in the U.S. if those foreign countries do not allow U.S. firms to participate in their markets. This proposal is part of the Senate Banking Committee's financial modernization legislation. In addition, under existing legislation, another National Treatment Study is due in 1994. Between now and then, there will also be periodic updates and requests for testimony. The issue will not go away.

Our concerns are shared by Taiwan's other trading partners. For example, the recent U.K.-Taiwan trade talks emphasized financial services, and the E.C. as a whole is likely to pay much closer attention to Taiwan. But pressure from the other nations should not be the reason Taiwan continues to liberalize its financial markets. Liberalization is, first and foremost, good for the growth and development of Taiwan.

Concluding Remarks

The fast pace of changes in the world will increase the internationalization of national economies, and thus the number of areas in which the economic and financial interests of the U.S. and Taiwan converge. Cooperation on financial and economic issues has been good and we sincerely hope it will continue. Taiwan's efforts have not gone unappreciated. Like Taiwan's leaders, we anticipate that Taiwan will play an increasingly significant role in the world economy as it further assumes the

responsibilities of an industrialized economy. But to attain that goal, Taiwan will need to make progress on a variety of issues, particularly in the financial sector. We hope to work together to secure these outcomes.

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FOR IMMEDIATE RELEASE
September 21, 1991

Contact: Claire Buchan
202/566-8773

Treasury Statement on Office of Government Ethics Review of Comptroller Clarke's Financial Filings

The Office of Government Ethics (OGE) review of Comptroller of the Currency Robert Clarke's financial filings confirms that Mr. Clarke has abided by ethical standards of conduct and that no conflict of interest has in fact occurred during Mr. Clarke's tenure as Comptroller.

In determining that Mr. Clarke adhered to ethics rules, the report says, "He disclosed all interests, executed and abided by all recusal agreements and most importantly...sought advice from ethics officials when he had any question as to the manner and appropriateness of his private sector financial transactions."

The OGE review notes that Mr. Clarke continually sought and adhered to legal advice. The review also notes that Mr. Clarke's recusals and disclosures resolve any issue of appearance of conflict of interest.

The review agrees with Treasury's conclusion in nearly all instances, with the single exception of a difference of opinion on an interpretive issue regarding a Treasury regulation. In this instance, the OGE again notes that Mr. Clarke did seek and adhere to legal advice.

As a matter of prudence, Mr. Clarke has elected to undertake additional steps to avoid even an appearance of conflict of interest. These steps include establishing a blind trust and improved coordination and review of his holdings and transactions by ethics officials at OCC, FDIC and the RTC.

-30-

NB-1462

United States
Office of Government Ethics
Suite 500, 1201 New York Avenue, N.W.
Washington, D.C. 20005-3919

September 20, 1991

The Honorable Carl Levin
Chairman
Subcommittee on Oversight of
Government Management
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

This is in response to your letter of June 14, 1991, concerning the report prepared by the Department of the Treasury (Treasury) on certain financial filings and activities of Robert Clarke, Comptroller of the Currency. You requested that this Office review all aspects of Mr. Clarke's financial disclosure and possible conflicts of interest to determine whether Treasury's disposition of these matters was appropriate.

By his letter of June 4, 1991, Dennis I. Foreman, Treasury's Designated Agency Ethics Official, transmitted to this Office the Department's report on their review of Mr. Clarke's financial filings and activities. The report discussed specific issues arising from Mr. Clarke's financial dealings as well as more general matters such as cooperation and interaction among ethics officials of the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Resolution Trust Corporation (RTC) regarding conflict of interest reviews for individuals like Mr. Clarke, who may serve all three agencies.

Based upon our review, we believe there is no demonstration that Mr. Clarke conducted his personal financial affairs with disregard for ethics standards. He disclosed all interests, executed and abided by all recusal agreements and most importantly, according to Treasury, sought advice from ethics officials when he had any question as to the manner and appropriateness of his private sector financial transactions. As discussed below, we believe, however, that the advice Mr. Clarke received in one instance was inaccurate and Treasury's review of his financial disclosure statements was incomplete. Finally, there is no demonstration that Mr. Clarke received any additional profit from bond market activities because of his Government position, a statement in which the FDIC concurs. I have an appointment with

Mr. Clarke to discuss the results of this review and my observations on these issues.

This Office believes that the actions proposed by Treasury and OCC officials will eliminate any problems associated with Mr. Clarke's financial interests and will improve the cooperation on conflict of interest issues among OCC, FDIC, and RTC. We note that Mr. Clarke has made commitments to establish a qualified diversified trust under the blind trust provisions of the Ethics in Government Act of 1978, as amended; to avoid parallel business interests or investment with employees of the OCC; and, to recuse himself from all particular matters involving Citizens and Southern National Bank of Atlanta. Further, he will pre-clear all investment transactions with OCC, FDIC, and RTC ethics officials, provide FDIC and RTC ethics officials with copies of his public financial disclosure reports for review, and strengthen existing procedures for prior review of FDIC and RTC Board meeting agendas to prevent his participation in matters from which he is precluded because of recusal commitments. Once these commitments are in place, we believe that Mr. Clarke will be in compliance with applicable laws and regulations governing conflicts of interest.

With regard to Mr. Clarke's financial disclosure statements, you asked that we address the adequacy of Treasury's review of these statements and the documentation supporting the reviewing officials' inquiries. It is our opinion that the reviewing officials at Treasury and OCC did not, in one instance, adequately explain in a comment or assist Mr. Clarke in eliminating all possible ambiguities on his financial disclosure reports and corresponding attachments. Mr. Clarke's financial disclosure reports for calendar years 1987 through 1989 and his new entrant report submitted in December 1990, indicate that he held a promissory note from Mr. Dana Cook, the Special Advisor to the Comptroller. The Department's report concludes that the promissory note was not a loan but rather a joint investment between the parties. The Department, in its initial review of the 1987 financial disclosure report should have resolved any inconsistency in this entry and Mr. Clarke should have been advised at that time of the proper manner in which to report the arrangement.

Additionally, you asked us to examine two complex transactions involving Mr. Clarke and Mr. Dana Cook which related to Pawleys Island Hammock Co., Ltd. (P.I. Ltd.) and St. Andrews Partners. You are interested in the rules with which the Office of Government Ethics (OGE) attributes corporate and partnership interests to individuals. You also asked whether or not OGE agrees with Treasury's conclusion that Mr. Cook's interest in P.I. Ltd. is

"both indirect and very small" and that, therefore, Mr. Clarke's loans to P.I. Ltd. do not constitute direct or indirect loans to Mr. Cook.

We believe that attribution principles should be employed with respect to the application of appearance standards in the context of non-public entities. Therefore, while we agree with Treasury's conclusion that Mr. Cook's interest in P.I. Ltd. was small, we disagree that it was indirect. As the sole owner of all the corporate stock of the general partner, we believe that Mr. Cook has a one percent direct interest in the limited partnership. In the case of providing working capital to P.I. Ltd., as opposed to the loan guarantees which we do not view as loans, we disagree with the conclusion that Treasury reached in its report.

We also note that Mr. Clarke sought advice on this issue and was advised by the OCC Chief Counsel, as well as its ethics official, that his facilitation of loans to P.I. Ltd. was proper under OCC guidelines.

We have discussed these issues with representatives of the Department. As noted above, Mr. Clarke will refrain from having any parallel business interests or investments in non-public entities with OCC employees. Further, OCC will strengthen and clarify the application of attribution rules. Also, OCC, RTC, and FDIC have agreed to consider a formal approach to dealing with indirect financial interests.

You also asked this Office to consider how and when the multi-agency review should be accomplished. Multiple agency service presents a unique set of problems. At this time, the ethics officials of the RTC and the FDIC are actively consulting with their counterparts at Treasury and OCC to fashion appropriate rules for an official in the multiple roles performed by the Comptroller of the Currency. Under the decentralized ethics program mandated for the executive branch, agencies may have rules requiring differing remedies and approaches. However, it is our opinion that the ethics officials of all agencies served by such multi-tasked officials should coordinate their approach for officials who, for whatever reason, are not already formally encompassed by the rules of all the agencies served. The decisions reached through such coordination should be the subject of formally adopted and announced policies and procedures.

OCC, FDIC and RTC have established an agreement to improve the existing procedures for dealing with potential conflicts of interest and other Government ethics considerations applicable to the Comptroller of the Currency's positions as a director of FDIC and RTC. Specifically, the three agencies will work cooperatively in the review of the Comptroller's public financial disclosure statement. OCC will share with FDIC and RTC ethics officials any comments or amendments to the statements raised by Treasury officials or this Office. Mr. Clarke has agreed to make all appropriate information from the qualified diversified trust agreement available to the OCC, FDIC and RTC and OCC will provide any other significant documentation such as waivers, recusals, and official correspondence related to the Comptroller's financial interests, available to FDIC and RTC officials. We will monitor the results of these efforts.

I hope this information has been helpful to you. If you have any further questions, please contact me.

Sincerely,

Stephen D. Potts
Director

Enclosure

United States
Office of Government Ethics
Suite 500, 1201 New York Avenue, N.W.
Washington, D.C. 20005-3919

September 20, 1991

Dennis I. Foreman
Designated Agency Ethics Official
Department of the Treasury
15th and Pennsylvania Avenue, NW.
Washington, DC 20220

Dear Mr. Foreman:

Pursuant to 5 C.F.R. §2638 you transmitted to this Office a copy of the June 4, 1991 report prepared by the Department of the Treasury (Treasury), which reviews the financial filings and activities of Robert Clarke, Comptroller of the Currency, and requested this Office's review and comments.

Our initial observations are that through the use of disclosure, recusal and seeking advice from agency officials, Mr. Clarke has insulated himself from what might otherwise be taken as valid public criticism of his handling of his personal financial affairs. Although not completely documented, we have accepted the representations of Office of the Comptroller of the Currency (OCC) officials that Mr. Clarke sought the advice of personnel within his agency regarding the matters addressed in the report and that he followed that advice.

Our conclusions regarding the activities discussed in the Treasury report are as follows:

High Yield Bonds

We found no evidence which demonstrates that Mr. Clarke received any additional profit from the occurrences and transactions discussed because of his Government position. Through discussions with officials at the Federal Deposit Insurance Corporation, we understand that they have arrived at the same conclusion. We further note that Mr. Clarke has made full disclosure of these holdings in all of his public financial disclosure reports.

Your report concludes that Mr. Clarke's investment activity did not give rise to any actual conflict of interest. However, Mr. Clarke has decided to establish a qualified diversified blind trust in order to eliminate even the potential for an appearance

question. This appearance of impropriety issue seems to be at the core of the public interest in these matters.

While we agree that after a review of the facts the average person with such knowledge would not be concerned with the transactions, we feel that it would be appropriate in high visibility matters such as those confronting the Resolution Trust Corporation (RTC) that better documentation and review of personal holdings are in order to preclude public confusion on these issues. A notation on the use of the advice of an institutional investment advisor as well as a more specific explanation of the OCC/RTC staff screening role, coupled with the actual entries on the financial disclosure report, would go far in eliminating unnecessary discussion of appearance issues.

The Home Loan

This loan was liquidated in accordance with its original terms and in accordance with the OCC Policy and Procedures Manual.

The Investment Loan

We agree that OCC policy does not provide specific guidance on renewing a loan originally made with a state bank after the state bank has merged with a national bank. However, the OCC April 7, 1986, Policies and Procedures manual clearly states that new employees may not renegotiate or renew a loan from a national bank. Guidelines involving an issue of this nature should be consistent, clear and unambiguous for all employees and in written form.

Mr. Clarke's recusal and disclosure of the loan, however, seem to resolve this issue notwithstanding the agency's lack of a clear renewal policy.

The Credit Card

Your report states that OCC policy generally requires an employee holding a credit card issued by a state bank that is taken over by a resulting national bank to terminate the use of the credit card. The OCC Policies and Procedures manual also states, for new employees, that credit cards, on which a national bank holds the receivable, may not be used. Although OCC has given permission for employees to borrow from a national bank when an existing recusal is in place, there is no formal written guidance addressing this exception. Any future OCC policy dealing with the

use of credit cards should include a discussion of the effects of recusal on such a policy.

We believe that Mr. Clarke's recusal and disclosure of the credit card resolve this issue.

1985 Ethics Commitment Regarding Partnerships

In our opinion, Mr. Clarke fully complied with the terms of his 1985 ethics agreements.

Tax Certificates

With regard to entries on his calendar years 1987 through 1989 financial disclosure statements reporting a promissory note from Mr. Dana Cook, you concluded that these entries incorrectly characterized the financial relationship between these two individuals. Your analysis concludes that these transactions did not involve lending by Mr. Clarke or borrowing by another OCC employee, rather they are correctly viewed as joint investments.

Further, a memorandum dated April 30, 1991, prepared by a Treasury ethics official, now deceased, would indicate that the Department has known this since this entry was first reported on his calendar year 1987 annual statement. However, there is no contemporaneous documentation which confirms Treasury's understanding of this arrangement, nor were any of the financial disclosure statements corrected to reflect this understanding. Mr. Clarke did not change this entry until his calendar year 1990 annual statement. The Department, in its initial review of the 1987 financial disclosure report should have resolved any inconsistency in this entry and Mr. Clarke should have been advised at that time of the proper manner in which to report the arrangement.

Pawleys Island Hammock Company Ltd. (P.I. Ltd.) and St. Andrews Partners L.P.

We disagree with your conclusion that the working capital advanced by Mr. Clarke to P.I. Ltd. did not constitute at least an indirect loan to Mr. Cook. This is so notwithstanding his corporate ownership of the general partner.

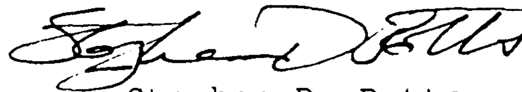
Our review of the organizational structure of P.I. Ltd. and St. Andrews Partners L.P. substantiates your position that Dana Cook's 1 percent interest in P.I. Ltd. and his .55 percent interest in Signature Broadcasting Ltd. were the only superior-subordinate

relationships involved in these ventures. However, we reconfirm our earlier stated position that dealings in businesses in which a subordinate also has an interest carries the potential for creating an appearance of conflict of interest.

While there is no way for us to confirm your representations, it is indeed fortunate that there is no indication that a conflict was in fact created during Mr. Cook's employment at OCC. However, viewing these business relationships in their totality, we conclude that Treasury, because of the unique nature of its regulatory duties, must develop a more comprehensive prohibited attribution rule. The only documentation of advice in this area involving Mr. Clarke's personal financial activities is a November 19, 1987, memorandum from an OCC ethics advisor which seems to be too technical an application of rules regarding what may be perceived as an appearance issue.

The issues raised here, and the need for such a report, demonstrate the importance of documenting advice provided by ethics officials in their role as counselors. This is particularly true in cases where the financial disclosure reports of high-level officials come under close scrutiny by members of the public and the press. Further, it demonstrates the need for well written policies which are made known to agency personnel at all levels and adhered to by those fulfilling their counseling roles.

Sincerely,



Stephen D. Potts
Director

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For Immediate Release
September 23, 1991

Contact: Anne Kelly Williams
(202) 566-2041

SEARCH COMMITTEE FOR RTC CHIEF OFFICER
SELECTS ALBERT V. CASEY

The search committee to find a new chief executive officer for the Resolution Trust Corporation (RTC) announced its selection of Albert V. Casey.

Secretary of the Treasury Nicholas F. Brady said, "Al Casey is a seasoned manager with strong experience in the private and public sectors. His record of success fills the bill for the RTC chief executive officer."

The search committee includes Secretary Brady, Chairman of the Federal Deposit Insurance Corporation L. William Seidman, Office of Thrift Supervision Director Timothy Ryan, RTC Oversight Board Member Robert C. Larson, and Deputy Secretary of the Treasury John E. Robson, who served as director of the committee.

"Mr. Casey is a smart, tough, proven leader with an excellent background in finance and business and an impressive track record of successfully managing large complex organizations," Robson said. "He will give the RTC strong direction."

L. William Seidman, FDIC Chairman, said, "I think he is an excellent choice and I am very pleased that he is willing to do it."

Mr. Casey's corporate and public sector experience includes:

- chairman and chief executive officer of American Airlines and its parent AMR Corporation (1974-85);

- various senior executive posts with the Times Mirror Company, including president of the corporation (1963-1974);

- Postmaster General of the United States (1986);

- chairman and chief executive officer of the First RepublicBank Corporation (1988-1989);

- Ann Cox Distinguished Professor of Business Policy at the School of Business of Southern Methodist University (1986-1988);

- his early business experience includes management positions at Southern Pacific Company and REA Express. He is a director of several corporations and holds a number of civic posts, including director of the International Executive Service Corps, trustee of the Urban Institute, director of the University Medical Center, and director of the University of Dallas.

Mr. Casey, 71, is a widower with two grown children and lives in Dallas, Texas.

The search committee will recommend Mr. Casey for the CEO's position to the RTC Board of Directors, which makes the formal appointment. Mr. Casey is expected to assume his position mid-October.

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202-219-3350

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RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

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Tenders for $10,607 million of 13-week bills to be issued September 26, 1991 and to mature December 26, 1991 were accepted today (CUSIP: 912794XS8).

RANGE OF ACCEPTED
COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.16%	5.31%	98.696
High	5.18%	5.33%	98.691
Average	5.18%	5.33%	98.691

Tenders at the high discount rate were allotted 52%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	30,045	30,045
New York	31,228,650	9,374,095
Philadelphia	23,380	23,380
Cleveland	50,395	50,395
Richmond	39,175	39,175
Atlanta	45,390	44,430
Chicago	1,199,115	162,475
St. Louis	52,695	17,895
Minneapolis	6,550	6,550
Kansas City	33,205	33,205
Dallas	23,140	23,140
San Francisco	652,600	85,200
Treasury	717,480	717,480
TOTALS	$34,101,820	$10,607,465
Type		
Competitive	$30,457,060	$6,962,705
Noncompetitive	1,422,850	1,422,850
Subtotal, Public	$31,879,910	$8,385,555
Federal Reserve	1,761,110	1,761,110
Foreign Official Institutions	460,800	460,800
TOTALS	$34,101,820	$10,607,465

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AUCTION RESULTS

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September 23, 1991

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CONTACT: Office of Financing
202-219-3350

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Tenders for $10,711 million of 26-week bills to be issued September 26, 1991 and to mature March 26, 1992 were accepted today (CUSIP: 912794YF5).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.22%	5.45%	97.361
High	5.23%	5.46%	97.356
Average	5.23%	5.46%	97.356

Tenders at the high discount rate were allotted 48%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	34,495	34,495
New York	31,390,220	9,508,515
Philadelphia	20,605	20,605
Cleveland	34,335	34,335
Richmond	41,935	41,935
Atlanta	46,730	45,210
Chicago	930,555	129,155
St. Louis	36,125	16,125
Minneapolis	12,330	12,330
Kansas City	42,580	42,580
Dallas	23,150	23,150
San Francisco	760,860	101,860
Treasury	700,820	700,820
TOTALS	$34,074,740	$10,711,115
Type		
Competitive	$30,051,920	$6,688,295
Noncompetitive	1,286,320	1,286,320
Subtotal, Public	$31,338,240	$7,974,615
Federal Reserve	1,950,000	1,950,000
Foreign Official Institutions	786,500	786,500
TOTALS	$34,074,740	$10,711,115

NB-1465

TREASURY NEWS

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

DEPT. OF THE TREASURY

TEXT AS PREPARED FOR DELIVERY
EMBARGOED UNTIL 9:30 A.M.
September 24, 1991

NICHOLAS F. BRADY
SECRETARY OF THE TREASURY
IOSCO ANNUAL MEETING
SEPTEMBER 24, 1991

This has been a turbulent year for the worldwide financial community. Political changes around the globe, wrongdoing, bad judgment, and technological advances have tested the world's financial markets and the rules that govern them. But the international markets have demonstrated resilience. Nevertheless, it is time to face up to the need for modernization and reform if we are to keep up with the continuing pace of change.

In the Soviet Union, we may be witnessing the beginnings of the free market. These events only reinforce the importance of a Western financial system that fosters creativity, rewards ingenuity and sparks competition. And, it further underscores the need for rules and regulations that properly channel these energies.

But, before we decide that today's bad news justifies a wave of new regulations in an already highly regulated market, let me tell you what overly regulated societies, such as Eastern Europe and the Soviet Union, aspire to. With all our problems, they want what we've got -- a free market economy and our help to develop one.

I have just returned from a trip to the Soviet Union. From President Gorbachev on down to the individual fledgling entrepreneur, they want our professional assistance on how to run a market economy. More than our money, the Soviets know they need training, organizational concepts, and management expertise. The Soviets and Eastern Europeans look to America's markets, and those of other western countries. They see that despite imperfections and some excesses, free markets raise the standard of living of people everywhere.

Let us continue to serve as a beacon for these emerging democracies by responding to new technologies and consumer needs. Only by doing so will we sustain the confidence of the world's financial markets. This is our obligation as world leaders, and it is essential to the success of our own markets.

This emphasis on the positive, pointing out the glass is half full, rather than half empty, doesn't mean that lawmakers, administration officials and industry leaders should be complacent for one moment about revelations of greed and wrongdoing. We should learn from these episodes and renew our commitment to improve the quality of regulation and enforcement in our markets. Our enemy is the imposition of piecemeal, uncoordinated, and ill-advised regulation. We should not pattern ourselves after the general who rides up to the battlefield and shoots the dead and dying just to prove his valor.

Instead, our goal should be to exert the firm hand of balanced regulation, and at the same time, signal by our actions that securities markets should reward professionals, not fast-buck artists. Our job should be to make sure that greedy hot shots don't get all four feet in the trough.

When Treasury and other agency investigations uncovered serious violations of government regulations in the auction market, we moved with dispatch to:

- -- Ban offending firms from buying government securities on behalf of customers;
- -- Require written verification of customer bids;
- -- Expand information sharing among government regulators;
- -- And, strengthen and accelerate the ongoing initiatives to automate the government auction process.

These initial changes were aimed at ensuring continued integrity in the government auction process. They are important steps in reconfirming to the rest of the world that the U.S. Treasury market remains not only the most liquid in the world -- but the fairest and most open. The events of the last several months were serious violations, and those who were responsible will have to pay for their mistakes. But the Treasury auction system has worked.

Last year, the Treasury issued $1.5 trillion of new securities. That's over $4 billion per day. These figures alone offer proof of the strength and integrity of the U.S. Treasury market.

We will continue to review the auction process to determine if other changes are appropriate, but decisions should not be made in haste, only to be repented at leisure. We should strive for securities markets that run like well-oiled machines, while still understanding that in free markets, there will always be frictions in the system.

The need for confidence in an integrated, international financial system has also been underscored by the unfolding scandal of BCCI.

The costs of this willful, malevolent operation have been enormous -- not only in money lost by trusting, innocent depositors abroad -- but in terms of the potential loss of confidence in the banking system. I yield to nobody in his resentment about this incredible deception. Nobody defends it. It is clear the world is not only bruised, but abused by this web of crime. We have been fortunate that, in this country, no depositors' money has been lost.

And the U.S. Customs Service was one of the first government agencies in the world to expose the institutional nature of BCCI's criminal activities. Bank officers are going to jail, and the bank is out of business. One of the reasons our BCCI investigation was successful was because of international and U.S. interagency cooperation. But, we can always do things better and faster, and the BCCI affair is a cry for improved international coordination.

We in the regulatory community will have the laboring oar in creating new regulations. If they are sensible, they will improve our chances to avoid this kind of fraud in the future. But let's remember the flow of money, like quicksilver or water, will seek its own path. And if the system we create is too onerous, the money and the markets will work around it, or not work at all.

In the desire to seek out criminals and build our reputation as tough enforcers, let us not forget there are many honorable people in our financial institutions who are as appalled as we are at recent events. However, they, as industry leaders, and we, as industry regulators, must confront the facts. There is something wrong in the way business has been conducted. A rising tide of greed has washed over the dam of professional integrity, and the result has been a dangerous glorification of monetary gain.

We cannot legislate against greed. Nor can we create a sense of profession by regulation and law. This must come from an inward sense of right maintained by those who compete in the business. And this sense of right must be buttressed by the knowledge that, when transgressions occur, there will be swift and fair justice from balanced and consistent regulators.

The Treasury market and BCCI episodes have intruded on the far-reaching debate over the regulatory structure of the U.S. financial services industry. Some have tried to use these aberrations as a charter for enacting new and overly burdensome regulation, and even for preserving the old anti-competitive restrictions, like Glass-Steagall. As a 35-year veteran of Wall Street, I understand the age-old competitive rivalries. But I firmly believe that it is time to make bold changes to the very securities laws under which I was trained on the Street.

President Bush has proposed the first comprehensive change in the banking industry and securities markets in over 50 years, and Congress is acting on this proposal as we speak. If the President's proposal is adopted, we will radically change not only the laws, but the philosophy, which have governed the banking and securities industries for half a century. In a world where plastic money cards are replacing checks and even cash, it is time for our laws to catch up with reality.

-- First, the President's plan will make deposit insurance safe for U.S. taxpayers and depositors by increasing market discipline, promptly addressing weak banks, and strengthening supervision. We will confront problems at banks before they become problems for the Bank Insurance Fund or, potentially, the taxpayer.

-- Second, our proposal will modernize archaic laws, which artificially restrict competition among financial services companies. Allowing banks to branch across state lines will lead to greater efficiency and geographic diversification. And permitting well-capitalized banks to affiliate with securities and insurance firms will make these institutions more competitive and better able to serve consumers.

-- Third, risk-based capital standards will reward stronger banks -- particularly smaller banks -- and force weaker banks to raise additional capital, making them safer and sounder.

-- Fourth, to make more private capital available to the industry, we would end the restriction on commercial ownership of banks. We should open the door to capital for banks -- and certainly for failing institutions, where the alternative could be taxpayers' money.

Finally, the effect of these changes will be to rekindle the international competitiveness of U.S. financial institutions and demonstrate again what every American knows -- that owning bank stocks can be a worthwhile investment. Private voluntary investment capital will flow back into the industry, so that the taxpayer will be spared paying for the losses of the banking industry.

Soon the European Community will have not just branch banking within individual member states, but intercountry branch banking, and technology has made that both possible and necessary. A technological revolution is taking place in the financial markets. Some countries are moving to meet these changes. The U.S. cannot lag behind a revolution that has already taken place.

Those who oppose comprehensive change would have you believe that reform is simply deregulation. It's not. It is a strategic change in approach that will work if we resist the urge to weigh it down with special interest protection. Opponents will try to use comprehensive reform as the vehicle for punitive re-regulation, and special interest protection. The last thing we need is more of what we already have -- rules that skew the markets and provide artificial protection for those who cannot compete on an open playing field. Our banking reform proposal is tough, balanced regulation, with competitiveness as its cornerstone.

There are strong advocates of responsible reform on both sides of the aisle -- Democrats and Republicans -- and they will not support provisions dealing with new bank activities which are anti-competitive. Yet there are those who still insist on such protectionist provisions. We will work hard to resist the easy path. We need to have reform that moves forward, not backward. I believe we can accomplish the full measure of comprehensive reform, and the coalition of supporters for fair competition tells me they intend to continue to work for that goal.

As technology brings our markets closer together, international coordination and cooperation will become even more important. We must be strong. We must be fair. And we must be current with the needs of the financial world today. In the end, I know we can provide what is needed to keep our markets safe and sound.

I commend Richard Breeden and the SEC for bringing this distinguished group together. And I appreciate the help we have received from other countries -- represented here today -- in keeping the international markets on the right track. With your help, that spirit of cooperation will continue. Thank you.

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TREASURY NEWS

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

DEPT. OF THE TREASURY

For Immediate Release
September 24, 1991

Contact: Anne Kelly Williams
(202) 566-2041

TREASURY ASSESSES PENALTY AGAINST BANK OF MINGO

The Department of the Treasury announced today that the Bank of Mingo of Naugatuck, West Virginia, has agreed to a settlement that requires it to pay a civil penalty of $54,600. The settlement is based on its failure to report ten (10) currency transactions as required by the Bank Secrecy Act.

Peter K. Nunez, Assistant Secretary for Enforcement, who announced the penalty, said the penalty represented a complete settlement of the civil liability of the bank for these violations. Mr. Nunez stated that the amount of the penalty imposed was the result of Bank of Mingo not voluntarily reporting the violations to the Department of the Treasury. The violations occurred while the compliance program of the bank's prior management was in effect. This case was developed through an investigation conducted by the United States Attorney in the Southern District of West Virginia.

The Department of the Treasury has no evidence that the Bank of Mingo engaged in any criminal activities in connection with these reporting violations. Current bank management has cooperated fully with the Treasury.

The Bank Secrecy Act requires banks and other designated financial institutions to keep certain records, to file currency transaction reports with the Treasury on all cash transactions by or through the financial institution in excess of $10,000, and, under some circumstances, to file reports on the international transportation of currency or other monetary instruments in bearer form or the equivalent. The purpose of the reports and records required under the Bank Secrecy Act is to assist the government's efforts in criminal, tax and regulatory investigations and proceedings.

oOo

NB-1467

PUBLIC DEBT NEWS

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

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DEPT. OF THE TREASURY

FOR IMMEDIATE RELEASE
September 24, 1991

CONTACT: Office of Financing
202-219-3350

RESULTS OF TREASURY'S AUCTION OF 2-YEAR NOTES

Tenders for $13,185 million of 2-year notes, Series AF-1993, to be issued September 30, 1991 and to mature September 30, 1993 were accepted today (CUSIP: 912827C42).

The interest rate on the notes will be 6 1/8%. The range of accepted bids and corresponding prices are as follows:

	Yield	Price
Low	6.13%	99.991
High	6.15%	99.954
Average	6.14%	99.972

Tenders at the high yield were allotted 31%.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	47,475	47,475
New York	34,465,930	10,384,900
Philadelphia	29,440	29,440
Cleveland	45,285	45,285
Richmond	1,127,230	863,940
Atlanta	581,540	548,330
Chicago	1,935,280	706,740
St. Louis	73,170	59,650
Minneapolis	29,815	29,815
Kansas City	87,120	83,670
Dallas	21,285	20,540
San Francisco	437,175	83,895
Treasury	281,780	281,770
TOTALS	$39,162,525	$13,185,450

The $13,185 million of accepted tenders includes $1,067 million of noncompetitive tenders and $12,118 million of competitive tenders from the public.

In addition, $1,028 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $1,110 million of tenders was also accepted at the average price from Federal Reserve Banks for their own account in exchange for maturing securities.

NB-1468

TREASURY NEWS

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DEPT. OF THE TREASURY

For Release Upon Delivery
Expected at 9:30 a.m.
September 25, 1991

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

I appear today at the Chairman's invitation to testify on the general subject of improving the tax system and protecting taxpayer rights. While I have been generally aware of the Subcommittee's interest in this subject through my Office's efforts over the past few weeks to provide revenue-estimating and technical support for the testimony the Commissioner will shortly deliver, I was unaware that the Subcommittee would request testimony from me until September 13, 1991. My testimony will, accordingly, be quite brief.

First, the Administration believes that simplification, within the fiscal constraints of last year's budget agreement, is the major compliance and administration improvement we could make in the tax system, apart from assuring that the Internal Revenue Service is adequately funded and that its systems modernization program is implemented in a timely manner. Simplification is a priority which the Commissioner and I have stressed in the regulatory guidance process, and we were both pleased when Chairman Rostenkowski announced his intention last year to make simplification a priority of the Ways and Means Committee. Since that time, we have engaged in productive cooperation with the staffs of the Ways and Means Committee and others to produce a broad range of simplification bills now before Congress, including H.R. 2777, the Tax Simplification Act of 1991, which enjoys bi-partisan support; H.R. 2730, the Pension Access and Simplification Act of 1991; and H.R. 3035, relating to intangible assets. Earlier this month (in testimony before the Taxation Subcommittee of the Senate Finance Committee), we suggested additional simplification proposals relating to the payroll tax deposit system and the earned income tax credit. We have already provided the Ways and Means Committee with detailed testimony on

most of these proposals and will address the intangible proposal on October 2.

With respect to the new items raised before the Finance Committee earlier this month, the Administration believes that the changes proposed in S. 1610 to the payroll tax deposit system merit serious consideration if steps are taken to make that bill revenue neutral. Like H.R. 2775 (about which we have previously testified before the Ways and Means Committee), S. 1610 would replace the eighth-monthly payroll tax deposit requirement in current law with a Tuesday/Friday, semi-weekly system. However, it would permit smaller employers to make monthly, rather than semi-weekly, deposits, while also shifting certain other small employers from a quarterly to the monthly system. We and the Internal Revenue Service believe that the monthly deposit approach may well be simpler for employers. We urge you to consider it seriously.

In addition, we have proposed repeal of the earned income tax credit (EITC) interaction rules (which cause the computation of the credit to be inter-dependent with the itemized deduction for medical expenses, the deduction for health insurance expenses of the self-employed, the child and dependent care tax credit, and the exclusion for employer-provided dependent care assistance). This change will significantly simplify the EITC rules and will permit the Service to compute the amount of the credit for all taxpayers who so desire. The EITC instructions would become simpler, thereby benefitting all potential claimants. To offset the modest revenue losses generated by the proposal, we have proposed a minor reduction in the basic credit rates which should not reduce the credit by more than $3.71 for any taxpayer (while other credit recipients will benefit by elimination of the interactions). Again, we urge favorable consideration.

These simplification bills and proposals offer the prospect of significant simplification for a broad range of taxpayers. Many are directly responsive to concerns and ideas of the Internal Revenue Service. Proposals such as payroll tax deposit reform, credit card payment of taxes, and simplification of reporting for household employers, to name but a few, have received significant support from the Service. Our work on the amortization of intangibles reflects an effort to address a significant compliance problem identified by the Service.

With Commissioner Goldberg, I believe American taxpayers are entitled to a comprehensible, predictable tax system. The cooperative efforts in which we have engaged over the past one and one-half years to achieve that most basic taxpayer right through simplification speak for themselves. These efforts will benefit literally millions of taxpayers. We intend to continue giving them priority effort.

Turning now to specific items in the Chairman's request for testimony, the Commissioner will advance six legislative proposals today in the area of taxpayer procedural rights and simplification. These proposals have been developed with our participation and cooperation; however, I will defer to the Commissioner for presentation of the specific proposals.

As we have previously testified with respect to simplification proposals, change in this area is not viable as a revenue-losing proposition. The Administration will insist that the pay-as-you-go provision of the budget agreement be satisfied by any combinations of these proposals ultimately adopted. Commissioner Goldberg's proposals satisfy this constraint because they are fully funded by the offset he is proposing. Indeed, his revenue offset will also provide some additional funds to meet existing revenue shortfalls in H.R. 2777, the bi-partisan simplification bill.

In addition, we have cooperated with the Commissioner's office over the past two years to provide regulatory guidance necessary to implement the Taxpayer Bill of Rights legislation enacted in 1988. These regulations include final regulations under section 6404 (erroneous written advice from IRS) and section 6326 (appeal of erroneous tax lien filing); proposed and temporary regulations under section 7811 (taxpayer assistance orders) and section 7605 (time and place of examination); and proposed regulations under section 6502 (collection after assessment), section 7432 (civil damages for failure to release lien), section 7433 (civil damages for unauthorized collection actions), section 7429 (review of jeopardy levy), and section 6332(c) (21-day holding period for levied accounts). We also expect to publish guidance in the near future under section 6332 (effect of honoring a levy); section 6335 (sale of seized property) and section 6343 (authority to release a levy and return property).

Other than the proposals which the Commissioner will shortly present, I am not aware of any legislative proposals dealing with procedural rights as to which the Commissioner has requested our concurrence during my tenure. During my tenure as Assistant Secretary, I have received no communication on the subject of taxpayer procedural rights from the Ombudsman other than the documents described in the next paragraph. In addition, I would further note that I have had no communication whatever from the staff of this Subcommittee on the subject of taxpayer procedural rights.

Upon receiving your September 12 letter, I requested my staff to review our files for communications from the IRS Commissioner and Ombudsman to our Office relating to recommendations on taxpayer rights. Prior to August of this year, we have no record that the Office of Tax Policy had

received any such communications. Given my responsibilities in the area of tax legislation, such requests for legislative change arising in the Department of the Treasury should be directed to me. We did recently receive some documents which contained legislative suggestions which the Ombudsman apparently had made over a period of time within the Internal Revenue Service with the request that we approve transmission of those documents to your Subcommittee. The Service's transmittal memorandum to me did not request that we support the Ombudsman's proposals and noted that the Service itself had not decided whether to support them. Given the fact that the documents pertained to legislative proposals, I advised that, like any other communication concerning legislation, the documents would require clearance by the Office of Management and Budget. Given the Subcommittee's interest in these essentially historical documents, we advised OMB that we recommended that their transmission to you be approved with the statement that the proposals themselves had not been reviewed by the Office of Tax Policy or the Office of Management and Budget and that, accordingly, the Administration had not taken any position on those proposals. Should this Subcommittee or the Internal Revenue Service wish to pursue particular proposals involving legislative action in addition to those identified by the Commissioner today, the Office of Tax Policy will, of course, review the proposals so identified and provide the views of the Administration.

In summary, we intend to pursue simplification vigorously on both the legislative and administrative fronts. We believe simplification improves the system for all taxpayers, not just those engaged in a tax controversy. Simplification will accordingly remain our Office's priority in the area of administration and compliance. We are, however, willing to consider well-articulated proposals for procedural change which demonstrably improve the tax system. Accordingly, we support, subject to the enactment of an acceptable revenue offset such as the one proposed by the Commissioner, the proposals set forth in the Commissioner's testimony today. We will be pleased to consider additional items meeting these criteria which the Committee may identify at a future date.

TREASURY NEWS

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

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DEPT. OF THE TREASURY

FOR RELEASE AT 2:30 P.M.
September 24, 1991

CONTACT: Office of Financing
202-219-3350

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $ 21,600 million, to be issued October 3, 1991. This offering will provide about $3,250 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $ 18,347 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, September 30, 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 $ 10,800 million, representing an additional amount of bills dated July 5, 1991 and to mature January 2, 1992 (CUSIP No. 912794 XT 6), currently outstanding in the amount of $ 10,727 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $ 10,800 million, to be dated October 3, 1991 and to mature April 2, 1992 (CUSIP No. 912794 YG 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 October 3, 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 $ 611 million as agents for foreign and international monetary authorities, and $4,636 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

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FOR IMMEDIATE RELEASE
September 25, 1991

CONTACT: BOB LEVINE
(202) 566-2041

UNITED STATES AND SRI LANKA SIGN PROTOCOL TO INCOME TAX TREATY

The Treasury Department announced today the signing, on September 20, in Colombo of a Protocol amending the pending income tax treaty between the United States and Sri Lanka. The Protocol was signed for the United States by Ambassador Marion V. Creekmore, Jr. and for Sri Lanka, by Ramalingam Paskaralingam, Secretary, Ministry of Finance. The pending treaty was signed on March 14, 1985, and was sent to the Senate for its advice and consent to ratification. The treaty, however, was never considered by the Senate because the passage of the Tax Reform Act of 1986 required certain changes to be made in the treaty. The Protocol incorporates those changes.

The principal substantive tax benefits provided by the 1985 treaty to residents of one country deriving income from the other (e.g., reduced withholding tax rates on dividends, interest and royalties, thresholds for the taxation by one country of business profits or personal services income earned by a resident of the other) are essentially unchanged by the Protocol. The most important changes affected by the Protocol include the exemption at source of income from the rental or use of containers in international traffic, the preservation by the United States of the right to impose the branch taxes on residents of Sri Lanka doing business in the United States, and the substitution of the anti-treaty-shopping rules in the 1985 treaty with the more comprehensive and flexible rules that have been used in more recent U.S. tax treaties.

The Protocol will be sent to the Senate for its consideration along with the 1985 treaty. The treaty, as amended by the Protocol, will enter into force upon the exchange of instruments of ratification. Its provisions will affect taxes withheld at source, for amounts paid or credited on or after the first day of the second month following entry into force. In respect of other taxes, it will have effect for taxable periods beginning on or after the first day of January of the year in which the treaty enters into force.

Copies of the Protocol may be obtained from the Office of Public Affairs, Treasury Department, room 2315, Washington, D.C. 20220, telephone (202) 566-2041.

NB-1471

AUCTION RESULTS

PUBLIC DEBT NEWS

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

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FOR IMMEDIATE RELEASE
September 25, 1991

CONTACT: Office of Financing
202-219-3350

RESULTS OF TREASURY'S AUCTION OF 5-YEAR NOTES

Tenders for $9,290 million of 5-year notes, Series T-1996, to be issued September 30, 1991 and to mature September 30, 1996 were accepted today (CUSIP: 912827C59).

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

	Yield	Price
Low	7.04%	99.834
High	7.05%	99.792
Average	7.05%	99.792

$50,000 was accepted at lower yields.
Tenders at the high yield were allotted 63%.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	37,203	36,278
New York	27,525,093	8,639,865
Philadelphia	18,337	18,337
Cleveland	42,494	42,479
Richmond	336,903	95,053
Atlanta	46,119	32,419
Chicago	1,016,709	164,818
St. Louis	46,268	36,783
Minneapolis	20,168	20,168
Kansas City	54,553	44,543
Dallas	18,587	18,587
San Francisco	552,747	61,647
Treasury	79,118	79,108
TOTALS	$29,794,299	$9,290,085

The $9,290 million of accepted tenders includes $737 million of noncompetitive tenders and $8,553 million of competitive tenders from the public.

In addition, $565 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $200 million of tenders was also accepted at the average price from Federal Reserve Banks for their own account in exchange for maturing securities.

NB-1472

DEPARTMENT OF THE TREASURY
BUREAU OF THE PUBLIC DEBT
WASHINGTON, D.C. 20239-0001

AUCTION YIELD TO PRICE CONVERSION TABLE

7% 5-YEAR TREASURY NOTES OF SERIES T-1996
CUSIP NUMBER: 912827 C5 9

AUCTION DATE: SEPTEMBER 25, 1991
SETTLEMENT DATE: SEPTEMBER 30, 1991
MATURITY DATE: SEPTEMBER 30, 1996
FIRST INT. PAYMENT: MARCH 31, 1992

INTEREST (COUPON) RATE: 7.000%

YIELD%	PRICE	YIELD%	PRICE	YIELD%	PRICE	YIELD%	PRICE
6.20	103.395	6.60	101.680	7.00	100.000	7.40	98.353
6.21	103.351	6.61	101.638	7.01	99.958	7.41	98.313
6.22	103.308	6.62	101.595	7.02	99.917	7.42	98.272
6.23	103.265	6.63	101.553	7.03	99.875	7.43	98.231
6.24	103.222	6.64	101.511	7.04	99.834	7.44	98.190
6.25	103.179	6.65	101.468	7.05	99.792	7.45	98.150
6.26	103.135	6.66	101.426	7.06	99.751	7.46	98.109
6.27	103.092	6.67	101.384	7.07	99.709	7.47	98.069
6.28	103.049	6.68	101.341	7.08	99.668	7.48	98.028
6.29	103.006	6.69	101.299	7.09	99.627	7.49	97.987
6.30	102.963	6.70	101.257	7.10	99.585	7.50	97.947
6.31	102.920	6.71	101.215	7.11	99.544	7.51	97.906
6.32	102.877	6.72	101.173	7.12	99.503	7.52	97.866
6.33	102.834	6.73	101.130	7.13	99.461	7.53	97.825
6.34	102.791	6.74	101.088	7.14	99.420	7.54	97.785
6.35	102.748	6.75	101.046	7.15	99.379	7.55	97.744
6.36	102.705	6.76	101.004	7.16	99.337	7.56	97.704
6.37	102.662	6.77	100.962	7.17	99.296	7.57	97.663
6.38	102.619	6.78	100.920	7.18	99.255	7.58	97.623
6.39	102.576	6.79	100.878	7.19	99.214	7.59	97.583
6.40	102.533	6.80	100.836	7.20	99.173	7.60	97.542
6.41	102.490	6.81	100.794	7.21	99.131	7.61	97.502
6.42	102.447	6.82	100.752	7.22	99.090	7.62	97.462
6.43	102.405	6.83	100.710	7.23	99.049	7.63	97.421
6.44	102.362	6.84	100.668	7.24	99.008	7.64	97.381
6.45	102.319	6.85	100.626	7.25	98.967	7.65	97.341
6.46	102.276	6.86	100.584	7.26	98.926	7.66	97.301
6.47	102.234	6.87	100.542	7.27	98.885	7.67	97.260
6.48	102.191	6.88	100.501	7.28	98.844	7.68	97.220
6.49	102.148	6.89	100.459	7.29	98.803	7.69	97.180
6.50	102.106	6.90	100.417	7.30	98.762	7.70	97.140
6.51	102.063	6.91	100.375	7.31	98.721	7.71	97.100
6.52	102.020	6.92	100.333	7.32	98.680	7.72	97.060
6.53	101.978	6.93	100.292	7.33	98.639	7.73	97.020
6.54	101.935	6.94	100.250	7.34	98.598	7.74	96.979
6.55	101.893	6.95	100.208	7.35	98.557	7.75	96.939
6.56	101.850	6.96	100.166	7.36	98.517	7.76	96.899
6.57	101.808	6.97	100.125	7.37	98.476	7.77	96.859
6.58	101.765	6.98	100.083	7.38	98.435	7.78	96.819
6.59	101.723	6.99	100.042	7.39	98.394	7.79	96.779

TREASURY NEWS

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STATEMENT OF THE HONORABLE
JEROME H. POWELL
ASSISTANT SECRETARY OF THE TREASURY
FOR DOMESTIC FINANCE
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES
SEPTEMBER 26, 1991

I appreciate this opportunity to discuss the Treasury security auction process, the oversight and regulation of the Government securities market, Salomon Brothers' recently admitted violations of auction rules, and that firm's possible violations of securities laws, antitrust laws, general fraud statutes, SEC regulations, and New York Stock Exchange rules. I also am pleased to address issues relating to public debt management and government securities market regulation.

While regulation of the government securities markets can be improved, the responsibilities of the various regulators are reasonably well-defined. With respect to the auctions, Treasury determines the amounts and maturities of the securities to be auctioned and sets the auction rules. The Federal Reserve conducts the auctions as Treasury's agent, and together the Treasury and the Federal Reserve review bids for compliance. Both the Treasury and the Federal Reserve have powerful, but limited, sanctions available to them to punish violators of these rules. The Treasury, for example, has forbidden Salomon Brothers to bid in auctions on behalf of its customers. Securities fraud in the form of deliberate violations of auction rules accompanied by false statements to the Treasury and antitrust violations are more generally the enforcement responsibility of the self-regulatory organizations, the SEC, and the Justice Department. In addition, price manipulation and other types of secondary market fraud are also the enforcement responsibility of the SEC and the Justice Department.

We believe that these agencies' legal authority to prosecute fraud and antitrust violations in Treasury auctions is beyond question. However, at a minimum, Treasury supports modifications to current law to strengthen enforcement of Treasury auction

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rules by providing that violations of these rules would also constitute violations of the securities laws.

All government securities brokers and dealers, including those that are financial institutions, are subject to regulation pursuant to the Government Securities Act of 1986. Under that Act, the Treasury was given the role as the rulemaker for government securities brokers and dealers. In its rulemaking capacity, Treasury issued rules for government securities brokers and dealers that adopted many of the existing SEC regulations that already applied to registered brokers and dealers. The responsibility for enforcing these rules was given to the SEC and the self-regulatory organizations for non-financial institution brokers and dealers and to the appropriate Federal banking agencies for financial institutions.

