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NFIB NEWS



HOLD FOR RELEASE UNTIL 10 AM TUESDAY, NOV. 12, 1991

SMALL BUSINESS OUTLOOK SOUR AS RECESSION HANGS ON

WASHINGTON, Nov. 12---As the economy hovers near a second recession, even the usually optimistic small-business sector is losing its confidence, according to the latest quarterly survey of more than 2,000 small firms released today by the nation's largest small-business advocacy organization, the National Federation of Independent Business.

NFIB's small-business optimism index, a reliable gauge of entrepreneurs' attitudes, continued its downward slide by dropping two percentage points from July to hit 98.5 (1978=100). The index has steadily declined since April. (Table I: Small-Business Optimism Index)

"The economy stopped falling in the third quarter, but it settled into the mud," NFIB Chief Economist William Dunkelberg said. "The fourth quarter will not be as good and could produce another decline in real GNP."

Small-business sales declines were among the worst reported in the survey's 19-year history. Spending and hiring plans lost ground and the employment outlook deteriorated.

On the bright side, there is still no sign of the much-rumored credit crunch and inflation should remain stable; planned price hikes are at a record low and actual third-quarter price cutting appeared widespread.

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Page Two: NFIB Survey

The small-business community represented by NFIB, which has more than 500,000 member firms in all 50 states, employs half of the private, non-farm workforce and produces 50 percent of the nation's gross private product.

Troubling entrepreneurs most is the specter of high taxes. One fourth (25 percent) of those responding to the survey called taxes their "most important problem," followed by government regulation and weak demand.

BORROWING BOTTOMS OUT

Although rumors of a credit crunch continued to circulate, even fueled at one point by White House officials, no evidence of such a trend was found in the October survey.

To the contrary, regular borrowing--at least once a quarter--hit an all-time survey-low of 33 percent. Only 11 percent reported that financing was harder to arrange now than earlier in the year, down one point from July; and only 1 percent reported paying higher interest rates--a significant improvement over the 36 percent figure recorded just two years ago. (Table II: Firms Reporting Credit Harder to Get)

"The hope that interest rates will stimulate the economy is a faint one," Dunkelberg said. "The economy is simply overloaded with goods and financed by a lot of debt."

The average interest rate paid by small firms fell 50 basis points to 10.5 percent in the third quarter. Just over half--51 percent--of all short-term loans were tied to the prime rate.

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Page Three: NFIB Survey

Less than one fifth (19 percent) reported paying lower rates.

No change was noted among those firms expecting tougher borrowing conditions ahead. The figure holds at 12 percent, while those expecting easier conditions remained at 1 percent.

Regionally, things are still difficult in New England where more than half (53 percent) of regular borrowers are reporting credit harder to get. Next in line came the South Atlantic states at 43 percent, Mountain states at 41 percent and West-South Central states where 37 percent encountered more problems getting loans.

By industry, transportation, financial services and non-professional service firms were having the most problems obtaining credit at 39 percent each, followed closely by manufacturing at 38 percent and construction at 34 percent.

INFLATION OUTLOOK GOOD

Another NFIB survey record was established during