Salomon Brothers is, therefore, subject to comprehensive regulation. As a registered broker/dealer and member firm of the New York Stock Exchange, it is subject to all SEC and NYSE rules, as well as Treasury rules under the Government Securities Act. Based on the recent admissions by Salomon Brothers, it is possible that the firm violated recordkeeping and customer confirmation requirements, as well as other requirements that the SEC and the NYSE have full authority to enforce. Moreover, any allegations of market manipulation or securities fraud, if true, would be a violation of securities laws that the SEC has the authority to enforce. Like all persons and entities, Salomon Brothers and its employees are subject to the antitrust laws and general fraud statutes. Violations of these provisions could result in criminal prosecution by the Justice Department.

As a general matter, the current regulatory structure has usually worked well. And yet the recent revelations of intentional wrongdoing have raised legitimate concerns about the integrity of the marketplace and about the adequacy of regulation and supervision. The ongoing investigations of misconduct are broad ranging. We believe that it is appropriate to conduct an equally careful review of the adequacy of current regulation, with the goal of maintaining the highest standards of integrity while also preserving the liquidity, efficiency, and depth of the government securities market.

We would expect to complete such a review and to report its results to Congress in early December. In the interim period, we believe that all parties involved -- including the regulators, market participants, and the Congress -- should exercise restraint. The market for U.S. government securities is the largest, most liquid, and most important financial market in the world. It is the means by which we finance the national debt. Moreover, it is the bedrock of the world financial system. It is essential that the integrity of this market be beyond question and that there be adequate regulation to ensure that integrity.

But it is also essential that hasty action not impair the liquidity and competitiveness of U.S. financial markets. To put the cost implications to the taxpayer in context, note that a one basis point increase in the interest cost on outstanding marketable Treasury securities amounts to approximately a $230 million increase in annual interest costs.

In my statement, I will first discuss Treasury auctions, including the role of the primary dealers and significant auction rules, then present a chronology from Treasury's perspective of developments concerning the February and May auctions, and conclude with a discussion of policy and regulatory issues.

I. Background on Treasury Issuance of Marketable Securities

Treasury Auctions

As the chart accompanying my statement shows, the Treasury Department has auctioned large amounts of marketable Treasury securities in the past ten years. In 1981, Treasury sold over $600 billion of marketable Treasury securities; by 1990, this figure had increased to over $1.5 trillion. As long as there is a budget deficit, the amount of securities Treasury is required to sell will tend to increase, not only to raise funds to cover the shortfall between receipts and expenditures, but also to refinance maturing debt.

The massive Treasury financing requirements have been accomplished in an extraordinarily smooth and efficient manner. In the face of the government's large demands on financial markets, interest rates, nevertheless, have trended down over the last ten years. Treasury believes that the best way to achieve the goal of minimizing borrowing costs to the U.S. taxpayer is to minimize surprises to the market while having in place procedures to ensure the fairness and integrity of the market for Treasury securities.

The Treasury Department has a regular and predictable schedule for offering marketable securities, which is well known to market participants. The Treasury makes an announcement as far in advance as is practical any time there is a change in the usual pattern, so that the market can digest the information and prepare for the offerings.

The Treasury Department provides a large amount of information to the public that helps investors estimate the amount that the Treasury will borrow and the types of securities that the Treasury will offer. At the end of the first month of each calendar quarter, the Treasury holds a press conference to announce the securities to be offered in the regular mid-quarter financing operation. At the press conference, the Treasury also

announces estimates of the Treasury's borrowing needs for the current calendar quarter and the succeeding three months.

Currently, the Treasury sells 13- and 26-week bills every week and 52-week bills every four weeks. Two-year and five-year notes are auctioned every month for settlement at the end of the month. Seven-year notes are issued in the middle of the first month of each calendar quarter. The quarterly financings, which settle on the 15th of February, May, August, and November, typically consist of three- and ten-year notes and a thirty-year bond. These regularly scheduled issues amount to about 157 separate securities auctions each year.[1]

The details concerning an offering of marketable securities are announced about one week prior to the auction, and the auction occurs from a few days to about one week prior to the settlement date, depending upon holidays and other vagaries of the calendar.

In a Treasury auction, competitive bidders submit tenders stating the yield (discount rate for bill auctions) at which the bidder wants to purchase the securities. The bids are ranked from the lowest yield to the highest yield required to sell the amount offered to the public. Competitive bidders whose tenders are accepted pay the price equivalent to the yield that they bid.

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[1] The Treasury also offers cash management bills from time to time to raise funds to cover low points in the Treasury cash balance. The maturity dates for cash management bills usually coincide with the regular Thursday maturities of regular weekly and 52-week bills. Short-term cash management bills maturing in a few days or a few weeks may be issued when the Treasury's cash balance is seasonally low. For example, cash management bills may be issued in early April, before the April 15 tax payment date, and mature later in April, when cash balances are at seasonal highs. Short-term cash management bills may be announced, auctioned, and settled in a period as short as one day, if necessary, to ensure that the government does not run out of cash. To shorten the time for the auction and reduce the cost of issuing short-term cash management bills, they usually are issued only in large minimum purchase amounts -- $1 million or more -- and noncompetitive tenders are not accepted.

Longer-term cash management bills are also issued from time to time. For example, the Treasury's borrowing requirement in the final calendar quarter of the year is typically larger than for the April-June quarter, when seasonally high tax payments are due. Cash management bills maturing after the April 15, 1991 tax date were issued in November 1990 to manage Treasury borrowing in light of this seasonal pattern.

In an auction of Treasury notes or bonds, the coupon rate is determined after the deadline for receipt of competitive tenders, based on the average yield of accepted competitive bids.

Noncompetitive bids for up to $1 million from the public are awarded in full at the weighted average yield of accepted competitive bids. The ability to bid on a noncompetitive basis ensures that smaller investors, who may not be able to obtain current market information, can purchase securities at a current market yield. Noncompetitive bidding eliminates the risk that a prospective investor might bid a yield that is too high and not obtain the securities desired or too low and pay too much for the securities. Noncompetitive bidding also benefits the Treasury, since the larger the amount awarded noncompetitively, the less needs to be awarded to competitive bidders at successively higher yields. It also serves the goal of achieving a broad distribution of Treasury securities.

To participate in the auction, any potential investor may submit tender forms to any Federal Reserve Bank or branch, which act as Treasury's agent in the auction, or to the Treasury's Bureau of the Public Debt. The tenders must be received before 12:00 noon, Eastern time, for noncompetitive bids and 1:00 p.m., Eastern time, for competitive bids. Currently, tenders are received at 37 sites. Typically, between 75 and 85 bidders submit competitive tenders in Treasury's auctions for securities to be held in the commercial book-entry system.[2] Additionally, between 850 and 900 bidders submit noncompetitive tenders in Treasury auctions for securities to be held in the commercial book-entry system. Also, on average there are about 19,000 noncompetitive tenders per auction for securities to be held in the Treasury Direct system.[3]

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[2] The commercial book-entry system for Treasury securities is operated by the Federal Reserve Banks, acting as Treasury's fiscal agents. The Federal Reserve maintains book-entry accounts for depository institutions and other entities such as government and international agencies and foreign central banks. In their book-entry accounts at the Federal Reserve, the depository institutions maintain their own security holdings and holdings for customers, which include other depository institutions, dealers, brokers, institutional investors, and individuals. In turn, the depository institution's customers maintain accounts for their customers. Broker-dealers are currently not permitted to maintain securities accounts directly with the Federal Reserve.

[3] The Treasury Direct system is designed primarily for those who wish to hold Treasury securities to maturity; no custodial or transaction fees are charged. At the end of 1990, 979,522 investors held 2.2 million security accounts in Treasury Direct

Depository institutions and primary dealers may submit either competitive or noncompetitive tenders for their own account <u>and</u> for the account of customers. All other entities or individuals may submit either competitive or noncompetitive tenders <u>only</u> for their own accounts. Depository institutions and primary dealers are required to submit customer lists when submitting bids for the accounts of customers. Customer lists for competitive bids must be submitted either with the tender or by the close of the auction. Customer lists for noncompetitive tenders must be received prior to the issue date.

The Federal Reserve Banks review the tenders for accuracy, completeness, and compliance with Treasury's rules and guidelines. The Federal Reserve Banks consult with the Treasury Department prior to taking any action on questionable tenders which could materially affect the results of the auction. The Treasury reserves the right to reject any tender.

Once it has been determined that the tenders have complied with Treasury's rules, the Federal Reserve Banks compile the auction summaries. The noncompetitive summary shows the total amount of noncompetitive bids received by each Federal Reserve district. The competitive bid summary shows the total amount bid at each yield. The summaries include information on specific bidders only when needed to apply the 35% limitation on the amount awarded or bid at a given yield by a single bidder or when specific bids appear irregular. This information is forwarded to the Treasury's Bureau of the Public Debt.

The Bureau of the Public Debt accepts noncompetitive bids in full and then determines the yields that are to be accepted on competitive bids. The amount awarded at the high yield is prorated based on the amount bid at that yield to obtain the offering amount.

Auction results are released to the public around 2:00 p.m., Eastern time, on the auction day.

Role of the Primary Dealers

In order to conduct monetary policy, the Federal Reserve buys and sells government securities in the secondary market. The Federal Reserve determines with which dealers it will trade, and these designated dealers, currently 39 in number, are called primary dealers. Despite the name, designation as a "primary dealer" refers to a secondary market relationship with the Open Market Desk of the Federal Reserve System, <u>not a relationship with the Treasury</u>. The Treasury does not determine which dealers

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with a par value of nearly $59 billion.

can be primary dealers, nor does it set any criteria for this designation.

The relationship between the Federal Reserve Bank of New York and the primary dealers is a business relationship, not a formal regulatory one. In order to assure itself of the creditworthiness of the primary dealers, the Federal Reserve Bank of New York requires that primary dealers submit reports to it and that they permit FRBNY staff to inspect their operations and books and records.

In addition to requirements that the primary dealers make markets in all maturity sectors of Treasury securities and that their share of the market meet certain minimums, the Federal Reserve expects that primary dealers demonstrate their continued commitment to the market for government securities by participating in Treasury auctions.

Because of their importance to the government securities market, their consistent participation in Treasury auctions, and the monitoring of their creditworthiness by the FRBNY, primary dealers share with depository institutions two privileges in the auctions. As mentioned, only primary dealers and depository institutions can submit bids for customers as well as for themselves. In addition, tenders from primary dealers are accepted without deposit, as is also the case for depository institutions, States, political subdivisions or instrumentalities thereof, public pension and retirement and other public funds, international organizations in which the United States holds membership, and foreign central banks and foreign states. Others must pay in full at the time the tender is submitted or, in the case of notes and bonds, present a guarantee from a commercial bank or primary dealer of 5 percent of the par amount applied for.[4]

That there is a group of dealers with a commitment to the government securities market is a benefit to the Treasury, which offers securities every week of the year. However, it needs to be emphasized that the auction process is open; and that others besides primary dealers can and do participate, either directly, or if they choose, through primary dealers or depository institutions.

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[4] Treasury also permits tenders to be received without deposit if there is a preexisting agreement with a depository institution on file at the Federal Reserve Bank that authorizes the Federal Reserve Bank to debit the reserve account of the depository institution on the issue date for the securities purchased by the bidder.

The 35% Rule

For the past 29 years, the Treasury has limited the maximum amount of securities awarded to a single bidder in a Treasury offering. The primary reasons for the limitation are to ensure broad distribution of Treasury securities and to make it less likely that ownership of Treasury securities becomes concentrated in a few hands as a result of the auction.

The limitation has evolved over the years. It was first set at 25 percent of the total offering amount and applied only to 3-month and 6-month Treasury bills. Today, for bills, notes, and bonds, the limitation is 35 percent of the public offering. The application of the 35 percent limit to any bidder includes consideration of positions in the futures, forward, and when-issued markets. The same limitation is also applied to the maximum amount Treasury will recognize as having been tendered at any particular yield.

The genesis of the maximum award limitation was the unusual occurrence of a single bidder tendering what would have been a successful bid for an exceptionally high proportion of the 13-week bills auctioned on August 27, 1962 and issued on August 30, 1962. On that occasion, Secretary of the Treasury Douglas Dillon invoked his right to reject any or all tenders, in whole or in part, because of concern about a possible market disturbance that could have resulted from the disproportionate allotment. On August 28, 1962, the Treasury announced that "no single bidder would be awarded more than one quarter of the total supply of bills offered in either the 3- or 6-month bill maturities." Subsequently, it became generally understood and accepted throughout the market as applying to all Treasury offerings of marketable securities.

The rule remained unmodified until May 14, 1979, when two rule changes were announced. First, the maximum award to any single bidder in Treasury security offerings was limited to 25 percent of the total combined amounts of the competitive and noncompetitive awards to the public. This rule excluded from the 25 percent calculation those Treasury securities allotted to the Federal Reserve in exchange for maturing securities for its own account and for the accounts of foreign official institutions. It also excluded Treasury securities allotted to foreign official institutions through the Federal Reserve for new cash.

This change was necessary because, by 1979, the size of bids from foreign official accounts through the Federal Reserve, had grown markedly. As a consequence, the amount of an offering remaining for the "public" had shrunk significantly, despite the general increase in the size of Treasury offerings.

The second modification announced on May 14, 1979, was the requirement, in effect today, that, beginning on June 18, 1979, all bidders in bill auctions report on the tender form the amount of any net long position in excess of $200 million in the bills being offered. This net long position is taken into account to compute whether awards to any single bidder would exceed the award limit. Such positions include when-issued, futures, and forward positions in the bill and holdings of the outstanding bill with the same maturity date as the new offering. Also, a primary dealer bidding on behalf of a customer was required to submit a separate tender for the customer whenever the customer's net long position in the bill being offered exceeded $200 million. This new rule recognized the growing importance of when-issued trading and trading in Treasury bill futures. A similar rule for notes and bonds became effective on December 30, 1981.

The Treasury announced on September 8, 1981, an increase in the limit on the maximum amount any one bidder may purchase in a bill, note, or bond auction to 35% from 25% of the combined amounts of competitive and noncompetitive securities available to the public. This was done to lessen the restrictive effect of the modification made in 1979.

A further modification to the 35% rule was made on July 12, 1990. While continuing to permit bidders to tender for securities at multiple yields, the Treasury announced that at any one yield the Treasury will not recognize amounts tendered in excess of 35 percent of the public offering. This rule change was made necessary because several dealers began to place very large bids, even greater than the total size of the offering, at what turned out to be the high or stop-out yield. Because the Treasury used the amount bid to prorate the securities awarded at the highest yield among all bidders at that yield, a dealer who guessed right about the stop-out yield and submitted a very large bid could obtain a large proportion of the auction at the most favorable yield. The rule change put a stop to this practice and resulted in a more equitable distribution for bids awarded at the highest accepted yield.

This abuse of the proration methodology occurred in the June 27, 1990, auction of four-year notes by a primary dealer who was directly requested not to repeat the practice. This same dealer, along with another bidder, however, placed bids for extremely large amounts at a July 10 auction of Resolution Funding Corporation bonds. This time the amounts were cut back for purposes of proration at the stop-out yield. Two days later, in order to put an end to this practice, Treasury announced the rule change limiting the amount recognized as bid at any one yield to 35% of the public offering.

Other Treasury Auction Rules

Single Bidder Guidelines. On June 1, 1984, the Treasury issued guidelines concerning the definition of a single bidder for the purpose of the $1 million limitation on noncompetitive bids. These guidelines are also used to determine what constitutes a single bidder for purposes of the 35 percent limitation.

When-Issued Trading Prior to Auction. Pre-auction trading in Treasury notes and bonds was effectively prohibited from 1941 to 1975. Pre-auction activity in Treasury bills has never been prohibited, except in the case of noncompetitive bidders. Until 1975, regular Treasury announcements of note and bond auctions included a clause banning from the auction any participants who engaged in purchasing, selling or making agreements on an issue before the auction time and date.

Between February 1975 and July 1977, however, Treasury announcements no longer carried this clause as it was thought to be unnecessary. This allowed a temporary when-issued market in Treasury notes and bonds prior to auction to develop. With the 2-year note auction of July 1977, however, Treasury once again included the provision against pre-auction trading, citing "undesirable speculative activity." This prohibition was effective only for coupon securities.

Treasury decided to allow auction participants to engage in pre-auction trading in order to "eliminate an unnecessary regulation" beginning with the August 1981 issue of two-year notes. Since then, when-issued trading has come to be considered an important and efficient mechanism for reducing the uncertainties surrounding Treasury auctions.

The only significant rule change subsequent to 1981 was an October 1983 Treasury announcement prohibiting pre-auction trading in securities awarded to noncompetitive bidders. This prohibition applies to all Treasury securities and was intended to prevent participants from garnering disproportionate shares of an issue through noncompetitive auction bidding.

Bidder Certifications. Bidders are required to certify on the tender form that their net long position in the security being auctioned is not in excess of $200 million, or, if it is in excess, the amount of the net long position. Depository institutions and primary dealers must certify that any bids submitted on behalf of customers have been entered under the same conditions, agreements, and certification set forth in the tender form.

II. Chronology of Recent Events Involving Salomon Brothers

The February 1991 Five-Year Note Auction

The Treasury's Bureau of the Public Debt received a call at approximately 1:30 p.m. February 21, 1991, from the Federal Reserve Bank of New York concerning the application of the 35% limitation at a single yield in connection with the five-year note auction that day. The FRBNY requested that a determination be made regarding two separate bid submissions from what appeared to be a single bidding entity -- S.G. Warburg & Co., Inc. (S.G. Warburg).

Salomon Brothers had submitted a tender for a customer identified on the tender as Warburg Asset Management. S.G. Warburg separately submitted a tender at the same yield for its dealer account. Combined, the two bids exceeded 35% of the public offering amount at a single yield by one bidder.

Prior to calling the Treasury, the Federal Reserve Bank of New York had called Salomon Brothers concerning the Warburg Asset Management bid. Salomon Brothers stated that they had made a mistake and that Warburg Asset Management was actually Mercury Asset Management.

The Treasury decided to accept both tenders. However, in an effort to prevent future auction delays and any potential for confusion, uncertainty, and inequity in the handling of bidders, the Treasury, in consultation with the Federal Reserve Bank of New York, decided to investigate the relationship of Mercury Asset Management and S.G. Warburg to determine whether these bidders constituted separate and distinct entities for bidding purposes.

The Treasury discussed the issue with Tom Murphy of Salomon Brothers and with an officer of S.G. Warburg. It was determined that Mercury Asset Management, a British company, is majority owned by the same holding company that owns the British subsidiary that owns the U.S. firm of S.G. Warburg.

After reviewing the facts of the case, the Treasury decided that S.G. Warburg and Mercury Asset Management would be treated as a single bidder for purposes of applying the 35% limitation rule in future auctions. The decision was based primarily on the fact that the Treasury's guidelines for determining a single bidding entity are based on the principle that bidders that share common investment advice and management control are viewed as a single entity.

The Treasury's Bureau of the Public Debt sent a letter dated April 17, 1991 to Mercury Asset Management which provided details concerning the two bids submitted in the February five-year note

auction and Treasury's decision to treat the two entities as a single bidder for purposes of the 35% limitation rule. Copies of this letter were sent to officers of S.G. Warburg, S.G. Warburg, PLC (the British parent company), and the Federal Reserve Bank of New York. In addition, a copy of the letter was sent to Mr. Paul Mozer of Salomon Brothers.

As Salomon Brothers has now admitted, the bid from Mercury Asset Management was unauthorized. The securities in question were in fact purchased by Salomon Brothers. It appears from Salomon Brothers' public statements that the letter from Treasury played an important role in Mr. Mozer's decision to inform senior management of the fraudulent bid. Salomon Brothers did not inform the government of this violation until August 9.

Although both Mercury and S.G. Warburg replied to the Treasury's April 17 letter on April 25 and May 22, respectively, they did not inform the Treasury that the Mercury bid was unauthorized. Treasury first learned of this fact from Salomon Brothers on August 9. The Treasury and the Federal Reserve met with Warburg officials on September 12 to discuss this matter.

The May Two-Year Note Auction

The May two-year note auction also attracted attention at the Treasury.

It soon became apparent after the auction of $12.25 billion of two-year notes on May 22, 1991, that a squeeze had developed in the issue. The yield on the two-year notes was out of line with market rates and the notes were "on special" in the repurchase agreement market. (In other words, market participants desiring to borrow temporarily the two-year notes had to accept a significantly lower interest rate on funds they deposited with their counterparties in effect as collateral than the prevailing repo rate.)

A number of market participants contacted the Treasury Department to point out this situation. Treasury Department officials also had details concerning the bids received and awarded to primary dealers and their customers. It appeared from this information that the squeeze had developed because Salomon Brothers and some of its customers had bid more aggressively than others and had been awarded the bulk of the securities. Treasury Department officials thought the situation serious enough to warrant investigation by the Securities and Exchange Commission. In late May, the Treasury told the Division of Market Regulation and the Division of Enforcement of the SEC about the problems stemming from the May auction and provided the SEC information concerning auction awards. The SEC promptly began investigating the matter. In addition, the Antitrust Division of the Justice

Department requested information pertinent to its own investigation of the squeeze.

On June 4, a Treasury Department official discussed Treasury's concerns with Mr. Paul Mozer. On June 10, Mr. John Gutfreund, chairman of Salomon Brothers, met with Treasury officials to explain the firm's point of view with respect to the May two-year notes. He did not mention the fraudulent bid in the February auction.

The Treasury was concerned about the squeeze in the May two-year note for several reasons. First, any such squeeze goes against the goal of achieving a broad distribution of securities. If dealers are not reasonably comfortable that they can obtain and deliver securities that they have sold prior to the auction, they will be less likely to participate in pre-auction distribution of new issues. Second, while squeezes can occur for reasons other than market manipulation, squeezes in Treasury securities that appear to be deliberately engineered would likely cause some market participants to question the fairness and integrity of the government securities market. If doubt concerning the fairness of Treasury auctions persists over the longer term, the number of active participants in the government securities market could be reduced. The resulting decline in participation in Treasury auctions and in the liquidity of the secondary market could raise Treasury borrowing costs. Finally, Treasury was concerned that there may have been possible violations of securities and other laws in the government securities market.

Subsequent Developments

On August 9, Mr. Gutfreund, in a telephone call to Under Secretary Robert R. Glauber, informed him of the unauthorized Mercury bid and his knowledge of this since April.

Also, on August 9, Treasury officials were provided an advance copy of Salomon Brothers' announcement released later that day, in which the firm admitted committing violations of the 35% rule in the December 1990 auction of four-year Treasury notes, the February 1991 auction of five-year notes, and the May 1991 auction of two-year notes and announced the suspension of two managing directors responsible for Treasury securities trading and two other employees.

On August 14, Treasury staff, along with staff from other concerned government agencies, attended meetings at the Justice Department and at the SEC with the law firm of Wachtell, Lipton, Rosen & Katz, which was representing Salomon Brothers in this matter. The Wachtell, Lipton lawyers detailed the results of their investigation of the irregularities and rule violations in Treasury auctions as well as related matters. Also, on

August 14, Salomon Brothers publicly announced further details of rule violations in Treasury auctions and the fact that the senior management had been informed in late April of an unauthorized bid in the February 1991 auction but had not informed the appropriate government officials of this.

After consulting with the Federal Reserve and the SEC, the Treasury Department announced on the morning of Sunday, August 18, that, in light of Salomon Brothers' auction rule violations, it would for an indeterminate time not allow the firm to participate in auctions of Treasury securities. This penalty was modified later in the day after Salomon Brothers' board meeting resulted in the immediate resignation of three senior officials of Salomon Brothers, the firing of the two suspended managing directors, and the placing of effective management control of the firm in the hands of Mr. Warren E. Buffett. Mr. Buffett assured Secretary Brady that appropriate controls were being put in place to ensure that there would be no future rule violations in Treasury auctions. Consequently, Secretary Brady decided to allow Salomon Brothers to bid in auctions for its own account but not to allow it to submit bids for its customers.

The Treasury was subsequently provided specific information concerning the procedures and controls Salomon Brothers has put in place to ensure that there would be no violation of auction rules. The new procedures and controls appear to be a good faith effort to prevent future rule violations.

The Treasury Department is assisting the SEC and the Justice Department in their continuing investigations of Salomon Brothers' activities in the government securities market. While the Treasury Department has no enforcement authority in the area of securities or antitrust law, the Treasury can help these two agencies with its expertise concerning the market for Treasury securities.

III. Policy and Regulatory Issues

The admissions that Salomon Brothers has made have caused us to reexamine various policy issues concerning both the issuance of Treasury securities and regulation of the government securities markets. I am pleased to share with the Subcommittee the Treasury Department's current thinking with respect to changes in the auction process, including automation, large customer certification, and "Dutch auctions," recent criticisms of Treasury debt management, the Treasury Borrowing Advisory Committee, and Government Securities Act issues.

Changes in the Auction Process

Automated bidding. We believe that automation of the auction process will make it more efficient, result in fewer

errors, facilitate broader participation, and assist in monitoring of compliance with auction rules. Consequently, the Treasury and the Federal Reserve have made the development of a system to permit automated bidding a high priority.

A project is underway at the Federal Reserve Bank of Kansas City that will allow medium and smaller depository institutions and other institutional bidders to submit their bids to the Federal Reserve Banks electronically. We expect this project to be completed by the second quarter of 1992.

There is also a project underway at the Federal Reserve Bank of New York that will enable electronic bidding by large bidders. This project is currently in the design phase.

Large customer certifications. The Treasury and the Federal Reserve Bank of New York will develop a system to require customers who make large winning bids through primary dealers or depository institutions to verify in writing their bids prior to the settlement date. This will prevent firms from putting in unauthorized bids in order to circumvent the 35 percent rule.

Already, the Federal Reserve Bank of New York has begun making spot checks with customers of primary dealers to verify the legitimacy of bids submitted for customer accounts.

"Dutch" auctions. The Treasury currently uses a sealed-bid "discriminatory price" auction to sell its securities. The auction is "discriminatory" because different bidders pay different prices for the same security, based on their bids. In other words, competitive bidders whose tenders are accepted pay the price equivalent to the yield that they bid.

In a sealed-bid uniform price auction, sometimes called a "Dutch" auction, all bidders whose tenders are accepted pay the same price for a given security. This price is the <u>lowest</u> of the <u>accepted</u> prices bid (or highest of the accepted yields). As a result, in a Dutch auction, some of the bidders whose tenders are accepted pay a lower price than they actually bid. At first glance, this appears to be a revenue loser, because money appears to be left on the table. On the other hand, participants in a Dutch auction can be expected to bid higher prices than they would in a discriminatory price auction. The expected revenue effects of a Dutch auction versus current practice thus turn on the following empirical question: Is the revenue generated from possible increased demand in Dutch auctions greater than the revenue lost due to the difference between prices bid and prices paid?

The perceived advantages of Dutch auctions are that they eliminate the primary dealers' advantage over less informed participants, since all buyers pay the same price. This could

broaden auction participation and induce more non-specialist investors to bid directly for their own account rather than through primary dealers. This should naturally lead to less concentration of ownership at auction.

A potential disadvantage of Dutch auctions relative to the current auction method is the concern that primary dealers may be somewhat less willing to participate in Treasury auctions. This could cost the Treasury, and taxpayers, in the long run. In addition, Dutch auctions could increase the number of bids from non-dealers and thereby complicate auction administration and possibly slow down the auction process. However, automation of the auction process would substantially reduce these costs. Finally, it should be noted that the implementation of a Dutch auction system would not remove the potential for collusion among market participants for purposes of underbidding on securities or cornering a particular issue. Collusion is a potential problem in any auction process.

Treasury is reviewing all of its auction procedures. We believe that changes should be made only after careful consideration, given the large volume of securities we issue and the potential costs to the taxpayers of ill-conceived or hastily implemented changes.

Dutch auction study. In 1976, two Treasury economists attempted to answer the empirical question referred to above concerning the revenue effects of Dutch auctions relative to discriminatory price auctions. They prepared a study using Treasury tender data from the six uniform price auctions Treasury conducted earlier in the 1970s and from discriminatory price auctions of Treasury bonds during the same general time period. The study indicated that there was some evidence that Dutch auctions resulted in somewhat reduced costs to the Treasury.

From 1976 to 1980, two consecutive Deputy Assistant Secretaries for Debt Management refused permission to the authors to have the study published. Finally, in early 1980, their successor decided that the study could be published with the usual disclaimer that it represented the views of the authors and not necessarily the views of the Treasury Department. The study was to have been included in a book edited by Professor Vernon Smith of the University of Arizona; however, in 1981, the authors discovered discrepancies in the data used in the study. In early 1981, both authors were no longer employed at the Treasury, and neither had the interest, the time, or easy access to the raw Treasury data to investigate this problem and put the article into publishable form.

The study does not discuss the fact that tenders received from the public in the August 1, 1973 uniform price auction of 7½% 20-year bonds were not sufficient to sell the entire issue.

Tenders from government accounts in an amount of $240 million were accepted in order to sell the entire $500 million offering. It does not appear that this was taken into consideration in the statistical analysis of the tender data. While the failure of this auction is probably unrelated to the auction technique, including large tenders from government accounts could have significantly biased the results.

Given the problems with the data and the failed auction, the Treasury Department does not believe that the study's statistical results make a convincing case about the efficacy of uniform price auctions.

Debt Management Policy

Periodically, Treasury debt management is criticized for relying too heavily on long-term securities. When interest rates seem relatively high, the criticism is that Treasury should not be locking the taxpayer into these high rates. In environments such as the current one, when interest rates have come down but the yield curve is positively sloped, the argument is made that it would be cheaper to finance the debt with shorter maturity securities. Also, the argument is sometimes made that Treasury should attempt to alter the term structure of interest rates by altering the maturity structure of its debt. Over the years, Treasury has usually resisted efforts to manage the public debt either on the basis of interest rate forecasts or for the purpose of manipulating the term structure of rates.

The Treasury has long followed a debt management philosophy characterized by regularity and predictability. Taking advantage of perceived momentary opportunities or choosing maturities based on interest rate forecasts would in the end be self-defeating. Opportunistic debt management strategies would increase uncertainty to government securities dealers and customers, who would need to attempt to guess Treasury's current debt management tactics and interest rate forecasts. Over time, this increased uncertainty would be reflected in an increase in the average borrowing cost to the Treasury. To believe otherwise requires the conviction that government officials can consistently beat the market, a highly dubious proposition at best.

A strategy of borrowing solely in the short-term sector of the market, as some suggest, would require constant churning of the public debt. It would put enormous pressure on the short-term sector of the market and on those entities, such as banks, that rely heavily on this sector for their financing. It would also result in great uncertainty concerning the size of the interest component of the government's budget, since this would be even more sensitive to changes in interest rates than is currently the case.

As it is, the maturity structure of Treasury marketable securities is very short. Treasury had to issue over $1.5 trillion in securities in calendar year 1990, most of which was for the purpose of rolling over maturing securities, not raising new funds for the government. Also, while the average maturity of privately-held marketable Treasury securities is 6 years, 33 percent of these securities mature in 1 year or less, and 48 percent, in 2 years or less.

Simplistic calculations based on hindsight of how much lower interest payments could have been if Treasury had borrowed only in the short-term sector of the market during the 1980s, a period of generally declining interest rates, are not persuasive. In the first place, these calculations assume that the term structure of interest rates would have remained the same, even in the face of Treasury's sole reliance on the bill market for its funding needs, an assumption that is not credible. Also, while some who make this argument would have the Treasury borrow short most, if not all, of the time, their backward looking methodology would, in fact, suggest that Treasury should have borrowed much more in the long-term market during the 1960s and 1970s, a period of generally increasing interest rates. For example, if the $84 billion principal amount of outstanding marketable Treasury bonds in 1981 had been financed at the average one-year Treasury bill rate for that year, the resulting interest cost would have been an additional $5.5 billion or approximately twice the actual coupon interest payments made on those securities in 1981.[5] In other words, while these types of backward looking calculations are easy to make, they are hardly useful guides for current policy.

Given the Treasury's enormous financing needs, the best strategy over time is to tap all maturity sectors. It is always possible to second guess such a policy after the fact, but the alternatives of market timing based on interest rate forecasts or borrowing only short-term are unattractive for the reasons given.

Finally, Treasury does not believe that it should borrow in the short-term sector in order to manipulate the shape of the yield curve. It would be difficult to fine-tune such a strategy to accomplish the desired results and Treasury would in such an effort be, in effect, using debt management policy to conduct monetary policy. Under our institutional arrangements, monetary policy is the responsibility of the Federal Reserve. Having two agencies conducting monetary policy is unlikely to result in better policy.

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[5] This calculation is based on marketable Treasury bonds issued between 1961 and 1980 with original maturities of more than 10 years.

Borrowing Advisory Committee

In light of the concerns that have recently been expressed about the Treasury Borrowing Advisory Committee, I would like to address this issue.

The Treasury Department receives advice on debt management from government securities market participants formally through the Treasury Borrowing Advisory Committee of the Public Securities Association, chartered under the Advisory Committee Act of 1972. Prior to 1972, Treasury had been receiving advice on debt management from informal committees since World War II. The Treasury meets with the advisory committee, at the request of the Secretary, the Tuesday before the regularly scheduled Wednesday announcement of 3-, 10-, and 30-year Treasury securities in the mid-quarter refunding. The committee is given a specific list of items on which its advice is sought.

The membership of the committee currently consists of senior level officials from ten primary dealer firms and eight institutional investor firms. The committee makes a unique contribution by providing informed advice in a forum that requires the members to form consensus recommendations, or at least majority recommendations, that the Treasury would be unable to get in any other way. Free and open discussion among the committee members during meetings prior to making recommendations has served to minimize any problems of evaluating whether recommendations reflect the specific business interests of the various members' employers.

In addition to receiving recommendations of the advisory committee, Treasury representatives meet with primary dealers at the Federal Reserve Bank of New York before each quarterly refunding operation. Moreover, we receive advice from market participants who call or write to the Treasury on an ad hoc basis.

At the beginning of each meeting, the committee receives Treasury's latest estimate of Treasury market borrowing needs and historical background information related to Treasury borrowing and debt outstanding. Members are not permitted to contact their firms from the time the meetings with the Treasury begin until the Treasury financing announcement appears on the news wire services the next afternoon.

The Treasury Department provides a large amount of information to the public that helps investors estimate the amount that the Treasury will borrow and the types of securities that the Treasury will offer. Treasury regularly makes information that is provided to the advisory committee available to the public during the press conference announcing each mid-quarter refunding. Beginning with estimates to be used in

connection with the November refunding, scheduled for announcement on October 30, 1991, we will release the latest estimates of Treasury borrowing requirements to the public prior to convening the committee.

Government Securities Act Issues

We believe that the basic regulatory structure of the Government Securities Act of 1986 (GSA) is sound. It recognizes that Treasury is in the best position to set rules for all brokers and dealers, including financial institutions, that are consistent, ensure fairness and integrity in the government securities market, but do not result in inordinate cost to the taxpayer.

However, some changes need to be made, particularly in the sales practice area. We support the modifications to the Government Securities Act of S.1247, which would grant authority to regulatory agencies and the NASD to issue government securities sales practice rules, if the Treasury has not determined that the rules would "adversely affect the liquidity and efficiency of the market for Government securities" or "impose any burden on competition not necessary or appropriate" in furtherance of the purposes of the GSA.

In addition, Treasury supports expanded disclosure of and access to government securities price and volume information. The expanded availability of such information would serve the public interest. When a broad spectrum of market participants can obtain current, accurate information on market conditions, the competitiveness, liquidity and efficiency of the government securities market should improve, as should the auction process. In order to encourage private sector initiatives in this area, Treasury supports S. 1247, which provides for a joint Treasury/SEC/Federal Reserve Board evaluation of private sector initiatives regarding the dissemination of price and volume information that will permit further development of these efforts, while providing for continued scrutiny.

IV. Conclusions

Salomon Brothers' recent admissions are a major development that are bringing the government securities market close scrutiny.

Treasury auctions. Since the May auction and the squeeze in two-year notes, Treasury has been considering changes in its auction rules. We stated in a letter to Congressman Markey dated July 1: "Treasury is concerned that there have been several recent auctions resulting in a concentration of ownership at original issue...Treasury is considering changes in its auction

rules that would make this concentration of ownership less likely."

With respect to the information advantage that it is perceived gives primary dealers an edge in Treasury auctions, the information that has recently been made available on interdealer broker screen quotes through GOVPX has made for much broader dissemination of market prices. We expect that in the future even more price and volume information will be made generally available. This will make for a more level playing field for all participants in the government securities market and in Treasury auctions.

Finally, with respect to the Salomon Brothers matter, we currently have no evidence that other firms have engaged in the specific types of auction practices admitted to by Salomon Brothers. We do, however, believe it is salutary that major market participants are reviewing their own procedures for participating in the auctions.

Debt Management. Treasury is constantly reviewing debt management policy in order to ascertain whether improvements can be made and will continue to do so. We do not believe that opportunistic strategies based on the shape of the yield curve or on interest rate forecasts are appropriate for the Treasury, which, as the world's largest issuer of securities, taps the financial markets every week of the year. We believe that regular, predictable issuance of securities across the maturity spectrum is the most efficient, least disruptive way to provide for the Government's huge financing and refunding needs.

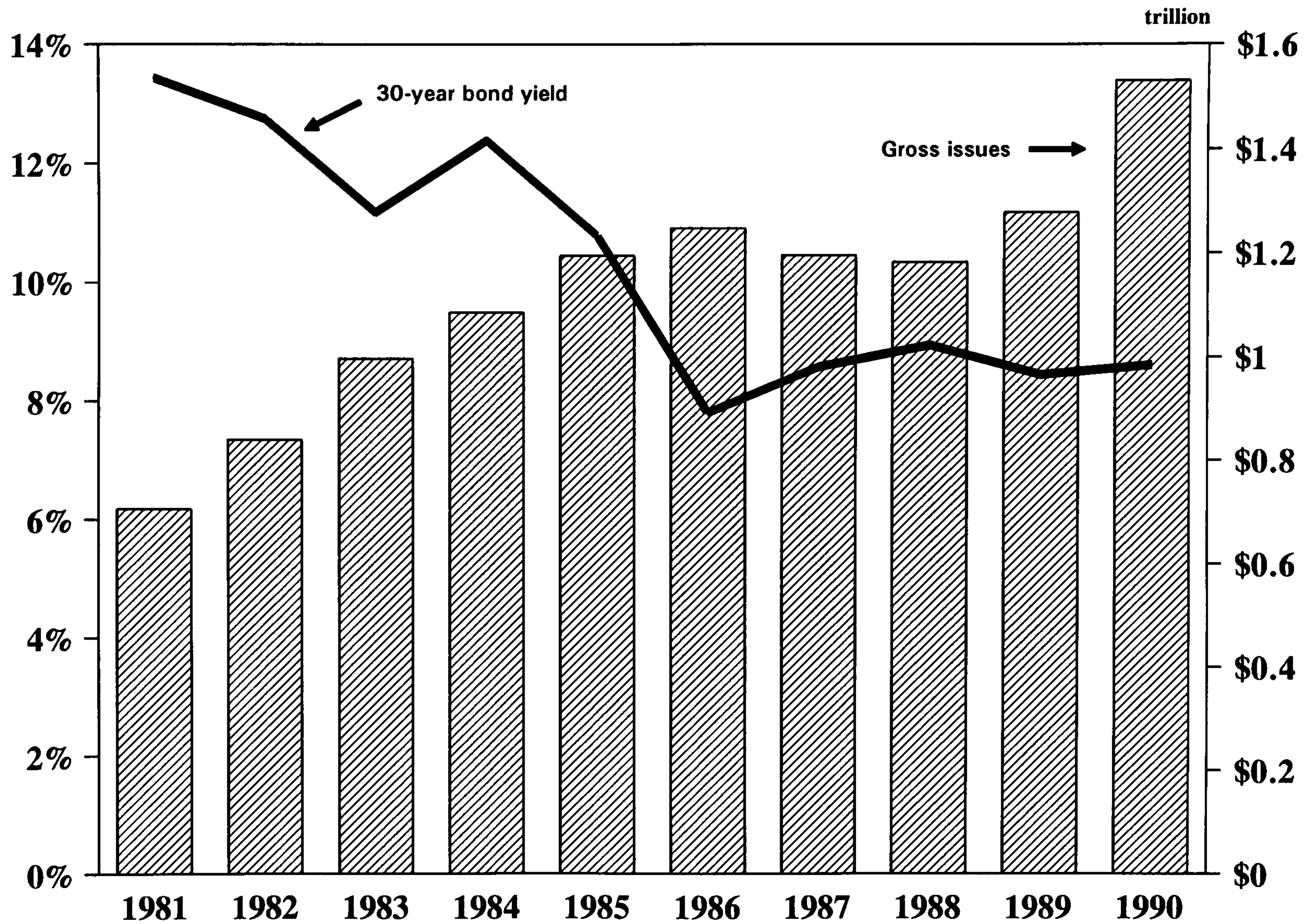
Regulation. Until recently, it had been our view that existing legal authority was sufficient to deal with misconduct in the government securities markets. However, Salomon Brothers' recent admissions of wrongdoing are deeply troubling, as are the allegations of more widespread misconduct in the markets. The entire situation warrants, and is receiving, a sweeping, thorough investigation by the appropriate regulatory authorities.

Until that investigation is reasonably complete, we would prefer to withhold judgment as to the adequacy of existing laws and regulations, as well as existing enforcement capabilities and practices. The market for U.S. government securities is the largest and most important securities market in the world, and any changes in its regulation should only be made after careful collection and review of the facts.

We also recognize the urgency of this matter and the desire of Congress to take prompt and appropriate corrective action. The Treasury, in consultation with the Federal Reserve and the SEC, therefore undertakes to report back to the Congress in early December as to any recommended legislative or regulatory changes.

We anticipate that this review will address in some depth the adequacy of existing legal authority and enforcement practices to detect and punish wrongdoing in the government securities markets, while also maintaining the extraordinary liquidity and depth of our marketplace.

Questions have also arisen as to the status of the Treasury's rulemaking authority under the Government Securities Act, which will lapse unless reauthorized by October 1. In the view of the Treasury, the Federal Reserve, and the SEC, it is important that there be no such lapse in rulemaking authority. We therefore urge that the reauthorization take place on schedule or that Treasury's rulemaking authority be temporarily extended beyond the October 1 "sunset" date.



Bond yield is annual average Treasury constant maturity 30-year bond yield.
Gross issues are total marketable securities sold.

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September 25, 1991

CONTACT: Claire Buchan
202/566-8773

Statement of Treasury Secretary Brady
on the reconfirmation of
Robert Clarke as
Comptroller of the Currency

The Administration strongly urges Congress to act favorably and promptly on Bob Clarke's reconfirmation as comptroller of the currency.

Mr. Clarke has headed up regulation of national banks during a time of extraordinary pressure on banks and other financial institutions. He deserves a fair, balanced hearing and an opportunity to present and discuss his record. To politicize this hearing would be a great disservice to the process of bank regulation, and it would be unfortunate if politics were put before objectivity.

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NB-1474

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September 25, 1991

Contact: Cheryl Crispen
(202) 566-2041

Statement by
Secretary of the Treasury
Nicholas F. Brady

The House Energy and Commerce Committee today took a step backward in financial services reform. This bill undoes many of the constructive steps taken by the House Banking Committee. The bill restricts competition in the financial services industry and protects vested interests. If enacted, it will impede the flow of private capital necessary to create a strong banking system. A strong banking system is the only guarantee against a taxpayer bailout.

We will continue to work vigorously for truly comprehensive reform.

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NB-1475

TREASURY NEWS

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FOR IMMEDIATE RELEASE
September 26, 1991

Contact: Claire Buchan
202/566-8773

Statement of Treasury Secretary Brady
on the Reconfirmation of Comptroller Robert Clarke

We are disappointed that Bob Clarke's reconfirmation hearing was shut down today after only 30 minutes of questioning, without additional hearings being scheduled. After enduring nine months of delay since his nomination was submitted to Congress, it is distressing that the confirmation process was again delayed.

Mr. Clarke was and is ready and eager to discuss his record as comptroller and respond to the committee's questions.

The Administration again urges Congress to act quickly to confirm Mr. Clarke. It would be damaging if politics got in the way of objectivity, created uncertainty in the process of confirming a key regulator, and sent a muddled message to financial institutions and examiners during a time of tight credit.

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NB-1476

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FOR IMMEDIATE RELEASE
September 27, 1991

CONTACT: BOB LEVINE
(202) 566-2041

TREASURY ANNOUNCES NEW RESTRICTIONS ON CUBA TRAVEL FUNDS

The U.S. Treasury Department's Office of Foreign Assets Control (OFAC) today announced new restrictions on funds that may be sent to Cuba from the United States under the Cuban Assets Control Regulations.

OFAC Director R. Richard Newcomb said, "the new regulations are designed to limit exorbitant fees imposed by the Cuban government by setting a reasonable cap on the amount of U.S. dollars that may be sent to Cuba to facilitate travel. At the same time, the provisions accomplish the objectives of the embargo by further limiting financial and commercial transactions with Cuba."

Under the amended regulations, a U.S. person or company may send no more than $500 for travel-related expenses, including transportation, to a Cuban national coming to the United States. The funds may not be sent until a visa has been issued to the Cuban traveller by the United States Interests Section in Havana. New procedures have been set up to inform U.S. travel service providers and banks that handle transfers of the funds when a visa has been issued.

A limit of $500 has also been placed on fees a U.S. person or company may pay the Cuban government for travel to Cuba. A third change reduces the limit on family remittances sent from the United States to close relatives in Cuba from $500 to $300 per three-month period. A fourth change prohibits Cubans returning from the United States from carrying non-Cuban currency in excess of the amount brought to the United States. An exception is made for family remittances which the traveller may legally receive.

Since March, 1990, Cuba has substantially eased travel restrictions, including progressively lowering the minimum age from 65 to 20 for Cubans travelling to the United States. This has resulted in a significant increase in the transfer of U.S. dollars to Cuba as a result of the rise in applications for nonimmigrant visas. The Cuban Government requires payment in U.S. dollars for travel-related services such as passports, exit visas and personal record procurement. The current fees are excessive. Since Cubans may not legally hold dollars, their travel is funded by relatives in the United States. The new regulations will permit the transfer of funds only after a visa has been issued. Currently many transfers are made on behalf of unqualified applicants who never receive their visas.

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REMARKS BY
NICHOLAS F. BRADY
SECRETARY OF THE TREASURY
TO THE
ATLANTA ROTARY CLUB
SEPTEMBER 30, 1991

Thank you, Rankin.

It's great to be back in Atlanta -- home of the Atlanta Braves, the Atlanta Falcons, the 1996 Summer Olympics, and John Robson, who used to be Dean of the Emory Business School and is now doing a great job as Deputy Secretary of the Treasury.

And, I'm privileged to have the opportunity to speak to this distinguished group. Many people believe that those of us in Washington do not know, or understand, what is going on in the real world -- that we are out of touch and living in a bubble inside the Washington Beltway. The President held two long meetings this past week with Cabinet members on the economy, and I can promise you, as long as you have a President like George Bush, you can rest assured that the message from Main Street will get through.

And one of the messages we have been hearing is that the credit crunch, and its effect on the economy, is a number one priority -- and not only here in Atlanta.

As we enter the fourth quarter of 1991, economic signals continue to read like mixed metaphors. The economic recovery, which began in the third quarter, is on track, although there are pockets of the economy where the recession clearly still lingers. Historically, the early stages of a recovery tend to be uneven, and this particular recovery seems to be following just such a bumpy route.

Assessments of the health of the economy are based on a variety of statistics, and the economy has, in fact, recorded a string of favorable statistics. These numbers indicate the economy turned the corner in the second quarter and is on the way up.

NB-1478

-- The leading indicators, which typically point to the pace of future economic activity, have risen for six straight months.

-- Industrial production, led by manufacturing, has also been on the rise for five months, and low inventories suggest that expansion will continue.

-- Inflation is under control, currently averaging below three percent.

-- The Fed funds rate has fallen 300 basis points since July 1990 and is now just over 5 percent.

-- And the discount rate is down to five percent from last year's seven percent -- an eighteen year low.

But statistics don't mean much to people who aren't participating in the good news yet.

-- The unemployment rate is down to 6.8 percent, but for the people who make up that 6.8 percent, that statistic is meaningless.

-- There have been signs of recovery in the housing market, but they are fitful and sluggish.

-- And most importantly, consumer confidence has not yet bounced back.

There is a statement often quoted in Washington that says "perception is reality". That saying can easily be applied to economic recovery. For the American people to perceive that economic recovery is here, they must believe that Congress, the Administration, and American businesses are doing all we can to promote that recovery. And until the recovery actually touches people's lives, all the economic statistics in the world will not convince them the recovery has arrived.

We must make the connection between perception and reality, and we can do that by addressing aspects of the economy that can add or subtract to economic growth. Most economists state that the recession has ended, and the economy is on track. But now we must continue to work to see that the recovery is not sidetracked.

One of the aspects of the recovery that is not on schedule is the availability of credit. If corporations are to expand and increase production, they must have access to credit. If small businesses, the traditional source of new job creation, are to be able to grow and perform that job-creating function, they must

have access to working capital. If homebuilders are to be able to meet downstream demand for new homes, they must have access to construction loans. If consumers are to release pent up demand for big ticket items, they must be able to obtain credit.

With the decline in the federal funds rate, credit should be more affordable than ever. And banks do have the liquidity to make loans. But they aren't making them.

There are numerous causes of the credit crunch. Clearly, the recession is a major cause. The downturn in the economy made financial institutions more cautious about lending, and businesses more cautious about borrowing. The recession scored a direct hit on the balance sheets of banks whose portfolios were not adequately diversified.

And, the recession resulted in an increase in non-performing loans in bank portfolios. When non-performing loans rise, bankers become more conservative, and regulators get nervous. For example, bank non-performing assets in real estate alone jumped 72 percent from March 1990 to March 1991. It is not surprising, then, that the credit crunch has been most evident in the real estate industry.

And in the real estate industry, the real problem is in commercial real estate. Ten years of overbuilding contributed to the problem. Fifty percent of current office space was built during the 1980s, and demand did not keep up with supply. If you have ever flown into Dulles Airport, about 20 miles outside Washington DC, you know what I mean. The route to that airport, which used to be lined with trees, is now a solid wall of high-rise office buildings -- and many of them stand empty. Every city has its horror stories, and that reflects the fact that national vacancy rates for office space increased from eight percent in 1980 to twenty percent in 1990.

In addition to the recession and overbuilding in commercial real estate, you can add the presence of regulatory overkill. As examiners became more nervous over the tilting of bank balance sheets, some individual examiners have overreacted to bank losses, and to Congressional criticism that regulators have been too lax. The result has been to create a "fear factor" in the banking system, and a hesitancy on the part of bankers to make any new loans which might be questioned by an examiner.

The Administration is taking steps to address this problem, and John Robson has taken the lead for Treasury. For over a year, John, Alan Greenspan of the Federal Reserve, Bob Clarke of the OCC, Bill Seidman of the FDIC, and Tim Ryan of the OTS, have met with bank and thrift examiners to make sure they know they should not be part of the problem -- they have to be part of the solution.

This group, and others, have held over 150 meetings around the country with regulators, bankers, and borrowers to identify problems and work toward solutions. Some of the most effective of these meetings have been regional meetings that include Members of Congress, regulatory supervisors, bankers and borrowers. Congressman Gingrich has been very instrumental in coordinating this "town meeting" effort with his colleagues in the House, and in fact, this morning I attended a credit crunch meeting organized by Congressman Gingrich in Clayton County.

The message we hope to convey at these meetings is that financial institutions should be making loans to worthy borrowers, and we are working to get that message out. Over the past several months, we have worked with the regulators to achieve changes in regulatory policy and regulatory attitudes based on the use of balance and common sense. The regulators have issued a number of directives, beginning in March of this year, which have:

-- Made clear that liquidation value appraisals should not be used;

-- Allowed banks with real estate concentrations to work with existing borrowers and make sound new loans;

-- Facilitated the restructuring of troubled credits;

-- Allowed commercial real estate loans to be prudently refinanced by banks without regulatory criticism.

-- And, clarified lender liability under Superfund legislation.

We believe these new guidelines will make a difference. As we have seen, the credit crunch has many causes, and regulatory zeal cannot be blamed for the entire problem. Each banker has his or her own board of directors and shareholders to whom they must answer. But it is a burden on the economy when banks do not perform their traditional role of providing loans. The financial world is changing, and the traditional role of banks as lenders has already been eroded as the market has developed new ways of raising capital.

Corporations raise capital through commercial paper. Consumers now use credit cards and personal finance corporations when they need additional credit. They get auto loans from GMAC and Ford Motor Credit, they save at Merrill Lynch and Sears Roebuck, and they even have checking accounts with Vanguard and Fidelity mutual funds.

I am sure each of you could provide your own reasons for the slowdown in credit availability. But the essential fact is that banks are not performing their traditional function as "shock absorbers", lending to businesses and individuals to help pull them through the tough times. Our financial institutions were weak heading into this recession. Instead of making loans to tide people over, they were forced to pull back and look out for themselves. Today, the banking industry is under stress, and that's not just a problem for the banks -- that's a problem for business. Financial institutions and businesses must work together if we are to see continued economic growth and more jobs.

At the President's urging, we in the Administration will continue to work with the regulators and the examiners to clarify regulatory guidelines and give examiners the confidence to perform honest, fair and balanced examinations of banks. We will also continue to work with the banking and thrift industries, as well as other business groups, to identify regulations and exam practices which are believed to contribute to the problem. We have heard many horror stories about draconian examinations, but most are from unnamed sources. If bankers believe exams, or examiners, are unfair, they need to step up and voice that concern.

Fear of retribution by the same examiners is the reason most given for the lack of official complaints. If that is the case, then bankers should work with us to devise an appeals process for examinations which alleviates that concern. All four regulators have assured me they have a strong commitment to address this problem, but we cannot solve nameless, faceless accusations. And we will not make examiners -- or regulators -- the scapegoats for bankers who have decided not to lend.

Addressing the credit crunch is a battle which must be waged in the short term to make the economic recovery a reality. We must also continue to work with the Congress to pass the President's economic growth package. When I say "work with the Congress", I have to admit to a certain level of frustration. The Administration is criticized for not having a domestic growth plan, but in fact, the Congress has chosen to ignore the President's plan.

In February of this year, the President proposed a package of economic growth incentives as part of the FY 1992 budget -- but the Congress has yet to act on a single one. The President's growth plan includes proposals which made sense at the beginning of this year, and make even more sense now. Our program would:

-- Reduce the capital gains tax rate;

-- Enhance personal savings through an expanded Individual Retirement Account (IRA) and the Family Savings Account;

-- Make the Research & Experimentation (R&E) tax credit permanent;

-- Increase federal investment in science, technology and infrastructure;

-- And keep the pay-as-you-go system in the budget process to ensure that any new spending must be offset by decreased spending elsewhere in the budget. This restraint on federal spending is working, and we must keep it in place to bring down the deficit.

Finally, we must reform the antiquated laws governing the banking system to make banks safer, sounder and stronger. We must pass the President's comprehensive banking reform legislation now before Congress. It is just good common sense to help banks renew the value of their franchise by strengthening their capital positions, and encouraging more diversified portfolios.

Congress has been considering the Administration's financial services reform proposal since March, and the lines of the debate have been clearly drawn. Those who oppose the Administration's bill, who want to leave things as they are, would have you believe that reform is simply deregulation. It's not. These opponents support measures which would take the banking industry backwards, restrict competition, and protect special interests.

The financial services industry needs progressive reform which encourages competition and shuns the protection of special interests. There are strong advocates of responsible change on both sides of the aisle -- Democrats and Republicans. In fact, Georgia Congressman Doug Barnard is one of the leaders for comprehensive reform because he knows strong banks and financial service firms are a key to the economic health of our country.

Although we are entering an election year, economic growth should not be a partisan issue. When the economy is growing, jobs are created, personal income rises, businesses expand and increase production, and the standard of living is higher for everyone. We must make the economic recovery a reality that is perceived by everyone, and with your help, we can make that happen.

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PUBLIC DEBT NEWS

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

FOR IMMEDIATE RELEASE
September 30, 1991

CONTACT: Peter Hollenbach
(202) 376-4302
or
L. Richard Keyser
(202) 708-1591

TREASURY AUTHORIZES HUD CALL OF FHA INSURANCE FUND DEBENTURES

The Departments of Treasury and Housing and Urban Development announced today the call of all Federal Housing Administration (FHA) debentures, outstanding as of September 30, 1991, with interest rates of 8 1/2 percent or higher. Debentures that have been registered on the books of the Federal Reserve Bank of Philadelphia as of September 30, 1991, are considered, "outstanding." The date of the call for the redemption of the more than $98 million in debentures is January 1, 1992, with the semi-annual interest due January 1, paid along with the debenture principal.

Debenture owners of record as of September 30, 1991, will be notified by mail of the call and given instructions for submission. Those owners who cannot locate the debentures should contact the Federal Reserve Bank of Philadelphia (215) 574-6684 for assistance.

No transfers or denominational exchanges in debentures covered by this call will be made on or after October 1, 1991, nor will any special redemption purchases be processed. This does not affect the right of the holder to sell or assign the debentures.

The Federal Reserve Bank of Philadelphia has been designated to process the redemptions and to pay final interest on the called debentures. To ensure timely payment of principal and interest on the debentures, they should be received by December 1, 1991, at:

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

oOo

PA-70

AUCTION RESULTS

PUBLIC DEBT NEWS

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FOR IMMEDIATE RELEASE
September 30, 1991

CONTACT: Office of Financing
202-219-3350

DEPT. OF THE TREASURY

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Tenders for $10,814 million of 13-week bills to be issued October 3, 1991 and to mature January 2, 1992 were accepted today (CUSIP: 912794XT6).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.09%	5.24%	98.713
High	5.12%	5.27%	98.706
Average	5.11%	5.26%	98.708

Tenders at the high discount rate were allotted 25%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	39,245	39,245
New York	33,963,515	9,423,265
Philadelphia	19,880	19,880
Cleveland	36,970	36,950
Richmond	112,700	67,700
Atlanta	45,130	42,130
Chicago	1,071,610	180,860
St. Louis	53,555	16,055
Minneapolis	10,320	10,320
Kansas City	45,425	43,975
Dallas	28,030	28,030
San Francisco	545,780	72,780
Treasury	833,235	833,235
TOTALS	$36,805,395	$10,814,425
Type		
Competitive	$32,855,255	$6,864,285
Noncompetitive	1,595,585	1,595,585
Subtotal, Public	$34,450,840	$8,459,870
Federal Reserve	2,286,135	2,286,135
Foreign Official Institutions	68,420	68,420
TOTALS	$36,805,395	$10,814,425

An additional $42,380 thousand of bills will be issued to foreign official institutions for new cash.

NB-1479

AUCTION RESULTS

PUBLIC DEBT NEWS

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DEPT. OF THE TREASURY

FOR IMMEDIATE RELEASE
September 30, 1991

CONTACT: Office of Financing
202-219-3350

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Tenders for $10,862 million of 26-week bills to be issued October 3, 1991 and to mature April 2, 1992 were accepted today (CUSIP: 912794YG3).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.12%	5.34%	97.412
High	5.14%	5.37%	97.401
Average	5.14%	5.37%	97.401

Tenders at the high discount rate were allotted 37%. The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	32,445	32,445
New York	35,582,145	9,398,305
Philadelphia	13,605	13,605
Cleveland	30,305	30,305
Richmond	52,620	46,320
Atlanta	30,615	29,280
Chicago	1,499,735	299,485
St. Louis	39,505	24,505
Minneapolis	6,510	6,510
Kansas City	49,785	49,785
Dallas	23,115	23,115
San Francisco	643,355	164,095
Treasury	744,370	744,370
TOTALS	$38,748,110	$10,862,125
Type		
Competitive	$34,635,795	$6,749,810
Noncompetitive	1,304,435	1,304,435
Subtotal, Public	$35,940,230	$8,054,245
Federal Reserve	2,350,000	2,350,000
Foreign Official Institutions	457,880	457,880
TOTALS	$38,748,110	$10,862,125

An additional $301,420 thousand of bills will be issued to foreign official institutions for new cash.

NB-1480

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

OCT 3 1991 000286
DEPT. OF THE TREASURY

FOR IMMEDIATE RELEASE September 30, 1991

FEDERAL FINANCING BANK ACTIVITY

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

FFB holdings of obligations issued, sold or guaranteed by other Federal agencies totaled $188.9 billion on August 31, 1991, posting an increase of $2.2 billion from the level on July 31, 1991. This net change was the result of increases in holdings of agency debt of $2,176.8 million, while holdings of agency assets decreased by $0.3 million and holdings of agency-guaranteed loans decreased by $7.9 million. FFB made 27 disbursements during August.

FFB holdings on August 31, 1991 were the highest in the Bank's history.

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

NB-1481

FEDERAL FINANCING BANK

AUGUST 1991 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
AGENCY DEBT					
FEDERAL DEPOSIT INSURANCE CORPORATION					
Note No. FDIC 0002					
Advance #4	8/6	$ 124,000,000.00	10/1/91	5.791%	
Advance #5	8/12	1,091,000,000.00	10/1/91	5.604%	
NATIONAL CREDIT UNION ADMINISTRATION					
Central Liquidity Facility					
Note #564	8/8	3,000,000.00	10/7/91	5.670%	
Note #565	8/12	10,000,000.00	11/8/91	5.606%	
+Note #566	8/13	13,000,000.00	11/8/91	5.595%	
+Note #567	8/20	3,000,000.00	11/8/91	5.384%	
+Note #568	8/23	10,000,000.00	10/22/91	5.596%	
+Note #569	8/27	6,000,000.00	11/8/91	5.697%	
+Note #570	8/28	10,000,000.00	11/8/91	5.671%	
Note #571	8/29	5,000,000.00	11/8/91	5.587%	
+Note #572	8/30	13,000,000.00	10/22/91	5.555%	
+Note #573	8/30	5,000,000.00	9/27/91	5.555%	
RESOLUTION TRUST CORPORATION					
Note No. 0010					
Advance #4	8/12	1,400,000,000.00	10/1/91	5.604%	
TENNESSEE VALLEY AUTHORITY					
Short-term Bond #112	8/5	180,000,000.00	8/12/91	5.847%	
Short-term Bond #113	8/5	50,000,000.00	8/19/91	5.847%	
Short-term Bond #114	8/12	158,000,000.00	8/26/91	5.659%	
Short-term Bond #115	8/14	140,000,000.00	8/28/91	5.593%	
Short-term Bond #116	8/16	134,000,000.00	8/30/91	5.576%	
Short-term Bond #117	8/17	25,000,000.00	8/30/91	5.586%	
Short-term Bond #118	8/19	198,000,000.00	9/9/91	5.586%	

+rollover

FEDERAL FINANCING BANK

AUGUST 1991 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
GOVERNMENT - GUARANTEED LOANS					
GENERAL SERVICES ADMINISTRATION					
Foley Square Courthouse	8/14	$ 1,193,114.39	12/11/95	7.478%	
Foley Square Office Building	8/28	1,775,981.00	12/11/95	7.402%	
U.S. Trust Company of New York					
Advance #16	8/2	2,077,484.68	11/15/91	5.887%	
Advance #17	8/6	876,854.19	11/15/91	5.824%	
RURAL ELECTRIFICATION ADMINISTRATION					
Cornbelt Power #292	8/16	4,889,000.00	1/2/18	7.983%	7.905% qtr.
S. Maryland Elec. #352	8/20	10,010,000.00	12/31/25	8.155%	8.074% qtr.
TENNESSEE VALLEY AUTHORITY					
Seven States Energy Corporation					
Note A-91-10	8/30	1,287,481.82	9/30/91	5.587%	

FEDERAL FINANCING BANK
(in millions)

Program	August 31, 1991	July 31, 1991	Net Change 8/1/91-8/31/91	FY '91 Net Change 10/1/90-8/31/91
Agency Debt:				
Export-Import Bank	$ 11,238.0	$ 11,238.0	$ -0-	$ -101.9
Federal Deposit Insurance Corporation	7,646.0	6,431.0	1,215.0	7,646.0
NCUA-Central Liquidity Fund	113.5	96.7	16.8	56.9
Resolution Trust Corporation	58,782.4	57,382.4	1,400.0	17,300.7
Tennessee Valley Authority	12,373.0	12,828.0	-455.0	-2,009.0
U.S. Postal Service	6,400.6	6,400.6	-0-	-297.2
sub-total*	96,553.4	94,376.6	2,176.8	22,595.5
Agency Assets:				
Farmers Home Administration	51,334.0	51,334.0	-0-	-715.0
DHHS-Health Maintenance Org.	61.2	61.3	-0.1	-8.3
DHHS-Medical Facilities	76.1	76.1	-0-	-6.7
Rural Electrification Admin.-CBO	4,463.9	4,463.9	-0-	56.7
Small Business Administration	6.4	6.6	-0.2	-2.0
sub-total*	55,941.6	55,941.9	-0.3	-675.3
Government-Guaranteed Loans:				
DOD-Foreign Military Sales	4,680.0	4,665.4	14.6	-5,075.6
DEd.-Student Loan Marketing Assn.	4,850.0	4,850.0	-0-	-30.0
DHUD-Community Dev. Block Grant	208.1	217.5	-9.4	-35.9
DHUD-Public Housing Notes +	1,903.4	1,903.4	-0-	-47.4
General Services Administration +	655.8	649.6	6.0	288.5
DOI-Guam Power Authority	29.1	29.1	-0-	-0.7
DOI-Virgin Islands	24.5	24.5	-0-	-0.7
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	18,846.4	18,831.5	14.9	-195.9
SBA-Small Business Investment Cos.	265.5	293.4	-27.9	-117.0
SBA-State/Local Development Cos.	693.0	699.9	-6.9	-48.6
TVA-Seven States Energy Corp.	2,413.8	2,412.6	1.3	57.8
DOT-Section 511	21.4	21.8	-0.4	-1.9
DOT-WMATA	177.0	177.0	-0-	-0-
sub-total*	36,425.2	36,433.1	-7.9	-6,318.5
grand total*	$ 188,920.2	$ 186,751.6	$ 2,168.6	$ 15,601.7

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

TREASURY NEWS

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

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DEPT. OF THE TREASURY

FOR IMMEDIATE RELEASE
OCTOBER 1, 1991

CONTACT: Barbara Clay
202-566-5252

TREASURY PENALIZES CATERPILLAR INDUSTRIAL FOR SALES TO LIBYA

Caterpillar Industrial, Inc., has paid $137,500 in fines for violating U.S. economic sanctions against Libya.

"This case illustrates the need for U.S. companies to be aware of all aspects of the economic sanctions before engaging in any transaction that may involve Libya," said Richard Newcomb, director of Treasury's Office of Foreign Assets Control (OFAC), which imposed the penalty against Caterpillar.

The Mentor, Ohio, company acted as middleman in facilitating the sale to Libya of 226 trucks shipped from South Korea, two shipped from Norway and 70 from the United Kingdom. The company maintained that it believed the sanctions did not apply to these transactions, since the trucks were not of U.S. origin.

The sanctions, however, prohibit a U.S. individual or company from exporting services to Libya, as well as from entering into contracts to support projects in Libya or dealing in property in which Libya has an interest.

Caterpillar, a division of Caterpillar Inc., of Peoria, Illinois, conducted an internal investigation after OFAC requested information on the company's involvement in a shipment. The company reported 18 similar shipments from 1988 through 1990. Its voluntary disclosure of the violations was a factor in reducing the amount of the penalty.

The U.S. sanctions were imposed in 1986 to exert financial pressure against Libya and to reduce Muammar Qadhafi's ability to promote and finance terrorism. Almost all economic transactions with Libya are prohibited, with civil penalties up to $10,000 for each violation. Criminal penalties of $500,000 per violation for corporations and $250,000 for individuals may apply, with prison terms of up to 12 years for individuals and senior corporate officers.

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DEPARTMENT OF THE TREASURY

Office of Foreign Assets Control

31 CFR Part 515

Cuban Assets Control Regulations

9-20-91

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

ACTION: Final Rule

SUMMARY: This rule amends the Cuban Assets Control Regulations, 31 CFR Part 515 (the "Regulations"), by reducing the dollar amount that may be sent to the remitter's close relatives in Cuba; generally prohibiting Cuban nationals from carrying non-Cuban currency to Cuba; and by limiting the dollar amount that can be expended by U.S. persons for transactions related to their travel to Cuba or for support for the travel of a Cuban national to the United States. These amendments to the Regulations are intended to reduce the flow of funds entering the Cuban economy from the United States. This rule also makes various clarifying and technical amendments.

EFFECTIVE DATE: [Thirty days after the date of publication]

FOR FURTHER INFORMATION: William B. Hoffman, Chief Counsel (tel.:202/535-6020), or Steven I. Pinter, Chief of Licensing

(tel.: 202/535-9449), Office of Foreign Assets Control, Department of the Treasury, Washington, D.C. 20220.

SUPPLEMENTARY INFORMATION: In order to reduce the flow of funds into the Cuban economy from the United States, § 515.560 is amended to limit the funds that a person traveling to Cuba may remit to Cuba for travel-related transactions such as passport or visa fees and taxes. Present § 515.563 permits, in pertinent part, the remittance of up to $500 in any 3-month period to the remitter's close relative(s) located in Cuba. This section is amended to reduce this amount to $300 per 3-month period. This change makes the amount consistent with the amount permitted in other programs administered by the Office of Foreign Assets Control for Vietnam and Cambodia. It also serves to reduce the amount of currency sent to Cuba from the United States. In addition, this section is amended to clarify that remittances for the purpose of enabling a Cuban national to emigrate are only authorized for the benefit of Cuban nationals emigrating from Cuba to the United States.

Present § 515.564, which authorizes transactions related to the travel to the United States by a Cuban national entering on a visa issued by the State Department, places no limit on the amount that may be remitted for such transactions. This section is amended to limit the amount of money that a U.S. person may remit to Cuba directly or indirectly for transactions related to

such travel to $500. In addition, such remittances may be sent only after the Cuban national has received a valid U.S. visa. This section is also amended to clarify that travel transactions authorized in this section include travel directly from Cuba to the United States. Finally, present § 515.569 is amended to add a new subsection prohibiting Cuban nationals from carrying non-Cuban currency to Cuba from the United States in excess of amounts brought into the United States. An exception is made for the carrying of family remittances which the travelers may legally receive pursuant to § 515.563.

This rule also includes two clarifying amendments. Present § 515.311 is amended to make explicit the longstanding interpretation of the Office of Foreign Assets Control that the term, "property," includes services. On February 2, 1989 (54 FR 5235), § 515.560(c)(5) was inadvertently revised when it had been correctly removed on November 23, 1988 (53 FR 47527). This paragraph is removed in this rule.

Because the Regulations involve a foreign affairs function, Executive Order 12291 and the provisions of the Administrative Procedure Act, 5 U.S.C. 553, requiring notice of proposed rulemaking, opportunity for public participation, and delay in effective date, are inapplicable. Because no notice of proposed rule making is required for this rule, the Regulatory Flexibility Act, 5 U.S.C. 601 et seq., does not apply.

List of subjects in 31 CFR part 515

Administrative practice and procedure, Cuba, Currency, Foreign investments in United States, Foreign trade, Penalties, Reporting and recordkeeping requirements, Securities, Travel restrictions

For the reasons set forth in the preamble, 31 CFR part 515 is amended as follows:

PART 515--CUBAN ASSETS CONTROL REGULATIONS

1. The "Authority" citation for part 515 continues to read as follows:

Authority: 50 U.S.C. App. 5, as amended; 22 U.S.C. 2370(a); Proc. 3447, 27 FR 1085, 3 CFR 1959-1963 Comp. p. 157; E.O. 9193, 7 FR 5205, 3 CFR 1938-1943 Cum. Supp. p. 1174; E.O. 9989, 13 FR 4891, 3 CFR 1943-1946 Comp. p.748.

Subpart C--General Definitions

§515.311 [Amended]

2. Section 515.311 is amended by adding the word, "services," after the phrase, "contracts of any nature whatsoever,".

Subpart E--Licenses, Authorizations, and Statements of Licensing Policy

List of subjects in 31 CFR part 515

Administrative practice and procedure, Cuba, Currency, Foreign investments in United States, Foreign trade, Penalties, Reporting and recordkeeping requirements, Securities, Travel restrictions

For the reasons set forth in the preamble, 31 CFR part 515 is amended as follows:

PART 515--CUBAN ASSETS CONTROL REGULATIONS

1. The "Authority" citation for part 515 continues to read as follows:

Authority: 50 U.S.C. App. 5, as amended; 22 U.S.C. 2370(a); Proc. 3447, 27 FR 1085, 3 CFR 1959-1963 Comp. p. 157; E.O. 9193, 7 FR 5205, 3 CFR 1938-1943 Cum. Supp. p. 1174; E.O. 9989, 13 FR 4891, 3 CFR 1943-1946 Comp. p.748.

Subpart C--General Definitions

§515.311 [Amended]

2. Section 515.311 is amended by adding the word, "services," after the phrase, "contracts of any nature whatsoever,".

Subpart E--Licenses, Authorizations, and Statements of Licensing Policy

3. Section 515.560 is amended by revising paragraph (c)(1) to read as follows:

§ 515.560 Certain transactions incident to travel to and within Cuba.

* * * * *

(c) * * *

(1) All transportation-related transactions ordinarily incident to travel to and from Cuba, provided no more than $500 may be remitted to Cuba directly or indirectly for fees imposed by the Government of Cuba in conjunction with such travel.

* * * * *

4. §515.560(c)(5), as published at 54 FR 47527, November 23, 1988, is removed.

5. Section 515.563 is amended by revising paragraph (a)(1) and (a)(2) to read as follows:

§ 515.563 Family remittances to nationals of Cuba.

(a) * * *

(1) For the support of the payee (including any members of the payee's household) in amounts not exceeding $300 in any consecutive 3-month period to any one household; and

(2) For the purpose of enabling the payee to emigrate from Cuba to the United States, in an amount not exceeding $500 to be

made only once to any one payee, provided that the payee is a resident of and located within Cuba on the effective date of this section.

* * * * *

6. Section 515.564 is amended by revising paragraphs (a) and (a)(1), and adding a new paragraph (c) to read as follows:

§ 515.564 Certain transactions incident to travel to, from and within the United States by certain Cuban Nationals.

(a) Except as provided in paragraphs (b) and (c) of this section, the following transactions by or on behalf of a Cuban national who enters the United States from Cuba on a visa issued by the State Department are authorized:

(1) All transactions ordinarily incident to travel between the United States and Cuba, including the importation into the United States of accompanied baggage for personal use:

* * * * *

(c) Remittances by persons subject to U.S. jurisdiction to Cuba or a Cuban national, directly or indirectly, for transactions on behalf of a Cuban national authorized in paragraph (a) may not exceed $500 and may be remitted only after the Cuban national has received a valid visa issued by the State Department. Authorized transactions include purchase of airline tickets and payment of visa fees or other travel-related fees.

made only once to any one payee, provided that the payee is a resident of and located within Cuba on the effective date of this section.

* * * * *

6. Section 515.564 is amended by revising paragraphs (a) and (a)(1), and adding a new paragraph (c) to read as follows:

§ 515.564 Certain transactions incident to travel to, from and within the United States by certain Cuban Nationals.

(a) Except as provided in paragraphs (b) and (c) of this section, the following transactions by or on behalf of a Cuban national who enters the United States from Cuba on a visa issued by the State Department are authorized:

(1) All transactions ordinarily incident to travel between the United States and Cuba, including the importation into the United States of accompanied baggage for personal use:

* * * * *

(c) Remittances by persons subject to U.S. jurisdiction to Cuba or a Cuban national, directly or indirectly, for transactions on behalf of a Cuban national authorized in paragraph (a) may not exceed $500 and may be remitted only after the Cuban national has received a valid visa issued by the State Department. Authorized transactions include purchase of airline tickets and payment of visa fees or other travel-related fees.

7. Section 515.569 is amended by redesignating paragraphs (d) and (e) as (e) and (f), and adding a new paragraph (d) to read as follows:

§ 515.569 Currency carried by travelers to Cuba.

* * * * *

(d) Except for remittances authorized for the traveler's household by § 515.563(a)(1) and the amount of U.S. currency or currency from a third country brought into the United States by the traveler and registered with the U.S. Customs Service upon entry, Cuban nationals returning directly to Cuba from the United States may carry no non-Cuban currency.

* * * * *

Dated: Sept 13, 1991

R. Richard Newcomb

Director

Office of Foreign Assets Control

Approved: Sept 16, 1991

Peter K. Nunez

Assistant Secretary (Enforcement)

SEMIANNUAL REPORT TO THE CONGRESS

Office of Inspector General
Department of the Treasury

October 1, 1990 - March 31, 1991

Foreword

During the 6-month period ended March 31, 1991, Treasury internal auditors issued 94 audit reports which recommended monetary benefits totaling $36.9 million. Treasury internal investigations resulted in 159 successful prosecutions and 302 administrative sanctions. In the final analysis, however, there would be little value to the audit and investigative processes without prompt and responsive actions by Treasury managers. For this reason, we make a special effort to explain in our semiannual reports not only what we found and recommended, but also what was done about it. In addition to being informative, this provides balance to the reports.

Led by the Secretary and the Deputy Secretary, Treasury has made a strong commitment to improving its management control program. Increased management attention is reflected in progress reports which show many completed corrective actions in the four problem areas that the Department reported to the Office of Management and Budget in July 1989. The reported management control problems concern: (1) data integrity; (2) management oversight of systems development activities; (3) management of accounts receivable at the IRS; and (4) funds controls at the U.S. Customs Service.

The OIG is participating in two Treasury task forces whose objectives are to minimize waste and improve management. Based on a report from one of the task forces, Treasury is implementing an Early Warning System to alert managers to emerging financial management issues before they become problems requiring substantial corrective actions. The OIG is also participating in a task force to assess internal controls in the organizations which report to the Treasurer of the U.S.: the U.S. Mint, the Bureau of Engraving and Printing, and the U.S. Savings Bonds Division.

For the remainder of this year and in Fiscal Year 1992, we plan to focus our efforts in four major areas. First, we will continue to be responsive to the Administration's objective of enhancing management controls, particularly at the U.S. Customs Service, Treasury's second largest bureau. The second focus will be to increase our capability to investigate sensitive matters at the IRS, the Customs Service, the Secret Service, and the Bureau of Alcohol, Tobacco and Firearms and to oversee their Offices of Internal Affairs and Inspection. Our third focus will be to advance the audit and investigative coverage provided to the Office of Thrift Supervision and to the Office of the Comptroller of the Currency. Our fourth focus will be to comply with the Chief Financial Officers Act of 1990 which requires the OIG to audit or arrange for audits of certain Treasury financial statements starting in 1992.

Donald E. Kirkendall
Inspector General
Department of the Treasury

April 30, 1991

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TREASURY BUREAU	ABBREVIATION
Bureau of Alcohol, Tobacco and Firearms	Bureau of ATF
Office of the Comptroller of the Currency	Comptroller of the Currency
U.S. Customs Service	Customs
Departmental Offices	Departmental Offices
Bureau of Engraving and Printing	Engraving and Printing
Federal Law Enforcement Training Center	FLETC
Financial Management Service	Financial Management Service
Internal Revenue Service	IRS
U.S. Mint	Mint
Bureau of the Public Debt	Public Debt
U.S. Savings Bonds Division	Savings Bonds
U.S. Secret Service	Secret Service
Office of Thrift Supervision	OTS

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TREASURY BUREAU	ABBREVIATION
Bureau of Alcohol, Tobacco and Firearms	Bureau of ATF
Office of the Comptroller of the Currency	Comptroller of the Currency
U.S. Customs Service	Customs
Departmental Offices	Departmental Offices
Bureau of Engraving and Printing	Engraving and Printing
Federal Law Enforcement Training Center	FLETC
Financial Management Service	Financial Management Service
Internal Revenue Service	IRS
U.S. Mint	Mint
Bureau of the Public Debt	Public Debt
U.S. Savings Bonds Division	Savings Bonds
U.S. Secret Service	Secret Service
Office of Thrift Supervision	OTS

Executive Summary

Public Law 100-504, the Inspector General Act Amendments of 1988, established a statutory Office of Inspector General (OIG) in the Department of the Treasury on April 16, 1989. This report is Treasury's fourth semiannual report to the Congress under the Inspector General Act of 1978, as amended. In addition to OIG activities, the report includes the activities of Treasury Offices of Internal Affairs and Inspection in the Bureau of ATF; Customs; IRS; and Secret Service. The OIG is responsible for overseeing the operations of these offices. The report also summarizes OIG activities with respect to the Inspector General's role as Inspector General of the Oversight Board of Resolution Trust Corporation.

The Department of the Treasury employs about 160,000 individuals who perform a wide range of critical responsibilities. Among these are: (1) formulating domestic and international financial, economic, and tax policy; (2) serving as the financial agent of the Government; (3) manufacturing coins and currency; (4) managing the public debt; (5) collecting Federal revenues; (6) enforcing laws related to such matters as firearms and explosives, imports and exports, counterfeiting, protection, and tax evasion; (7) exercising general supervision over the operations of the national banks and thrift institutions; and (8) training Federal law enforcement officers.

The Inspector General Act requires Inspectors General to report significant problems, abuses, deficiencies, and recommendations for corrective actions. **Accordingly, the audit and investigative results should not be viewed as representative of the conditions within the Department and its bureaus.**

MAJOR CONTROL ISSUES

Considerable Congressional, Administration, and media attention has been focused on weaknesses in the thrift industry regulatory process, which was transferred from the Federal Home Loan Bank Board to Treasury's Office of Thrift Supervision (OTS) in October 1989. Treasury's OIG is performing several major audits of OTS operations and is also assessing the Comptroller of the Currency's supervision of the national banks.

In July 1989, Treasury reported four areas as its most serious management control problems: data integrity, management oversight of systems development, management of IRS accounts receivable, and funds control at Customs. Completed, ongoing, and planned internal audits are addressing the four problem areas.

INTERNAL AUDITING ACTIVITIES

Contract Administration and Closeout

Over the 12 months ended March 31, 1991, Treasury auditors completed coordinated audits of contract administration and closeout at seven bureaus: Customs, Departmental Offices, Engraving and Printing, Financial Management Service, IRS, Mint, and Secret Service. The audits identified weaknesses in several major areas.

Formal contract closeout procedures were deficient at all of the bureaus, with nearly 1,500 contracts needing closure. A review of completed Customs' contracts, for example, identified over $1 million in excess funds which should have been deobligated and made available for other purposes. Moreover, day-to-day administration of contracts needed to be improved or better documented at five of the seven bureaus, and four of the seven bureaus needed to improve their contract administration management information systems. The OIG is preparing an overall audit report which will recommend actions the Department should take to address common problems. In the meantime, each of the bureaus audited has taken or initiated actions to address problems within their respective procurement activities.

$10.7 Million in Questioned Contract Costs Sustained

OIG auditors completed six preaward contract audits and three postaward contract audits during the first half of Fiscal Year 1991. A total of $10.7 million in questioned costs was sustained, including amounts which were sustained from audits performed prior to September 30, 1990. In addition, OIG auditors questioned $3.7 million on contracts for which negotiations have not yet been completed.

For example, in a preaward audit of a proposal for currency paper with security threads, over $7.1 million in questioned costs were sustained. The savings resulted after auditors questioned the proposed materials cost, machine processing costs, and general and administrative costs.

Tax Exemption on Exported Alcoholic Beverages

An OIG audit found that the Bureau of ATF's Western Region did not take action to assess at least $3.2 million in potential taxes and interest because of weaknesses in the administration of the alcohol producer compliance program. The audit determined that the Western Region lacked procedures requiring validation of exporters' claims for excise tax exemption, did not include adequate validation of documented proof of export in inspections, and did not follow up promptly when exporters failed to submit required proof of export. The Bureau of ATF agreed with the recommendations and has taken or planned actions which should correct the deficiencies.

In addition, a similar audit of the Bureau of ATF's North Atlantic Region identified potential additional taxes and interest totaling $187,000. Management agreed with the recommendations and will take actions to assess taxes due.

Processing Employee Benefit Plan Returns

An IRS internal audit concluded that the Service had effectively consolidated the processing of employee benefit plan returns in four service centers. However, IRS needed to improve processing of the returns by taking actions to identify erroneous deductions, eliminate unnecessary processing steps, and reduce and improve correspondence. Corrective actions could result in additional revenues and cost avoidances totaling over $14 million.

IRS agreed with the audit recommendations and is implementing corrective actions. For example, an error resolution check has been installed to limit the Individual Retirement Account deduction when certain criteria are met, and a test recovery project will be initiated on 1989 returns with erroneous pension-related deductions.

Information Systems

An OIG audit found that the Office of Thrift Supervision (OTS) did not consistently use its national information systems and that some field offices maintained local systems that duplicated some of the national systems' information. Consequently, OTS did not have a fully effective nationwide mechanism to prevent or identify inadequate supervisory activity or to prevent inappropriate individuals from entering or advancing in the thrift industry. The audit also found that internal controls over access and changes to four of the national systems were inadequate, thus leaving the systems vulnerable to misuse of information.

The audit report recommended that OTS develop policies and procedures to ensure that the nationwide information systems be used throughout OTS and contain the necessary information. In addition, the OIG recommended changes to improve the internal controls over access and changes to the national systems to prevent misuse of information. The actions taken or proposed by OTS management generally comply with the intent of the recommendations.

INTERNAL INVESTIGATIVE ACTIVITIES

Employee Misconduct Case

An OIG investigation of a senior Departmental Offices official determined that the official had retained a continuing financial relationship with a former employer following appointment, even though the official had previously represented that all ties were severed with the company. The official has since severed all financial arrangements with the former employer and has received a reprimand for not adhering fully to applicable regulations.

Bribery Cases

Bribery continues to be a major concern for the Office of Internal Affairs in its efforts to ferret out corruption. For example, a Nigerian national offered a $100,000 bribe to a Customs inspector in an attempt to be released from a secondary examination. A Customs "rover team" at Los Angeles International Airport had selected the national for intensive secondary examination at a local hospital. At the hospital, the individual offered the bribe and was arrested by Customs Internal Affairs agents. Forty-four packets of heroin were found on the subject. The subject pled guilty to bribery and two narcotics violations and is awaiting sentencing.

Businessman Sentenced on Bribery Charges

A Michigan businessman was sentenced to a 21-month prison term and 3 years probation after pleading guilty to charges of bribing an IRS agent and illegal posession of an unregistered machine gun. During Inspections's 11-month investigation, payments of $31,000 in bribes were made to an informant and an undercover agent posing as a corrupt employee. The bribes were offered in exchange for fraudulently crediting nearly $145,000 in payroll tax deposits to the tax account of the businessman's firm.

Lottery Winner Arrested for Bribery

The winner of an $11-million state lottery was arrested for attempting to bribe an IRS revenue officer into removing a $100,000 tax lien which was unrelated to the lottery winnings. The subject had originally requested that the lien be released for a payment of $4,000 to $5,000. In cooperation with the Inspection Service, the revenue officer informed the subject that the proposed payment was not sufficient. The subject agreed to pay the revenue officer $25,000 for her personal use in return for abating the $100,000 in taxes and releasing the lien. The subject explained that he held a winning lottery ticket and did not want IRS collecting the unpaid taxes out of his lottery winnings.

Assaults and Threats to IRS Employees

The Inspection Service has the primary responsibility for investigating assaults, threats, and forcible interference toward IRS employees. Investigations can result in severe penalties after conviction -- from 1 to 10 years imprisonment and $3,000 to $10,000 in fines. According to the Federal Bureau of Investigation's Uniform Crime Report, in 1988 "IRS enforcement officers suffered more assaults than any law enforcement group in the Federal Government, over five times higher than Drug Enforcement Agency officers who have the second greatest number of assaults."

PREVENTION ACTIVITIES

Early Warning Task Force

Treasury is implementing an Early Warning System to alert managers to emerging financial management issues before they become problems requiring substantial corrective actions. An Early Warning Task Force of representatives of the Assistant Secretary (Management), the Office of Inspector General, and Treasury bureaus defined 16 criteria and related indicators for identifying possible problem issues relating to receivables, cash management, and other activities. The system, which has been tested at the Bureau of the Public Debt, is being implemented Treasury-wide. By early April 1991, each bureau will prepare a summary report on the results of a mid-year review using the criteria and approach developed by the Task Force.

Integrity Awareness: A High Priority

Integrity awareness remained a high priority for the OIG and the Offices of Internal Affairs and Inspection during the 6 months ended March 31, 1991. The OIG and the Offices of Internal Affairs and Inspection at the Bureau of ATF, Customs, and Secret Service gave 187 integrity awarensss presentations to Treasury employees. In addition, IRS presented over 430 integrity awareness briefings to more than 13,000 employees during the 6 months ended September 30, 1990.

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Auditor Training Institute

Treasury's OIG has accepted the role of lead agency on behalf of the President's Council on Integrity and Efficiency (PCIE) to develop an Auditor Training Institute. The Institute will permit the efforts of PCIE members to be combined in order to provide more effective and economical training which will serve the basic training needs of the Federal audit community.

The pilot session of a Basic Auditor Training Course will be held in July 1991, with at least five more sessions to be conducted during the rest of 1991. Fifty-nine of the 61 OIGs have indicated that they will send students to the Institute.

Chief Financial Officers Act

The OIG is preparing to fulfill its obligations under the Chief Financial Officers Act of 1990. The Act requires Treasury to prepare financial statements for certain accounts not later than March 31, 1992, and annually thereafter. It also requires that audits of these statements be performed by the Inspector General or by an independent external auditor, as determined by the Inspector General.

The OIG will perform some of the required audits and will have independent external auditors perform other audits. The OIG has expanded training efforts in order to have qualified staff available to perform the work.

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of Internal Affairs and Inspection in the Bureau of ATF, Customs, and Secret Service and internal audits and internal investigations of the Inspection Service of IRS.

The OIG audits the programs and operations of 12 of the 13 bureaus (Departmental Offices, Bureau of ATF, Comptroller of the Currency, Customs, Engraving and Printing, FLETC, Financial Management Service, Mint, Public Debt, Savings Bonds, Secret Service, and OTS). In addition, the OIG investigates allegations of criminal and other misconduct by employees in nine bureaus (Departmental Offices, Comptroller of the Currency, Engraving and Printing, FLETC, Mint, Financial Management Service, Public Debt, Savings Bonds, and OTS); investigates or oversees cases on matters of significance throughout the Department; and helps to promote integrity awareness among employees.

The OIG also exercises oversight responsibility for the activities of the Offices of Internal Affairs and Inspection at Treasury's four law enforcement bureaus (Bureau of ATF, Customs, IRS, and Secret Service) and represents the Department on the President's Council on Integrity and Efficiency. On April 27, 1990, the Secretary delegated to the Inspector General the authority to act as Inspector General of the Oversight Board of the Resolution Trust Corporation.

Organization

Treasury's Inspector General reports directly to the Secretary and Deputy Secretary. A Deputy Inspector General assists the Inspector General in fulfilling responsibilities to ensure that Treasury has comprehensive internal audit, internal investigative, and oversight programs.

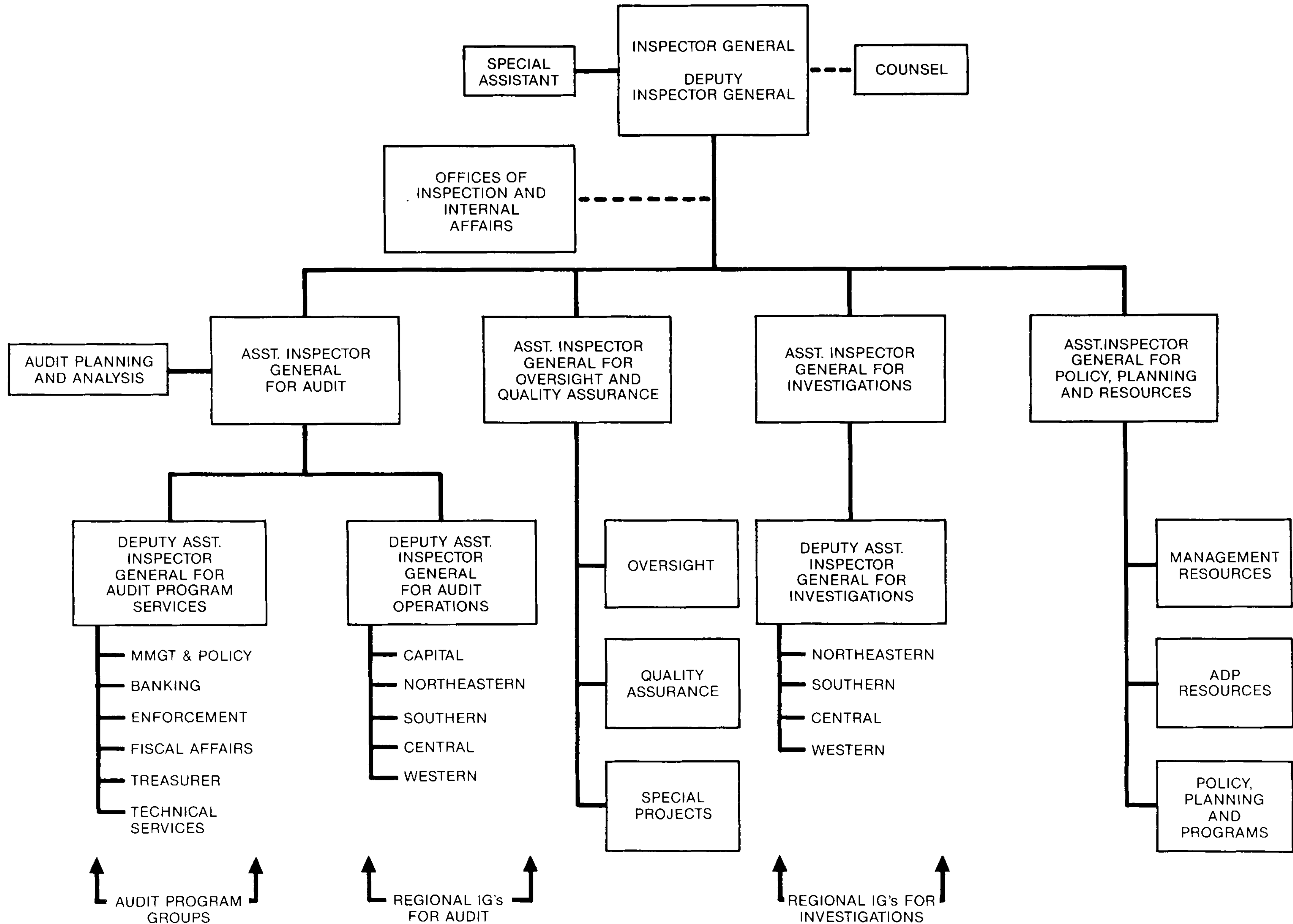
Four Assistant Inspectors General are responsible for the OIG's audit, investigative, oversight, and management functions. The Assistant Inspector General for Audit has overall responsibility for Treasury OIG audit activities, including multibureau audits of the same program, activity, or function. The Assistant Inspector General for Investigations has overall responsibility for the investigative activities of the OIG, for helping to promote integrity awareness among Treasury employees, and for liaison with law enforcement bureau Internal Affairs and Inspection Offices on investigative matters.

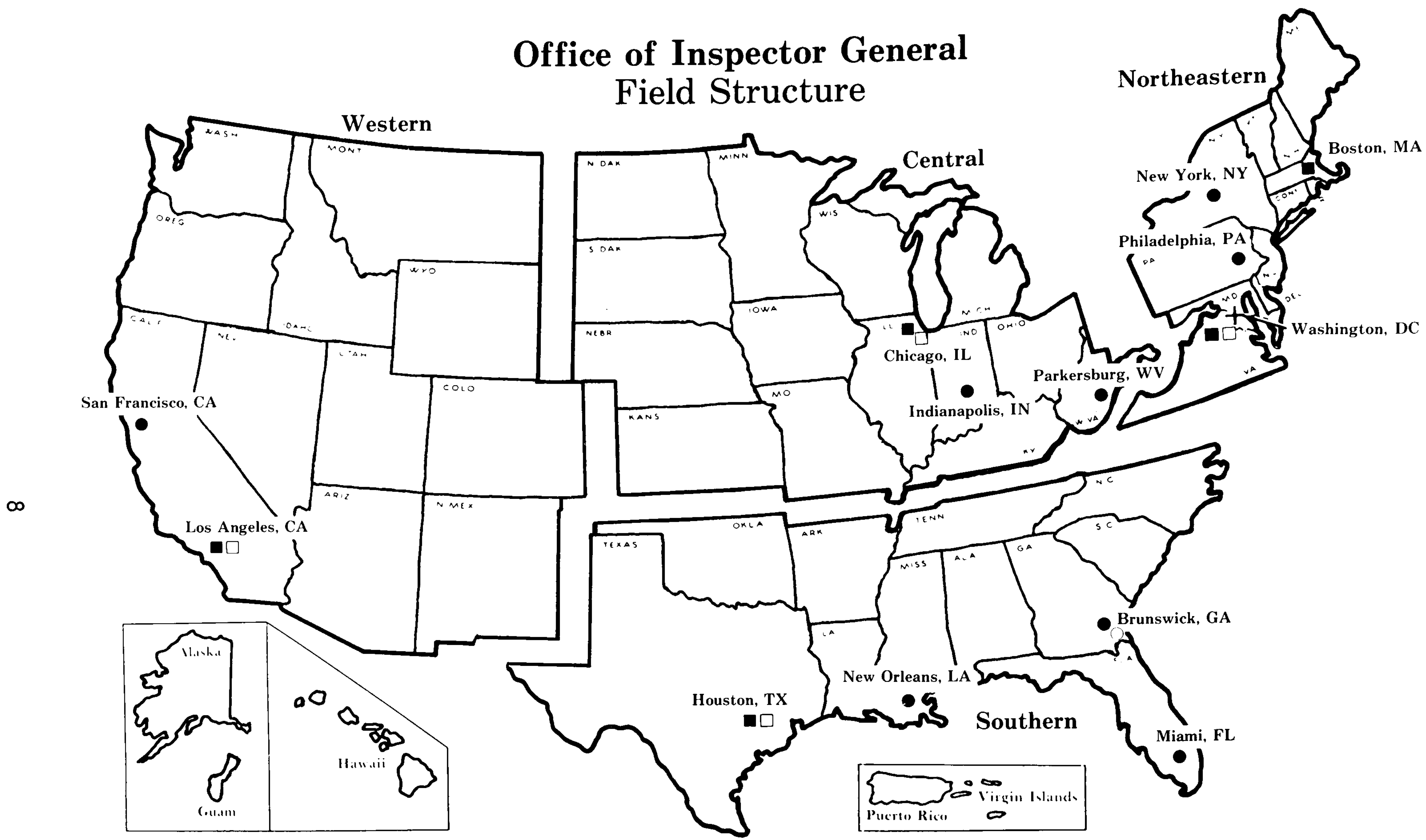
The Assistant Inspector General for Oversight and Quality Assurance is responsible for carrying out requirements in the Inspector General Act to oversee Treasury Offices of Internal Affairs and Inspection. The Assistant Inspector General also directs a quality assurance program to ensure that OIG audit and investigative programs are carried out efficiently and effectively and directs studies or projects of special interest or which cut across organizational or functional lines. The Assistant Inspector General for Policy, Planning and Resources has overall responsibility for policy, planning, personnel, budget, ADP, and other supporting activities.

Realignment of the Office of Audit

A realignment of the OIG's Office of Audit was initiated in order to (1) improve managerial flexibility by eliminating the overlap of responsibilities between bureau-specific audit staffs and regional audit staffs and (2) provide greater focus on long-range audit planning and technical support. The new alignment divides the Assistant Inspector General for Audit's responsibilities and staff into two basic components: one for audit execution and the other for planning, program technical support, and liaison. A Deputy Assistant Inspector General for Audit will direct each component. In place of bureau-specific audit staffs, a regional audit office will perform all audit work in the metropolitan Washington, D.C., area.

DEPARTMENT OF THE TREASURY — OFFICE OF INSPECTOR GENERAL





Office of Inspector General
Field Structure
Western
Central
Northeastern
Southern
Boston, MA
New York, NY
Philadelphia, PA
Washington, DC
Chicago, IL
Indianapolis, IN
Parkersburg, WV
San Francisco, CA
Los Angeles, CA
Houston, TX
New Orleans, LA
Brunswick, GA
Miami, FL
Alaska
Hawaii
Guam
Puerto Rico
Virgin Islands
+ Headquarters
■ Audit Regional Office
□ Investigative Regional Office
● Audit Field Office
○ Investigative Field Office

Major Control Issues

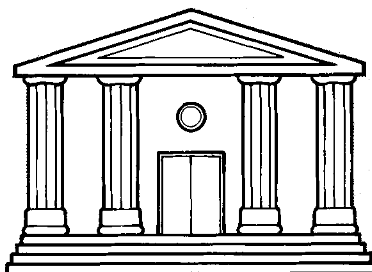
This chapter outlines major control issues, recognizes efforts to address them, and explains what the OIG and the Inspection Service of IRS are doing to help the Department address them. The chapter covers thrift and banking industry problems and four areas which Treasury reported to the Office of Management and Budget (OMB) in July 1989 as its most serious management control problems: data integrity, management oversight of systems development activities, management of accounts receivable at the IRS, and funds control at the U.S. Customs Service.

Treasury managers are strongly committed to correcting internal control weaknesses. In a July 1990 response to OMB's request for a review of progress in high risk areas, Treasury reported that significant progress had been made in addressing its four high risk areas but that additional work needed to be done. A detailed progress report was also included in the Department's December 1990 self-evaluation report under the Federal Managers' Financial Integrity Act (FMFIA). It showed that many corrective actions had been completed and included target dates for the remaining actions which ranged from 1991 to early 1995.

Planned OIG audits will review the effectiveness of actions to correct deficiencies identified by FMFIA reviews, OIG audits, and General Accounting Office (GAO) audits and will assess the progress reported on addressing the major control issues.

Thrift and Banking Industries

Regulatory, examination, and supervisory responsibilities for savings and loan institutions were transferred to Treasury's Office of Thrift Supervision (OTS) with the passage of the Financial Institution Reform, Recovery, and Enforcement Act of 1989 (FIRREA). Considerable Congressional, Administration, and media attention on thrift industry problems has been focused on weaknesses in the thrift industry regulatory process.



The Department's December 1990 FMFIA report said that OTS recognized that it had some management control issues that needed to be addressed. Concerns that OTS is committed to addressing include: improvements to management information systems by eliminating ineffective systems and streamlining the number of systems; the accuracy and propriety of thrift ratings; examination report content and workpaper standards; consumer compliance activities; adequate and uniform implementation of policies and procedures; a national (regional and district) quality assurance process; adherence to timeliness standards for examinations and related regulatory processes; and oversight of capital plan compliance. While these issues are important, the report expressed a belief that as currently defined, they did not meet the materiality requirements for reporting under the FMFIA.

Treasury's OIG is performing several major audits which are covering many of these areas. These audits will provide a documented basis for OTS and the Department to consider in future FMFIA reporting.

A recent OIG audit found that OTS did not consistently use its national information systems and that some field offices maintained local systems that duplicated some of the national systems' information. An audit of the application review process is nearly completed, and an audit of the examination process, conducted in four OTS regional offices, is evaluating the adequacy of supporting documentation for examination results. A fourth audit is evaluating the consistency, timing and appropriateness of enforcement actions in three OTS field offices and headquarters. A fifth audit is evaluating security over sensitive information.

GAO raised concerns about the supervision of the commercial banks in a 1990 report which questioned the adequacy of the Federal Deposit Insurance Fund. In its report, GAO identified the need for deposit insurance fund reform and expressed concern about the effectiveness of bank regulations in light of the financial problems that have occurred in a number of the nation's larger banking organizations.

The OIG is also assessing the Comptroller of the Currency's supervision of the national banks. Ongoing and planned audits will examine the national bank licensing process, the bank examination

process, enforcement actions, and implementation of the Financial Institution Reform, Recovery and Enforcement Act of 1989.

Data Integrity

The Department identified data integrity as a management control problem because of major problems in Treasury accounting systems, including a lack of general ledger controls, inability to reconcile accounts in a timely manner, and other systems inefficiencies. Questionable or inaccurate data can undermine the reliability of financial statements and Treasury's ability to manage its programs.

The Department's July 1990 high risk progress report noted that data integrity weaknesses had been most pronounced within two Treasury bureaus--Public Debt and Customs. The progress report said that Public Debt actions over the previous 18 months had corrected all significant operational deficiencies with the existing public debt accounting system and that Customs had reported significant progress in correcting all of its identified FMFIA deficiencies.

OIG audits are addressing a number of data integrity issues at Public Debt, Customs, and other Treasury bureaus. For example, a recent audit report confirmed that Public Debt had taken aggressive action to resolve 18 general ledger accounts for public debt transactions which were out of balance with records of the Financial Management Service by a total of $53 billion. This problem impaired the integrity of the general ledger system and had been reported in the Bureau's FMFIA report and prior OIG and GAO audits. Public Debt reduced the unreconciled account balances to $832 million, developed a recommendation for resolving the remaining difference, and created a quality assurance staff to ensure that differences in the accounts are immediately resolved.

The OIG is continuing to audit the design and development of the Public Debt Accounting and Reporting System (PARS). PARS is scheduled to be completed in 1992 and will control all public debt financial and security transactions through a fully integrated, automated accounting system.

Since assuming the responsibility for auditing Customs in April 1989, the OIG has made a strong commitment to reviewing Customs' programs, including seized and abandoned property, for which it has a contract with a private firm. The OIG is reviewing the controls and accounting for seized property retained by Customs and not turned over to the contractor, including currency, monetary instruments, narcotics, and firearms. The OIG also plans to audit the effectiveness of the seized property program itself and Customs' oversight of the new contractor. Another audit will follow up on corrective actions in response to prior audits and management reviews, including recommendations relating to seized property.

As noted in the OIG's last report to the Congress, the control over unliquidated obligations is another concern, and Departmental managers are taking corrective actions. An OIG audit in three bureaus concluded that procedures at the bureaus reviewed were generally inadequate to monitor unliquidated balances in the "M" accounts for prior years' appropriations.

An ongoing audit addressing data integrity issues is examining accounting, investment, and redemption services that the Financial Management Service provides to Government trust funds and other accounting entities, and a planned audit will examine cost accounting system development activities at the Mint. In addition, the OIG is preparing to fulfill its financial statement auditing obligations under the Chief Financial Officers Act of 1990.

Systems Development Oversight

Systems at some bureaus were developed without adequate management oversight, user involvement in the development process, and proper integration with other systems. Inadequate oversight of systems development efforts was reported by Treasury as a major factor contributing to the data integrity problems and, in addition, had adversely affected revenue collection and budgetary controls.

The Department's basic strategy to address systems development deficiencies is by thoroughly reviewing and analyzing bureau 5-year information systems plans and reemphasizing the need for Departmental approval of major systems replacement or enhancement projects. In addition, cross-servicing opportunities will continue to be explored.

An ongoing audit is evaluating the procedures, practices, and controls for designing and developing Treasury systems. Audit work is underway at the Financial Management Service and Public Debt and may be extended to other bureaus. In addition, OIG auditors are now reviewing the design and development of several systems.

Similarly, IRS internal auditors have conducted numerous reviews for the various phases of the design, development, and procurement of information systems at IRS. In addition, IRS management has taken actions to assure that the Service develops quality information systems within reasonable time and cost con-

straints in response to an internal audit report entitled "Trend Analysis of Systems Development Activities for Fiscal Years 1987-1989." The report analyzes IRS systems development activities based on audit findings over the 3-year period. During this period, IRS improved its systems development process. The trend analysis concluded, however, that further improvements were needed to strengthen the systems development methodology, contract administration process, and quality review procedures to assure that the Service develops timely, high quality products at the lowest overall cost to the Government.

Accounts Receivable

Accounts receivable at IRS have grown from $18 billion in 1981 to over $73 billion, before adjustment for accruals and currently not collectible accounts. The system currently being used to maintain accounts receivable does not produce accurate and reliable information on amounts owed by taxpayers.

An action plan addressing the recommendations of contractor and in-house studies has been developed, and an Executive Oversight Committee was formed to finalize action dates and provide top-level support for plan implementation.

IRS internal auditors are monitoring accomplishment of the action plan. Three audits relating to accounts receivable have been completed and draft reports issued. These audits covered the reporting of accounts receivable and the allowances for doubtful accounts on the quarterly statements, the collection of large dollar accounts receivable, and the management of accounts held in the queue (no active collection action). Also, an audit of collection statute processing and control procedures was recently initiated, and the system for developing the allowance for doubtful accounts is being evaluated.

Funds Control

Treasury reported that management of funds at Customs was a serious problem, including untimely deposits, untimely reconciliation of amounts due, and inadequate control over collection documents. In addition, known delinquent debt totaled over $96 million.

Customs' main strategy is to replace its primary accounting system ("CAMIS"), which is outdated and the source of numerous FMFIA deficiencies, with a new modern system (the Asset Information Management System) and to make necessary enhancements to the Automated Commercial System, which accounts for revenue collection. In addition, policies and procedures for revenue collections are to be revised to correct known deficiencies.

The OIG is monitoring Customs' actions to improve its accounting system and bring it into conformance with the Comptroller General's standards. Ongoing and planned OIG audits are addressing the following accounts receivable and revenue collection matters at Customs and at the Bureau of ATF, which also has substantial revenue collection responsibilities:

- ☐ Customs' fines, penalties, and forfeitures program.
- ☐ Collection of passenger user fees by Customs.
- ☐ Collection of excise taxes paid by tobacco manufacturers.
- ☐ Collection of delinquent special occupational taxes on certain businesses in the alcohol, tobacco and firearms industries.

Prior audits as well as the Department's FMFIA process have also reported problems in controlling appropriated funds at Customs. In an interim report issued in 1989, the OIG concluded that Customs had inappropriately supplemented its Fiscal Year 1987 appropriation for salaries and expenses with anticipated reimbursements from its seized property program and that the anticipated reimbursements were substantially overstated. In its final report, however, the OIG concluded that Customs had not violated the Anti-deficiency Act because adjusting accounting entries that had been developed by Customs and verified by the OIG are sufficient to cover an apparent $3.8 million deficiency in the appropriation. Customs discontinued the practice of including anticipated reimbursements as a budgetary resource in Fiscal Year 1988 and has identified a number of actions to improve the reliability of its accounting records. The OIG will conduct several audits in Fiscal Year 1991 that will evaluate fund control and the budgetary processes at Customs.

Internal Auditing Activities

- **During the 6 months ended March 31, 1991, Treasury internal auditors issued 94 audit reports: 39 on the operations of Treasury bureaus served by the OIG and 55 on the operations of IRS.**
- **Potential monetary benefits from management actions on audit recommendations totaled $36.9 million.**
- **Many audits have strengthened or will strengthen internal controls, thereby helping to prevent and detect fraud, waste, and abuse.**

Except for audits of contractors, Treasury internal audits focus on reviewing the internal operations of Treasury bureaus. This chapter describes some of the more significant audits, pursuant to Inspector General Act requirements to report significant problems, abuses, deficiencies, and recommendations for corrective actions. **Because this chapter describes only selected significant findings, they should not be considered as representative of the conditions in the Department and its bureaus.**

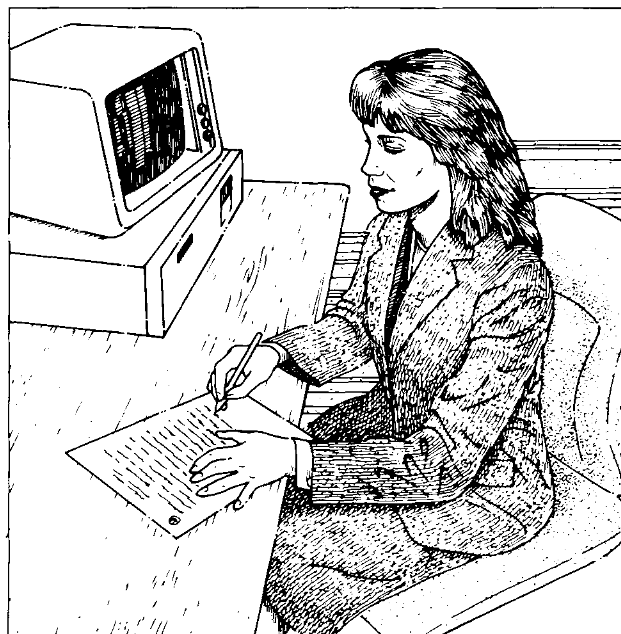
Audits covered a variety of Treasury programs, activities, and functions. Some of the examples illustrate audits with savings and other kinds of monetary findings, while others illustrate audits which have strengthened or will strengthen internal controls, thereby helping to prevent and detect fraud, waste, and abuse. Significant multibureau audit, contract audit, and individual bureau audit activities follow.

MULTIBUREAU AUDIT ACTIVITIES

Contract Administration and Closeout

Over the 12 months ended March 31, 1991, Treasury auditors completed coordinated audits of contract administration and closeout at seven bureaus: Customs (Report #OIG 91-24), Departmental Offices (Report #OIG 91-015), Engraving and Printing (Report #OIG 91-009), Financial Management Service (Report #OIG 91-010), IRS (Report #002212), Mint (Report #OIG 90-038), and Secret Service (Report #OIG 90-068). The audits identified weaknesses in several major areas. For example:

- ☐ Formal contract closeout procedures were deficient at all of the bureaus. These procedures assure that contract requirements were fulfilled, that payments were proper, and that any unliquidated obligations are valid. The audits identified nearly 1,500 contracts which needed closure. A review of completed Customs' contracts, for example, identified over $1 million in excess funds which should have been deobligated and made available for other purposes.
- ☐ Day-to-day administration of contracts needed to be improved or better documented at five of the seven bureaus. Administration weaknesses can lead to improper procurement practices and unnecessary costs when contractors are paid for services not performed or for goods of inferior quality. Engraving and Printing, for example, paid $29,000 for a product that did not meet contract specifications, did not take full advantage of purchase discounts, and did not properly implement proce-



dures for testing the quantities of inks and postage stamp papers received.

- Four of the seven bureaus needed to improve their contract administration management information systems. Analysis of the Contract Information System (COINS) at IRS, for example, identified conflicting, incomplete, and missing data, impairing the system's usefulness in planning and monitoring acquisitions.

The OIG is preparing an overall audit report which will recommend actions the Department should take to address common problems. In the meantime, each of the bureaus audited have taken or initiated actions to address problems within their respective procurement activities. For example:

- All seven bureaus developed contract closure procedures and/or planned, initiated, or completed reviews of contracts needing closure.

- Customs established a contract administration division, and Secret Service requested funds for a new contract administration branch.

- IRS, Departmental Offices, and Customs are enhancing their contract administration MIS's, and Engraving and Printing is developing a new system.

Bank Secrecy Act Implementation

An audit of Treasury's implementation of the Bank Secrecy Act concluded that the Department had not sufficiently monitored the Bank Secrecy Act (BSA) data collection activities performed by IRS and Customs. The audit covered BSA activities at Departmental Offices' Office of Financial Enforcement (OFE), IRS, Customs, and Comptroller of the Currency.

OIG auditors discuss Treasury's implementation of the Bank Secrecy Act (BSA). Law enforcement agencies use Treasury's BSA database on the movement of funds to investigate criminal and regulatory violations.

Background

The Financial Recordkeeping and Currency and Foreign Transactions Reporting Act, referred to as the Bank Secrecy Act, was enacted in 1970. Under the BSA, financial institutions and individuals must file reports and maintain records of certain transactions involving currency and monetary instruments exceeding $10,000. All of this BSA information is input into databases maintained by Customs and made available to law enforcement agencies through the Treasury Enforcement Communications Systems II (TECS II).

The primary purpose of the reporting and recordkeeping requirements is to aid law enforcement agencies in detecting and investigating criminal, tax, and regulatory violations by identifying the source, volume, and movement of funds coming into and out of the country or being deposited, withdrawn, or exchanged for currency, or transferred by or through financial institutions. BSA administration and enforcement responsibilities have been delegated to OFE and eight agencies, including IRS, Customs, and the Comptroller of the Currency.

Treasury Audits

An overall audit report issued in December 1990 deals with the need for the Department to increase its BSA monitoring and oversight activities. Because OFE had not always been able to address BSA data processing problems, BSA data provided to the law enforcement community was not always complete, timely, or accurate. For example, during the first 6 months of 1988, 47 percent of the three million Currency Transaction Reports filed by financial institutions were not entered into IRS' on-line computer system. Moreover, neither the IRS nor the Customs databases contained Reports of Foreign Bank and Financial Accounts or Currency Transaction Reports by Casinos. As of October 1988, this encompassed over 134,000 documents.

The auditors recommended that Treasury allocate additional resources to establish a more active monitoring and oversight program. Also, the Department needed to work closely with IRS and other Treasury bureaus having BSA responsibilities to resolve problems and conflicts that adversely impact effective administration of the BSA. OFE has initiated corrective actions on both recommendations. OFE budgeted for seven additional permanent positions and is presently recruiting for four of these positions. In addition, OFE is preparing guidelines outlining IRS's BSA responsibilities. (Report #OIG 91-013)

The OIG's semiannual report for the 6 months ended March 31, 1990, summarized the separate audit reports that were issued to OFE and each of the Treasury bureaus on their BSA-related activities. In response to these audits, actions were taken or iniated to improve the BSA databases and to act on other problems identified by the audits. For example, procedures were instituted to require that all BSA documents be entered into the IRS BSA database by the end of the month following receipt.

Collection and Deposit Control

A Treasury-led interagency audit of collection and deposit controls identified procedural and compliance issues relating to each agency's operations. However, the audit did not identify any Government-wide issues or weaknesses in cash management regulations of Treasury's Financial Management Service.

The audit was undertaken on behalf of the President's Council on Integrity and Efficiency (PCIE). The overall objective of the audit was to determine the effectiveness of cash deposit mechanisms. Inspectors General from the Departments of Agriculture, Transportation, Housing and Urban Development, and Health and Human Services participated in the audit.

Treasury summarized the results of the audit in a memorandum which was circulated to PCIE members. However, a comprehensive consolidated report will not be issued because no Government-wide issues were identified.

Contracts for Advisory and Assistance Services

The Department obligated about $22 million for advisory and assistance services in Fiscal Year 1990. A consolidated report on Contracts for Advisory and Assistance Services (CAAS) summarized audits at five bureaus: Departmental Offices, Engraving and Printing, Financial Management Service, IRS, and Customs. The report concluded that the Department had issued and implemented contract approval, on-site review, and other policies and procedures which adequately addressed the management control requirements in OMB Circular A-120, Guidelines for the Use of Advisory and Assistance Services. However, improvements were needed in the controls at the bureau level. The audits at the bureau level showed that:

- ☐ IRS management controls did not ensure that requests for CAAS were properly approved by appropriate management levels, thus increasing the potential for unauthorized CAAS procurements.

- ☐ Three bureaus needed to implement controls to ensure that CAAS did not duplicate previously performed work or work that could be accomplished by using in-house sources. Engraving and Printing and IRS contract files lacked documentation certifying that advisory and assistance services did not duplicate previously performed work, and Customs did not perform cost comparisons to determine the economic feasibility of using in-house resources instead of contractors.

- ☐ Departmental Offices, Engraving and Printing, IRS, and Customs did not prepare written evaluations at the conclusion of CAAS procurements. This increases the risk of paying for products or services of questionable value.

Bureau managers have taken or plan to take actions to address each of the recommendations. IRS, for example, issued a memorandum which provides detailed requirements for CAAS approvals and the documentation needed to justify a CAAS request. Engraving and Printing, Customs, Departmental Offices, and IRS planned or took actions to prepare written evaluations of CAAS procurements. (Report #OIG 91-021)

CONTRACT AUDIT ACTIVITIES

$10.7 Million in Questioned Contract Costs Sustained

OIG auditors completed six preaward contract audits and three postaward contract audits during the first half of Fiscal Year 1991. A total of $10.7 million in questioned costs was sustained, including amounts which were sustained from audits performed prior to September 30, 1990. In addition, OIG auditors questioned $3.7 million on contracts for which negotiations have not been completed.

Preaward audits provide information on whether pricing proposals

are fair and reasonable, and contracting officers use them in negotiating contracts. For example, in a preaward audit of a proposal for currency paper with security threads for the Bureau of Engraving and Printing, over $7.1 million in questioned costs were sustained. The savings resulted after auditors questioned the proposed materials cost, machine processing costs, and general and administrative costs. (Report #OIG 91-014)

Postaward audits verify that the costs claimed on cost-reimbursement type contracts are documented and properly charged to the Government. For example, in a postaward audit performed for the Customs Service, over $759,000 was sustained. The audit questioned overbillings on cost reimbursable contracts for information services provided to the Saudi Arabian Department of Customs. The overbillings resulted from the application of incorrect indirect rates to contract costs and an inappropriate billing method for housing costs. In addition, the contractor improperly charged automobile, transportation, and food allowances to overhead. (Report #89-HO-10)

BUREAU OF ALCOHOL, TOBACCO AND FIREARMS

Unsupported Tax Exemption on Exported Alcoholic Beverages

An OIG audit found that the Bureau of ATF's Western Region did not take action to assess at least $3.2 million in potential taxes and interest because of weaknesses in the administration of the alcohol producer compliance program. The law requires the payment of Federal excise taxes on alcoholic beverages withdrawn from inventories for sale in domestic markets. The law allows tax exemption on production amounts exported to foreign markets, provided that documented proof of export is submitted.

The Western Region lacked procedures requiring validation of exporters' claims for excise tax exemption, did not validate documented proof of export in inspections, and did not follow up promptly when exporters failed to submit required proof of export. Because validation procedures were inadequate, the Region did not identify one exporter who had not provided proof of export on 222,000 gallons of distilled spirits. The exporter had claimed an excise tax exemption of $2,775,000. In addition, $440,000 in taxes and interest was not collected because examiners did not take prompt followup actions when exporters failed to provide documented proof of export.

Regional management agreed with the audit recommendations and has taken or planned corrective actions which should correct the deficiencies. For example, the Regional Director (Compliance) issued a proposed letter of assessment to the exporter for the claimed 1989 tax exemption of $2,775,000. The Region's review of this exporter's transactions for 1988 and 1990 resulted in additional assessments. The Region is awaiting a response from the exporter, who has been requested to provide export documentation. (Report #OIG 91-037)

A companion audit of the Bureau of ATF's North Atlantic Region identified potential additional taxes and interest totaling $187,000. The New York Technical Services unit did not adequately monitor producers records to assure that tax-free alcohol was exported as claimed by the producers. Also, the Philadelphia Technical Services unit was not promptly assessing taxes on undocumented exports of tax-free alcohol. Management agreed with the recommendations and will take actions to assess taxes due. (Report #OIG 91-034)

U.S. CUSTOMS SERVICES

Establishment of the Virginia Inland Port

An OIG review performed at the request of Senator Paul Sarbanes disclosed that the Customs Service did not follow Treasury and Customs procedures when it established the Virginia Inland Port at Front Royal, Virginia. The auditors found that approval was based on incomplete and unconfirmed data; the workload at the port did not justify the expense of maintaining permanent Customs service; policies and procedures had not been promulgated for establishing POE's on a test basis; and general provisions of the annual appropriations acts could prevent Customs from using appropriated funds to reduce or consolidate POE's once they were established.

The report recommended that Customs (1) implement procedures for establishing POEs in accordance with Treasury regulations, (2) promulgate procedures for establishing POEs on a test basis, (3) pursue legislative action to remove restrictions that prevent port closings or consolidations, and (4) remove POE status from the Virginia Inland Port once restrictions preventing port closings are rescinded.

Corrective actions planned or taken by Customs management should correct the deficiencies. For example, Customs is drafting a proposal for the Federal Register under which the importing com-

FLETC leases facilities near Marana, Arizona, for training Bureau of Indian Affairs tribal police and other participating organizations. An OIG audit examined lease arrangements and other activities.

munity would bear Customs' costs until a locality is eligible for POE status. In addition, Customs is pursuing modifications to the Fiscal Year 1992 appropriations language which precludes changes to the status of port designations; and, pending legislative action, Customs has agreed to withdraw POE status from the Virginia Inland Port. (Report #OIG 91-017)

FEDERAL LAW ENFORCEMENT TRAINING CENTER

FLETC's Marana Facility

An audit of the operation of FLETC's satellite facility near Marana, Arizona, identified several contract and internal control problems. FLETC leases facilities and acquires lodging and food services from a lessor.

The average resident student population guaranteed to the contractor was excessive and needed to be reduced. The lease requires a minimum average resident student population of 100 for the first year and increasing numbers for succeeding years. The current student population is less than the minimum and is not expected to increase. In Fiscal Year 1990, the shortfall in students cost FLETC about $250,000.

Ineffective contract administration resulted in $136,000 in duplicate payments. In addition, FLETC purchased bottled water at a cost of $8,000 a year instead of enforcing the requirement in the lease for the lessor to provide suitable drinking water. Also, motor pool vehicles were being serviced at a local garage and cleaned at a local car wash even though the training support contract for Marana required the contractor to provide these services.

Corrective actions are being taken in response to the audit. For example, negotiations are underway to reduce the number of guaranteed students for Fiscal Year 1991 through the end of the lease, and the overpayments were recovered. (Report #OIG 91-019)

FINANCIAL MANAGEMENT SERVICE

Computer Security Act

An OIG audit found that although the Financial Management Service was generally in conformance with the requirements of the Computer Security Act of 1987, further action was needed. Through the Computer Security Act of 1987, Congress declared that it is in the public interest to improve the security and privacy of sensitive information in Federal computer systems. Essentially the Act requires Federal agencies to provide periodic training in computer security awareness, identify systems which contain sensitive information, and establish a plan for the security and privacy of each system identified by the agency.

The auditors found, for example, that the Financial Management Service needed to include systems under development that contain sensitive data in the inventory of sensitive systems and to prepare the related security plans. The auditors also identified areas which, although not required by the Act, would improve controls over computer systems containing sensitive data. The duties, responsibilities, and training provided for Security Administrators were not uniform. In addition, the individuals selected to serve as Security Administrators were not formally designated in writing, as required.

The Financial Management Service agreed with the recommendations and has taken corrective actions. For example, the inventory of sensitive systems includes systems under development and security plans have been prepared for all sensitive systems, with the plans distinguishing between those systems which are operational and those under develop-

ment. Also, appropriate ADP security training was established for Security Administrators. (Report #OIG 91-002)

INTERNAL REVENUE SERVICE

Processing Employee Benefit Plan Returns

An IRS internal audit concluded that the Service had effectively consolidated the processing of employee benefit plan returns in four service centers. However, IRS needed to improve processing of the returns by taking actions to identify erroneous deductions, eliminate unnecessary processing steps and reduce and improve correspondence. Corrective actions could result in additional revenues and cost avoidances totaling over $14 million.

Administrators or sponsors of employee benefit plans subject to the Employee Retirement Income Security Act of 1974 (ERISA) must file a Form 5500 Series report annually with the IRS. These returns provide basic information which enables IRS and the Pension and the Welfare Benefits Administration of the Department of Labor to fulfill their administrative and enforcement responsibilities.

The audit report said, for example, that the Service needed to:

- ☐ Enhance its computer programs to identify erroneous pension-related deductions on Forms 1040. Taxpayers avoided an estimated $12.8 million in taxes by claiming these erroneous IRA deductions in 1989. Taxpayers also avoided an estimated $.8 million in taxes in one center by erroneously deducting thrift plan contributions.

- ☐ Eliminate the posting of 320,000 "Applications for Extension of Time to File Certain Employee Plans Returns." This will not affect the delinquency process. The Service spends an estimated $290,000 to post the applications on the masterfile.

- ☐ Reduce correspondence with return filers by providing better explanations in the first letters. Also, the Service needs to develop better return preparation instructions so that filers provide more accurate and complete information. By taking the recommended actions, the Service can improve its image with filers and save an estimated $248,000 annually in processing costs.

IRS agreed with the recommendations and is implementing corrective actions. For example, an error resolution check has been installed to limit the IRA deduction when certain criteria are met, and a test recovery project will be initiated on 1989 returns with erroneous pension-related deductions. (Report #01147)

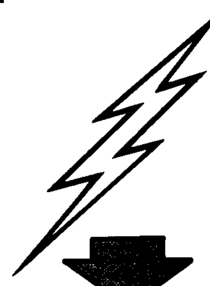
Electronic Filing System

An IRS internal audit found that controls over the electronic system for filing tax returns needed improvement. The audit was prompted by a 1989 refund scheme involving use of the electronic filing system and management concerns that there were insufficient safeguards to protect IRS from unscrupulous preparers who had been accepted into the program.

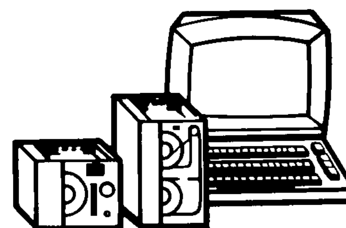
Electronic filing has been identified as a method to both save processing resources and provide a better service to taxpayers, and

1 Return is prepared on computer

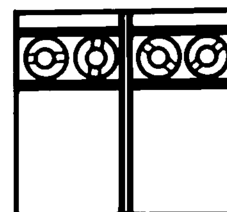
2 Return is transmitted electronically to IRS by qualified preparers



3 Tapes are created in the receiving station and are loaded into the EFS computer system for validity checks and automated front-end processing



4 After EFS processing tapes are procesed through Distributed Input System to the Sperry UNIVAC Computer System. From this point, the processing steps are identical to those of other returns.



IRS actively markets electronic filing to professional tax preparers. These expansion efforts must be balanced against computer crime risks.

The audit identified several disreputable preparers who had been accepted into the program. The auditors recommended that officials independent from those promoting electronic filing be responsible for applicant suitability checks and that criteria for accepting applicants be improved.

In response to one recommendation, IRS revised the contractual statement for electronic filing to state that the rights and privileges to file a tax return electronically are non-transferable. Corrective actions on the five remaining recommendations are on schedule. (Report #01115)

Information Systems Development Organization

An audit determined that IRS's Information Systems Development (ISD) organization did not have a comprehensive security program, and that existing security procedures needed to be better implemented. IRS is re-designing its computer-based tax administration system, and ISD was established to oversee and coordinate this massive modernization program.

Recognizing that ISD was taking steps to strengthen security and project management, the audit report said that:

- ISD had no standard physical and document security policy that would ensure a consistent, coordinated, and effective approach to security throughout the ISD organization.
- 34 ISD managers at three separate office locations did not conduct required documented security checks.
- Managers were unable to identify memorandums with guidelines concerning physical and document security procedures and could not identify the security coordinator for ISD.
- Methods and policies for physically safeguarding sensitive information differed among the managers surveyed.

In addition, existing security procedures needed to be better implemented. For example:

- Documentation authorizing access to the system was on file for only 11 of 86 computer system users.
- Inventory records for software were not maintained, verified, or recorded and hardware inventory records were dependent on information provided by individual ISD offices with no follow-up verification.
- An internal systems risk analysis had not been completed.

Not having a comprehensive security program increases the basic risks of theft and loss of Government property, including information, and the disruption of necessary program operations. The lack of updated files for access authorizations and software and hardware inventories, coupled with frequent employee turnover, increased the risk of intrusion to the systems and created the potential for integrity breaches, accidental errors, data loss, and improper manipulation of information. Further, management's ability to monitor the performance of security responsibilities is reduced without a comprehensive security and risk evaluation.

Of the 16 recommendations, 14 had been implemented as of March 1, 1991. For example, ISD improved procedures to document users accessing ISD systems, issued a procedural directive to clarify physical and document security requirements, and assigned responsibility for maintaining inventories. (Report #01096)

BUREAU OF THE PUBLIC DEBT

Undeliverable Payments

An OIG audit identified weaknesses in the processing of undeliverable payments at Public Debt's Washington, D.C., and Parkersburg, West Virginia, offices. Public Debt is responsible for contacting payees, authorizing payments, and accounting for undeliverable principal, interest, and discount payments on public debt securities. At the time of the audit, the outstanding balance for undeliverable payments was over $26 million.

Weaknesses identified by the audit compromised the reliability of accounting records and could result in erroneous or fraudulent undeliverable transactions going undetected. For example, Public Debt overstated the undeliverable account by over $3 million because stale-dated check payments were improperly classified and deposited as undeliverables and released over $250,000 in payments without reviewing supporting documentation during 1989 and 1990.

Other problems included a backlog of unresolved adjusting entries in the undeliverable accounts and not complying with IRS back-up withholding rules when processing interest payable to deceased bond owners in cases where the taxpayer account number or reporting number was not updated to show

the legal recipient of the payments. Projected tax losses in these cases from unreported interest income amounted to $96,000 annually. The Internal Revenue Code requires payors of interest to withhold 20 percent if a payee fails to furnish a taxpayer identification number.

Public Debt has taken or initiated corrective actions. For example, procedures regarding the review of supporting documentation were implemented at the time of the audit, and procedures were established in January 1991 to ensure compliance with IRS back-up withholding rules for interest payable to deceased bond holders. (Report #OIG 91-011)

OFFICE OF THRIFT SUPERVISION

Information Systems

An OIG audit found that OTS did not consistently use its national information systems and that some field offices maintained local systems that duplicated some of the national systems' information. Two of the nationwide systems that were not fully utilized contained information on enforcement and supervisory actions taken against thrift institutions and on individuals with previous criminal referrals or questionable thrift activities. Consequently, OTS did not have a fully effective nationwide mechanism to prevent or identify inadequate supervisory activity or to prevent inappropriate individuals from entering or advancing in the thrift industry.

The audit also found that internal controls over access and changes to four of the national systems were inadequate, thus leaving the systems vulnerable to misuse of information. Weaknesses included the use of generic passwords and user identifications and not voiding the passwords of former employees.

The audit report contained a recommendation that OTS develop policies and procedures to ensure that the nationwide information systems be used throughout OTS and contain the necessary information. In addition, the OIG recommended changes to improve the internal controls over access and changes to the national systems to prevent misuse of information. The actions taken or proposed by OTS management generally comply with intent of the recommendations. (Report #OIG 91-035)

Internal Investigative Activities

- **During the 6 months ended March 31, 1991, the OIG and Treasury Offices of Internal Affairs and Inspection closed 1,940 investigations, including 1,452 IRS cases.**

- **Treasury internal investigations resulted in 159 successful prosecutions, 302 administrative sanctions, and investigative recoveries and other monetary benefits of $4.9 million.**

- **Convictions and sanctions help to deter fraud and abuse.**

Investigations by the OIG and Treasury Offices of Internal Affairs and Inspection focus on criminal wrongdoing by Treasury employees, third parties working in collusion with employees, and violations of employee standards of conduct. This chapter describes some of the more significant investigative activities, pursuant to Inspector General Act requirements to report significant problems, abuses, and deficiencies. The examples illustrate cases which have resulted in indictments, prosecutions, adverse personnel actions, and monetary penalties and recoveries. **Readers should not assume that the conditions described are representative of the conditions in the Department and its bureaus.** The material in this chapter is organized by Treasury internal investigative organizations.

OFFICE OF INSPECTOR GENERAL

Employee Misconduct Case

An OIG investigation of a senior Departmental Offices official determined that the official had retained a continuing financial relationship with a former employer following appointment, even though the official had previously represented that all ties were severed with the company. The individual charged personal expenses to a corporate credit card. These expenses were being repaid as a reduction of an unpaid severence bonus. The official also received a personal loan. In addition, the investigation showed that an automobile leased by the former employer continued to be furnished to the senior official following entrance to duty. The official has since severed all financial arrangements with the former employer and has received a reprimand for not adhering fully to applicable regulations.

BUREAU OF ATF OFFICE OF INTERNAL AFFAIRS

Former Agent Sentenced

In October 1990, a former Bureau of ATF special agent was sentenced to 2 years probation and fined $2,500 for aiding and abetting in fraudulently acquiring an identification document with the intent to use the document to defraud the United States.

Office of Internal Affairs investigators found that the agent had conspired to conceal and harbor a fugitive who had violated narcotics laws. In exchange for payment from the fugitive, the agent procured a deputy sheriff's badge for him to evade Customs

authorities while transporting illegal drugs. The agent obtained the badge from a county sheriff after introducing the fugitive as a Bureau of ATF agent. In October 1988, the Bureau of ATF had terminated the agent from employment.

CUSTOMS OFFICE OF INTERNAL AFFAIRS

Bribery Cases

Bribery continues to be a major concern for the Office of Internal Affairs in its efforts to ferret out corruption. The following cases illustrate bribery offers made to Customs employees whose prompt reporting to and cooperation with the Office of Internal Affairs resulted in the apprehension of the suspects.

- A Nigerian national offered a $100,000 bribe to a Customs inspector in an attempt to be released from a secondary examination. A Customs "rover team" at Los Angeles International Airport had selected the national for intensive secondary examination at a local hospital. At the hospital, the individual offered the bribe and was arrested by Internal Affairs agents. Forty-four packets of heroin were found on the subject. The subject pled guilty to bribery and two narcotics violations and is awaiting sentencing.

- Another individual offered a $10,000 bribe to a Customs inspector at Los Angeles International Airport when an outbound search disclosed significantly more than the $10,000 in currency reported by the individual. Agents from Customs' Offices of Internal Affairs and Enforcement arrested the individual. The search revealed approximately $70,000 on his person and $50,000 in his luggage. The individual was indicted for bribery, false statements, and a currency violation.

- A third individual paid a $14,500 bribe to a Customs inspector to facilitate narcotics smuggling. The inspector reported the bribe to Internal Affairs. A surveillance team later followed the loaded vehicle and seized approximately 715 pounds of cocaine and 35 pounds of marijuana smuggled through the San Luis, Arizona, Port of Entry. Customs' Offices of Internal Affairs and Enforcement worked jointly on the investigation. The individual was indicted for bribery and narcotics violations. Three others were indicted for narcotics violations.

- Three individuals were arrested on bribery charges after one of them offered a bribe of $2,000 to a Customs inspector for each illegal alien from the Dominican Republic that he allowed to enter Newark International Airport without proper inspection. The inspector reported the bribe attempt to Internal Affairs. One individual pled guilty to conspiracy to bribe a public official. No illegal aliens entered the country as a result of the bribe attempt.

Imprest Fund Embezzlements

Two imprest fund embezzlements involving over $50,000 resulted in sentences for two Customs employees.

- A secretary was sentenced to 6 months home confinement, 5 years probation, and full restitution for the embezzlement of approximately $22,500 from Customs' New York Area Director's imprest fund. Internal Affairs agents arrested her after a Customs National Finance Center employee discovered what appeared to be double billings from vendors. The investigation disclosed that the secretary had submitted bogus vouchers.

- A former secretary in Customs' Office of Enforcement was sentenced to 5 years probation and must make restitution of over $31,000 in connection with her embezzlement from the office imprest fund. The embezzlement was discovered when local management reported a shortage to Internal Affairs, which in turn verified the shortage. The secretary confessed to the embezzlement.

IRS INSPECTION SERVICE

Revenue Officer Convicted of Bribery

A revenue officer was sentenced in February 1991 to 2 years in prison, 3 years supervised probation, a $5,000 fine, $600 restitution, and a lifetime prohibition from Federal employment because of his acceptance of bribes.

In February 1990, a taxpayer alleged that he was being "shaken down" by the revenue officer and had paid the officer $250 in bribery money. The allegations were corroborated through a subsequent recorded meeting in which the officer demanded and received $500 from the taxpayer in exchange for placing the taxpayer on a monthly payment plan.

In July 1990, an undercover inspector posing as a delinquent taxpayer met with the officer to resolve his 1984 delinquent tax ac-

count. The officer advised that in exchange for $600 he would write off the $10,000-case as "unlocatable."

In August 1990, an owner of a taxicab business reported a $3,000 bribery payment made in April 1990 to the officer. The officer had allegedly pressured her to pay the bribe in exchange for his promise that IRS would not seize her cab.

When interviewed, the officer denied any wrongdoing until he was introduced to the undercover inspector. The court took the previously mentioned actions against the revenue officer because of his lack of truthfulness and cooperation with the court.

Businessman Sentenced on Bribery Charges

A Michigan businessman was sentenced to a 21-month prison term and 3 years probation after pleading guilty to charges of bribing an IRS agent and illegal possession of an unregistered machine gun. During Inspection's 11-month investigation, payments of $31,000 in bribes were made to an informant and an undercover Criminal Investigation Division agent posing as a corrupt employee. The bribes were offered in exchange for fraudulently crediting nearly $145,000 in payroll tax deposits to the tax account for the businessman's firm.

False Filing of IRS Forms

As reported in the last semiannual report to the Congress, a number of investigations have been conducted involving schemes in which IRS Forms 1099 for reporting miscellaneous income to IRS are fraudulently filed with IRS by tax protestors to harass targeted individuals. Police officers, revenue officers, judges, bank officers, and the Commissioner of IRS are common targets. There has been considerable success in prosecuting perpetrators.

To illustrate, inspectors executed an arrest warrant in October 1990 on a New Yorker, charging him with attempting to interfere with the administration of Internal Revenue laws. The man allegedly mailed a fraudulent IRS Form 1096, Annual Summary and Transmittal of U.S. Information Returns, and 90 Form 1099s which reported to IRS that the targeted subjects had been paid total compensation of over $2.3 billion. Among those receiving Forms 1099 from the subject were five Federal judges. A joint Inspection Service and Criminal Investigation Division investigation is continuing.

Lottery Winner Arrested for Bribery

The winner of an $11-million state lottery was arrested for attempting to bribe an IRS revenue officer into removing a $100,000 tax lien which was unrelated to the lottery winnings. The subject had originally requested that the lien be released for a payment of $4,000 to $5,000. In cooperation with the Inspection Service, the revenue officer informed the subject that the proposed payment was not sufficient. The subject then agreed to pay the revenue officer $25,000 for her personal use in return for abating the $100,000 in taxes and releasing the lien. The subject explained that he held a winning lottery ticket and did not want IRS collecting the unpaid taxes out of his lottery winnings. He subsequently paid the revenue officer with a $25,000 cashier's check.

Operation Tax Doctor

Thus far, six defendants in a scheme to bribe an IRS agent have pled guilty to various counts of bribery, conspiracy, and/or money laundering. Three have pled not guilty.

The pleas are the aftermath of a previously reported 20-month undercover investigation in which the above parties allegedly attempted to bribe the agent, who in turn cooperated with investigators. The investigation was dubbed "Operation Tax Doctor" after several of those charged had referred to the agent as the "tax doctor."

Those charged paid $277,000 in cash to the agent and laundered checks worth nearly $244,000 during the course of the scheme. The United States Attorney said this was the largest bribery scheme ever investigated by the IRS Inspection Office in that judicial district and one of the largest nationally.

Assaults and Threats to IRS Employees

The Inspection Service has the primary responsibility for investigating assaults, threats, and forcible interference toward IRS employees. Investigations can result in severe penalties after conviction – from 1 to 10 years imprisonment and $3,000 to $10,000 in fines. The Inspection Service also maintains the Potentially Dangerous Taxpayers Program and can provide employees with armed escorts.

According to the Federal Bureau of Investigation's Uniform Crime Report, in 1988 "IRS enforcement officers suffered more assaults than any law enforcement group in the Federal Government, over five times higher than Drug Enforcement Agency officers who have the second greatest number of assaults."

For example, a revenue officer in the Southeast Region was as-

saulted when he attempted a court-ordered automobile seizure. The taxpayer tried to strike the officer and then threw his body against the car. In another case, a taxpayer visiting a California IRS office became irate when told that research was needed to trace his refund. He threw a sign at the IRS employee, grabbed her, and tried to pull her onto the counter. The taxpayer was subsequently arrested.

Examination Group Manager Convicted

An IRS Examination Group Manager was convicted in December 1990 of conspiracy, disclosure of information, and money laundering. As explained in the previous semiannual report, the violations were discovered during a drug trafficking investigation by the Criminal Investigation Division (CID).

During a CID interview with a cooperating defendant in the drug investigation, his attorney identified the Examination Group Manager as a "leak within the IRS." Subsequent investigation by the Inspection Service and CID revealed that the employee had used his position to access the IRS records system to disclose information to a drug trafficker – a long-time friend – about IRS' investigation of him. The employee had knowledge of the trafficker's activities and had used drugs supplied by him. The employee had also provided the trafficker with information that he obtained during conversations with IRS agents about CID's investigation of the drug trafficker. In addition, during 1987 the employee had assisted the trafficker and a friend in establishing documentation to conceal the trafficker's assets from possible seizure as a result of his illegal activities.

SECRET SERVICE OFFICE OF INSPECTION

Thefts from the White House

Secret Service inspectors and agents identified three Uniformed Division officers as responsible for thefts of china and other items of lesser value from the White House in 1989. Through plea bargain arrangements with the U.S. Attorney's office in March 1990, one officer resigned and a second retired from the Service. Both were ordered to complete 100 hours of community service and provide testimony regarding the thefts before a grand jury, as necessary. The third officer, through a November 1990 plea bargain agreement, pled guilty to one felony count of theft of Government property. He resigned, was ordered to perform 100 hours of community service, and was placed on 3 years probation.

Prevention Activities

- **The OIG is participating in two Treasury task forces whose objectives are to minimize waste and improve management.**
- **Customs has a comprehensive integrity program under the oversight of the Office of Internal Affairs.**
- **OIG and IRS internal auditors continue to take an active role in reviewing the design and development of major new information systems and significant modifications to existing systems.**

This chapter describes various prevention activities of the OIG and Offices of Internal Affairs and Inspection. Prevention activities differ from those designed to detect fraud, waste, and abuse. Detection activities are often remedial, with the "damage" having already occurred. In contrast, prevention activities are designed to deter misconduct and avert waste or to provide an early warning of fraud and waste. Thus, prevention activities are a cost-effective means of improving Treasury operations.

Early Warning Task Force

Treasury is implementing an Early Warning System to alert managers to emerging financial management issues before they become problems requiring substantial corrective actions. An Early Warning Task Force of representatives of the Assistant Secretary (Management), the Office of Inspector General, and Treasury bureaus defined 16 criteria and related indicators for identifying possible problem issues relating to receivables, cash management, and other activities. The early warning indicators include such things as:

- ☐ Growth trends in outstanding receivables, delinquencies, and write-offs.
- ☐ Growth trends in undeposited collections.
- ☐ Growth in payments of Prompt Payment Act interest penalties.
- ☐ Growth in outstanding audit recommendations.
- ☐ High end-of-year obligation rates.

The system, which has been tested at the Bureau of the Public Debt, is being implemented Treasury-wide. By early April 1991, each bureau will prepare a summary report on the results of a mid-year review using the criteria and approach developed by the Task Force.

Treasurer of U.S. Task Force

The OIG is participating in a task force to assess internal controls in the organizations which report to the Treasurer of the U.S.: Mint, Engraving and Printing, and Savings Bonds. The task force has focused its initial efforts on Engraving and Printing.

A report to the Deputy Secretary has been prepared which addresses opportunities to improve management controls within the Bureau. The report is being reviewed internally within Treasury and will be consolidated with the reports on the other organizations. The task force is currently studying controls within the Mint and is gathering and analyzing data concerning all recent audits, investigations, and other reviews performed of that organization.

Customs Integrity Program

In January 1990, the Commissioner of Customs initiated the Customs Integrity Program–a bureau-wide anti-corruption effort. An Integrity Committee consisting of four Assistant Commissioners oversees the program.

The program affects all Customs employees and represents a continuing commitment by Customs to maintain the highest standards of personal conduct and professional behavior. Training, employee participation and enforcement are the program's core elements.

In February 1991, the Commissioner reinforced the emphasis on integrity awareness in a Service-wide memorandum which described and institutionalized the Integrity Program. To further institutionalize the program, Internal Affairs special agents will be training over 400 integrity instructors, representing various Customs disciplines. The new trainers will, in turn, make formal 4-hour integrity presentations to all Customs employees.

Employee participation has been achieved in part through integrity videotapes produced by Customs employees. In addition, former employees convicted of criminal integrity violations while employed by Customs have consented to be videotaped describing how and why they began engaging in

criminal activity. These tapes have also been well-received by employees.

System Design and Development Efforts Are Being Reviewed

An ongoing audit is evaluating the procedures, practices, and controls for designing and developing Treasury systems. Audit work is underway at the Financial Management Service and Public Debt and may be extended to other bureaus. ADP system development projects frequently are not completed on time or within budget, and the resulting systems do not fully meet user requirements. These and other shortcomings can often be linked to inadequacies in the design and development process.

In addition, OIG and IRS internal auditors continue to take an active role in reviewing the design and development of individual information systems and significant modifications to existing systems. System design and development reviews help ensure that systems are cost-justified; are designed to meet user needs; operate efficiently; and contain control features to guard against fraud, misuse, unauthorized disclosure, and error. A basic premise of such reviews is that it is far more cost-effective to correct a problem during the design or development stages than to do so after an information system has been implemented.

Several Treasury bureaus served by the OIG are developing or redesigning major ADP systems, and OIG auditors are now reviewing the design for such systems as:

- ☐ The Public Debt Accounting and Reporting System, which will control all public debt financial and security transactions.

- ☐ The PAMIS/PRA software conversion which will enhance Engraving and Printing's tracking capability for currency production.

- ☐ The Electronic Certification System which will provide a more secure and efficient certification process for payments made by the Financial Management Service on behalf of Federal agencies.

Similarly, IRS internal auditors have made numerous reviews of the various phases of the design, development and procurement of information systems at IRS. Recent reports covered the prototype for the Integrated Management System, which will replace the cumbersome management and cost system used by IRS service centers, and the prototype of the Automated Examination System, which will automate the examination of income tax returns.

In addition, IRS management has taken actions to assure that the Service develops quality information systems within reasonable time and cost constraints in response to an internal audit report entitled "Trend Analysis of Systems Development Activities for Fiscal Years 1987-1989."(Report #01033)

The report analyzes IRS systems development activities based on audit findings over the 3-year period. During this period, IRS improved its systems development process by reorganizing the information systems development function to better control the Service's development efforts and establishing new Information Systems Policy Board oversight procedures. The trend analysis concluded, however, that further improvements were needed to strengthen the systems development methodology, contract administration process, and quality review procedures to assure that the Service develops timely, high quality products at the lowest overall cost to the Government.

Integrity Awareness: A High Priority

Integrity awareness remained a high priority for the OIG and the Offices of Internal Affairs and Inspection during the 6 months ended March 31, 1991. The OIG and the Offices of Internal Affairs and Inspection at the Bureau of ATF, Customs, and Secret Service gave 187 integrity awareness presentations to Treasury employees. In addition, IRS presented over 430 integrity awareness briefings to more than 13,000 employees during the 6 months ended September 30, 1990. Highlights of these programs follow:

- ☐ The OIG gave 11 integrity awareness presentations to Departmental Offices, Customs, IRS, OTS, Bureau of ATF, and Secret Service employees.

- ☐ The Bureau of ATF's Office of Internal Affairs conducted 21 integrity awareness briefings for approximately 345 special agents, inspectors and supervisors. Integrity Awareness briefings are conducted monthly at the Federal Law Enforcement Training Center for all new inspector and special agents' training classes. Internal Affairs management officials, as well as other staff members, present briefings at Bureau of ATF conferences, meetings, and at supervisory training classes.

- ☐ Customs' Office of Internal Affairs conducted 151 bribery awareness classes for employees. These classes are designed for Customs employees who have contact

An OIG special agent gives an integrity awareness presentation to Treasury employees.

with the public or importing community. The idea behind the presentations derived from investigative findings which revealed that many employees were unaware of the proper response to bribery situations.

- In addition to its integrity awareness briefings, IRS published its semiannual publication, the Internal Security Division Digest, which includes informative articles for management identifying trends in employee misconduct and areas of integrity weaknesses. In addition, IRS is producing a film on integrity for its employees.

- Secret Service's Office of Inspection conducted integrity awareness briefings for 58 newly appointed Secret Service agents, new supervisors, and special agents attending training classes.

1 than the final tractor, itself. In other words, the steel
2 plate that goes into the -- before they put the wheels on,
3 before they put the engine in, before they put the
4 steering wheel on and that sort of thing, they just sold
5 the steel, it would be worth more than the price they get
6 for the tractor when they're finished.

7 You know, that kind of example is repeated time
8 after time. If you try to search for some place to which
9 we could attach the help we're trying to give in terms of
10 changing the society around.

11 The one -- you know, the one place where
12 primitive capitalism I saw, exists, is in the commodity
13 exchange, which is in the Post Office Building, very near
14 Red Square. They are on the floor, you know, completely
15 disorganized -- it's even more disorganized than our
16 commodities exchanges, if you've seen them. But people
17 milling around, but doing trades. They sell a cargo. They
18 sold the U.S. cargo plane for $12 million. They were
19 selling wheat and food supplies. They even sold an
20 apartment in Los Angeles, of which they were very proud, 2
21 weeks ago.

22 But these guys are at least forming the basis,
23 the very primitive, of the beginnings of a free enterprise
24 system. They are very worried that it is going to get
25 squashed. And they are more worried, interestingly, about

General or by an independent external auditor, as determined by the Inspector General.

The OIG will be performing some of the required audits and will have some of the audits performed by independent external auditors. OIG training efforts have been expanded in several areas in order to have qualified staff available for performing or overseeing the work.

The OIG has also undertaken a significant new initiative at Customs. The OIG is conducting a two-phase review of the overall process for managing and controlling activities within Customs' Southwest Region. The first phase, which is currently ongoing, will identify any weaknesses in Customs' overall management control and direction over regional office activities in the Southwest; evaluate how problems are brought to the attention of regional and headquarters officials; evaluate how regional and headquarters officials deal with reported problems; and report on the status of allegations brought to the attention of Customs' management and Customs' Office of Internal Affairs. The second phase of the review will evaluate the effectiveness of the enforcement program in the Southwest Region. The OIG's Office of Investigations is conducting concurrent investigative work into allegations relating to the Southwest Region.

IRS Information System Initiatives

IRS's Inspection Service has undertaken several significant information systems initiatives. An Inspection Systems Development and Integration project is building a state-of-the-art system to conduct audits and investigations in the paperless environment being created by the IRS Tax Systems Modernization Program. In addition, new technology developed in the Southwest Region for audit planning purposes to analyze open collection accounts for unusual trends or fluctuations has been adopted nationwide. Internal Audit and Internal Security have also initiated a project which will allow direct access between Inspections' microcomputer-based networks and the minicomputers located at various IRS regional offices. This project will also interconnect Inspection's network systems at remote sites.

Deputy Secretary of the Treasury John E. Robson and Inspector General Donald E. Kirkendall at the AGA Leadership Conference (Photograph by Peg Koetsch)

AGA Conferences

On January 10 and 11, 1991, the 13,000-member Association of Government Accountants (AGA) held its Second Annual Conference on Emerging Leadership Issues at the Four Seasons Hotel in Washington, D.C. Health and Human Services Inspector General Richard P. Kusserow, AGA's President, and Treasury Inspector General Donald E. Kirkendall, the conference's chairman, welcomed a capacity audience of 300 people.

Deputy Secretary of the Treasury John E. Robson addressed the conference on the safety, soundness, and profitability of financial institutions. Plenary sessions covered legislative and executive branch perspectives on the implementation of Chief Financial Officer legislation, using the Defense Department's concept of corporate information management, and preparing for the future shock of changes in the workplace. Other topics included a progress report on the 33 new Inspectors General and external quality control reviews of Inspector General auditing activities.

At an awards ceremony, IRS Internal Audit Division Director Gary Bell received the Internal Auditor of the Year Award for leadership in audits expected to produce over $100 million in revenue, participation in a unique project that detected an embezzlement scheme, and dedication to using sound and innovative auditing techniques to improve tax system efficiency. Commissioner William E. Douglas of Treasury's Financial Management Service received the

IRS Internal Audit Division Director Gary Bell, AGA's Internal Auditor of the Year

Elmer Staats Award for promoting financial integrity through sound money management.

Inspector General Kirkendall also addressed the Indianapolis chapter of AGA. The theme for the presentation was "Inspectors General: We improve Government operations, save money, and where it exists, find fraud." In addition, Deputy Inspector General Robert P. Cesca addressed the New Orleans chapter of AGA

IRS Oversight Reviews

During the 6 months ended March 31, 1991, the OIG's Office of Oversight completed three reviews of internal audit and internal investigative activities of IRS's Inspection Service. The Office has taken a three-level approach to its reviews at IRS for both the audit and investigative functions.

The first level included a review of the IRS policies and procedures for both functions to determine whether they conformed with the Comptroller General's auditing standards and the President's Council on Integrity and Efficiency's investigative standards. The second level will review the quality assurance programs for both functions to determine whether Inspection Service managers have adequate information to judge performance. The third level will include tests of completed and ongoing audits and investigations in IRS's seven regions and in the National Office to determine that its policies and procedures are being adequately implemented in accordance with professional standards.

- A review of investigative procedures concluded that investigative methods used by the Inspection Service's Internal Security Division illustrated a logical and effective approach to conducting internal investigations. (Report#OIG-OQA-001-1)

- A review of the Internal Audit Division's policies and procedures concluded that, if properly implemented, they would provide reasonable assurance that audits are conducted in accordance with the Comptroller General's Government Auditing Standards. To promote consistency the report recommended that the Internal Audit Division formalize policies and procedures for: (1) disclosing audit scope impairments; (2) determining the reliability of data obtained form automated systems; and (3) cross-referencing audit work plans to the corresponding working papers. (Report#OIG-OQA-90-001-3)

- A report on the IRS Centralized Background Investigations System concluded that considerable improvements had been made in case processing times, that the quality of work on background cases was adequate, and that appropriate action had been taken on internal recommendations for improvement. (Report #OIG-OQA-90-003-5)

Resolution Trust Corporation Oversight Board

The Secretary of the Treasury chairs the Oversight Board of the Resolution Trust Corporation. Acting on an Oversight Board resolution, the Secretary signed a Treasury Order on April 27, 1990, delegating to Treasury's Inspector General the authority to act as Inspector General of the Oversight Board.

The Oversight Board includes the Secretary of the Treasury, the Chairman of the Federal Reserve Board, the Secretary of Housing and Urban Development, and two public members. A small staff assists the Board in carrying out its responsibilities to review the operations of the Resolution Trust Corporation (RTC). RTC, which has its own Office of Inspector General, is responsible for managing and resolving failed savings and loan institutions and disposing of any related assets in the most economical way possible.

During the 6 months ended March 31, 1991, Treasury's Inspector General reviewed the RTC Oversight Board's draft Strategic Plan, briefed the President of the Board on critical issues affecting both RTC and OTS, and participated in Board meetings. Because the RTC Oversight Board has a relatively small staff of 34 employees, Treasury's OIG has not scheduled any audits of Board activity during its first year of operation, but will consider future audits where warranted. Treasury's OIG plans to audit the process by which OTS places an institution into conservatorship or receivership, including OTS's coordination with the RTC. Further, the Inspector General will continue the meetings which he initiated to identify common concerns with the Inspector General of RTC and other bank regulatory agency Inspectors General.

Security Management at Customs

Customs' Office of Internal Affairs is responsible for overseeing all aspects of security within the U.S. Customs Service. In addition to investigating integrity matters and offenses against Customs employees and property, Internal Affairs manages information, physical, EDP, and communications security programs and conducts security training. Internal Affairs also has responsibilities pertaining to background investigations, the issuance of security clearances, and responses to Freedom of Information/Privacy Act (FOIA/PA) requests.

During the first 6 months of Fiscal Year 1991, the Office completed 147 classified document briefings, 24 physical security evaluations, and 15 international airport inspections. In addition, the Office completed a comprehensive directive updating Customs' policy on the safeguarding of classified information, and issued a Security Programs Manual for use in conducting investigations and program inspections. Finally, Internal Affairs initiated more than 1,758 personnel security investigations, issued 377 security clearances, and responded to more than 53 FOIA/PA requests.

Peer Review Agreement

On February 8, 1991, Inspectors General for Treasury, the General Services Administration (GSA), the Nuclear Regulatory Commission (NRC), and the Office of Personnel Management (OPM) signed a Memorandum of Understanding to conduct peer reviews of their respective audit operations. GSA will review OPM and NRC, Treasury will review GSA, and OPM and NRC will review Treasury.

To determine compliance with standards established by the Comptroller General of the United States, Offices of Inspector General are required to have an external quality control review of their audit operations at least once every 3 years. The reviews must evaluate whether (1) the audit organization's internal quality control system is in place and operating effectively and (2) established policies and procedures and applicable auditing standards are being followed.

Four Inspectors General signed a Memorandum of Understanding to conduct peer reviews: (seated, left to right) Donald E. Kirkendall, Department of the Treasury; Patrick E. McFarland, OPM; William R. Barton, GSA; and David C. Williams, NRC. Assistant Inspectors General for Audit who attended the ceremony included: (standing, left to right) Jay M. Weinstein, Department of the Treasury; Harvey P. Thorp, OPM; William E. Whyte, Jr., GSA; and Thomas J. Barchi, NRC.

Secret Service Inspections

The Office of Inspection carries out an inspection program designed to promote the effectiveness and efficiency of every Secret Service element. Each unit or function is inspected on a cycle varying from 18 to 36 months.

Every inspection includes an activity analysis of the unit's assigned mission and covers such areas as personnel, office security, communications, training, and management and supervision. During the 6 months ended March 31, 1991, the Office of Inspection conducted 19 inspections of offices, divisions, and resident agencies.

Monograph on Auditor-Client Relations

The Association of Government Accountants published Inspector General Kirkendall's monograph, "Auditor-Client Relations in Government." The monograph presents the results of Mr. Kirkendall's 1989 study which explored the perceptions about the Federal Government's audit process by both the auditors and the managers to whom the audit service is rendered.

In general, the study concluded that the state of the relationship between the Government auditor and the client "painted a rather dismal picture." In the study, the managers queried thought that almost 70 percent of their colleagues would label the auditors

with an image of policeman or prosecutor. In addition, these managers believed that 42 percent of their associates would opt to either cancel the audit function or restrict the auditor's efforts to accounting and finance activities.

The study suggested that audit executives may be able to reduce the level of conflict by reexamining policy areas that appear to show client relationship problems:

- ☐ Create a spirit of cooperation– For most routine audit assignments, which do not involve suspected wrongdoing, auditors should be encouraged to be open.
- ☐ Use of exception reporting--A change in audit policy may allow audit reports to contain more balance and perhaps improve relations with and service to managers.
- ☐ Expand education of auditors– Government auditor training and development courses and organizational staff conferences should stress the importance of the human relations aspects of auditing.

The study said that these suggestions to improve auditor-client relationships would not eliminate all existing conflicts. However, audit executives have a responsibility to do what they can to manage the adversarial relationship and to keep the tension at constructive levels.

Legislative Review

The Inspector General Act requires the Inspector General to review existing and proposed legislation and regulations relating to the programs and operations of the Department and to make recommendations concerning their impact. In compliance with this requirement, the OIG commented on drafts of the Bank Reform legislation raising several issues with regard to the status of the proposed new banking agency; the applicability of other laws and regulations to the new agency; compensation of employees; reorganization of the agency; extension of Comptroller of the Currency and OTS authority over banks and savings and loans; and assessment of interstate branching.

The OIG also reviewed draft OMB Guidance on Computer Matching and Privacy and commented to the President's Council on Integrity and Efficiency raising several concerns.

Investigative Training

On February 4 and 5, 1991, the Northeastern Region of the OIG's Office of Investigation held a training conference which focused on the important role that proactive activities play in the development of investigations and investigations at bank regulatory agencies. A representative of the Resolution Trust Corporation's Office of Investigations explained his agency's mission and investigative activities, and a representative from the United States Attorney's Office for the District of Columbia discussed the most recent court cases involving financial institutions and a review of criminal statutes applicable to banking violations. Additionally, guest speakers from the OIG's Office of Audit discussed the operations of OTS and the Comptroller of the Currency, audits completed and underway in these bureaus, and areas of vulnerability.

Regional Inspector General for Audit Robert J. Wesolowski addresses investigative training conference.

Statistical Summaries

This chapter contains statistical analyses on OIG and Office of Inspection and Internal Affairs activities. It includes analyses showing audit reports by bureau, management decisions on audits with potential monetary benefits, and audit resolution matters. It also contains analyses of hotline and other allegations, caseloads, prosecutive actions, successful prosecutions, administrative sanctions, and investigative monetary benefits. Lastly, it reports on current access to information issues. Several of the analyses fulfill reporting requirements in the Inspector General Act, as amended.

Audit Reports Issued

Appendix B of this report lists individual audit reports issued during the 6 months ended March 31, 1991. The following table summarizes the number of reports by bureau.

Bureau	Audit Reports
Multibureau Audits	3
Bureau of ATF	5
Comptroller of the Currency	0
Customs	6
Departmental Offices	4
Engraving and Printing	8
FLETC	2
Financial Management Service	4
IRS	55
Mint	3
Public Debt	3
Savings Bonds Division	0
Secret Service	0
OTS	1
Total	94

Audit Reports With Questioned Costs

The following schedule presents statistical information on management decisions concerning OIG audit reports with questioned costs. IRS did not issue any audit reports with questioned costs during this semiannual reporting period. The term "questioned cost" means a cost that is questioned because of:

- an alleged violation of a provision of a law, regulation, contract, or other requirement governing the expenditure of funds;
- a finding that, at the time of the audit, such cost is not supported by adequate documentation ("unsupported cost"); or
- a finding that the expenditure of funds for the intended purpose is unnecessary or unreasonable.

The term "disallowed cost" means a questioned cost that management, in a management decision, has sustained or agreed should not be charged to the Government.

OIG AUDIT REPORTS
WITH RECOMMENDATIONS QUESTIONING COSTS
6 MONTHS ENDED MARCH 31, 1991

	No.	Amount (In Thousands) Questioned Costs a/	Amount (In Thousands) Unsupported Costs a/
1. For which no management decision has been made by the commencement of the reporting period	9	$1,889	$ 0
2. Which were issued during the reporting period	6	1,101	0
3. Subtotals (1 plus 2)	15	$2,990	$ 0
4. For which a management decision was made during the reporting period	8	1,443	0
- dollar value of disallowed costs	7b/	1,328	0
-dollar value of costs not disallowed	2b/	115	0
5. For which no management decision has been made by the end of the reporting period (3 minus 4)	7	$1, 547	$ 0
6. Reports for which no management decision was made within six months of issuance	5	$ 873	$ 0

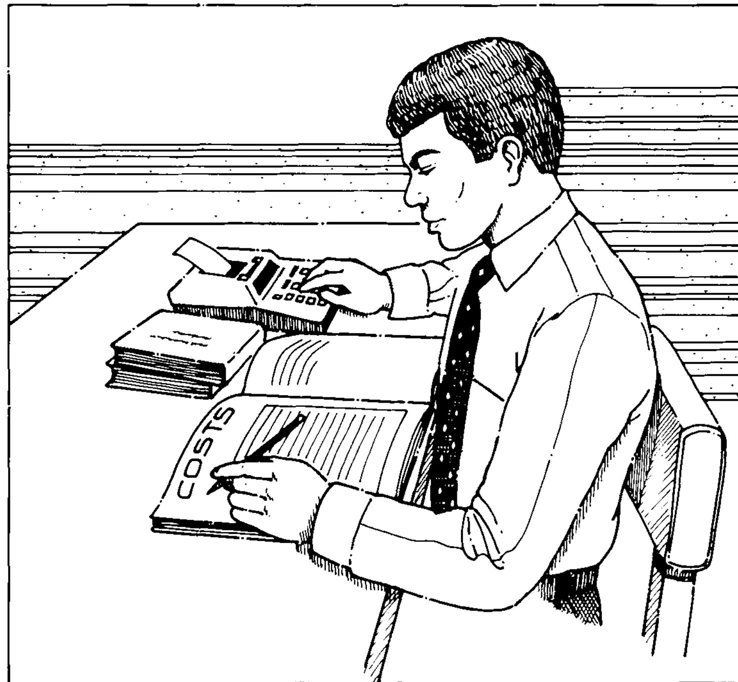
a/ "Questioned costs" includes "unsupported costs."
b/ Recommended questioned costs in one report were partially agreed to and partially not agreed to.

Audit Reports With Recommendations That Funds Be Put To Better Use

The schedules that follow present statistical information on management decisions concerning audit reports with recommendations that funds be put to better use. The term "recommendation that funds be put to better use" means a recommendation that funds could be used more efficiently if management took actions to implement and complete the recommendation, including:

- reductions in outlays;
- deobligation of funds from programs or operations;
- costs not incurred by implementing recommended improvements related to operations;
- avoidance of unnecessary expenditures noted in preaward reviews of contract agreements;
- any other savings which are specifically identified; or
- enhancements to revenues.

The term "management decision" means the evaluation by management of the findings and recommendations included in an audit report and the issuance of a final decision concerning its response to such findings and recommendations, including actions concluded to be necessary.



OIG AUDIT REPORTS
WITH RECOMMENDATIONS THAT FUNDS BE PUT TO BETTER USE
6 MONTHS ENDED MARCH 31, 1991

		Amount (In Thousands)		
	No.	Total	Savings	Revenue Enhancements
1. For which no management decision has been made by the commencement of the reporting period	6	$12,397	$11,964	$ 433
2. Which were issued during the reporting period	12	21,584	18,021	3,563
3. Subtotals (1 plus 2)	18	33,981	29,985	3,996
4. For which a management decision was made during the reporting period	8	30,023	26,743	3,280
-dollar value of recommendations that were agreed to by management	7 a/	15,957	12,677	3,280
- based on proposed management action		15,957	12,677	3,280
- based on proposed legislative action		0	0	0
-dollar value of recommendations that were not agreed to by management	3 a/	14,066	14,066	0
5. For which no management decision has been made by the end of the reporting period (3 minus 4)	10	$ 3,958	$ 3,242	$ 716
6. Reports for which no management decision was made within six months of issuance	2	$ 1,058	$ 625	$ 433

a/ Recommended cost avoidances in two reports were partially agreed to and partially not agreed to

IRS AUDIT REPORTS
WITH RECOMMENDATIONS THAT FUNDS BE PUT TO BETTER USE
6 MONTHS ENDED MARCH 31, 1991

	No.	Amount (In Thousands) Total	Savings	Revenue Enhancements
1. For which no management decision has been made by the commencement of the reporting period	0	$ 0	$ 0	$ 0
2. Which were issued during the reporting period	2	14,206	606	13,600
3. Subtotals (1 plus 2)	2	14,206	606	13,600
4. For which a management decision was made during the reporting period	2	14,206	606	13,600
- dollar value of recommendations that were agreed to by management	2	14,206	606	13,600
-based on proposed management action		14,206	606	13,600
- based on proposed legislative action		0	0	0
- dollar value of recommendations that were not agreed to by management	0	0	0	0
5. For which no management decision has been made by the end of the reporting period (3 minus 4)	0	$ 0	$ 0	$ 0
6. Reports for which no management decision was made within six months of issuance	0	$ 0	$ 0	$ 0

Audit Resolution Information

The Inspector General Act requires Inspectors General to provide information on significant management decisions with which the Inspectors General disagree and prepare a summary of each report which has been unresolved for more than 6 months. As of March 31, 1991, there were no outstanding unresolved audit issues which had been referred to the Treasury Audit Followup Official for resolution. However, there were seven unresolved reports over 6 months old. An identification and explanation of the unresolved reports follow:

	Questioned Costs	Funds Put to Better Use
1. Advisory Audit Report on Equitable Adjustment Claims Submitted under Contract TOS-87-16 Orders SE-88-726 and SE-88-351, Departmental Offices, Report # OIG 89-074, 9/11/89	$217,864	$
2. Bureau of ATF Acquisition and Utilization of Space, Report # OIG 90-019, 12/15/89	390,000	
3. Advisory Audit Report, Costs Incurred Under Subcontract TC-87-048, Modification #3 for In-depth Analysis of Import Industry Data, Report # OIG 90-079, 7/30/90	169,941	
4. Costs Incurred Under Contract No. TM-OLY-88-1008 for Advertising and Marketing of the Commemorative Olympic Coins,	1,433	
5. Evaluation of Costs Incurred Under Contract No. TEP-86-11 (TN) for Integrated State of the Art Security System, Bureau of Engraving and Printing, Report # OIG 90-090, 8/23/90	93,678	
6. Evaluation of Price Proposals Under Contract No. CS-90-006 for Logistics Support for AN/APG Radars, Customs, Report # OIG 90-093, 8/30/90		626,526
7. Philadelphia, Pennsylvania District Operations, Customs, Report # OIG 90-096, 8/30/90		432,593
Totals	$872,916	$1,059,119

(1)An ongoing analysis is being made by Departmental Offices regarding the equitable adjustment claims submitted under Contract TOS-87-16. (2)The Bureau of ATF has requested credits from the General Services Administration to offset excess rental payments. (3)The Customs Service has not finalized negotiations for the modification under Subcontract TC-87-048. (4)The Mint has not finalized review of the costs incurred under Contract TM-OLY-88-1008. (5)Engraving and Printing has not finalized negotiations for the costs incurred under Contract TEP-86-11 (TN). (6)The General Counsel for Customs is reviewing the proposals for Contract CS-90-006. (7)Finally, all action plans have not been completed to address the recommendations cited in the audit report for the Customs Philadelphia, Pennsylvania, District operations.

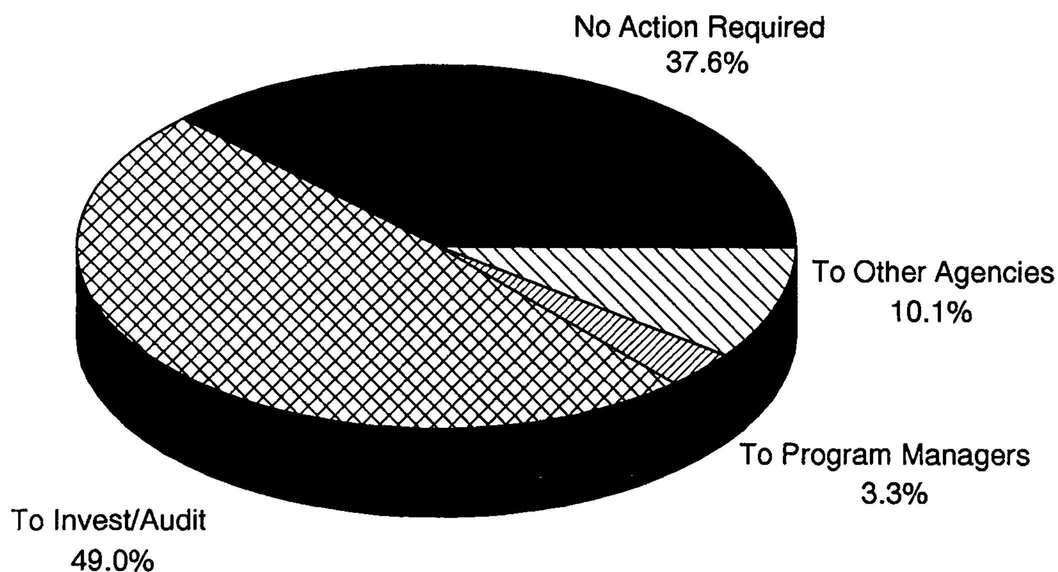
Significant Revised Management Decisions

The Inspector General Act requires Inspectors General to provide a description and explanation of the reasons for any significant revised management decisions made during the reporting period. There are no significant revised management decisions to report.

Hotline and Other Allegations

This table summarizes allegations of fraud, waste, or mismanagement received through hotlines or other means during the 6 months ended March 31, 1991. It does not include inquiries on taxes and other matters which are referred informally to Treasury program managers and others for appropriate disposition.

	Total	OIG	Organization ATF USCS USSS	IRS
Disposition of Allegations:				
No action required	438	23	415	0
Referred for investigative or audit inquiry	571	24	378	169
Referred to program managers	39	9	20	10
Referred to other agencies	118	0	57	61
Totals	1,166	56	870	240



Caseload Accounting

This table accounts for the caseload of the OIG and Offices of Internal Affairs and Inspection. The beginning balance of cases, plus the cases opened, minus the cases closed, equals the ending balance of open cases.

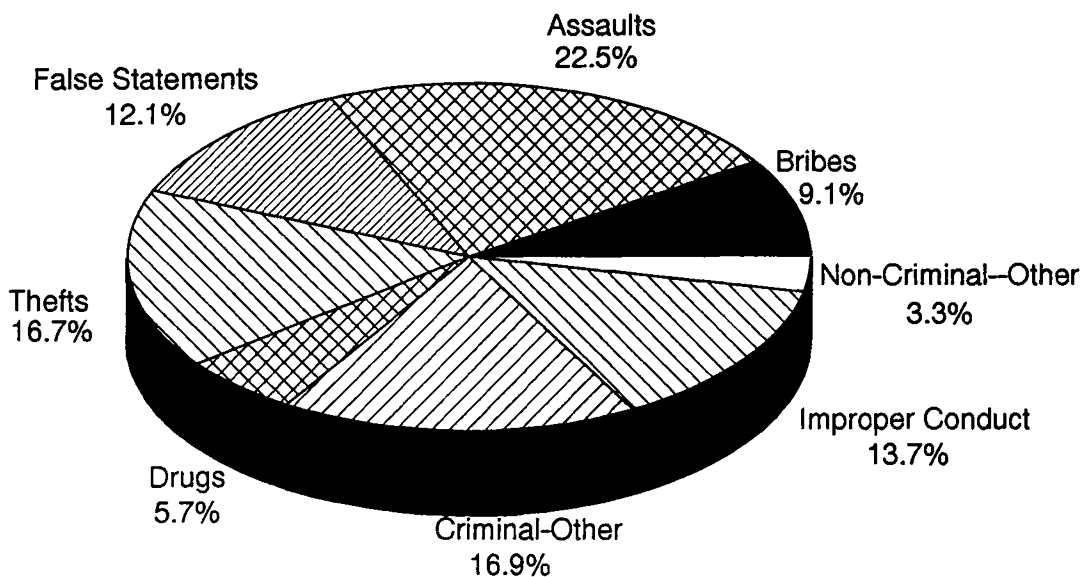
	Total	Organization		
		OIG	ATF USCS USSS	IRS
Number of open cases at the beginning of the period	2,412	191	508	1,713a/
Number of cases opened during the period	1,750	31	423	1,296
Number of cases closed during the period	1,940	93	395	1,452
Number of open cases at the end of the period	2,222	129	536	1,557

a/ Adjusted balance.

Nature of Allegations

This chart and table classify the nature of allegations for investigative cases opened during the period. The number of allegations equals the number of cases opened because only the most significant allegation per case was counted.

		Organization		
	Total	OIG	ATF USCS USSS	IRS
Bribes, graft, kickbacks	160	3	37	120
Assaults	393	0	0	393
False statements and claims	211	7	92	112
Theft/misuse of funds/property	293	8	50	235
Drug abuse and control	99	0	42	57
Criminal - Other	296	2	72	222
Improper conduct or disclosure	240	10	102	128
Non-Criminal – Other	58	1	28	29
Total allegations	1,750	31	423	1,296



Prosecutive Actions

This chart and table account for the prosecutive actions of the OIG and Offices of Internal Affairs and Inspection . The OIG and IRS statistics were based on analyses of cases closed during the period. ATF, USCS, and USSS statistics fully account for prosecutive actions during the period. For these organizations, the number of pending cases at the beginning of the period, plus the cases referred to prosecutive authorities, less the cases accepted for prosecution, less the declinations, equals the pending cases at the end of the period.

		Organization		
	Total	OIG	ATF USCS USSS	IRS
Number of cases pending prosecutive decision at the beginning of the period	19	NA	19	NA
Number of cases referred to prosecutive authorities during the period	692	24	133	535
Number of cases accepted for prosecution during the period	226	4	49	173
Number of declinations during the period	454	20	72	362
Number of cases pending prosecutive decision at the end of the period	31	NA	31	NA

Successful Prosecutions

This chart shows the number of successful prosecutions involving the cases of the OIG and Offices of Internal Affairs and Inspection during the 6 months ended March 31, 1991. Successful prosecutions include the number of individuals who as a result of investigations (1) are found guilty by a Federal or state court, (2) are accepted for pretrial diversion agreements by the Department of Justice, or (3) are granted plea bargaining agreements.

Organization	Prosecutions
OIG	5
ATF, USCS, USSS	23
IRS	131
Total	159

Administrative Sanctions

This chart shows the number of (1) personnel actions and (2) suspensions and debarments of contractors involving OIG and law enforcement bureau cases.

Organization	Personnel Actions	Suspensions and Debarments
OIG	27	1
ATF, USCS, USSS	121	1
IRS	152	0
Total	300	2

Investigative Monetary Benefits

This table summarizes monetary benefits relating to OIG and law enforcement bureau investigations.

	Amounts in Thousands			
Organization	Total	Recoveries	Penalties	Savings a/
OIG	$ 18	$ 14	$ 4	$ 0
ATF, USCS, USSS	3,535	3,445	90	0
IRS	1,381	1,163	218	0
Total	$4,934	$4,622	$ 312	$ 0

a/ Savings and other types of funds put to better use.

Access to Information

The Inspector General Act requires Inspectors General to report on unreasonable refusals of information available to the agency which relate to programs and operations for which the Inspector General has responsibilities. There are no instances to report where information or assistance requested by the Inspector General was unreasonably refused.

Appendix A
Audit Reports with Recommended Monetary Benefits: 6 Months Ended March 31, 1991

Report Title and Date	Report Number	Recommended Monetary Benefits (In Thousands) Questioned Costs	Funds Put to Better Use Savings	Revenue Enhancements
Bureau of Alcohol, Tobacco and Firearms				
Regulation of National Firearms Act Weapons Dealers. 11/19/90	OIG 91-007			$ 64
Producer Compliance-Excise Tax Exemption on Exported Alcoholic Beverages, North Atlantic Region. 3/22/91	OIG 91-034			187
Controls Over Export Alcoholic Beverage Tax Exemption. 3/29/91	OIG 91-037			3,216
U.S. Customs Service				
Review of the Virginia Inland Port. 1/17/91	OIG 91-017		$ 46	
Contract Administration and Closeout Procedures. 2/06/91	OIG 91-024		1,084	
Bureau of Engraving and Printing				
Evaluation of Claim for Contract Price Adjustment Delivery Order W-4093-00 Contract TEP-83-79(M). 10/31/90	OIG 91-004	$ 125		

Report Title and Date	Report Number	Recommended Monetary Benefits (In Thousands)		
			Funds Put to Better Use	
		Questioned Costs	Savings	Revenue Enhancements
Evaluation of Contract Pricing Proposal Submitted for Denominated Distinctive Currency Paper with Security Threads. 12/20/90	OIG 91-014		15,303	
Evaluation of Bid Sample Cost Incurred for Denominated Distinctive Currency Paper with Security Threads. 1/23/91	OIG 91-020	549		
Evaluation of Unsolicited Contract Price Proposal for Advanced Counterfeit Deterence Capability. 2/21/91	OIG 91-027		53	
Evaluation of Contract Pricing Proposal for Heatset Intaglio Postage Stamp Inks and Varnish. 3/18/91	OIG 91-032		495	
Evaluation of Firm-Fixed-Price Redetermination-Prospective Proposal for Distinctive Currency Paper 3/18/91	OIG 91-033		470	
Federal Law Enforcement Training Center				
FLETC's Marana Satellite Facility. 1/18/91	OIG 91-019	136		
Evaluation of Cost Proposal For Janitorial Services at the FLETC's Glynco, Georgia, Facility. 2/15/91	OIG 91-025		469	
Financial Management Service				
Contract Administration and Closeout Procedures. 11/30/90	OIG 91-010	45		
Credit Card Use. 3/21/91	OIG 91-033B	225		

Report Title and Date	Report Number	Recommended Monetary Benefits (In Thousands) Questioned Costs	Funds Put to Better Use Savings	Revenue Enhancements
Internal Revenue Service				
Selected Activities in the Midwest Region Fiscal Management Branch 1/03/91	310210		68	
Effectiveness of Processing Employee Benefit Plan Returns. 3/22/91	01147		538	13,600
U.S. Mint				
Evaluation of Contract Termination Settlement Proposal Contract TM-89-2013. 12/21/90	OIG 91-016	21		
Bureau of the Public Debt				
Evaluation of the Contract Pricing Proposal for Conversion of Records to Microfilm and Document Destruction. 10/02/90	OIG 91-001		101	
Undeliverable Payments. 12/05/90	OIG 91-011			96
TOTALS		$1,101	$18,627	$17,163

Appendix B
Audit Report Listing
October 1, 1990, Through March 31, 1991

Multibureau Audits

Treasury's Implementation of the Bank Secrecy Act (Customs, Departmental Offices, IRS, and Comptroller of the Currency). OIG 91-013, 12/11/90

Evaluation of Treasury's Management Controls Over Advisory and Assistance Services (Engraving and Printing, Customs, Financial Management Service, Departmental Offices, and IRS). OIG 91-021, 1/25/91

Evaluation of Treasury's Compliance with Public Law 101-121 Requirements for Limiting Use of Appropriated Funds for Lobbying (Customs, Departmental Offices, Financial Management Service, and Mint). OIG 91-022, 1/25/91

Bureau of Alcohol, Tobacco, and Firearms

Regulation of National Firearms Act Weapons Dealers. OIG 91-007, 11/19/90

Visa Card Operations. OIG 91-026, 2/20/91

Producer Compliance - Excise Tax Exemption on Exported Alcoholic Beverages, North Atlantic Region. OIG 91-034, 3/22/91

Efforts to Reduce OWCP Payments. OIG 91-036, 3/27/91

Controls Over Export Alcoholic Beverage Tax Exemption. OIG 91-037, 3/29/91

U.S. Customs Service

Contracted Advisory and Assistance Services. OIG 91-002A, 10/18/90

El Paso Special Agent-In-Charge. OIG 91-003, 10/25/90

Federal Managers' Financial Integrity Act. OIG 91-008, 11/28/90

Review of the Virginia Inland Port. OIG 91-017, 1/17/91

Review of the Appropriation Accounts for FY 1987. OIG 91-023, 1/30/91

Contract Administration and Closeout Procedures. OIG 91-024, 2/06/91

Departmental Offices

Examination of the Exchange Stabilization Fund's Statements for the Fiscal Years Ended September 30, 1989 and 1988. OIG 91-006, 11/16/90

Departmental Offices' Conversion to the Department of Agriculture's Integrated Payroll/Personnel System. OIG 91-012, 12/06/90

Contract Administration and Closeout Procedures. OIG 91-015, 12/20/90

Forest Hill Company Cash Disbursements, November 1, 1989 through November 16, 1990. OIG 91-031, 3/18/91

Bureau of Engraving and Printing

Evaluation of Claim for Contract Price Adjustment Delivery Order W-4093-00 Contract TEP-83-79(N). OIG 91-004, 10/31/90

Review of Contract Administration and Closeout Procedures. OIG 91-009, 11/28/90

Evaluation of Contract Pricing Proposal Submitted for Denominated Distinctive Currency Paper with Security Threads. OIG 91-014, 12/20/90

Evaluation of Bid Sample Costs Incurred for Denominated Distinctive Currency Paper with Security Threads. OIG 91-020, 1/23/91

Evaluation of Unsolicited Contract Price Proposal For Advanced Counterfeit Deterrence Capability. OIG 91-027, 2/21/91

Product Accountability Systems Conversion. OIG 91-030, 3/15/91

Evaluation of Contract Pricing Proposal for Heatset Intaglio Postage Stamp Inks and Varnish. OIG 91-032, 3/18/91

Evaluation of Firm-Fixed-Price Redetermination-Prospective Proposal for Distinctive Currency Paper. OIG 91-033, 3/18/91

Federal Law Enforcement Training Center (FLETC)

FLETC's Marana Satellite Facility.
OIG 91-019, 1/18/91

Evaluation of Cost Proposal For Janitorial Services at the FLETC's Glynco, Georgia, Facility.
OIG 91-025, 2/15/91

Financial Management Service

Implementation of the Computer Security Act of 1987.
OIG 91-002, 10/11/90

Contract Administration and Closeout Procedures.
OIG 91-010, 11/30/90

Electronic Certification System.
OIG 91-028, 3/04/91

Credit Card Use.
OIG 91-033B, 3/21/91

Internal Revenue Service

The Effectiveness of Central Region's Problem Resolution Program.
41022, 10/01/90

Employee Plans and Exempt Organizations Activities in the Mid-Atlantic Region.
80095, 10/01/90

KCSC Adjustment/Correspondence Branch Workload.
30064, 10/10/90

Information Systems Development Requirements Analysis Package (RAP) Process.
01022, 10/12/90

Problem Resolution Program in the Manhattan District.
60097, 10/16/90

Procurement Activities in the Midwest Regional Offices.
30055, 10/16/90

Collection's Employment Tax Examination Program in the Central Region.
41015, 10/18/90

Recommendations for Improvements to the Automated Collection System.
01083, 10/31/90

Taxpayer Service Activities in the Seattle District.
91014, 10/31/90

Information Systems Development's Security and Project Management Programs.
01096, 11/01/90

Service Center Adjustments Fresno.
91032, 11/09/90

High Risk Collection Activities in the Helena District.
31012, 11/09/90

Planning for Check Handling Enhancements Expert System (CHEXS).
01103, 11/16/90

Procurement and Property Management in the Pittsburgh District.
81019, 11/20/90

Abstracting Excise Taxes from Quarterly Excise Tax Returns at the Andover Service Center.
60132, 11/28/90

The Electronic Filing System.
01115, 11/29/90

Controls Over Payments of Delinquent Taxes in the Boston District.
61040, 12/03/90

Examination Division Code to Prevent Subsequent Year Examinations.
01161, 12/07/90

The Integrated Management System (IMS) Prototype.
01153, 12/10/90

Examination Activities in the Brooklyn District.
60125, 12/11/90

The Small Purchases Imprest Fund in the Boston District.
61024, 12/18/90

The Processing of Informants' Claims for Reward in the North Atlantic Region.
61033, 12/19/90

Use of Enforcement Statistics by Collection Divisions in the Southeast Region.
11012, 12/21/90

Earned Income Credit.
01174, 12/26/90

Adequacy of Corrective Actions to Ensure that Bankruptcy Freeze Codes Are Properly Reversed.
31031, 12/27/90

Selected Activities in the Midwest Region Fiscal Management Branch.
310210, 1/03/91

Assessments on Bankrupt Taxpayers' Accounts.
01041, 1/04/91

The Small Purchases Imprest Fund in the Denver District.
51011, 1/09/91

Trend Analysis of Systems Development Activities FY 1987-1989.
01033, 1/09/91

The Bankruptcy Program in the Dallas District.
51027, 1/14/91

Follow-Up Processing of Fiduciary Income Tax Returns.
01210, 1/16/91

Laguna Niguel District Examination Division Controls Over Statute Protection.
91022, 1/18/91

District Office Remittance Processing, Los Angeles District.
91041, 2/01/91

The Detroit Computing Center's Small Purchases Imprest Fund.
41034, 2/01/91

Information Gathering Activities in the Criminal Investigation Division.
01014, 2/07/91

National Audit of the Computer Resources Management System.
01255, 2/07/91

The Automated Taxpayer Service System Prototype Tests.
01192, 2/12/91

Examination Division Returns and Statute Controls in the San Jose District.
91087, 2/12/91

Service Center Candling Operations.
01231, 2/12/91

Office Examination Case Management and Control in the Western Region.
91052, 2/19/91

Investigative Imprest Fund and Equipment in the Boston District.
61055, 2/27/91

Estimated Tax Remittance Processing Lockbox Depository System.
01221, 3/04/91

Monitoring of Travel Advances in the Office of the Assistant Commissioner (International).
81022, 3/05/91

National Audit Review of the Bankcard Program Pilot.
01073, 3/07/91

Use of Restricted Interest on Taxpayer Accounts.
01265, 3/11/91

Selected Activities In the Special Procedures Branch Pittsburgh District.
81045, 3/12/91

Statute Controls Follow-up at the Philadelphia Service Center.
81030, 3/12/91

Problem Resolution Program in the Anchorage District.
91071, 3/12/91

Small Purchases Imprest Funds in the Office of the Assistant Commissioner (International).
81053, 3/15/91

An Analysis of Interest Paid on the Refunds.
01243, 3/20/91

Small Purchases Imprest Fund.
01276, 3/22/91

Effectiveness of Processing Employee Benefit Plan Returns.
01147, 3/22/91

Procedures Used to Requisition and Control Returns for the Examination Division.
11021, 2/22/91

Puerto Rico Trust Fund Cases.
81062, 3/26/91

Undercover Activities and Investigative Imprest Funds in the Southwest Region.
51030, 3/26/91

U.S. Mint

The Processing of Numismatic Coin Orders and Remittances by the Lockbox Depository.
OIG 91-005, 11-09-90

Evaluation of Contract Termination Settlement Proposal Contract TM-89-2013.
OIG 91-016, 12/21/90

The 1988 Olympic Coin Program.
OIG 91-029, 3/08/91

Bureau of the Public Debt

Evaluation of the Contract Pricing Proposal for Conversion of Records to Microfilm and Document Destruction.
OIG 91-001, 10/02/90

Undeliverable Payments.
OIG 91-011, 12/05/90

Reconciliation of Account Balances.
OIG 91-018, 1/09/91

Office of Thrift Supervision

Information Systems.
OIG 91-035, 3/20/91

Appendix C
Cross References to Inspector General Act

Inspector General Act, as amended

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FOR RELEASE AT 2:30 P.M.
October 1, 1991

CONTACT: Office of Financing
202-219-3350

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $ 21,600 million, to be issued October 10, 1991. This offering will provide about $ 3,825 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $ 17,765 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, October 7, 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 $ 10,800 million, representing an additional amount of bills dated July 11, 1991 and to mature January 9, 1992 (CUSIP No. 912794 XU 3), currently outstanding in the amount of $ 10,715 million, the additional and original bills to be freely interchangeable.

182-day bills (to maturity date) for approximately $ 10,800 million, representing an additional amount of bills dated April 11, 1991 and to mature April 9, 1992 (CUSIP No. 912794 YH 1), currently outstanding in the amount of $ 11,022 million, the additional and original bills to be freely interchangeable.

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

The bills will be issued for cash and in exchange for Treasury bills maturing October 10, 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 $ 732 million as agents for foreign and international monetary authorities, and $ 4,390 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).

NP-1483

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.

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TREASURY NEWS

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

I am pleased today to present the views of the Administration on H.R. 3035, a bill to amend the Internal Revenue Code of 1986 with respect to the amortization of goodwill and certain other intangibles; H.R. 1456, the Intangibles Amortization Clarification Act of 1991; and H.R. 563, a bill to amend the Internal Revenue Code of 1986 to clarify that amounts paid to acquire certain intangible items are treated as being paid for goodwill. As I stated in a letter to Chairman Rostenkowski shortly after introduction of H.R. 3035, we believe that H.R. 3035 provides a very promising approach to address a difficult issue for both taxpayers and the Internal Revenue Service (IRS), and we support it.

Commissioner Goldberg and I believe that H.R. 3035, which would require amortization of purchased goodwill and other intangible assets over 14 years, is one of the most important simplification proposals before you this year. If enacted it would avoid innumerable tax controversies concerning the tax treatment of future acquisitions. It also would move the tax law with respect to goodwill toward conformity with generally accepted accounting principles which prevail not only in domestic financial accounting but also in international financial and tax accounting.[1]

Given our strong preference for the mechanism proposed in H.R. 3035, we oppose H.R. 1456 and H.R. 563 because we do not believe that either would reduce controversy as effectively as H.R. 3035. We particularly object to H.R. 563 because that bill would increase the number of unamortizable assets by providing, as a matter of law, that a customer base, market share, or any

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[1] Amortization of goodwill is permitted for tax purposes by several of our major trading partners, including Canada, Germany and Japan.

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similar item has an indeterminate useful life and is therefore nondepreciable. These statutory measures, while generally consistent with current IRS positions and some decided cases would ignore factual conclusions reached by the courts in a number of cases, as well as the emerging consensus of the accounting profession, the Securities and Exchange Commission, and banking regulatory agencies, that goodwill should be amortized for accounting purposes. Moreover, H.R. 563 would work to the disadvantage of domestic acquirers who are generally denied any amortization deductions for the cost of acquired goodwill vis-a-vis foreign acquirers whose home country tax law permits amortization of goodwill. In some cases, this advantage could be significant in future competition against United States bidders for businesses with significant trademarks, going concern value and goodwill. In addition, the terms "customer base", "market share", and "similar items" in H.R. 563 are vague and not well defined.

We believe that the proper objective here is simplification, not raising revenue. H.R. 3035 has been designed to be essentially revenue neutral and thus meets that requirement for our support.

Our objection to H.R. 1456 is that we believe H.R. 3035 is clearly the better rule for the future and will more definitively resolve the issue. We understand that many of the proponents of H.R. 1456 would support H.R. 3035 as a prospective rule for purchased intangibles if their solution were made applicable to currently pending cases. The IRS would not agree with their premise that H.R. 1456 simply restates and clarifies current law. We traditionally oppose retroactive legislation. Accordingly, we do not support application of the approach set forth in H.R. 1456 to existing controversies.

Having summarized our basic position on the three bills before you, I would like to return to a review of current law and its history, the specific provisions of the bills before you, and certain requests for changes to and clarification of H.R. 3035 which have arisen since its introduction.[2]

Congress has never explicitly addressed by statute whether goodwill should be amortized. Instead, the rule that goodwill cannot be amortized is found in Treasury Regulation section 1.167(a)-3.[3] While the current version of this regulation was

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[2] A more detailed review of current law is attached as an Appendix.

[3] That regulation also permits amortization of intangible assets if experience or other factors establish that the asset will be of use for only a limited period, the length of which can be

adopted in 1956 and amended in 1960,[4] versions of the rule can be traced back to the earliest days of the income tax. As a result of subsequent reenactments by Congress and frequent judicial endorsement, the regulatory pronouncement that goodwill may not be amortized has become well settled law. Accordingly, the validity of the regulation is beyond challenge and it is a rule of such longstanding that we believe that it should only be altered by legislation.

A rule disallowing any amortization for goodwill has been consistent with the rule that taxpayers must present facts to prove both the allowability and the amount of any deduction, and it caused few difficulties in an earlier time when a relatively small amount of business value consisted of intangible assets (other than patents and copyrights, which had limited lives by statute). However, it is now time to reevaluate the question.

Financial accounting conventions have over time begun to require amortization or depreciation of goodwill in order to prevent financial statements from overstating assets and income. The financial accounting community has recognized that goodwill is not a perpetual asset akin to land or a fine painting, but rather that the value of goodwill and other intangible property is eventually consumed in the production of income, even though the period over which the value disappears may be indeterminate. Prior to 1970, there was considerable flexibility in the amortization of intangible property for financial accounting purposes. Since 1970, generally accepted accounting principles have required amortization of the cost of goodwill and other intangible property over the period estimated to be benefitted, but not to exceed 40 years.[5] Thus, there is a discontinuity between sound accounting practices and the tax rule that goodwill cannot be amortized.

In estimating the useful life of an intangible asset for financial accounting purposes, consideration is given to (1) legal, regulatory, or contractual limits on the useful life, (2) competition, obsolescence, and other economic factors that may

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estimated with reasonable accuracy.

[4] The 1960 amendment merely added a cross-reference to section 177 of the Code for rules concerning trademarks and trade names.

[5] See Accounting Principles Board Opinion No. 17, Intangible Assets. See also Statement of Financial Accounting Standards No. 72 and Financial Accounting Standards Board Interpretation No. 9; Securities and Exchange Commission, Staff Accounting Bulletin No. 42 Topic 2.A.3; Office of the Comptroller of the Currency, Revised Banking Circular 164 and <u>Bank Accounting Advisory Series</u>.

limit the useful life, and (3) provisions for renewal or extension. With respect to goodwill and certain other intangible property, the Accounting Principles Board acknowledges that, "Since the date at which the value becomes zero is indeterminate, the end of the useful life must necessarily be set arbitrarily at some point or within some range of time for accounting purposes."[6]

The current state of the law in this area is very unsettled. Courts continue to follow the rule that goodwill cannot be amortized, but some courts have been persuaded that certain intangible assets can be distinguished from goodwill and can be amortized. The result is uncertainty and a lack of uniformity in application of the rule. It is thus often unclear to the buyer and seller whether a particular intangible asset is amortizable. The primary common feature of decisions allowing amortization is dependence on the facts of the particular case. In addition, results may differ from court to court depending on the legal principles that are considered controlling and the quality of proof adduced by the taxpayer. Thus, some courts may hold for the taxpayer based on a finding that an identifiable asset has an ascertainable value and a limited useful life, while other courts may find that similar assets are so closely linked to the customer relationship that they are inseparable from goodwill or that their lives are indeterminate.[7]

A determination that an intangible asset can be amortized does not end the uncertainty because the amount of the amortization deduction allowable depends on the asset's cost, its useful life, and the rate at which it is exhausted. In the case of intangible assets acquired as part of a business, valuation may be especially difficult because comparable assets are not often sold separately. Determining an intangible asset's useful life and the rate at which it is exhausted is equally problematic.

This uncertainty about how existing law will be applied in particular cases can be expected to have adverse effects on economic efficiency. Capital markets function best when relevant information is readily available to prospective investors. Under current law, however, the tax consequences, and thus the ultimate cost, of a business acquisition involving significant intangible assets cannot be predicted with accuracy.

Intangible assets for those companies included on the Compustat data base (about 7,000 of the largest U.S.

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[6] Accounting Principles Board Opinion No. 17, Intangible Assets, paragraph 23.

[7] See Appendix.

corporations) are valued for financial accounting purposes at over $400 billion in 1990.[8] For the Compustat group of firms, the value of intangibles has grown from just about 1.5 percent of the total assets of manufacturers in 1971 to about 7 percent in 1990. Likewise, from 1971 to 1990, intangibles have increased from about 1.5 percent to over 4 percent of the share of total assets in the retail and wholesale trade sector of the economy. Even in the transportation and public utility sector, the share of intangibles has grown from less than 0.5 percent to about 2.5 percent, while in the service industries, the share has grown from about 5 percent to about 10 percent of total assets between 1971 and 1990. While the pattern varies among sectors, most of this growth has occurred in the last decade. These statistics indicate that intangible assets are more significant than in earlier years.

A comparison of the treatment historically afforded tangible versus intangible property is useful. Initially, the Revenue Act of 1913 applied identical depreciation standards to tangible and intangible property (i.e., "a reasonable allowance for the exhaustion, wear and tear of property"). Since the introduction of this standard, however, significant administrative and legislative efforts have been made from time to time to resolve the obvious difficulties that arise in applying this inherently factual standard to each tangible asset used in a trade or business. In the case of tangible property, these efforts have resulted in statutorily mandated methods of depreciation and useful lives. Impelling this change was dissatisfaction with the uncertainty created by differing results in litigation involving depreciation of tangible assets.[9] In contrast, the 1913 standard (a "reasonable allowance") remains unchanged in its application to intangible property.

We believe the time has come to adopt statutory amortization rules for intangible property, and we view H.R. 3035 as important in achieving that objective.

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[8] The Compustat database is published by Standard and Poor's Compustat Services, Inc.

[9] In describing the pre-1981 depreciation procedures and the reasons for adopting statutory lives, Congress stated that the then-existing system "required determinations on matters, such as useful life and salvage value, which are inherently uncertain and, thus, too frequently resulted in unproductive disagreements between taxpayers and the Internal Revenue Service." General Explanation Of The Economic Recovery Tax Act of 1981, p. 75 (1981), prepared by the Staff of the Joint Committee on Taxation.

DESCRIPTION OF PROPOSALS

H.R. 3035

H.R. 3035 would require the cost of most purchased intangible property (including goodwill and going concern value) to be amortized ratably over 14 years. The cost of purchased intangibles would continue to be determined under the principles of current law.[10] Except as otherwise provided below, the bill would apply to intangible property acquired in stand-alone purchases as well as intangible property acquired in the purchase of an ongoing business.

Since the bill applies only to purchased intangible property, it would not change the tax treatment of self-created intangible property or the costs of creating such property.

If a taxpayer acquires property that is subject to amortization under the bill and disposes of a portion of the property acquired in the transaction, no loss would be allowed with respect to the disposition and the adjusted basis of the remaining intangible assets would be adjusted accordingly.

The following property would be subject to the bill[11], and hence amortized ratably over 14 years:

-- goodwill and going concern value;

-- work force in place, its composition, terms and conditions of employment, including employment contracts, favorable wage rate structures, technical expertise of work force, and similar property;

-- information bases, including customer lists, credit lists, client files, business books and records, insurance expirations, data bases, manuals, and similar property;

-- technology, including software, formulas, processes, designs, patterns, know-how, formats, recipes, and similar property;

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[10] Allocation disputes would be substantially reduced, however, because in many cases, there would be no need to allocate among individual assets the aggregate amount paid for 14-year intangibles.

[11] The following listing is intended to illustrate the scope of the bill; however, the listing of an item does not imply that it does or does not constitute a depreciable asset under current law.

-- customer-based intangibles, including insurance in force, favorable market structure or other competitive advantages, customer contracts, mortgage servicing rights, core deposits, and similar property;

-- supplier-based intangibles, including favorable service contracts, favorable manufacturing contracts, favorable supply contracts, favorable leases (except as otherwise provided below), and similar property;

-- licenses, permits and other rights granted by a governmental unit or an agency thereof, provided the rights are not granted for an indefinite period and are not reasonably expected to be renewed for an indefinite period;

-- covenants not to compete or similar arrangements that are entered into in connection with the acquisition of a trade or business; and

-- franchises, trademarks and trade names, including renewals of franchises, trademarks or trade names (but excluding any rights granted by a governmental unit or an agency thereof and certain contingent amounts paid or incurred with respect to a franchise, trademark or trade name).

Several classes of intangible property would be excluded from the scope of the bill and therefore not subject to 14-year amortization. Costs associated with the acquisition of excluded property would be controlled by current law principles. For example, if in connection with the acquisition of tangible property the purchaser also acquires an interest as a lessor in a lease, the cost of acquiring the leasehold interest would be added to the basis of the property acquired rather than amortized over 14 years. The cost of acquiring a leasehold interest in tangible property, as a lessee, would be excluded from the scope of the bill provided the lease has a fixed duration, is not renewable, and is acquired in a stand-alone purchase. With the exception of core deposits and similar items held by financial institutions, the bill would not apply to any interest as a creditor under any existing indebtedness. The bill also would not apply to the cost of acquiring the following property:

-- favorable financing, provided the favorable financing has a fixed term and is nonrenewable;

-- any interest in land that has a remaining recovery period under current law of 30 years or more;

-- any property of a kind that is regularly traded on an established market, such as futures contracts, foreign currency contracts, and similar instruments;

-- patents and copyrights acquired in a stand-alone purchase;

-- sports franchises and items acquired in connection with the acquisition of sports franchises; and

-- licenses, permits or other rights granted by governmental units or agencies thereof for an indefinite period or reasonably expected to be renewed for an indefinite period.

The bill would provide the Treasury Department with regulatory authority to exclude the cost of acquiring rights under contracts, provided the rights have a fixed duration and are acquired in a stand-alone purchase. The bill would apply to intangible property acquired after the date of enactment of the bill.

H.R. 1456

H.R. 1456 would provide for amortization of the value of customer-based, market share, and any similar intangible property, provided the taxpayer can demonstrate that (1) the property has an ascertainable value that is separate and distinct from other assets acquired in the same transaction (including goodwill and going concern value), and (2) such property has a limited useful life. H.R. 1456 would provide the Treasury Department with regulatory authority to prescribe safe harbor recovery periods for specific types of customer-based, market share, or similar intangible property. The bill would apply to all taxable years beginning before, on, or after the date of introduction. Legislation similar to H.R. 1456 has also been introduced in the Senate.

H.R. 563

H.R. 563 would provide that any amount paid or incurred to acquire customer base, market share, or any similar item has an indeterminate useful life and is therefore not depreciable. The bill would apply to customer base, market share, or any similar item acquired after the date of enactment of the bill.

ADMINISTRATION POSITION

As set forth above and in my letter to Chairman Rostenkowski, we support H.R. 3035 as a promising approach for resolving the tax treatment of purchased intangible property in a revenue neutral manner. However, a number of possible modifications to the specific provisions of H.R. 3035 have been brought to our attention since the bill was introduced.

One possible modification was suggested in a recent General Accounting Office Report, "Tax Policy: Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets." The report suggested the adoption of asset classes and multiple recovery periods analogous to those of the current law depreciation system for tangible property. The argument in favor of this proposal is that recovery periods for intangible assets would correspond more closely with their actual useful lives resulting in better matching of amortization deductions with related revenue and more accurate measurement of income.

Notwithstanding this argument, we oppose a multiple class system for intangibles generally. Multiple recovery periods will inevitably lead to disputes over the class in which an asset should be included and over the allocation of purchase price among different classes of intangible assets. Both of these problems are minimized by the uniform amortization period of H.R. 3035.

Commenters have questioned the exclusion of governmental rights with an indefinite duration (such as renewable Federal broadcast licenses or grazing leases) from the provisions of the bill (thereby making such assets ineligible for 14-year amortization). We oppose application of the proposal to such governmental rights. Often, government-granted rights are effectively perpetual in nature, i.e., not subject to exhaustion. H.R. 3035 does not purport to reverse the longstanding requirement that depreciation is limited to property that is subject to "exhaustion, wear and tear." Thus, tangible and intangible property that is not subject to exhaustion, wear and tear, such as land or the stock of an acquired trade or business, must be capitalized and recovered only upon disposition of the property. The proposal establishes a 14-year useful life for classes of intangible property that have been recognized in the financial accounting practice to be generally subject to exhaustion. The exclusion of governmental rights of an indefinite duration is therefore consistent with the purpose of the bill.[12]

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[12] While it is conceivable that certain private contracts might retain their value indefinitely, such private contracts are relatively infrequent. We, therefore, concur in the judgment

Other commenters have questioned whether the bill's coverage of leases is sufficiently broad to reach depletable mineral interests. While we do not believe that the bill was intended to reach leases of mineral interests where cost recovery is accomplished primarily through an allowance for depletion, we believe that this exclusion should be made explicit.

Commenters have also questioned the propriety of a 14-year amortization period for purchased software. The term "software", however, covers a broad range of intangibles. We agree with the proposition that the bill should not cover purchases of a nonexclusive license to use software that is generally available for purchase through commercial outlets. Examples of this category of software would be commercially available spread sheet, database and word processing programs. By way of contrast, if the developer of a software program sold its copyrights and related know-how for the software program to another developer/marketer of software, the acquired rights should be subject to 14-year amortization in the hands of the purchaser.

Accordingly, we would favor clarifying the bill to exclude purchases of nonexclusive licenses to use commercially available software while making it equally clear that purchased software will be subject to the 14-year amortization rule when the purchaser acquires all rights to the software or acquires any exclusive rights with respect to the software (e.g., the exclusive right to exploit the software in a particular market). Finally, we recommend that Congress adopt an explicit amortization period for nonexclusive licenses of commercially available software. Such a rule could be patterned after the Service's administrative safe harbor, Rev. Proc. 69-21, 1969-2 C.B. 303, which generally provides a 5-year amortization period for software that is purchased separately and treats the cost of software included in the purchase price of a computer as part of the depreciable basis of the computer. Adoption of this clarification would not, in our view, require any change in the 14-year amortization period proposed by the bill.

CONCLUSION

We strongly support enactment of H.R. 3035 with the clarifications I have discussed today. We look forward to working with the Committee to achieve this important and needed simplification.

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that private contracts do not warrant a similar exclusion.

This concludes my written testimony, Mr. Chairman. I will be pleased to answer any questions which you or other members of the Committee may have.

APPENDIX

Current Law

Statutory and Regulatory Provisions Relating to Depreciation of Intangible Property

Section 167 of the Code allows a depreciation deduction for exhaustion, wear and tear, and obsolescence of property that is used in a trade or business or held for the production of income. This deduction allocates the cost or other basis of the property over the estimated useful life of the property, thereby matching costs and related income. The basis upon which the allowance for depreciation is to be computed with respect to any property is the basis under section 1011 for the purpose of determining gain on the sale or other disposition of the property.

In the case of tangible property the depreciation method and recovery period are generally prescribed in section 168. With the exception of property with a 15-year or 20-year class life, property used in a farming business, and certain property for which the taxpayer elects an alternate recovery method, tangible personal property is generally depreciated using the 200-percent declining balance method. Tangible property with a 15-year or 20-year class life, property used in a farming business, and certain property for which the taxpayer makes the appropriate election, is depreciated using the 150-percent declining balance method. Nonresidential real property, residential rental property, railroad grading or a tunnel bore, and property for which the taxpayer elects to use the straight line method, is generally depreciated using the straight line method. The recovery periods prescribed under section 168 vary between 3 years and 50 years, depending upon the class life of the particular property. Salvage value is disregarded in determining the allowance for depreciation under section 168.

Treasury Regulation section 1.167(a)-3 provides that if an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. An intangible asset, the useful life of which is not limited, is not depreciable. Treasury Regulation section 1.167(a)-3 specifically provides that no deduction for depreciation is allowable with respect to goodwill.

Treasury Regulation section 1.167(a)-1(a) provides that the depreciation allowance is generally based on the amount which should be set aside for the taxable year in accordance with a reasonably consistent plan, so that the aggregate of the amounts

set aside, plus salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property. Treasury Regulation section 1.167(a)-1(b) provides that the estimated useful life is the life over which the asset may reasonably be expected to be useful to the taxpayer in its trade or business or in the production of income. Some of the factors to be included in determining this period are (1) wear and tear and decay or decline from natural causes, (2) the normal progress of the art, economic changes, inventions, and current developments within the industry and the taxpayer's trade or business, (3) the climatic and other local conditions peculiar to the taxpayer's trade or business, and (4) the taxpayer's policy as to repairs, renewals, and replacements.

Statutory, Regulatory, and Administrative Provisions Providing Recovery Periods for Intangible Property

Several statutes, regulations and administrative pronouncements prescribe useful lives and depreciation or amortization methods for certain types of intangible property; however, relatively few intangible assets are subject to these rules.

Some of the most significant of these special rules relate to transfers of franchises, trademarks, and trade names. Section 1253 of the Code limits the circumstances in which such transfers are treated as sales or exchanges of capital assets and prescribes the treatment of payments on account of such transfers. These rules prescribe the following recovery methods:

- Installment payments contingent on productivity or similar criteria may be deductible when made. This rule applies only if the installments are payable at least annually over the term of the transfer agreement and are substantially equal or determined under a fixed formula.

- Noncontingent principal payments (and contingent principal payments to which the preceding rule does not apply) may be (1) amortized ratably over the shorter of 10 years or the term of the transfer agreement if payable in a lump sum, (2) deductible when made if payable in approximately equal installments over a specified period, and (3) taken into account under regulations consistent with the foregoing rules in other cases. These rules apply only if the transfer is not treated as a sale or exchange of a capital asset and the aggregate amount of the payments does not exceed $100,000.

-- The transferee may be required to capitalize the payments. In that case, the transferee may elect to amortize the amounts charged to the capital account over 25 years. (If the transferee does not make the election, depreciation is determined under section 167.) These rules apply if the transfer is treated as a sale or exchange of a capital asset. Payments on account of transfers not treated as a sale or exchange of a capital asset are also subject to these rules if no other rule applies.

Section 248 of the Code provides that a corporation may elect to amortize organizational costs ratably over a period of not less than 60 months, beginning with the month in which it begins business. Treasury Regulation section 1.248-1(b)(1) defines organizational expenses as those expenditures that are directly incident to the creation of the corporation, are chargeable to a capital account, and are of a character which, if expended incident to the creation of a corporation having a limited life, would be amortizable over such life. Examples of organizational expenditures include legal and accounting services incident to the organization of the corporation, expenses of temporary directors or stockholders of the corporation, and fees paid to the State of incorporation. Under section 709 of the Code, a similar rule applies to organizational expenditures of partnerships.

From 1956 through 1986, section 177 of the Code provided a similar rule with respect to trademark and trade name expenditures (i.e., expenditures that are (1) directly connected with the acquisition, protection, expansion, registration, or defense of a trademark or trade name, (2) chargeable to the capital account, and (3) not part of the consideration paid for a trademark, trade name, or business). Electing taxpayers could amortize these expenditures ratably over a period of not less than 60 months beginning with the first month of the taxable year in which the expenditure was paid or incurred. Section 177 was enacted to minimize disparities of treatment that resulted from the failure of some taxpayers (generally, large companies with in-house legal staffs) to capitalize all of their trademark and trade name expenditures. The provision was repealed by the Tax Reform Act of 1986, because, on reconsideration, "the possibility that some taxpayers may fail accurately to compute nondeductible expenses was [not] a justification for rapid amortization." H.R. Rep. No. 426, 99th Cong., 1st Sess. 171 (1985).

Treasury Regulation section 1.167(a)-6(a) provides for depreciation of the cost or other basis of a patent over the remaining useful life of the patent. If a patent becomes worthless in any year before its expiration, the unrecovered cost or other basis may be deducted in that year. The cost of a self-created patent includes the various Government fees, cost of

drawings, models, attorneys' fees, and similar expenditures. Amounts paid or incurred in the development of a patent and that qualify as research and experimental expenditures under section 174 of the Code may be deducted during the year in which they are paid or incurred. Alternatively, the taxpayer may elect to capitalize and amortize research and experimental expenditures. Under Treasury Regulation section 1.174-4(a)(4), if these capitalized expenditures result in the creation of a patent, the unrecovered capitalized amount is depreciable over the useful life of the patent.

A number of administrative procedures provide safe harbor recovery periods for various classes of intangible property. For example, Rev. Proc. 69-21, 1969-2 C.B. 303, provides that the cost of purchased software may be amortized ratably over a period of 5 years provided the cost of the purchased software is separately stated from the cost of any purchased hardware. Similarly, Rev. Proc. 90-63, 1990-2 C.B. 664, provides that the cost of purchased or self-created package designs may be amortized ratably over either a 4-year or 5-year period. Taxpayers electing 5-year amortization of package design costs may deduct the unamortized portion of the basis of the package design in the tax year of disposition or abandonment. Taxpayers electing 4-year amortization of package design costs may not deduct the unamortized portion of the basis of the package design in the tax year of disposition or abandonment.

Statutory Provisions Relating to Valuation of Intangible Property

Section 1060 of the Code provides that the purchaser of the assets of a trade or business must use the method prescribed in the regulations under section 338(b)(5) to allocate the purchase price among the assets acquired.

Treasury Regulation section 1.338(b)-2T(b) prescribes a "residual method" under which the purchase price is allocated as follows:

-- First, to cash, demand deposits, and similar accounts in depository institutions (Class I assets).

-- Second, to certificates of deposit, U.S. Government securities and readily marketable stock, securities and foreign currency (Class II assets).

-- Third, to any remaining tangible and intangible property other than intangible assets in the nature of goodwill and going concern value (Class III assets).

-- Fourth, to intangible assets in the nature of goodwill and going concern value (Class IV assets).

In general, the purchase price allocated to assets in each of the first three classes will be equal to their fair market value. If, however, the fair market value of a class of assets exceeds the remaining purchase price (i.e., the purchase price reduced by amounts allocated to prior classes), the remaining purchase price is allocated among the assets in proportion to their relative fair market values. The residual purchase price, after allocation to the first three classes, is allocated to goodwill and going concern value (Class IV assets).

Prior to 1987, the two most common methods of valuing goodwill in connection with an acquisition of the assets of a going business were the residual method and the formula method. Under the formula method, goodwill and going concern value were separately valued along with the other assets of the business.[13] Taxpayers using the formula method often employed a "second-tier allocation" procedure to allocate any premium paid for the business among the assets acquired, including goodwill and going concern value. The second-tier allocation procedure involved (1) a valuation of each asset acquired, including goodwill and going concern value, (2) an allocation of purchase price among the assets acquired in an amount equal to each asset's fair market value, and (3) an allocation of any remaining purchase price among all assets, except cash and cash equivalents, in proportion to their relative fair market values. The obvious benefits for taxpayers using the formula method and second-tier allocation procedure to assign purchase price to depreciable property, rather than goodwill and going concern value, led to protracted controversy and litigation concerning purchase price methodologies. See Banc One Corp. v. Commissioner, 84 T.C. 476 (1985), aff'd 815 F.2d 75 (6th Cir. 1987).

Section 1060 of the Code was enacted, as part of the Tax Reform Act of 1986, in order to limit controversy concerning purchase price allocations, particularly allocations to goodwill and going concern value. By requiring taxpayers to apply the residual method, any premium is effectively treated as a payment for assets in the nature of goodwill or going concern value. Section 1060 effectively limits controversy regarding the mechanics of the purchase price allocation but does not resolve questions concerning the proper classification of the assets acquired. Thus, disputes persist concerning whether an intangible asset acquired in the purchase of an ongoing business is within Class III and amortizable, or constitutes goodwill or

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[13] Goodwill and going concern value were generally valued by capitalizing, at an appropriate discount rate, the excess earning capacity of the business. The IRS recognized the formula method in situations in which there was no "better evidence available from which the value of intangibles can be determined." See Rev. Rul. 68-609, 1968-2 C.B. 327.

going concern value and, therefore, is within Class IV and nonamortizable.

Brief Overview of the Evolution in Treatment of Tangible Property

The Revenue Act of 1913 permitted a deduction from income for "a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business." Prior to 1934, taxpayers had considerable discretion in establishing the amount of depreciation allowable during the taxable year.[14] This discretion resulted in excessive depreciation allowances and ultimately led to a 1934 administrative reform of depreciation practices.[15]

During 1934, Treasury issued regulations which (1) limited the deduction for depreciation to an amount necessary to recover the cost or other basis of the property and (2) placed the burden of proof for the correctness of depreciation deductions claimed squarely upon the taxpayer. See T.D. 4422, XIII-1, C.B. 58 (1934). During this period, the IRS generally determined the useful life of tangible property by reference to standardized useful lives prescribed in "Bulletin F."[16] This approach led to

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[14] Bureau of Internal Revenue, Regulations 74 and 77, Article 205 provided that, "the capital sum to be replaced should be charged off over the useful life of the property, either in equal annual installments or in accordance with any other recognized trade practice, such as an apportionment of the capital sum over units of production. Whatever plan or method of apportionment is adopted must be reasonable and must have due regard to operating conditions during the taxable period. While the burden of proof must rest upon the taxpayer to sustain the deduction taken by him, such deductions will not be disallowed unless shown by clear and convincing evidence to be unreasonable."

[15] See H.R. 704, 73rd Cong., 2d Sess. 8-9 (1934) and Letter from the Secretary of the Treasury to the Chairman of the Ways and Means Committee, House of Representatives, January 26, 1934, in H.R. 704, 73rd Cong., 2d Sess. 8-9 (1934).

[16] The earliest edition of Bulletin F, dated August 31, 1920, did not contain suggested useful lives. The Bulletin stated that, "[t]he Bureau does not prescribe rates to be used in computing depreciation and obsolescence, as it would be impractical to determine rates which would be equally applicable to all property of a general class or character. For this reason, no table of rates is published. The rate applicable and the adjustment of any case must depend upon the actual conditions existing in that particular case." However, in 1931 the Internal Revenue Service published a schedule of suggested useful lives

unacceptable levels of controversy concerning depreciation deductions. As a result, the IRS announced a new policy in 1953 under which it would not disturb depreciation deductions, except where there was a "clear and convincing basis for a change." See Rev. Rul. 90, 1953-1 C.B. 43. However, taxpayers generally continued their pre-1934 depreciation practices and the IRS continued to challenge these practices.

Beginning in the late 1950s, Treasury undertook several major studies of the useful lives of tangible property. In 1962 Treasury issued Rev. Proc. 62-21, 1962-2 C.B. 418, which was specifically designed to provide taxpayers with a greater degree of certainty in determining the useful lives of tangible assets. Rev. Proc. 62-21 provided asset "guideline lives" which were approximately 30-40 percent shorter than the useful lives suggested in Bulletin F. Under the revenue procedure, if the useful life used by a taxpayer was equal to or longer than the prescribed guideline life, the taxpayer's depreciation deductions would not be disturbed, provided the taxpayer also satisfied a "reserve ratio test."[17] Taxpayers were not required to elect the guideline useful lives.

Rev. Proc. 62-21 initiated a fundamental change in the determination of useful lives for tangible property by abandoning the historic asset-by-asset useful life determination in favor of industry-wide useful life standards. Homogeneous assets were aggregated into "classes" with a single guideline useful life for each class.[18] The revenue procedure replaced the thousands of useful lives suggested in Bulletin F with 75 asset guideline lives.

The reserve ratio test promulgated under Rev. Proc. 62-21 ultimately proved unsatisfactory and controversy concerning useful lives continued. Accordingly, on June 22, 1971, Treasury adopted the Asset Depreciation Range (ADR) System. ADR, inter alia, sanctioned depreciation allowances within a 20-percent

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entitled "Depreciation Studies -- Preliminary Report of the Bureau of Internal Revenue."

[17] The reserve ratio test was designed as a mechanical procedure to test whether the taxpayer's actual period of use conformed with the guideline life.

[18] For example, all machinery and equipment used in agriculture was grouped in a single class for which a 10 year guideline useful life was established. Some of the assets within a particular class would obviously have longer, or shorter, useful lives than the guideline useful life; however, the industry experience should produce a "reasonable" allowance for the group of assets.

range of tolerance above, and below, the guidelines prescribed in Rev. Proc. 62-21.[19] By abandoning the reserve ratio test, the ADR system completed the transition from historic individualized useful life determinations to industry-based useful life determinations. ADR also operated as an elective procedure. For assets that were not covered, and for taxpayers who did not elect ADR, useful lives were determined according to the facts and circumstances pertaining to each asset.

During 1981, Congress undertook a comprehensive reform of the depreciation system. ADR was replaced with a statutory depreciation scheme, the Accelerated Cost Recovery System (ACRS). ACRS, embodied in section 168 of the Code, prescribed mandatory depreciation rates for broad classes of tangible assets, thereby de-emphasizing the concept of useful lives and depreciation methods. ACRS was designed to both stimulate investment and simplify depreciation practices. The depreciation categories and procedures have been revised since 1981, but the statutory framework of prescribed depreciation methods and useful lives has continued.

Controversy and Litigation with Respect to Intangible Property

Application of the language of section 167 of the Code, and the regulations thereunder, to intangible property has been a constant source of controversy between taxpayers and the IRS. Taxpayers attempt to (1) value identifiable intangible property and (2) establish a useful life for the property. The IRS often takes the position that the intangible property is inseparable from goodwill and going concern value or that the property has an indeterminate useful life. If the IRS prevails on either of these assertions, depreciation of the property is forbidden under Treasury Regulation section 1.167(a)-3. On other occasions the IRS accepts the existence and useful life of the intangible property but questions the value assigned to the property. Resolution of these differences has frequently fallen to the courts.

These issues are frequently litigated, with courts reaching widely divergent and often contradictory conclusions from very similar sets of facts. Comparison of the following cases will suggest the uncertain state of the law in this area:

-- Compare Newark Morning Ledger Co. v. United States, No. 90-5637 (3rd Cir. 1991), rev'g 734 F.Supp. 176 (D. N.J. 1990) (newspaper subscription list inseparable

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[19] As with most depreciation changes, the ADR system was recognized as having significant effects on capital investment as well as administrative complexities.

from goodwill) with Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240 (5th Cir. 1973), cert. denied, 414 U.S. 1129 (1974) (newspaper subscription list amortizable).

-- Compare Decker v. Commissioner, 54 T.C.M. 338 (1987), aff'd 864 F.2d 51 (7th Cir. 1988) (insurance expirations nonamortizable) with Richard S. Miller & Sons, Inc. v. United States, 537 F.2d 446 (Ct. Cl. 1976) (insurance expirations amortizable).

-- Compare AmSouth Bancorporation & Subsidiaries v. United States, 681 F.Supp. 698 (N.D. Ala. 1988) (core deposits inseparable from goodwill) with Citizens and Southern Corporation and Subsidiaries v. Commissioner, 91 .C. 463 (1988), aff'd 900 F.2d 266 (11th Cir. 1990) (core deposits amortizable).

-- Compare Westinghouse Broadcasting Corp. v. Commissioner, 36 T.C. 912 (1961), aff'd 309 F.2d 279 (3rd Cir. 1962), and Indiana Broadcasting Corporation v. Commissioner, 350 F.2d 580 (7th Cir. 1965), rev'g 41 T.C. 793 (1964) (network affiliation contract nonamortizable) with Miami Valley Broadcasting Corporation v. United States, 499 F.2d 677 (Ct. Cl. 1974) (network affiliation contract amortizable).

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TREASURY NEWS

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FOR RELEASE AT 2:30 P.M.
October 2, 1991

CONTACT: Office of Financing
202/219-3350

TREASURY TO AUCTION $9,250 MILLION OF 7-YEAR NOTES

The Department of the Treasury will auction $9,250 million of 7-year notes to refund $5,398 million of 7-year notes maturing October 15, 1991, and to raise about $3,850 million of new cash. The public holds $5,398 million of the maturing 7-year notes, including $376 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

The $9,250 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 $347 million of the maturing securities that may be refunded by issuing additional amounts of the new notes at the average price of accepted competitive tenders.

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

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Attachment

NB-1485

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

October 2, 1991

Amount Offered:

To the public	$9,250 million

Description of Security:

Term and type of security	7-year notes
Series and CUSIP designation	H-1998 (CUSIP No. 912827 C6 7)
Maturity date	October 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	April 15 and October 15
Minimum denomination available ..	$1,000

Terms of Sale:

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

Payment Terms:

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

Key Dates:

Receipt of tenders	Wednesday, October 9, 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 ..	Tuesday, October 15, 1991
b) readily-collectible check ..	Thursday, October 10, 1991

TREASURY NEWS

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For Release Upon Delivery
Expected at 10:00 a.m.
October 3, 1991

STATEMENT OF
PHILIP D. MORRISON
INTERNATIONAL TAX COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Committee:

I am pleased to present the views of the Administration on H.R. 2889, introduced by Representatives Dorgan and Obey, and on a proposal to allow U.S.-controlled foreign corporations to elect to be taxed as domestic corporations.

Background

The income of foreign corporations controlled by U.S. shareholders generally is not subject to U.S. tax when earned; instead, U.S. tax is deferred until the income is repatriated. Subpart F of the Internal Revenue Code (Code) eliminates deferral, however, for certain types of income that are passive or particularly mobile, taxing the U.S. shareholder on his pro rata share of such income as it is earned by the controlled foreign corporation, rather than when it is later distributed to the shareholder.

Traditionally, subpart F has eliminated deferral only on income that is passive or particularly mobile, because such income presents obvious opportunities for tax avoidance and tax-motivated behavior. This was subpart F's relatively limited goal upon enactment in 1962 and has remained its goal through nearly three decades of amendments. In contrast, income earned by a U.S.-controlled foreign corporation from less mobile, active business activities such as manufacturing is excluded from subpart F and is subject to U.S. tax only when the profits are repatriated to the United States. Subpart F presumes that bricks and mortar will not ordinarily be moved for tax reasons alone. In some circumstances, active business income may be diverted via a conduit company, from the locus of economic activity from which it arises to a low-tax jurisdiction. The "base company" rules for sales and services income under subpart F were enacted in part to prevent this abuse.

In evaluating subpart F, and any proposals to amend it, administrability is an important factor. We are dealing with foreign corporations engaged in international trade, often with unrelated persons in jurisdictions from which we can obtain little information. We must assure ourselves that both the taxpayer and the Internal Revenue Service (IRS) can identify and compute the tainted subpart F income with reasonable clarity.

Subpart F must also be viewed in conjunction with the foreign tax credit, since the elimination of deferral will sometimes have no U.S. tax impact. This occurs, generally, whenever the income being taxed under subpart F has already borne creditable foreign tax equal to or in excess of the U.S. rate. Because that income has borne as much foreign tax in its country of source as we would impose, the foreign tax credit ensures that we do not tax it again. Eliminating deferral also may have no impact on U.S. tax liability, however, even when the foreign tax on a particular item of income is low, if there are similar items of foreign income that are high-taxed. This is because of the mechanics of our limitation on the foreign tax credit.

The foreign tax credit is generally limited to prevent a credit against U.S. tax for foreign taxes that exceed the U.S. rate. To prevent excessive averaging of high and low foreign taxes, the foreign tax credit limitation is applied separately to various categories or "baskets" of income so that income that is ordinarily subject to high foreign taxes or that is not easily moved is separated from income that is ordinarily subject to low or no foreign tax (or income that might easily be moved to jurisdictions with low or no tax on such income). When there are more high taxes in one basket than low taxes, the result is excess foreign tax credits. Excess foreign tax credits can be carried forward only five years and, if still unused, then expire. If, however, there is low-taxed income in the same basket as high-taxed income, those foreign taxes can be averaged and may, in many cases, eliminate any residual U.S. tax on all the income in that basket.

Because of excess foreign tax credits in the residual or active income basket, some U.S. corporations are essentially indifferent to deferral. In fact, if these companies could elect to have their controlled foreign subsidiaries taxed currently as domestic corporations, we speculate that many would, in order to avoid an extra allocation of interest expense to foreign income (and a corresponding reduction in allowable foreign tax credits) that may occur because of the inability to consolidate foreign subsidiaries with the U.S. group for interest allocation purposes.

H.R. 2889

H.R. 2889 would expand subpart F by eliminating deferral on a new class of income of controlled foreign corporations called "imported property income." The bill defines "imported property income" broadly to include profits, commissions, fees, and any other form of income from property imported into the United States, whether derived in connection with its manufacture, production, growth, or extraction; sale, exchange, or other disposition; or lease, rental, or licensing. "Imported property" includes not only property imported into the United States by the controlled foreign corporation or a related person, but also property sold to an unrelated person, if it was reasonable to expect that the unrelated person would import the property, or a product which incorporates the property as a component, into the United States. Exceptions are provided for foreign oil and gas extraction income, foreign oil related income, and income from subsequently exported property.

In addition to the new subpart F income category, H.R. 2889 would create a new, separate foreign tax credit limitation basket for imported property income.

Because of a combination of factors, the Administration opposes H.R. 2889. First, we believe it will be exceedingly hard to administer and enforce and will add to the already considerable complexity of the taxation of U.S. multinationals. Second, we believe that the bill represents a significant departure from the traditional subpart F focus. Third, because of excess foreign tax credits and the opportunities for averaging of high and low foreign taxes within a basket, we think the bill could, in many cases, have little or no impact, even where a manufacturing plant is located in an offshore tax haven solely for tax purposes.

Our administrability, enforceability and complexity concerns are the most serious. The threshold fact that must be proved for the bill to apply -- that property produced by a controlled foreign corporation was destined for import into the United States -- would often be very difficult to determine. In the simplest case, where a finished product is shipped directly from a U.S.-controlled foreign corporation to the United States for consumption here, destination determination is straightforward. The bill itself, however, recognizes that simply addressing the direct import case is not enough since the simple case could be easily avoided. As a result, the bill requires tracing products through related and unrelated party sales (in the latter case under a "reasonable expectations" test), as well as tracing of components into the products in which they are embedded. These aspects of the bill's destination test are complex and would be unadministrable.

There are some destination-based rules already in the Code, such as the base company sales income rules under subpart F. Under these rules, a company earns subpart F foreign base company sales income when it re-sells property for use, consumption, or disposition in a country other than the same country in which it is incorporated. These rules generally do not present the significant enforcement problems that we foresee under H.R. 2889, however, because they address a narrower set of facts than the bill, i.e., either the buying or the reselling of the property must involve a related party. For this reason it is relatively easy for a foreign subsidiary to know whether it need be concerned about the base company rules. This in turn justifies the approach in the base company sales regulations which establish broad presumptions that the taxpayer must rebut. That is, all subsidiaries engaged in such purchases or re-sales are presumed to earn subpart F income unless the taxpayer can establish that the income is not subpart F income because of its source or destination. Thus, it is the taxpayer under these rules who has the incentive to know the destination of the property it sells.

It may not be feasible to adopt a comparable approach under H.R. 2889, i.e., to assume that all sales by foreign subsidiaries generate imported property income unless the taxpayer establishes the opposite. A presumption that property sold to an unrelated foreign person is destined for the country to which it is shipped would undercut the bill's rule, discussed below, that property is imported if it was "reasonable to expect" that it would be imported (or incorporated into a product that would be imported) by the unrelated buyer. A presumption that property sold to a related person was necessarily destined to be imported into the United States would be overbroad, given the common practice of locating production facilities overseas precisely to serve overseas, rather than U.S., markets.

As mentioned, the bill would tax the sale of property to an unrelated person if "it was reasonable to expect" that the property would be imported, presumably either by the unrelated buyer or anyone in its chain of distribution, whether related to the buyer or not. The IRS would thus be required to trace indirect sales through what may be a long chain of unrelated parties, some of whom may transform the property sold by the U.S. controlled foreign corporation or otherwise incorporate it into another product. In addition, the IRS would have to demonstrate whether the U.S.-controlled foreign corporation should reasonably have expected at the time of the initial sale that the property would ultimately be imported into the United States.

The first task could prove insurmountable without the cooperation of all of the parties. Such cooperation from unrelated foreign customers with no financial or legal interest in cooperating, however, may be unlikely. The IRS may also have

to trace sales through multiple unrelated foreign parties in several countries, including countries with which we have no tax treaty relationship and from which we cannot readily obtain information. The likelihood of obtaining accurate information and of being able to perform an audit in such a case is very low. If the transactions involve fungible property, such as minerals, agricultural products, or other commodities, the IRS would have no practical way to tell what was imported indirectly by a U.S.-controlled foreign corporation and what was not. Further, where property produced by a U.S-controlled foreign corporation is substantially transformed by its purchaser, as, for example, when bauxite mined by the controlled foreign corporation is used to make aluminum which is then imported into the United States, it is unclear whether the property that was transformed (the bauxite) should be considered imported property or not.

The second task, determining whether "it was reasonable to expect" that the property would be imported, would also be difficult. If reasonable expectations require an inquiry into intent, the inability to prove or disprove a state of mind at a point in the past will likely stymie effective enforcement. Even if reasonable expectations can be established by objective facts existing at the time of sale without an inquiry into intent, however, the task will not be easy. The investigation would require not only an examination of the documentary and other evidence actually in the U.S.-controlled foreign corporation's possession but also a determination of whether it was reasonable for the controlled foreign corporation not to have made further inquiry. Is it reasonable, for example, for a U.S.-controlled foreign corporation to rely on a buyer's statement that it has no present intention to import the property into the United States, or must the U.S.-controlled foreign corporation exercise some form of due diligence to look behind the statement? Must it go even further and insist on a warranty to enforce the statement?

From the perspective of the U.S.-controlled foreign corporation, the broad application of H.R. 2889 could also make a good faith attempt to comply very difficult. For example, the bill would require a U.S.-controlled foreign corporation selling personal computers to an unrelated Hong Kong company to predict whether the Hong Kong company would subsequently import the computers into the United States or sell the computers to a third party that would import them. Even if the U.S.-controlled foreign corporation had no indication of such intent, its income from the initial sale would become subject to current U.S. tax if it turns out that the computers actually were imported into the United States and it is found that the controlled foreign corporation should have anticipated that outcome.

The enforcement and compliance problems posed by H.R. 2889 are further complicated by the fact that the bill applies not only to finished products, but also to components that may be

incorporated into other products prior to importation. We recognize that, if the bill is to be effective, it cannot simply exempt component parts. On the other hand, the administrative and compliance burden could be overwhelming if components must be traced in every case, even where the imported product contains relatively few components manufactured by a U.S.-controlled foreign corporation.

It would be difficult, for example, to trace a component, such as a semiconductor chip, once it has been incorporated into a product, such as a personal computer. Such tracing might be impossible if the component is produced in accordance with the purchaser's specifications, as is often the case, and is therefore indistinguishable from components manufactured by other suppliers. As another example, where recycled paper and virgin paper from different sources are both used to produce cardboard boxes that are shipped both to the United States and abroad, the commingling of raw material inputs can make it impossible to distinguish which boxes contain which paper.

This problem is compounded because an unrelated foreign purchaser of components from a U.S.-controlled foreign corporation would have no incentive, financial or otherwise, to provide the information necessary to determine whether or not the components will be incorporated into products for the U.S. market. Indeed, the incentive is likely the opposite -- <u>not</u> to provide such information -- since it may be proprietary or of a competitively sensitive nature or quite costly to obtain. For example, a U.S.-controlled foreign corporation manufacturing television components may be aware that an unrelated foreign purchaser of such components is selling some of its output of televisions to the U.S. market. The purchaser, however, may well be unwilling to put in place the expensive inventory tracking mechanisms necessary to trace the components, solely for its supplier's benefit. Nor would such a purchaser divulge such information to a supplier if it were likely to give that supplier an advantage over other suppliers. If a U.S.-controlled foreign corporation component manufacturer insists on information from its foreign customers regarding the finished product into which the component is incorporated and its destination, the foreign customer might simply choose other, non-U.S. controlled sources of supply rather than disclosing sensitive, competitive information.

The administrative problems of H.R. 2889 are further complicated by the exception the bill provides for property imported into the U.S. but subsequently exported. It is common for U.S. manufacturers in certain industries to produce components overseas for use in U.S.-manufactured or U.S.-assembled products that are then sold both in U.S. and foreign markets. In some cases, this may be the only way for a U.S. manufacturer to avoid relying on a foreign-owned parts supplier.

Under the bill, however, if a U.S.-controlled foreign corporation is used, the U.S. manufacturer will be taxed on the controlled foreign corporation's income unless it can trace the parts through the finished product and show that the finished product is exported.

Even if U.S.-controlled foreign corporations can surmount these compliance problems and determine whether and to what extent their gross income is derived from "imported property," H.R. 2889 would result in onerous new accounting and reporting requirements. For example, to compute the amount of "imported property income," both for subpart F and for foreign tax credit purposes, the corporations would have to determine their expenses deductible against that income. This would place additional pressure on the already complex and controversial expense apportionment provisions of the Code and the regulations. Where the imported property income arises as the result of the unanticipated subsequent actions of an unrelated party, the U.S.-controlled foreign corporations may not have maintained books and records to support an allocation of expenses.

Compliance and enforcement problems are not the sole reason for opposing this bill. As noted above, subpart F generally does not tax non-mobile, active income such as most income from manufacturing. Since H.R. 2889 would impose current U.S. tax on a category of non-mobile, active business income, it departs in an important way from the traditional rationale for subpart F.

Foreign production of goods for the U.S. market may, in many cases, be primarily attributable to factors such as the proximity of raw materials and other natural resources, or to comparative economic advantages such as lower labor costs or a more favorable climate. In comparison, the data suggest that taxes often represent a relatively small part of total costs, particularly where the savings are not likely to be inflated artificially by non-arm's length transfer pricing.

Further, the goods produced by a U.S.-owned company abroad may not necessarily replace those that it would produce if it were operating in the United States. The most obvious example is that of agricultural products, such as bananas, or minerals that cannot be grown or extracted in adequate quantities in the United States because of climate or insufficient deposits. The bill appears to recognize the importance of some geographical limitations, since it provides an exception for foreign oil and gas extraction income and foreign oil related income, but it ignores other geographic factors. The bill may, therefore, serve to increase taxes for U.S.-controlled foreign agricultural companies or non-oil mineral companies that have no choice but to produce or extract abroad.

Finally, we have serious reservations about whether the bill would accomplish its intended purposes in certain circumstances. Commerce Department data indicate that a relatively small share -- approximately 15 percent -- of total imports come from U.S. affiliates located in low-tax countries. Most imports from affiliates are from Canada, Japan and Europe. If the same U.S. multinational company that imports from its manufacturing plant in a low-tax country also imports from an affiliate in relatively high-tax Canada or Germany, the excess foreign tax credits from the Canadian or German imports would be averaged with those from the low-taxed country imports, since both would be in the new "imported property income" basket. Those credits would thus shield the low-taxed country income from residual U.S. tax under an amended subpart F. This could, of course, essentially eliminate the impact of the bill for such companies.

U.S. Election for Controlled Foreign Corporations

The Committee has also requested our views on allowing U.S. shareholders to elect to treat their controlled foreign corporations as U.S. corporations for tax purposes. The Administration opposes this proposal because it would entail a substantial revenue loss. Preliminary estimates are that the provision would lose about $1.5 billion over the five-year budget window, even with safeguards.

Obviously, taxpayers would make such an election only if it reduced their U.S. tax liability. A reduction in U.S. taxes could occur for a significant number of U.S. multinationals through the greater use of foreign tax credits obtained via the election. Specifically, the election would permit a U.S. multinational to treat its controlled foreign corporations as members of its U.S. affiliated group for purposes of allocating interest expense between domestic and foreign source income. The effect for many U.S. multinationals would be a smaller allocation of interest expense to foreign source income. The resulting increase in foreign source income would permit the multinational to utilize more foreign tax credits. While the existing interest allocation rules are often criticized on policy grounds for allocating too much interest expense to foreign source income, and the elimination of deferral via the U.S. election would remove a policy objection to allocating interest on a worldwide group basis, elective relief from these rules would be very costly.

If such a provision were to be considered by Congress, certain safeguards could be desirable to help to minimize revenue loss and to prevent abuse. These include a consistency rule requiring that a U.S. shareholder make the election with respect to all affiliated controlled foreign corporations of which it is a U.S. shareholder, and not merely those that generate net

operating losses or bear high foreign taxes. In addition, each controlled foreign corporation to which an election applied could be treated as transferring all of its assets to a domestic corporation at the time of the election, and the "toll charge" now imposed on inbound reorganizations could apply. Finally, restrictions could be imposed on revocation of the election.

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CONTACT: Barbara Clay
202-566-5252

STATEMENT BY TREASURY SECRETARY NICHOLAS BRADY

As we approach the G-7 meeting in Bangkok, I welcome the report that twelve republics have initialed an "economic commonwealth" agreement. This agreement, if fully supported by all major republics, will serve as a valuable step forward for discussions with the Soviets in Bangkok.

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NB-1487

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TEXT PREPARED FOR DELIVERY

REMARKS BY
NICHOLAS F. BRADY
SECRETARY OF THE TREASURY
TO THE
BUSINESSWEEK SYMPOSIUM OF CHIEF EXECUTIVE OFFICERS
OCTOBER 4, 1991

Thank you, Jack.

As you know, one of the President's top priorities this year is to reform the out-of-date laws governing our financial services industry. In preparing for this speech, I looked back at some of the speeches I gave in the spring of this year, when we first introduced the President's financial services reform proposal. At that time, everyone was predicting the proposal was doomed to failure. During the intervening months, we've worked hard, along with a number of Members of Congress, to keep this comprehensive proposal on track.

Despite tremendous controversy and several obituaries, we've achieved a great deal of progress. In the face of all the predictions that our bill was dead on arrival, let's look at what's been accomplished. The banking committees in both the House and Senate have adopted provisions calling for prompt regulatory action, limits on risky activities, limitations on insurance coverage for brokered deposits, and interstate branching. Reports of bank reform's death were greatly exaggerated.

Following the August Congressional recess, supporters of a comprehensive bill approached the fall session with the very real possibility of achieving meaningful reform. But then Congress reconvened, additional Congressional committees took up the bill, adding new restrictions, and for a brief moment, I recalled a very meaningful quote: "There are moments when everything goes well; don't be frightened, it won't last."

Let me say again, we firmly believe that fair and competitive comprehensive reform is possible, but we are now at a very familiar crossroads on banking reform legislation. The debate has started to stray from larger principles to industry-specific concerns on the bill. Lobbyists for various financial service industries are jockeying for special pieces of the pie,

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just as they have every other time the Congress has tried to deal with comprehensive banking reform. All the historical arguments that banking reform is just internecine warfare -- one faction of the financial services industry protecting it's turf against another faction -- seem to again be coming true.

But this time, the situation is different. The stakes are higher, and the issue is just too important to allow competing interests to self-destruct and thereby destroy the process.

The stakes are higher because the banking industry has some serious problems, and we must recapitalize the Bank Insurance Fund this year. Therefore, it is mandatory that we have some kind of banking legislation this year. The big question which has always lingered is whether it will be a "band-aid" approach, or true reform.

You don't need me to tell you that the banking industry is troubled. You have been reading about it in the newspapers for months. Bank failures are at an all-time high, and the Bank Insurance Fund (BIF) is at a low level. But the important point is that these are not just bank statistics -- they are business, consumer, and taxpayer concerns. The good news is that through true reform, we can do something about it. The bad news is there are those in Congress who don't want to.

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

The credit crunch is just one symptom of the problems facing the banking industry. I don't want to oversimplify. There are numerous causes of the credit crunch. Clearly, the recession is a major cause, along with overbuilding in the commercial real estate industry, and reported overkill on the part of bank examiners. But the underlying cause is more fundamental.

Our financial institutions were weak heading into the recession. The result is that banks are not performing their function as "shock absorbers", lending to businesses and individuals to help pull them through the tough times. Instead of making loans, banks are pulling back and improving their balance sheets, running to quality. And that's not just a problem for the banks -- that's a problem for business and consumers.

The needs of businesses and consumers have outgrown and outpaced our financial service institutions and the laws which govern them. The marketplace has already found innovations which bypass out-of-date laws and have left the traditional banking system out in the cold. If we don't face today's reality, tomorrow's reality will be a second-class financial system.

It reminds me of Louis XV of France. As the citizens began to advance on the French aristocracy, the King turned to an aide and asked, "Is this a revolt?" His aide replied, "No Sir, it is a revolution." We are facing a technological revolution. In a world where plastic money cards are replacing checks, and even cash, it is time for our laws to catch up with reality.

Consumers long ago began to ignore the artificial restrictions on banking practices, using credit cards, cash machines, and the 800 number to handle their financial affairs when and where they want. Customers have increasingly turned away from the banks, and now get auto loans from GMAC and Ford Motor Credit, checking services from Vanguard and Fidelity mutual funds, business loans through General Electric Credit Corporation and Goldman Sachs, and they save at Merrill Lynch and Sears Roebuck.

President Bush has proposed the first true change in the banking industry and securities markets in over 50 years.

-- First, make deposit insurance safe for U.S. taxpayers and depositors by increasing market discipline, promptly addressing weak banks, and strengthening supervision. We will confront problems at banks before they become problems for the Bank Insurance Fund, or, potentially the taxpayer.

-- Second, modernize archaic laws, which artificially restrict competition among financial services companies. Allowing banks to branch across state lines will lead to greater efficiency, and enormous benefits will result for consumers and communities. And permitting well-capitalized banks to affiliate with securities and insurance firms will make these institutions more competitive and better able to serve customers.

-- Third, link risk-based premiums to capital levels. This will reward strong banks -- particularly smaller banks -- and encourage weak banks to raise additional capital, making them safer and healthier.

-- Fourth, end the restriction on commercial ownership of banks to make more private capital available to the industry. We should open the door to capital for banks -- and certainly for failing institutions, where the alternative could be taxpayers' money. Let me give you a statistic -- 33 commercial firms have bought thrifts and pumped over $3 billion of capital into those thrifts, making stronger institutions.

The bipartisan plan for reforming the banking system is simple and straightforward. It is based on the time-proven philosophy of free and open competition. We believe that competition will lead to a stronger and more profitable financial services industry. Opponents of banking reform should not be allowed to protect markets for the benefit of entrenched interests.

Banking reform is alive in the Congress. The reform proposal is on the table. But, as we head into the final days of the Congressional session, turf battles between Congressional committees inevitably lie ahead. Similar turf battles in past debates have traditionally led to Congressional paralysis -- or worse, legislation aimed at protecting special interests. But, this time, we must put the American people ahead of turf.

The special interest arguments are also the same as in previous years. Opponents of true reform will tell you it is deregulation all over again. It is not. Our reform proposal rejects artificial restrictions in the name of protection. It brings 1930's banking laws into the 21st century, while providing strong new supervisory standards that will make banks both safer and stronger.

I am shocked that opponents of true reform want more of what weakened our financial system in the first place. We don't need re-regulation and special interest protection. And we certainly don't need more rules that distort markets and artificially restrict competition.

We knew we would eventually reach this point in the debate, but there are strong advocates of reform on both sides of the aisle -- Democrats and Republicans. We will continue to work together with them, but Congress has to act, and it has to act now.

There will be a banking bill this year. Congress must act to recapitalize the Bank Insurance Fund, and they know they must act this year. If we do it right this time -- if we recapitalize the Bank Insurance Fund with industry money, if we adopt changes to make banks safer, stronger and healthier -- we will have faced the challenge before us.

But if the foes of reform run to a narrow banking bill, a bill which does not address the issues of the day, then we face the real possibility of having to approve another recapitalization bill down the road -- perhaps the next time with taxpayer funds. And that means those who oppose competitive reform this year may have to answer to the taxpayers the next time for refusing to act when they had the chance.

The reform coalition is not discouraged. We are right, we have the time to act this year, and we have the makings of historic banking reform legislation. We can create a modern financial system that is internationally competitive, that will protect depositors, save taxpayers money, serve consumers and strengthen the economy. The strength, if not the future, of our banking system depends on whether we can stand on principle. By facing up to the marketplace of today, we can help to ensure financial security for the future.

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AUCTION RESULTS

PUBLIC DEBT NEWS

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

FOR RELEASE AT 3:00 PM
October 4, 1991

Contact: Peter Hollenbach
(202) 219-3302

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

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

	Dollar Amounts in Thousands
Principal Outstanding (Eligible Securities)	$544,825,443
Held in Unstripped Form	$414,228,648
Held in Stripped Form	$130,596,795
Reconstituted in September	$4,701,960

The accompanying table gives a breakdown of STRIPS activity by individual loan description. The balances in this table are subject to audit and subsequent revision. These monthly figures are included in Table VI of the Monthly Statement of the Public Debt, entitled "Holdings of Treasury Securities in Stripped Form." These can also be obtained through a recorded message on (202) 447-9873.

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PA-71

TABLE VI—HOLDINGS OF TREASURY SECURITIES IN STRIPPED FORM
(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	$5,428,154	$1,230,400	-0-
11-1/4% Note A-1995	2/15/95	6,933,861	6,438,341	495,520	-0-
11-1/4% Note B-1995	5/15/95	7,127,086	5,866,126	1,260,960	$216,960
10-1/2% Note C-1995	8/15/95	7,955,901	7,272,301	683,600	-0-
9-1/2% Note D-1995	11/15/95	7,318,550	6,243,750	1,074,800	-0-
8-7/8% Note A-1996	2/15/96	8,575,199	8,349,599	225,600	-0-
7-3/8% Note C-1996	5/15/96	20,085,643	19,821,643	264,000	-0-
7-1/4% Note D-1996	11/15/96	20,258,810	19,948,410	310,400	-0-
8-1/2% Note A-1997	5/15/97	9,921,237	9,820,037	101,200	-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	9,747,529	60,800	-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	9,128,387	37,000	-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	9,605,275	297,600	-0-
8-7/8% Note A-1999	2/15/99	9,719,623	9,602,823	116,800	-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	10,373,030	123,200	-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	11,308,802	4,000	-0-
8% Note B-2001	5/15/01	12,398,083	12,398,083	-0-	-0-
7-7/8% Note C-2001	8/15/01	12,339,185	12,337,585	1,600	-0-
11-5/8% Bond 2004	11/15/04	8,301,806	4,437,806	3,864,000	540,800
12% Bond 2005	5/15/05	4,260,758	1,818,108	2,442,650	215,800
10-3/4% Bond 2005	8/15/05	9,269,713	8,385,713	884,000	20,000
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	1,576,784	4,428,800	222,400
11-1/4% Bond 2015	2/15/15	12,667,799	2,156,599	10,511,200	13,280
10-5/8% Bond 2015	8/15/15	7,149,916	1,679,516	5,470,400	110,400
9-7/8% Bond 2015	11/15/15	6,899,859	2,215,059	4,684,800	236,800
9-1/4% Bond 2016	2/15/16	7,266,854	6,515,654	751,200	32,000
7-1/4% Bond 2016	5/15/16	18,823,551	17,089,151	1,734,400	100,000
7-1/2% Bond 2016	11/15/16	18,864,448	15,940,288	2,924,160	435,360
8-3/4% Bond 2017	5/15/17	18,194,169	6,179,129	12,015,040	310,880
8-7/8% Bond 2017	8/15/17	14,016,858	9,455,258	4,561,600	225,600
9-1/8% Bond 2018	5/15/18	8,708,639	2,302,239	6,406,400	56,000
9% Bond 2018	11/15/18	9,032,870	1,200,070	7,832,800	80,000
8-7/8% Bond 2019	2/15/19	19,250,798	5,026,798	14,224,000	321,600
8-1/8% Bond 2019	8/15/19	20,213,832	10,975,752	9,238,080	193,600
8-1/2% Bond 2020	2/15/20	10,228,868	4,072,068	6,156,800	210,000
8-3/4% Bond 2020	5/15/20	10,158,883	2,998,563	7,160,320	478,560
8-3/4% Bond 2020	8/15/20	21,418,606	7,588,686	13,829,920	200,640
7-7/8% Bond 2021	2/15/21	11,113,373	8,620,573	2,492,800	139,200
8-1/8% Bond 2021	5/15/21	11,958,888	10,393,448	1,565,440	342,080
8-1/8% Bond 2021	8/15/21	12,163,482	12,163,482	-0-	-0-
Total		544,825,443	414,228,648	130,596,795	4,701,960

[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.

signed 12:23 p.m. EDT

THE WHITE HOUSE

Office of the Press Secretary

For Immediate Release October 4, 1991

EXECUTIVE ORDER
#12775

PROHIBITING CERTAIN TRANSACTIONS WITH RESPECT TO HAITI

By the authority vested in me as President by the Constitution and the laws of the United States of America, including the International Emergency Economic Powers Act (50 U.S.C. 1701 et seq.), the National Emergencies Act (50 U.S.C. 1601 et seq.), and section 301 of title 3 of the United States Code,

I, GEORGE BUSH, President of the United States of America, find that the grave events that have occurred in the Republic of Haiti to disrupt the legitimate exercise of power by the democratically elected government of that country constitute an unusual and extraordinary threat to the national security, foreign policy, and economy of the United States, and hereby declare a national emergency to deal with that threat.

I hereby order:

Section 1. Except to the extent provided in regulations, orders, directives, or licenses which may hereafter be issued pursuant to this order, all property and interests in property of the Government of Haiti, its agencies, instrumentalities and controlled entities, including the Banque de la Republique d'Haiti, that are in the United States, that hereafter come within the United States, or that are or hereafter come within the possession or control of United States persons, including their overseas branches, are hereby blocked.

Sec. 2. Except to the extent provided in regulations, orders, directives, or licenses which may hereafter be issued pursuant to this order, any direct or indirect payments or transfers to the de facto regime in Haiti of funds, including currency, cash or coins of any nation, or of other financial or investment assets or credits, by any United States person, or by any person organized under the laws of Haiti and owned or controlled by a United States person, are prohibited. All transfers or payments owed to the Government of Haiti shall be made when due into an account at the Federal Reserve Bank of New York, or as otherwise may be directed by the Secretary of the Treasury, to be held for the benefit of the Haitian people.

Sec. 3. For the purposes of this order:

(a) The term "de facto regime in Haiti" means those who seized power illegally from the democratically elected government of President Jean-Bertrand Aristide on September 30, 1991, and includes any persons, agencies, instrumentalities, or entities purporting to act on behalf of the de facto regime, or under the asserted authority thereof, or any extraconstitutional successor thereto.

more

(OVER)

(b) The term "United States person" means any United States citizen, permanent resident alien, juridical person organized under the laws of the United States, or any person in the United States.

Sec. 4. The measures taken pursuant to this order are not intended to block private Haitian assets subject to the jurisdiction of the United States, or to prohibit remittances by United States persons to Haitian persons other than the de facto regime in Haiti.

Sec. 5. The Secretary of the Treasury, in consultation with the Secretary of State, is hereby authorized to take such actions, including the promulgation of rules and regulations, and to employ all powers granted to me by the International Emergency Economic Powers Act, as may be necessary to carry out the purposes of this order. Such actions may include prohibiting or regulating payments or transfers of any property, or any transactions involving the transfer of anything of economic value, by any United States person to the de facto regime in Haiti. The Secretary of the Treasury may redelegate any of these functions to other officers and agencies of the United States Government, all agencies of which are hereby directed to take all appropriate measures within their authority to carry out the provisions of this order, including suspension or termination of licenses or other authorizations in effect as of the date of this order.

Sec. 6. This order is effective immediately.

Sec. 7. Nothing contained in this order shall confer any substantive or procedural right or privilege on any person or organization, enforceable against the United States, its agencies or its officers, or the Federal Reserve Bank of New York or its officers.

This order shall be transmitted to the Congress and published in the Federal Register.

GEORGE BUSH

THE WHITE HOUSE,
October 4, 1991.

To be published
10/7/91

# # #

AUCTION RESULTS

PUBLIC DEBT NEWS

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

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DEPT. OF TREASURY

FOR IMMEDIATE RELEASE
October 7, 1991

CONTACT: Office of Financing
202-219-3350

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Tenders for $10,804 million of 13-week bills to be issued October 10, 1991 and to mature January 9, 1992 were accepted today (CUSIP: 912794XU3).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.03%	5.18%	98.729
High	5.04%	5.19%	98.726
Average	5.04%	5.19%	98.726

$6,895,000 was accepted at lower yields.
Tenders at the high discount rate were allotted 77%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	33,290	33,290
New York	28,784,765	9,208,295
Philadelphia	39,895	39,895
Cleveland	54,865	54,865
Richmond	48,975	48,285
Atlanta	39,555	37,555
Chicago	1,175,125	204,105
St. Louis	55,275	15,275
Minneapolis	7,365	7,335
Kansas City	40,955	40,955
Dallas	23,110	22,110
San Francisco	554,505	79,515
Treasury	1,012,935	1,012,935
TOTALS	$31,870,615	$10,804,415
Type		
Competitive	$27,656,880	$6,590,680
Noncompetitive	1,751,315	1,751,315
Subtotal, Public	$29,408,195	$8,341,995
Federal Reserve	2,289,930	2,289,930
Foreign Official Institutions	172,490	172,490
TOTALS	$31,870,615	$10,804,415

An additional $84,410 thousand of bills will be issued to foreign official institutions for new cash.

NB-1489

PUBLIC DEBT NEWS

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

OCT 3 1 0 0 0 9 7 4
DEPT. OF THE TREASURY

FOR IMMEDIATE RELEASE
October 7, 1991

CONTACT: Office of Financing
202-219-3350

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Tenders for $10,852 million of 26-week bills to be issued October 10, 1991 and to mature April 9, 1992 were accepted today (CUSIP: 912794YH1).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.06%	5.28%	97.442
High	5.08%	5.30%	97.432
Average	5.08%	5.30%	97.432

$945,000 was accepted at lower yields.
Tenders at the high discount rate were allotted 67%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	37,990	37,990
New York	26,062,480	8,961,915
Philadelphia	18,785	18,785
Cleveland	32,935	32,935
Richmond	47,560	45,910
Atlanta	39,495	39,210
Chicago	1,571,765	698,365
St. Louis	36,950	20,300
Minneapolis	8,785	8,785
Kansas City	51,940	51,940
Dallas	23,705	23,705
San Francisco	720,285	161,175
Treasury	750,810	750,810
TOTALS	$29,403,485	$10,851,825
Type		
Competitive	$25,421,665	$6,870,005
Noncompetitive	1,335,610	1,335,610
Subtotal, Public	$26,757,275	$8,205,615
Federal Reserve	2,100,000	2,100,000
Foreign Official Institutions	546,210	546,210
TOTALS	$29,403,485	$10,851,825

An additional $287,490 thousand of bills will be issued to foreign official institutions for new cash.

NB-1490

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TREASURY NEWS

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DEPT. OF THE TREASURY

Embargoed Until 3PM
October 8, 1991

Contact:
Claire Buchan
566-8773

EASING THE CREDIT CRUNCH TO PROMOTE ECONOMIC GROWTH

Secretary of the Treasury Nicholas Brady today announced new steps in the Administration's ongoing efforts to address "credit crunch" problems identified by the business community, bankers, and regulators. The steps build on the President's economic agenda and are aimed at sustaining the economic recovery.

"Maintaining the economic recovery depends on banks playing their traditional role, businesses making investments, and consumers purchasing goods and services," Brady said. Recent statistics show employment levels, housing starts, and industrial production rising. The Administration wants to insure that proper balance in the regulation of the banking sector continues the upward trend and that Congress passes other Administration economic growth proposals.

The Administration's new steps were developed in consultation with the Federal Reserve Board, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and the Office of Thrift Supervision. They are designed to promote confidence and balance in the lending environment, and to help businesses and consumers in their economic activity.

The Administration's program builds on the previous efforts by the Treasury Department and financial regulators to assure that sound businesses and consumers can get needed credit. These efforts include encouraging lenders to make prudent loans and assuring that examiners perform their reviews in a balanced, sensible manner. The federal banking and thrift regulators have stated that they do not want the availability of credit to sound borrowers to be adversely affected by supervisory policies or depository institutions' misunderstandings about them.

In particular, the Administration, while avoiding any encouragement of regulatory laxity, wants to ensure that the specific guidance issued by the regulators over the past several months is being fully implemented by examiners in the field, and that additional opportunities for assuring balanced regulation are pursued. Among the areas addressed are:

NB-1491

- Directives that bankers should work constructively with borrowers experiencing temporary difficulties and facilitate the orderly restructuring of credits;
- Prudent refinancing of economically sound commercial real estate loans;
- Improved verification by regulatory supervisors that recent policy changes and clarifications are appropriately applied in each examination;
- Enhancements in the process for appeals of alleged misapplication of regulatory standards;
- Harmonization of the treatment of preferred stock in U.S. capital standards with other signatory countries under the Basle capital accord;
- Appropriate application of valuation standards especially in real estate credits so as to avoid a liquidation approach to valuation;
- Improved guidance in the appraisal process and steps to reduce excessive appraisal costs for lenders;
- Legislative action to make permanent recent EPA regulations to limit lender liability for environmental cleanup of loan collateral properties;

This program is in addition to the President's comprehensive economic growth package, which has been stalled in the Congress. These proposals designed for increasing job-creating investment include: reducing the capital gains tax, permanently extending the research and experimentation tax credit, establishing enterprise zones, and promoting saving through Family Savings Accounts and expanded Individual Retirement Accounts. "These proposals should be voted upon without delay," Brady said.

"Congress can also help by passing the Administration's comprehensive banking reform legislation and approving its nominees for top financial regulatory positions which are before the Senate. Holding up these measures and appointments creates further uncertainty about fiscal, monetary, and regulatory policies," Brady said.

Details of the Administration program are found on the attached fact sheet.

EASING THE CREDIT CRUNCH TO HELP PROMOTE ECONOMIC GROWTH

FACT SHEET

I. NEW REGULATORY ACTIONS TO BE IMPLEMENTED

A. Efforts to Improve Lending Environment

Conform U. S. Implementation of Basle Capital Standards

Conform U. S. treatment of Preferred Stock in Tier One capital with other countries under the Basle accord. No amendment to the Basle capital standards is needed.

Removing this ceiling will give bank holding companies an additional method of raising Tier One capital, as there are investors who prefer preferred stock to common shares.

This could result in an increase in Tier One capital and thus expand lending capacity.

The target date for completing this conforming change is October 31, 1991.

B. Build Banker Confidence

1. Enhanced Examination Appeals Process

Each agency has an existing appeals process for bankers who believe that examiners have made an error in their evaluation of loans. Although the guidelines issued March 1st encouraged bankers to take advantage of this mechanism, few bankers have done so.

Thus, it is recommended that the appeals process be strengthened by allowing a banker to appeal directly to senior officials or a Reserve Bank President separate from the supervisory process. Investigations would be conducted in a confidential manner.

Each regulatory agency will implement this system by November 15, 1991.

2. Improve Examination Management

In order to further assure that consistent and balanced examination standards are applied, agencies will take the following steps:

a. Regional supervisory management will be required to:

i) make sure that the March 1st policy changes and clarifications, and all subsequent guidelines, have been effectively communicated to each examiner;

ii) make sure that these policy changes and guidelines have been explained to the banker by the examiner in each examination; and

iii) certify that these policy changes and clarifications, and all subsequent guidance, have been followed by examiners in each exam.

These policy changes and clarifications include the instruction that:

- bankers should work in an appropriate and constructive fashion with borrowers who may be experiencing temporary difficulties;

- income producing property loans are to be assessed on the income-producing capacity of the properties over time. Examiners should take into account the lack of liquidity and cyclical nature of real estate markets. Liquidation appraisal values are to be used only if the property is to be liquidated;

- banks with real estate concentrations should not automatically refuse new credit to sound real estate developers or to work with existing borrowers;

- regulatory agencies do not have rigid rules (or percentages) on asset concentrations, as bankers and regulators know well the benefits of adequate portfolio diversification;

- institutions attempting to raise capital by shrinking assets should avoid actions such as the sale of all high-quality assets. Such actions by themselves, or the refusal to make sound, new loans, fail to achieve an important goal of improving the quality of the institution's loan portfolio;

- bankers and examiners should not lump all real estate together: distinctions should be made. For example, credit for a residential builder, should not be automatically penalized by local oversupply conditions in commercial office development;

- bankers should facilitate the orderly restructuring of

troubled credits by using established techniques under FASB 15, "Troubled Debt Restructurings"; and

- o banks should be able to prudently refinance commercial real estate loans without fear of regulatory retribution ("mini-perm" guidance).

b. The agencies will develop a method for regular communication with bankers by central office and/or regional senior personnel to determine banker views on the fairness and balance of examination standards and practices. Examples of this communication would include polling and regular meetings with bankers.

The agencies will implement these changes by November 15, 1991.

C. Improve Real Estate Guidance

1. Real Estate Valuation Policies

The bank and thrift regulatory agencies have been developing a uniform and comprehensive set of real estate examination guidelines, especially for real estate in troubled markets. These detailed guidelines cover loan classification procedures, indicators of troubled loans, proper analysis of appraisals and loan values, and proper reserve analysis.

These guidelines will be released by October 31, 1991 and will be distributed to all examiners -- and bankers.

2. Use of Appraisals

As a part of Subsection 1 above, a letter will be sent by the primary regulator to every bank chief executive outlining the guidelines for using appraisals emphasizing balance and appropriate time lines.

3. Random Audit Program

The regulatory agencies would establish quality control through a random audit program to determine how examiners are using appraisals in the loan documentation process.

This can be implemented by October 31, 1991.

4. Appraisal Costs

The Administration supports the actions taken recently by the regulatory agencies to limit the costs of appraisals on residential real estate loans by raising the minimum loan size subject to appraisal requirements to $100,000 from $50,000.

The Administration calls on the regulatory agencies to consider additional steps that can be taken administratively to lower the burden of appraisal costs, especially for home buyers and small business.

The agencies will report their recommendations to the Secretary of the Treasury by January 1, 1992.

D. Further Clarify the Definition of Highly Leveraged Transaction (HLT)

Leveraged borrowers in businesses such as cable television or broadcast media have cited the HLT definition as unreasonably restraining credit to their industries.

The agencies published their definition for public comment in the *Federal Register*. The comment period concluded on September 23, 1991, resulting in over 200 comment letters.

The regulatory agencies will review the comments and propose improvements to the definition by December 1, 1991.

E. Convene National Meeting of Examiners

The Treasury Secretary has requested that by mid-November, 1991, the regulatory agencies convene a meeting of all key supervisory management and senior field examination professionals.

Examiners would participate in a series of meetings about the economy and a thorough briefing on the policy changes and guidelines and their application.

II. PROPOSALS THAT WOULD HELP CURE THE CREDIT CRUNCH WHICH REQUIRE ACTION BY CONGRESS

The Administration supports a number of legislative proposals that would promote savings and economic growth, make the financial sector more efficient and create a better climate for lending. These include:

A. Banking Reform

The President's Banking Reform bill will spur confidence for investment by assuring that the United States has a modern banking system with stronger, safer banks.

Stronger, more competitive banks would have greater flexibility in working with borrowers to avoid future credit crunches.

B. Lender Liability Reform

Banks have been reluctant to make certain loans because of recent court cases that have found lenders liable for environmental clean-up costs, even when the bank's only interest in a property is a security interest to secure a loan.

To address this uncertainty concern, the EPA issued a proposed regulation interpreting the Superfund Act which would properly limit lenders' liability for any Superfund clean-up costs as long their participation is merely that of a lender, and not a long term operator.

To make this certainty permanent, the Administration is supportive of efforts to further clarify these rule changes in statute.

C. The President's Growth Initiatives

To increase demand and boost asset values, including real estate, the Administration continues to urge Congress to pass the President's growth package. The program would:

- reduce the capital gains tax rate;
- enhance personal savings through an expanded Individual Retirement Account (IRA) and Family Savings Account;
- make the Research and Experimentation (R&E) tax credit permanent;
- increase federal investment in science, technology and infrastructure;
- reform the education system; and
- keep the discipline of the budget agreement.

D. Nominees for Regulatory Positions

Three out of four bank and thrift regulatory agencies are without a Senate-confirmed head. Presidential nominees for regulatory positions awaiting Senate confirmation, include two members and the Chairman of the Federal Reserve Board, as well as the Comptroller of the Currency and the Chairman of the FDIC.

The Administration urges Congress to eliminate uncertainty about the direction of monetary policy and regulatory leadership by acting quickly to confirm the President's

nominees. Congress' preoccupation with second guessing regulators has continued to exacerbate the credit crunch.

E. Bankruptcy Reform

Some in Congress and the American Bankers Association point out that recent court decisions, a developing social acceptability of bankruptcy, and aggressive tactics by borrowers have weakened bankruptcy practices and thus, reduced the willingness of bankers to lend.

The Justice Department has recently undertaken a comprehensive review of the bankruptcy law and practice. The President has asked the Acting Attorney General to complete this review, analyze pending legislative initiatives, and, together with the Secretary of the Treasury, evaluate their impact on credit extensions by financial institutions.

This report will be made to the Economic Policy Council in January 1992.

The Economic Policy Council and the regulatory agencies will continue to review the credit crunch and related issues.

TREASURY NEWS

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

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DEPT. OF THE TREASURY

FOR RELEASE AT 2:30 P.M.
October 8, 1991

CONTACT: Office of Financing
202-219-3350

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $21,600 million, to be issued October 17, 1991. This offering will provide about $3,900 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $17,703 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239-1500, Tuesday, October 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 $10,800 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 $22,880 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $ 10,800 million, to be dated October 17, 1991, and to mature April 16, 1992 (CUSIP No. 912794 YJ 7).

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

The bills will be issued for cash and in exchange for Treasury bills maturing October 17, 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 $741 million as agents for foreign and international monetary authorities, and $ 4,597 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-1492

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

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For Immediate Release
October 8, 1991

Contact: Anne Kelly Williams
(202) 566-2041

Statement by
Acting Secretary of the Treasury
John E. Robson

Today the Financial Institutions Subcommittee of the House Banking Committee reported out legislation that is flawed and inadequate. Among other things, this legislation fails to provide adequate funding for the RTC; imposes new bureaucratic obstacles on the RTC; and busts the budget agreement between Congress and the Administration. This legislation would delay the savings and loan clean-up and raise the costs to the American taxpayer.

We urge the full committee to take responsible action to address these flaws.

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NB-1493

TREASURY NEWS

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

Remarks of the Honorable
Robert R. Glauber
Under Secretary of the Treasury for Finance
before the
Forum on Cooperation Between Shareholders and Corporations

October 3, 1991

Introduction

Good afternoon. It is a pleasure to be here today to discuss corporate governance. Let me especially commend Michael Jacobs on rounding up such an able group of individuals. It reminds me of President Kennedy's remark, at a state dinner of collected notables, that the White House had not seen such an assemblage of talent since Thomas Jefferson dined alone.

The standard of living of Americans clearly depends upon the success of our nation's businesses, and their ability to compete in the international arena. The effectiveness of how our corporations are run becomes an issue of national significance.

International events over the last few months, as well as the last few years, show that nation after nation is acknowledging that free people and free markets are necessary to deliver the highest standard of living to their citizens. The revolutions that have taken place in Eastern Europe and the Soviet Union have been won on the basis not of military strength but of ideas, and the quality of life we have achieved in America has made our system of democratic capitalism the envy of the world. As the rest of the world is adopting our rules, we are competing in an increasingly global economy with the home field advantage.

But we also face unprecedented competition. The other players are getting economically stronger and, in many cases, growing faster. We need to invigorate our economy to preserve our role as the world's leading economy.

There is also a broader risk if corporate America on its own does not perform effectively. Many will encourage the federal government to become more involved, like the Japanese, in targeting our industries of the future, deciding where federal capital should be funneled, and protecting those industries. I am troubled by the underlying assumption that government always knows best -- even though I am now part of it. The marketplace is the best allocator of capital to good ideas and projects. The role of the government should be to create a stable and healthy economic climate and then to minimize unnecessary restraints upon businesses.

It is most appropriate that this forum be held now.

The Ideal System

I do not mean to imply that there is no need for improvement in corporate America, nor am I suggesting that a radical restructuring of U.S. industry is required. Rather, I believe we need to look for ways to improve the existing structure. I would characterize most of the corporate governance issues which you are addressing at this forum as examples of ways to improve the existing system.

Right now, we have a corporate governance system which appears to rely on a troika approach:

Management, which sets the strategic plan for the business and manages the day-to-day operations.

The Board of Directors, which approves the strategic direction set by management, monitors management's performance and holds management accountable to shareholder interests.

Shareholders, the true owners, who provide patient capital and select members of the board to look after their interests.

When these three entities work together to maximize shareholder value, everyone benefits. Each in its way should contribute to improving corporate performance through creating value, rather than merely skimming personal profits at the others' expense. If any of these groups is less than fully engaged, the three-legged stool is unbalanced.

Problems with the System

Unfortunately, the reality often belies the theory -- the system does not always work the way it should. In many companies, an adversarial relationship has developed between management and owners. Shareholders complain that management focuses less on long-term value than their own job and pay security, and on insulating themselves from accountability to shareholders rather than on making the company more competitive.

Management counters that it is pressure from short-sighted investors, who sell on quarterly earnings reports without consideration of long-term prospects, which shortens investment time horizons. However, shareholders in turn argue that they only sell because management is not responsive to their concerns. This adversarial attitude continues to feed on itself.

Improving the System

It does not have to be this way. Institutional investors, who own the majority of shares of public companies, do not benefit from short-term trading. Most of them underperform the market average. Furthermore, as they continue to accumulate assets, it becomes more and more difficult for them to sell without moving the market. I believe they essentially want one-decision stocks, where they can buy shares of a company which they feel confident has excellent long-run potential, and then not worry about it. Furthermore, corporations need owners and investors, not traders and speculators, who worry little about accountability, and do not provide the third pillar necessary for proper corporate governance.

I doubt that institutional investors really want to take matters into their own hands. They have too many stocks to follow to monitor the activities of individual corporations closely. Nevertheless, institutional investors are often being forced to get involved. Institutional investors are increasingly frustrated that management can not be trusted to put company interests ahead of personal interests. This frustration is evidenced by the number of shareholder resolutions which appeared on corporate proxies this past year, and the increasing shareholder support some of those resolutions received.

I commend those of you who have been involved in enacting change through the existing system. It is a testimony, again, that corporate governance can work and that shareholders can initiate reasonable changes without involving themselves in day-to-day operations. The relatively modest gains achieved to date, however, have brought to light some significant barriers which shareholders must overcome if they want to voice their opinions. Some of these barriers have been created by government -- both at the state level, through anti-takeover laws, and the federal level.

Proxy Reform

An example of a federal government barrier to better corporate governance can be found in the current proxy rules. Essential to corporate governance is effective and efficient communication among interested parties. Communication is a fundamental prerequisite to making an informed voting decision, and is especially important given the myriad owners who often lack, on an individual basis, the knowledge and experience to make informed judgments. An ongoing education process can therefore be beneficial. Significant shareholders, like Warren Buffett, never know when they may be asked to assume greater responsibility. Yet the current proxy rules place

severe restrictions on the ability of shareholders to communicate among themselves about issues which appear on corporate ballots -- restrictions which reduce information flow to shareholders.

The SEC has been engaged in a very thorough study of this issue for the past two years. It has proposed some changes to allow greater communications among shareholders on certain issues. It is in the process of evaluating comments on its proposed regulations before a final regulation is submitted. We have been impressed at the thoroughness and quality of the SEC review. The SEC clearly raised the key issues in their comment request, has carefully considered the different sides of the issues, and is attempting to strike a balance between competing interests. I applaud the progress it has made thus far, and I particularly support the concept of allowing shareholders to be better informed.

Shareholders and Management

While I believe that changes to the existing proxy rules are necessary to allow shareholders to become better informed, I believe it is ultimately up to shareholders and management themselves to improve their relationship.

Managers should try less to insulate themselves from their shareholders and more to explore policies which would align management/shareholders interests in the common goal of building a competitive enterprise. In fact, major institutional investors, like pension funds, could become their greatest allies -- the source of the patient capital they are looking for. I doubt that pension funds really want to fight with management over poison pills and golden parachutes. What they would prefer is to be able to trust management to act in their best interest. For they too have a vested interest in finding relationships where they can invest large amounts over extended time periods. These institutions have grown so large that they cannot simply sell the stock in every company where they disagree with management.

For most investors, though, patience requires participation. Yet many shareholders have come to think that their voices are not sought, much less heeded. In fact, corporate raiders have, in many instances, assumed the role of policemen of capitalism. This is not the most effective solution -- we should do better. From an economic cost and efficiency point of view, takeovers are not the ideal way of imposing discipline on managers. Instead, they are the option of last resort for shareholders who have no other way to make management responsive to their goals. Effective corporate governance would minimize the need for hostile takeovers, as the interests of management and shareholders would not be sufficiently discordant to justify one. Investors should be seen as potential partners in achieving

corporate strategic objectives rather than adversaries. Prudent management of corporate assets combined with solid communication with the owners of the stock can move long-term thinking back into the markets and the board rooms.

Board of Directors

Of great importance to this improvement is strengthening the role of the board of directors. It is their job to ensure that management has the proper incentives to maximize the long-term value of the company, to exercise, as independent policymakers, their good business judgment on behalf of shareholders. For shareholders, the board of directors in many ways is where the buck stops.

To do this, I think it is critical that the majority of board members be independent from management. A board cannot keep management accountable if they are being overly influenced by management. It is their job to independently assess management proposals, and to challenge management when they have questions as to the viability of a given plan. The day of the sinecure, where long-term friends are gently put out to financial pasture and need only show up on board meeting days to rubber stamp management decisions and pick up their check, should be over.

A second, critical board responsibility is to ensure that executive compensation provides managers with incentives which are consistent with shareholder interests. Managers should be made shareholders, so that executive compensation plans motivate behavior which truly maximizes the value of the corporation. People behave differently when they have an ownership interest. Homeowners have a different attitude about their homes than do renters. In the same way, executives will care more about the long-term value of the company if they own a stake in it which is significant to them. I do not think the answer is merely to tack on long-term incentives to already existing pay. Executives should not become millionaires while shareholders lose value. Boards of directors should reevaluate the composition of compensation plans and should consider substituting plans that tie executive fortunes, in both senses of the word, to the long-term value of the firm. Likewise, companies should reevaluate how board members are compensated. Paying board members at least partially with stock would better ensure that directors are looking after stockholder interests. Greater accountability and compensation truly tied to performance would, in my view, lead to more competitive companies.

Third, the Business Roundtable has also proposed that large public corporations should have a nominating committee of the board composed solely of independent directors. This seems appropriate. The Nominating Committee could develop guidelines for selecting directors which have the qualifications which could be most beneficial to the firm. Such a committee could also respond to shareholder comments and recommendations and be the forum to recommend the removal of directors who no longer have time or expertise to perform their stewardship role toward shareholder wealth.

Conclusion

In conclusion, it is ultimately private industry which will determine the success of our nation. If private industry is to succeed, we need shareholders, managers and boards of directors working together to develop and implement successful long-term strategies for the future. How we respond to our changing world will determine where the United States will stack up in global competition. We have the resources, we have the people, and we have the tradition on our side. But we have no God-given right to success. Our response to the challenge will impact the quality of life for generations to come. I am optimistic that positive changes can be made to existing corporate governance structures -- changes which will ultimately make U.S. corporations more competitive. This forum demonstrates your dedication to this goal.

* * * *

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AUCTION RESULTS

PUBLIC DEBT NEWS

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

OCT 11 91 001235

FOR IMMEDIATE RELEASE
October 9, 1991

CONTACT: Office of Financing
202-219-3350

RESULTS OF TREASURY'S AUCTION OF 7-YEAR NOTES

Tenders for $9,280 million of 7-year notes, Series H-1998, to be issued October 15, 1991 and to mature October 15, 1998 were accepted today (CUSIP: 912827C67).

The interest rate on the notes will be 7 1/8%. The range of accepted bids and corresponding prices are as follows:

	Yield	Price
Low	7.19%	99.647
High	7.20%	99.593
Average	7.20%	99.593

$35,000 was accepted at lower yields.
Tenders at the high yield were allotted 76%.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	22,115	22,090
New York	19,282,342	7,788,382
Philadelphia	8,266	8,266
Cleveland	17,692	17,687
Richmond	348,068	341,588
Atlanta	827,286	785,076
Chicago	890,259	216,324
St. Louis	20,192	16,192
Minneapolis	9,202	9,202
Kansas City	17,925	17,875
Dallas	7,547	7,547
San Francisco	169,094	43,814
Treasury	5,837	5,822
TOTALS	$21,625,825	$9,279,865

The $9,280 million of accepted tenders includes $379 million of noncompetitive tenders and $8,901 million of competitive tenders from the public.

In addition, $623 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $347 million of tenders was also accepted at the average price from Federal Reserve Banks for their own account in exchange for maturing securities.

NB-1495

DEPARTMENT OF THE TREASURY
BUREAU OF THE PUBLIC DEBT
WASHINGTON, D.C. 20239-0001

AUCTION YIELD TO PRICE CONVERSION TABLE

7-1/8 % 7-YEAR TREASURY NOTES OF SERIES H-1998
CUSIP NUMBER: 912827 C6 7

AUCTION DATE: OCTOBER 9, 1991
SETTLEMENT DATE: OCTOBER 15, 1991
MATURITY DATE: OCTOBER 15, 1998
FIRST INT. PAYMENT: APRIL 15, 1992

INTEREST (COUPON) RATE: 7.125%

YIELD%	PRICE	YIELD%	PRICE	YIELD%	PRICE	YIELD%	PRICE
6.33	104.440	6.73	102.176	7.13	99.973	7.53	97.827
6.34	104.383	6.74	102.121	7.14	99.918	7.54	97.774
6.35	104.325	6.75	102.065	7.15	99.864	7.55	97.722
6.36	104.268	6.76	102.009	7.16	99.810	7.56	97.669
6.37	104.211	6.77	101.953	7.17	99.756	7.57	97.616
6.38	104.154	6.78	101.898	7.18	99.701	7.58	97.563
6.39	104.097	6.79	101.842	7.19	99.647	7.59	97.510
6.40	104.040	6.80	101.787	7.20	99.593	7.60	97.458
6.41	103.982	6.81	101.731	7.21	99.539	7.61	97.405
6.42	103.925	6.82	101.675	7.22	99.485	7.62	97.353
6.43	103.868	6.83	101.620	7.23	99.431	7.63	97.300
6.44	103.812	6.84	101.565	7.24	99.377	7.64	97.247
6.45	103.755	6.85	101.509	7.25	99.323	7.65	97.195
6.46	103.698	6.86	101.454	7.26	99.269	7.66	97.142
6.47	103.641	6.87	101.398	7.27	99.215	7.67	97.090
6.48	103.584	6.88	101.343	7.28	99.162	7.68	97.038
6.49	103.527	6.89	101.288	7.29	99.108	7.69	96.985
6.50	103.471	6.90	101.233	7.30	99.054	7.70	96.933
6.51	103.414	6.91	101.178	7.31	99.000	7.71	96.880
6.52	103.357	6.92	101.122	7.32	98.947	7.72	96.828
6.53	103.301	6.93	101.067	7.33	98.893	7.73	96.776
6.54	103.244	6.94	101.012	7.34	98.839	7.74	96.724
6.55	103.188	6.95	100.957	7.35	98.786	7.75	96.672
6.56	103.131	6.96	100.902	7.36	98.732	7.76	96.619
6.57	103.075	6.97	100.847	7.37	98.679	7.77	96.567
6.58	103.018	6.98	100.792	7.38	98.625	7.78	96.515
6.59	102.962	6.99	100.737	7.39	98.572	7.79	96.463
6.60	102.905	7.00	100.683	7.40	98.518	7.80	96.411
6.61	102.849	7.01	100.628	7.41	98.465	7.81	96.359
6.62	102.793	7.02	100.573	7.42	98.412	7.82	96.307
6.63	102.737	7.03	100.518	7.43	98.358	7.83	96.256
6.64	102.680	7.04	100.464	7.44	98.305	7.84	96.204
6.65	102.624	7.05	100.409	7.45	98.252	7.85	96.152
6.66	102.568	7.06	100.354	7.46	98.199	7.86	96.100
6.67	102.512	7.07	100.300	7.47	98.146	7.87	96.048
6.68	102.456	7.08	100.245	7.48	98.092	7.88	95.997
6.69	102.400	7.09	100.191	7.49	98.039	7.89	95.945
6.70	102.344	7.10	100.136	7.50	97.986	7.90	95.893
6.71	102.288	7.11	100.082	7.51	97.933	7.91	95.842
6.72	102.232	7.12	100.027	7.52	97.880	7.92	95.790

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TREASURY NEWS

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

FOR IMMEDIATE RELEASE
October 9, 1991

CONTACT: Cheryl Crispen
(202) 566-2041

TREASURY CALLS 7-1/2% BONDS OF 1988-93

The Treasury today announced the call for redemption at par on February 15, 1992, of the 7-1/2% Treasury Bonds of 1988-93, dated August 15, 1973, due August 15, 1993. There are $1.8 billion of these bonds now outstanding, of which $.9 billion are held by private investors. Securities not redeemed on February 15, 1992, will cease to earn interest.

The two-year notes to be announced on October 16, 1991, for settlement on October 31, 1991, will include an amount that is sufficient to hedge the call of the $.9 billion held by private investors.

This is the first call by the Treasury since December 15, 1962, and is the first call involving securities held in book-entry form. Payment will be made automatically by the Treasury for bonds in book-entry form, whether held on the books of the Federal Reserve Banks or in TREASURY DIRECT accounts. Bonds held in coupon or registered form should be presented for redemption through a financial institution, or to a Federal Reserve Bank or Branch, or to the Department of the Treasury, Washington.

Coupon bonds must have all unmatured coupons attached to the security upon presentation for redemption at par. As required by Department of the Treasury Circular No. 300 (31 CFR 306.27), if any coupons for the three interest payment dates from August 15, 1992, through August 15, 1993, are missing, the Treasury must deduct the full face amount of the missing coupons from the par value.

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NB-1496

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DEPT. OF THE TREASURY

SECRETARY NICHOLAS F. BRADY

PRESS CONFERENCE

U.S. EMBASSY
TOKYO, JAPAN

OCTOBER 10, 1991

FOR: USINFO P/P, P/PFF, EA; STATE/EAP/J, STATE/PM; STATE PASS TO USTR; TREASURY/IMI, IMA; NSC; COMMERCE FOR DAS; USIA FOR P/M, EA, P/FW

E.O. 12356: N/A
SUBJECT: "FASTPRESS" - TREASURY SECRETARY NICHOLAS F. BRADY'S PRESS CONFERENCE AT U.S. EMBASSY TOKYO ON 10/10/91

BEGIN TEXT:

OBVIOUSLY THIS IS A VERY IMPORTANT TIME FOR RELATIONSHIPS BETWEEN JAPAN AND THE UNITED STATES. OUR LONG-STANDING PARTNERSHIP ON ANY NUMBER OF ISSUES WILL BE CALLED TO DEMONSTRATE AGAIN THE STRENGTH OF THAT PARTNERSHIP AS WE FACE THE PROBLEMS BEFORE THE SOVIET UNION. SO, FOR THAT REASON, AND ALSO BECAUSE THE PRESIDENT IS COMING HERE IN LATE NOVEMBER, WE THOUGHT IT WAS IMPORTANT TO STOP ON OUR WAY TO BANGKOK, TO MEET WITH PRIME MINISTER KAIFU, FOREIGN MINISTER NAKAYAMA AND FINANCE MINISTER HASHIMOTO. I DON'T THINK THAT IT IS ANY SURPRISE TO ANYBODY TO KNOW THAT THE UPCOMING MEETINGS AT THE WORLD BANK AND IMF ARE ONES THAT, ALTHOUGH THEY WILL OBVIOUSLY

TAKE INTO ACCOUNT ALL OF THE MINISTERIAL THINGS ARE DONE AT THOSE MEETINGS, A GREAT PART OF THE DISCUSSION AND EMPHASIS AT THOSE MEETINGS WILL BE ABOUT THE SITUATION IN THE SOVIET UNION, AND WHAT THE NATIONS OF THE WORLD ARE GOING TO DO ABOUT IT. WE WILL HAVE A MEETING, MEETINGS IN BANGKOK OF THE G-7 FINANCE MINISTERS WHICH WILL ADDRESS THAT ISSUE, BUT ALSO THE NORMAL ISSUES THAT ARE DISCUSSED IN FINANCE MINISTERS' MEETINGS, AND OF COURSE, AS YOU KNOW, THERE WILL BE REPRESENTATIVES FROM THE SOVIET UNION WHO WILL BE JOINING US IN BANGKOK OVER THE WEEKEND, SO WITH THAT AS A BACKGROUND, I'LL BE GLAD TO TAKE ANY QUESTIONS THAT ANYBODY MIGHT HAVE.

Q: TOM O'TOOLE, NIKKEI. GIVEN THE SOVIET UNION'S LARGE EXTERNAL DEBT, AND THE DIFFICULTIES THEY WILL HAVE IN REPAYING THAT, WILL THERE BE ANY MOVEMENTS IN G-7 MEETINGS TO POSTPONE A PORTION OF THAT DEBT? AND IF YOU CAN'T ANSWER DIRECTLY, COULD YOU GIVE ME YOUR OPINION ON THAT PLEASE? THANK YOU.

A: WELL, THE MATTER OF ADDRESSING THE SOVIET DEBT WILL BE A MATTER THAT WILL BE DISCUSSED BY THE G-7 FINANCE MINISTERS. THERE IS NO CLEAR VIEW AT THIS PARTICULAR POINT IN TIME AS TO EXACTLY HOW THAT SHOULD BE CARRIED OUT. WE'VE BEEN TOLD BY THE SOVIETS THAT THEY ARE GOING TO BE EXPERIENCING DIFFICULTY OF A BALANCE OF PAYMENTS NATURE. SO FAR, PART OF THE PROBLEM IS THAT THE EXACT CALIBRATION OF WHAT THOSE FIGURES ARE HAVEN'T BEEN MADE CLEAR. AND THAT IS ONE OF THE ITEMS THAT WE WILL BE TALKING TO THE SOVIET REPRESENTATIVES WHEN WE ARE THERE, ABOUT WHAT AMOUNTS COULD BE INVOLVED. THERE ARE ALL SORTS OF WAYS TO ADDRESS THIS PROBLEM. NONE HAS BEEN DECIDED ON, AND IT WOULD BE PREMATURE OF ME AT THIS PARTICULAR TIME TO GET INTO DETAILS.

Q: KATHLEEN TANZY OF FUTURES WORLD NEWS. THE JAPANESE HAVE OFFERED A DIRECT AID PACKAGE TO THE USSR. I WOULD LIKE TO KNOW WHAT YOUR OPINION IS OF THAT PACKAGE, AND WHETHER THE U.S. WILL BE CONSIDERING A PACKAGE OF A SIMILAR PATTERN.

A: WELL, WE LIKE YOU WERE ADVISED OF THE PACKAGE JUST A DAY OR SO AGO. WE HAVEN'T HAD A CHANCE TO ANALYZE IT COMPLETELY. I KNOW THE JAPANESE WILL BE DISCUSSING IT MORE WITH US WHEN WE GET TO BANGKOK. I WOULD POINT OUT TO YOU THAT THE UNITED STATES ALREADY HAS BEEN GENEROUS

IN THEIR ASSISTANCE TO THE SOVIET UNION. WE RECENTLY ARE ON OUR WAY TO COMPLETE AMONG OTHER THINGS A TWO AND A HALF BILLION DOLLAR CCC CREDIT FOR FOOD FOR THE SOVIET UNION. AND THAT PROGRAM, WHICH WAS SUPPOSED TO CARRY INTO 1992, IS BEING ADVANCED SO THAT THE FUNDS CAN BE SUPPLIED THIS YEAR. CABINET MINISTER FOR AGRICULTURE MADIGAN IS IN THE SOVIET UNION AT THIS PARTICULAR POINT IN TIME. I DO NOT KNOW THE RESULTS OF HIS TRIP. HE WILL BE BACK THIS NEXT WEEK, SO IT WOULD BE PREMATURE OF ME TO TALK MORE ABOUT THAT.

Q: HECTOR RUEDA DE LEON OF TELEVISA MEXICO. MR. SECRETARY, JAPANESE OFFICIALS HAVE BEEN VERY APPREHENSIVE ABOUT THE FREE TRADE PACT BETWEEN MEXICO, CANADA AND THE UNITED STATES. HAS THIS BEEN BROUGHT UP IN YOUR TALKS WITH THE JAPANESE OFFICIALS AND IF SO, WHAT?

A: NO, IT HASN'T BEEN BROUGHT UP, BUT I DON'T THINK THEY SHOULD BE APPREHENSIVE ABOUT THAT. WE EXPECT THAT THE FREE TRADE AGREEMENT BETWEEN MEXICO, CANADA AND THE UNITED STATES WILL CREATE A LARGER MARKET IN EACH OF THOSE THREE COUNTRIES, ONE INTO WHICH THE JAPANESE ARE WELL PLACED TO BE PARTICIPANTS. AND THEY'VE DONE PRETTY WELL IN THE UNITED STATES MARKET AS IT IS, AND IF IT GETS BIGGER AND BECOMES A MARKET THAT IS INTEGRATED WITH CANADA AND MEXICO, I EXPECT THE JAPANESE WILL DO JUST AS WELL THERE AS THEY HAVE ELSEWHERE AROUND THE WORLD, SO I THINK TO THE EXTENT THERE IS APPREHENSION, THAT IT SHOULDN'T BE. THEY SHOULDN'T HAVE IT.

Q: VLADIMIR SOLNTSEV FROM TASS. WHAT ARE THE TERMS OF THE FINANCIAL AID TO THE SOVIET UNION BY THE UNITED STATES AND THE G-7? IS THIS PROBLEM BEING DISCUSSED AT THE MOMENT? AND SECONDLY, I WOULD LIKE TO ASK WERE THERE ANY REQUESTS FROM THE SOVIET SIDE FOR UNITED STATES OR THE WEST IN GENERAL TO PARTICIPATE IN MAKING A MASTER PLAN FOR SOVIET REFORMS?

A: WELL, AS I MENTIONED A MINUTE AGO, THE MEETINGS IN BANGKOK WILL -- THE G-7 MEETINGS, AND THE I AM SURE THE PLENARY SESSIONS OF THE IMF AND THE WORLD BANK WILL BE VERY MUCH CONCERNED WITH THE SITUATION IN THE SOVIET UNION. SO, THERE WILL BE FURTHER PROGRESS MADE ON THAT ONE WHEN GET TO BANGKOK. BUT ON THE VISIT THAT I MADE TO THE SOVIET UNION SOME TWO WEEKS AGO, IT WAS QUITE CLEAR TO ME THAT THE SOVIET UNION UNDERSTOOD THEIR PROBLEMS

VERY CLEARLY THEMSELVES. AND BY THAT, I MEAN THEY UNDERSTAND THAT THE IDEA THAT THE WESTERN NATIONS WOULD SUPPLY UNLIMITED AID INTO A SITUATION, INTO AN ECONOMY, THAT WAS NOT PREPARED TO RECEIVE IT, WAS SOMETHING THEY UNDERSTOOD WOULDN'T WORK EITHER. AND WE TALKED VERY CLEARLY ABOUT THE NECESSITY FOR REFORMS AND REORIENTATION OF THEIR COUNTRY TOWARDS A MARKET-BASED DEMOCRACY. NOW, AS YOU ALL KNOW THAT CAN'T BE DONE OVERNIGHT. AND THEY HAVE ASKED VERY CLEARLY AND FORTHRIGHTLY FOR OUR ASSISTANCE TO HELP THEM DO THAT. AND THIS ALL-ENCOMPASSING TERMS THAT'S USED OF "TECHNICAL ASSISTANCE," WHICH SEEMS TO BE CONFUSING AND SOMETIMES IS REGARDED AS A WAY OF NOT TALKING ABOUT SPECIFICS, IN MY MIND, IS VERY CLEAR AND IS VERY SPECIFIC. WHAT IT REALLY REFERS TO IS, THEY DO NOT HAVE THE WHEREWITHALL IN TERMS OF PERSONNEL SYSTEMS AND THE LIKE TO GET THIS JOB DONE AND THEY ARE ASKING OUR HELP. THERE ARE VERY FEW IF ANY COST ACCOUNTANTS IN THE SOVIET UNION; THERE ARE NO BUSINESS LAWYERS, THERE ARE NO ACCOUNTANTS, THERE ARE NO INVESTMENT ANALYSTS TO SPEAK OF. THOSE PEOPLE WHO WOULD NORMALLY FORM THAT PLACE IN THE SOCIETY HAVE BEEN ENGAGED IN OTHER OCCUPATIONS OF HELPING SUPPORT THE MILITARY-INDUSTRIAL COMPLEX. SO WHEN THEY TALK ABOUT TECHNICAL ASSISTANCE, THEY ARE ASKING US, HOW DO YOU FORM THE CENTERPIECE, THE WORKING MECHANISIM THAT CREATES A MARKET-BASED SOCIETY, SO IT'S IN THAT AREA WHERE I THINK WE CAN BE OF THE MOST HELP, AND ONE THAT THEY QUITE CLEARLY RECOGNIZE IS ONE THAT'S THE MOST IMPORTANT FOR THEIR POINT OF VIEW. I DID NOT GET WHILE I WAS IN SOVIET UNION REPEATED REQUESTS, IN FACT VERY FEW, AND IN FACT ALMOST NO REQUESTS FOR THE IDEA THAT THE WESTERN WORLD WAS GOING TO DUMP MONEY INTO THAT ECONOMY. THEY KNOW THAT WON'T WORK. AND THEY ARE NOT ASKING FOR IT.

Q: MARY WALSH, CBS NEWS. JAPAN'S TRADE SURPLUS CONTINUES TO GROW. DID YOU BRING THIS UP IN YOUR MEETINGS, SUGGESTING THAT THE BALANCE OF TRADE NEEDS TO BE IMPROVED?

A: WELL, WE ALWAYS -- WE ARE IN CONTINUAL DISCUSSIONS WITH JAPAN ABOUT THE SIZE OF THEIR TRADE SURPLUS. AND THE NECESSITY ON THEIR PART TO PROVIDE TO THE UNITED STATES AND OTHER WORLD COUNTRIES THE SAME OPPORTUNITIES INSIDE JAPAN IN TERMS OF ABILITY TO COMPETE THAT THEY ARE AFFORDED INSIDE THE UNITED STATES. THE JAPANESE KNOW FULL WELL THAT THIS IS AN ISSUE THAT CONTINUES TO BE PARAMOUNT FOR THE UNITED STATES. AND THOSE DISCUSSIONS HAVE TAKEN PLACE AND WILL CONTINUE TO TAKE PLACE. THE SII TALKS AND THE YEN-DOLLAR DISCUSSIONS ARE THE PARTICULAR FORUMS IN WHICH THOSE DISCUSSIONS CARRY FORWRAD, AND WE ARE ALWAYS PRESSING ON THAT PARTICULAR POINT. THE JAPANESE KNOW THAT AND OF COURSE THEY ARE TRYING TO BE RESPONSIVE.

Q: RICH MILLER, REUTERS. YOU MENTIONED THAT YOU'D COME BACK FROM THE SOVIET UNION FAIRLY ENCOURAGED ABOUT THE REFORMS AND THEIR DESIRE TO MOVE AHEAD. BUT RECENTLY, THERE HAS BEEN SOME SIGNS THAT THE REFORM PROCESS THERE MIGHT BE STALLED, AND IN PARTICULAR, I AM THINKING ABOUT RUSSIAN'S RELUCTANCE TO SIGN AN ECONOMIC UNION TREATY. I WONDER IF YOU COULD COMMENT ON THAT. HAVE YOUR VIEWS CHANGED AT ALL SINCE YOU CAME BACK FROM MOSCOW?

A. NOT REALLY, RICH. BECAUSE IT WAS ALWAYS EVIDENT, IT WOULD BE EVIDENT TO ANYBODY THAT SPENT SOME TIME IN THE SOVIET UNION, THAT THERE IS A CRITICAL DISCUSSION GOING ON AT THIS PARTICULAR POINT IN TIME ABOUT THE RELATIONSHIPS BETWEEN THE REPUBLICS AND THE CENTRAL GOVERNMENT. AND THAT DISCUSSION IS IN A FORMATIVE STAGE, IT'S ONE THAT'S CRITICALLY IMPORTANT FROM THE POINT OF VIEW OF THOSE COUNTRIES THAT ARE TRYING TO PROVIDE HELP TO THE SOVIET UNION AT THIS PARTICULAR POINT IN TIME. IT ISN'T ANY GREAT REVELATION TO SAY THAT, WHEN YOU ARE TRYING TO PUT TOGETHER A FINANCIAL PLAN, THAT IT IS EASIER IF YOU CAN DEAL WITH ONE CENTRAL AUTHORITY OR ONE, OR AT LEAST AN ORGANIZATION OF CENTRAL AUTHORITY AND REPUBLICS WHICH SUITS -- I AM NOT TRYING TO GET INTO THE BUSINES OF THE SOVIET UNION INTERNALLY, BUT IN TERMS OF TRYING TO ORGANIZE WESTERN RESPONSE TO THE SOVIET PROBLEM, IT OBVIOUSLY SHOULD BE CLEAR TO EVERYBODY THAT IF YOU HAVE ON THE OTHER END OF THAT CONVERSATION, A CENTRAL POINT OF VIEW, A POINT OF VIEW THAT IS AGREED TO, IN THIS CASE, BY THE CENTER AND THE REPUBLICS, WHICH WILL GIVE US THE OPPORTUNITY TO HELP, THAT THAT'S VERY IMPORTANT.

NOW, TO THE OTHER PART OF YOUR QUESTION, WHICH IS, HAS THIS PROCESS OF IRONING OUT THE RELATIONSHIP BETWEEN THE CENTER AND THE REPUBLICS GONE BACKWARDS, I WOULD ONLY GIVE YOU A VIEW THAT IT'S ONE OF THOSE THINGS LIKE LEGISLATION IN THE UNITED STATES -- IT'S ONE STEP FORWAD AND TWO STEPS BACK, AND THEN YOU GATHER YOURSELF AND GO FORWARD AGAIN. SO I DON'T THINK ANYBODY -- NOR WERE WE LED TO BELIEVE BY THE SOVIETS -- EXPECTS THAT THIS IS GOING TO BE SOME KIND OF A STRAIGHT-LINE MARCH TO AN AGREEMENT WHICH WOULD BE VERY CLEAR IN A SHORT PERIOD OF TIME. IT WON'T. IT'S GOING TO TAKE A LOT OF TIME. THERE IS A LOT OF PAST HISTORY, CENTURIES OF HISTORY BEING UNDONE HERE, AND I THINK WE SHOULD BE UNDERSTANDING OF THE FACT THAT IT IS NOT GOING TO HAPPEN IN A CLEAR, CONCISE VIEW IN A SHORT PERIOD OF TIME. SO, ALTHOUGH AGAIN I WANT MAKE A POINT CLEAR THAT IT IS GOING TO BE IN THE SOVIET UNION'S INTERESTS TO HAVE AN ORGANIZATION, BE IT ONE KIND OR ANOTHER, WITH WHICH THE G-7 AND WORLD COMMUNITY CAN RELATE AND HAVE IT BE SPECIFIC, SINCE WE ARE GOING TO BE TALKING ABOUT SPECIFIC AGREEMENTS IN SOME POINT IN TIME, SO THAT WE CAN COMPLETE THOSE AGREEMENTS, IS AN ENORMOUS ADVANTAGE NOT ONLY TO THE SOVIET UNION BUT TO THOSE OF US THAT ARE TRYING TO HELP. THANK YOU VERY MUCH.

(END TEXT.)
OLSSON, ACTING##

TREASURY NEWS

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

FOR RELEASE AT 12:00 NOON
October 11, 1991

CONTACT: Office of Financing
202/219-3350

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 October 24, 1991, and to mature October 22, 1992 (CUSIP No. 912794 YZ 1). This issue will provide about $2,375 million of new cash for the Treasury, as the maturing 52-week bill is outstanding in the amount of $10,132 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, October 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 bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. This series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing October 24, 1991. In addition to the maturing 52-week bills, there are $18,142 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 $1,437 million as agents for foreign and international monetary authorities, and $7,139 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 none 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-1497

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.

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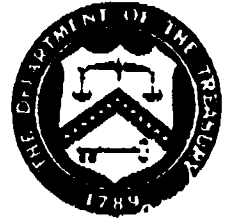
TREASURY NEWS



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

AS PREPARED FOR DELIVERY
EMBARGOED UNTIL 3:45 P.M.

REMARKS BY
THE HONORABLE NICHOLAS F. BRADY
SECRETARY OF THE TREASURY
AT THE ANNUAL MEETING
OF THE WORLD BANK AND THE INTERNATIONAL MONETARY FUND
BANGKOK, THAILAND
OCTOBER 15, 1991

Mr. Chairman, Managing Director Camdessus, President Preston, and fellow Governors. I want to express the gratitude of my delegation for the warm hospitality extended by our Thai hosts. Here in Bangkok, we are reminded of Asia's economic dynamism and the region's growing importance in our economic future.

I would like to welcome the newest members of the International Monetary Fund and the World Bank: Albania and Mongolia. And also to welcome the special guests from the Baltics and the Soviet Union.

We meet at a turning point in history. Market-based systems that produce better economic performance and higher living standards are sweeping the globe. Countries in every region of the world, now including the Soviet Union, are shifting course in their direction. We can glimpse possibilities previously beyond our view: global economic integration, cooperation, and prosperity.

These developments confront the international financial institutions with an unprecedented challenge. Inevitably, these institutions will be held accountable in an important way for the success or failure of efforts to integrate former command and state-dominated economies into the global market system. Like it or not, that is the reality.

The difficulty of this kind of transformation should not be underestimated. There are no time-tested blueprints for charting the course from a state-dominated command system to a successful market economy. But what is clear is that this transformation is a fundamental, all-encompassing process. Every area of economic activity and policy is involved.

This reality brings with it an important question. Are we up to the task? To rise to this challenge, the international financial institutions must be willing to adapt. They must change their attitudes, broaden their objectives, and improve their assistance capabilities. And they must begin this process right away.

NB-1495

Recently, the IMF and the World Bank have demonstrated their capacity to diversify in response to emerging needs. During and after the Gulf conflict, they moved quickly to provide resources to those countries most seriously affected. The IMF rapidly disbursed resources through the Compensatory and Contingency Financing Facility (CCFF) to help countries adjust to the economic costs of Iraq's aggression. The World Bank expanded lending programs and accelerated disbursements to assist sectoral adjustment and to resettle worker refugees.

In Eastern Europe, the IMF and the World Bank have been at the forefront of efforts to promote free markets and democracy. With IMF and World Bank assistance, these countries are implementing programs of reform and stabilization. IMF financial commitments to Bulgaria, Czechoslovakia, Hungary, Poland, and Romania in 1991 total $8 billion. World Bank commitments to Eastern Europe for fiscal year 1991 reached over $2.6 billion.

The IMF and the World Bank have established a special association with the Soviet Union to help that country address the pressing problems of comprehensive reform. We welcome this special association and urge that no effort be spared to work intensively in the days ahead. Like others, we believe special association will help clear the way for full Soviet membership in both institutions.

In the Soviet Union and Eastern Europe, we are confronted with the most radical economic change in the post-war period. The search for new values has its costs. These countries have made a conscious decision to switch rapidly from one political and economic system to another. They are literally rewriting all the rules. My visit to the Soviet Union last month brought to mind the Colonial American experience of making a fresh start and creating a new form of government. Over two hundred years ago, the United States began its efforts to create stable institutions -- a process which took decades to complete. Yet the Soviet Union is trying to accomplish a similar task in only a matter of months.

The international financial institutions will have a special role in assisting this transformation. In defining this role, we must understand what transforming countries need. There is no question that part of what they need is provided by the traditional IMF/World Bank approach: advice on formulating comprehensive economic policy programs, and the financial assistance to support those programs. But they also need more fundamental assistance that goes well beyond standard adjustment programs.

Let me list the tasks:

(1) Attitudes toward the creation of wealth need to be changed to release the dynamism of the private sector. Free enterprise and entrepreneurship means that businesses and individuals are free to succeed. State orders are no substitute for individual initiative.

(2) Countries need help in building basic private and government economic institutions, such as the development of capital markets and banking and reserve systems.

(3) They need basic training on how to run profitable private businesses, which involve the special professions of cost accounting, contract negotiations, distribution, and marketing.

(4) They need practical advice on the operation of a sound fiscal system: a tax code and collection system, a public sector budget mechanism, a customs operation for the borders, and a data collection system.

(5) And last but not least, they need assistance on how to establish a workable legal system for private enterprise, including an enforceable contract system.

These are the basic underpinnings of a successful market economy. We will be up to the task only if the World Bank and the IMF build on this institutional framework, as well as instituting macroeconomic policy reform. To do this, the Bretton Woods institutions need to develop a partnership with the private sector to elicit their expertise in helping countries build solid foundations for market economies.

To provide assistance in all of these areas, the IMF and the World Bank will need to develop new modes of operation. Brief mission visits to negotiate adjustment programs with central governments will not be enough.

The IMF and the World Bank will have to pay much greater attention to the human capital component of their programs. They will have to put people in-country for extended periods of time. They will have to draw on experts from national governments, business, banking, law, and universities.

The Fund and the Bank will also have to expand in-country contacts to all levels of government. This assistance cannot be provided by dealing with central governments only. Fund and Bank staff will have to advise and educate individuals in the private sector and in local government.

Some have legitimately raised the question of whether this emphasis on the Eastern European countries and the Soviet Union will result in a diminution of resources to traditional recipients. Both the World Bank and the IMF are well capitalized and I see no reason why there should be any shortfall in financial flows. Resources will be adequate to the task.

Others have asked whether there will be any reduction of IMF and World Bank technical expertise available to traditional recipients due to a concentration of attention on Soviet and Eastern European problems. Legitimate traditional priorities should not be weakened. In addition, the gains for world stability should be well worth the price for countries large and small.

In other regions of the world, the IMF and the World Bank are addressing their ongoing responsibilities by playing a crucial part in the success of the international debt strategy. Under this strategy, the IMF and the World Bank have encouraged market reforms and supported a wide variety of commercial bank packages in several debtor countries in varied economic circumstances. Mexico, Chile, and Venezuela are once again enjoying voluntary access to the international capital markets, new investment, and returning flight capital. Only a short while ago, they were mired in debt.

To complement the benefits of commercial bank debt reduction packages under the debt strategy for countries which are heavily indebted to commercial banks, President Bush's Enterprise for the Americas Initiative proposes to reduce debts owed to the U.S. Government by eligible countries within Latin America and the Caribbean. Chile, Jamaica, and Bolivia have already received initial benefits under this program. The Inter-American Development Bank (IDB) has moved to implement a new investment sector loan program to encourage investment reforms in developing countries. The United States has also proposed a Multilateral Investment Fund to help the economies in the region adapt to today's competitive world. The U.S. and Japan each propose to contribute $500 million to this Fund. We expect others will be joining us in this effort in the near future.

In the poorest countries, including those of Sub-Saharan Africa, the IMF and the World Bank are providing concessional resources to promote sustained growth and the alleviation of poverty. Some of these countries have turned the corner. Their example confirms that market-oriented reform is possible and beneficial at all stages of development. For our part, over the last year the United States has forgiven $2.3 billion in bilateral concessional debt owed by these countries. We also support an expansion of the list of countries eligible for the Enhanced Structural Adjustment Facility (ESAF) in order to increase the Fund's capacity to support low-income countries.

The IMF and the World Bank are to be congratulated for their emphasis on the environment. I very much agree with Prime Ministe Anand's remarks this morning that we all need a common commitment to the environment for our own sake and for the sake of future generations. In addition, poverty reduction and the role of women in development require stronger emphasis. We must ensure sustaine progress on these fronts.

The time has come for the Fund and the Bank to strengthen their support for the private sector. The World Bank is reviewing what changes need to be made in the Articles of Agreement in order to permit direct lending to the private sector. As countries release ownership of enterprises to the private sector, individual companies in the process of privatization will need resource flows from the World Bank. At stake is the relevance of the World Bank in support of economic development. To this end, we are pleased to support the $1 billion IFC capital increase and related private sector policy measures.

The expanding financial needs in debtor countries, Eastern Europe, and the poorest countries necessitate that the international financial institutions have ample resources. To this end, the U.S. strongly supports the IMF quota increase to meet its global financial responsibilities.

Conclusion

In closing, allow me to again stress that the international financial institutions must now implement programs for economic transformation and for the ultimate achievement of a unified global economic system. IMF and World Bank activities must adapt and expand as this unprecedented global economic potential comes into view. We must seize the opportunity provided by near universality of membership in these institutions and acceptance of market-oriented principles. Leadership by the IMF and the World Bank can translate shared economic philosophy into shared prosperity.

Seldom in the course of human affairs has the world's community of nations been faced with an opportunity such as we face today. With imagination, with determination, with vision and with courage, I believe that it is within our ability to seize this moment and to translate that glimpse of prosperity and harmony of which I spoke earlier into a reality. I believe that we are up to that task.

October 12, 1991

G-7 MINISTERIAL COMMUNIQUE

1. The Finance Ministers and Central Bank Governors of Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States met on October 11 and 12, 1991 in Bangkok for an exchange of views on current international economic and financial issues. The Managing Director of the IMF participated in the multilateral surveillance discussions.

2. The Ministers and Governors reviewed developments and prospects in their economies. On balance, aggregate growth in G-7 countries in 1991 has been weak. Differences in cyclical positions persisted in the first half of this year. They noted that the United Kingdom is moving towards recovery while recovery is underway in the United States and Canada. They also noted that growth was projected to pick up in Italy and France. In Japan and Germany, growth has slowed from the rapid pace in 1990 to a more sustainable rate. Inflationary pressures have eased in most countries, especially those in recession, reflecting the more moderate pace of activity, lower oil prices, and other factors. These pressures are expected to ease further in most countries, while remaining strong in others. They welcomed the substantial reduction in external imbalances that has occurred in recent years, and noted the importance of avoiding the re-emergence of very large imbalances. They reaffirmed their continued support for economic policy coordination as essential for achieving their common objectives of sustained global economic growth with price stability.

3. According to the different economic conditions in each country in recent months, interest rates have declined in Japan, the United Kingdom, Canada, the United States, France and Italy, while remaining broadly unchanged in Germany. The Ministers and Governors emphasized the importance of fiscal and monetary policies which, while reflecting the differing situation in each country, provide the basis for lower real interest rates and sustained growth with price stability in a medium-term perspective.

4. The Ministers and Governors noted the importance of strengthening global savings. They stressed that the full implementation of budgetary measures adopted in some countries is essential in order to have substantial reductions in high budget deficits, and they emphasized the need for all countries to curb unproductive expenditures. In addition, they reaffirmed the importance to remove obstacles to private savings.

5. The Ministers and Governors reviewed developments in international financial markets, and concluded that the recent exchange market developments were broadly in line with continued

adjustment of external imbalances. They also reaffirmed their commitment to cooperate closely on exchange markets.

6. The Ministers and Governors, regarding recent irregularities that were revealed in some financial markets, affirmed the need for effective measures to avoid the recurrence, with a view to preserving the integrity of financial markets and systems.

7. The Ministers and Governors reaffirmed their support for the international debt strategy aimed at achieving and maintaining debtor countries' external viability. As concerns specifically the poorest, most indebted countries, they acknowledged the need to more concessional restructuring terms in support of sound economic actions. They therefore called on the Paris Club to continue its discussions on how best to implement promptly additional debt relief measures, on a case by case basis, that go well beyond the relief already granted under the Toronto terms.

8. In view of the importance of a market-oriented approach in development strategies, the Ministers and Governors noted that it is essential for developing countries to encourage private capital flows to develop a dynamic private sector, and to improve the investment climate. They observed that emphasis placed on entrepreneurial initiatives complemented by appropriate economic policy management has been the sources of the economic success in many countries, as witnessed, for example, in the Asian region. They agreed on the importance of the Multilateral Investment Fund (MIF) in supporting Latin American and Caribbean countries in reforming their investment regimes and welcomed actions being taken to make the MIF operational.

9. The Ministers and Governors underscored that the IMF and the World Bank must have adequate resources to fulfill their systemic responsibilities in supporting comprehensive economic reforms. In this regard, they reaffirmed their commitment to complete implementation of the Ninth Quota Review, including the ratification of the Third Amendment to the IMF's Articles by the end of 1991 and they encouraged all other countries to take the necessary steps.

10. The Ministers and Governors noted that improved market access and sustained expansion in global trade would provide the basis for world economic growth, and is particularly vital for countries implementing market-oriented reforms. In this connection, they re-emphasized the importance of bringing the Uruguay Round to a rapid and successful conclusion.

11. The Ministers and Governors reviewed the current economic situation and the ongoing efforts toward economic reform in the Soviet Union. They have invited the Soviet representatives for an informal discussion this evening.

October 13, 1991

COMMUNIQUE OF THE G-7 MEETING ON THE SOVIET UNION

1. The Ministers and Governors met with the Soviet representatives twice yesterday and today to discuss the historic events unfolding in their country. These meetings represented a unique opportunity for a direct exchange with the Soviets on the current economic situation and the status of their reform efforts.

2. The Ministers and Governors recognized that the Soviet Union and the Republics are confronting serious economic and financial problems. They reviewed the efforts being made to transform the Soviet Union to a market-oriented economy. In this context, they welcomed the recent agreements with the IMF on a Special Association and the establishment of the Technical Assistance Trust Fund in the World Bank. They stressed the importance of the implementation of appropriate adjustment and reform policies with the support of the international financial institutions.

3. The Soviet representatives described the immediate economic difficulties they face and welcomed the steps being taken by the G-7 and other countries in the area of humanitarian assistance for food and medicine.

4. The Ministers and Governors and the Soviet representatives also discussed the external payments situation. In this regard, they strongly endorsed the intention of the Soviet Union and the Republics to resolve certain fundamental issues essential for the maintenance of international creditworthiness and for ensuring their access to new credits, including:

- the introduction of comprehensive economic reform programs;
- the clear commitment by both the Center and Republic authorities to the timely servicing of all financial obligations;
- the establishment of an operational framework for fulfilling existing and future financial responsibilities of the Center and Republics;
- the full disclosure of Soviet economic and financial data.

5. The Ministers and Governors recognized that the adoption of a more open, democratic political system and the initiation of wide-ranging economic reforms in the Soviet Union, including steps towards the implementation of a treaty creating an economic community, are resulting in a restructuring of financial relations between the Center and the Republics. They welcomed these developments, noting that they are taking place in the context of heightened financial uncertainties. The Soviet representatives requested a continuing dialogue with the major industrial countries to help them deal with their economic and financial problems within the framework of paragraph four above. Therefore, the Ministers and Governors have agreed to send the G-7 Deputies to Moscow shortly to discuss specific approaches for dealing with these issues.

October 13, 1991

Communiqué of the Interim Committee
of the Board of Governors of the
International Monetary Fund

1. The Interim Committee of the Board of Governors of the International Monetary Fund met in Bangkok, Thailand on October 13-14, 1991 under the chairmanship of Mr. Carlos Solchaga, Minister of Economy and Finance of Spain. Mr. Michel Camdessus, Managing Director, participated in the meeting, which was also attended by a number of observers. A U.S.S.R. delegation was invited to attend some of the discussion.

2. The Committee observed that the pronounced slowdown of world economic growth this year was expected to be followed in 1992 by a moderate recovery. The recent moderation of inflation would likely continue, improving prospects for sustained growth in the medium term.

Monetary and fiscal policies in the industrial countries should continue to focus on achieving the medium-term objectives of sustained global expansion, progress toward price stability, and provide the basis for lower real interest rates. Structural reforms, including measures to reduce trade restrictions and to improve the functioning of labor markets, are needed to enhance economic efficiency and, in many countries, reduce persistently high unemployment. Continued progress in fiscal consolidation would help to increase saving, raise private investment and potential output, and alleviate the debt-service burden of heavily indebted countries. The need to raise global saving is heightened by the new claims on resources associated with reconstruction in the Middle East, unification in Germany, the economic transformation of Eastern Europe, and prospects for reform in the U.S.S.R. It is essential that these additional demands be met by reductions in the absorption of saving by governments and an increase in private saving. In that respect, an important contribution could be made by reassessing spending on defense and subsidies.

3. The Committee was unanimous in its concern over the delays in the Uruguay Round and the attendant risks to the world economy. The Committee emphasized that the liberalization of the trade system would contribute importantly to global economic growth and thereby to the resolution of the debt problem. The failure of the Round could seriously jeopardize the international trade and payment system, of which the multilateral institutions are an integral part, as well as the outward-looking economic reforms supported by the Fund and the World Bank, under which many countries have proceeded unilaterally to dismantle trade barriers. The Committee therefore urged all governments to attach the highest political priority to a speedy and successful conclusion to the Round in order to realize the efficiency gains on which future growth depends.

4. The Committee reaffirmed its support for the international debt strategy. It was encouraged by the progress made by an increasing number of developing countries toward restoring external viability and achieving sustainable growth. This testifies to the effectiveness of the growth-oriented adjustment policies that have been supported by the international community and of the instruments developed to assist members in the resolution of their debt difficulties, including commercial bank debt and

debt service reduction. The Committee welcomed emerging trends toward capital repatriation and the recovery of private direct investment flows, as well as the resumption in some cases of voluntary capital market financing. It stressed the importance of continued adequate and timely financial support for all countries that are sustaining sound policies. In this context, the list of countries eligible for support under the ESAF should be kept under consideration with a view to a possible expansion.

Direct financial assistance from bilateral creditors and official debt restructuring remain essential. As concerns specifically the poorest, most indebted countries, the Committee acknowledged the need for more concessional restructuring terms in support of sound economic actions. The Committee called on the Paris Club to continue its discussions on how best to implement promptly additional debt relief measures, on a case by case basis, that go well beyond the relief already granted under the Toronto terms. The Committee also urged commercial banks to provide support to countries engaged in strong economic reform programs that have continued to service their debt despite very difficult external circumstances. It also called upon all parties to work expeditiously toward a normalization of financial relations in those cases where restructuring of bank debt is a necessary complement to strong domestic adjustment efforts.

5. The Committee warmly welcomed the continuing commitment of Eastern European countries to stabilizing and reforming their economies along market oriented lines in spite of the added difficulties caused by the collapse of trade in the former CMEA area. The Committee reasserted the importance for these countries to move speedily with institutional and structural reform, including the opening of their economies. The Committee praised the rapid and effective response of the Fund to the changes in Eastern Europe, and its role, in cooperation with the World Bank, the EBRD, the G-24 and the Paris Club, in organizing financing for the region in 1991. Adjustment efforts in these countries must continue to be actively supported during the next few years by adequate and timely financing, with private financing playing an increasingly important role. Improved access to industrial country markets also is indispensable to the reorientation and recovery of these economies.

6. The Committee welcomed the intention of the authorities in the U.S.S.R. to intensify reliance on market mechanisms and to integrate the economy into the multilateral trade and payments system. In view of the present circumstances of the country, the Committee warmly welcomed the signing of the Special Association between the U.S.S.R. and the Fund, as a step toward membership. The wide ranging expertise that has become available under this association will assist the authorities in moving forward with urgently needed economic stabilization and structural reforms so as to overcome the current crisis and set the stage for a successful transformation of the economy.

7. The Committee took stock of the progress made by members in consenting to increases in their quotas under the Ninth General Review and in accepting the Third Amendment of the Articles. The Committee urged those members who have not yet done so to complete the necessary procedures before the end of this year.

8. The Committee expressed its appreciation to the Kingdom and people of Thailand for their warm hospitality. It agreed to hold its next meeting in Washington, D.C. on Monday, April 27, 1992.

AUCTION RESULTS

PUBLIC DEBT NEWS

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

FOR IMMEDIATE RELEASE
October 15, 1991

CONTACT: Office of Financing
202-219-3350

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Tenders for $10,812 million of 13-week bills to be issued October 17, 1991 and to mature January 16, 1992 were accepted today (CUSIP: 912794XV1).

RANGE OF ACCEPTED
COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	4.97%	5.12%	98.744
High	5.00%	5.15%	98.736
Average	4.99%	5.14%	98.739

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	30,855	30,855
New York	27,999,200	8,833,890
Philadelphia	32,010	32,010
Cleveland	56,370	56,370
Richmond	148,950	73,350
Atlanta	38,695	31,495
Chicago	1,985,935	686,735
St. Louis	44,355	14,355
Minneapolis	7,535	7,535
Kansas City	37,875	37,875
Dallas	25,160	25,160
San Francisco	1,031,015	198,855
Treasury	783,120	783,120
TOTALS	$32,221,075	$10,811,605
Type		
Competitive	$28,190,810	$6,781,340
Noncompetitive	1,698,715	1,698,715
Subtotal, Public	$29,889,525	$8,480,055
Federal Reserve	2,146,720	2,146,720
Foreign Official Institutions	184,830	184,830
TOTALS	$32,221,075	$10,811,605

An additional $164,970 thousand of bills will be issued to foreign official institutions for new cash.

NB-1499

AUCTION RESULTS

PUBLIC DEBT NEWS

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

FOR IMMEDIATE RELEASE
October 15, 1991

CONTACT: Office of Financing
202-219-3350

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Tenders for $10,839 million of 26-week bills to be issued October 17, 1991 and to mature April 16, 1992 were accepted today (CUSIP: 912794YJ7).

RANGE OF ACCEPTED
COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.01%	5.23%	97.467
High	5.03%	5.25%	97.457
Average	5.03%	5.25%	97.457

Tenders at the high discount rate were allotted 57%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	26,625	26,625
New York	28,137,500	9,473,190
Philadelphia	15,045	15,045
Cleveland	33,600	33,600
Richmond	39,760	37,610
Atlanta	51,710	42,990
Chicago	1,509,540	254,740
St. Louis	34,435	17,285
Minneapolis	7,680	7,680
Kansas City	39,840	39,840
Dallas	21,075	21,075
San Francisco	696,840	204,050
Treasury	665,195	665,195
TOTALS	$31,278,845	$10,838,925
Type		
Competitive	$27,137,615	$6,697,695
Noncompetitive	1,215,960	1,215,960
Subtotal, Public	$28,353,575	$7,913,655
Federal Reserve	2,450,000	2,450,000
Foreign Official Institutions	475,270	475,270
TOTALS	$31,278,845	$10,838,925

An additional $436,730 thousand of bills will be issued to foreign official institutions for new cash.

NB-1500

TREASURY NEWS

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

FOR RELEASE AT 2:30 P.M.
October 15, 1991

CONTACT: Office of Financing
202/219-3350

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $21,200 million, to be issued October 24, 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 $18,142 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, October 21, 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 $10,600 million, representing an additional amount of bills dated July 25, 1991, and to mature January 23, 1992 (CUSIP No. 912794 XW 9), currently outstanding in the amount of $10,933 million, the additional and original bills to be freely interchangeable.

182-day bills (to maturity date) for approximately $10,600 million, representing an additional amount of bills dated May 24, 1991, and to mature April 23, 1992 (CUSIP No. 912794 YK 4), currently outstanding in the amount of $16,014 million, the additional and original bills to be freely interchangeable.

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

The bills will be issued for cash and in exchange for Treasury bills maturing October 24, 1991. In addition to the maturing 13-week and 26-week bills, there are $10,132 million of maturing 52-week bills. The disposition of this latter amount was announced last week. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. For purposes of determining such additional amounts, foreign and international monetary authorities are considered to hold $1,410 million of the original 13-week and 26-week issues, but hold none of the original 52-week issue. Federal Reserve Banks, for their own account, hold $7,139 million in combined holdings 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-1501

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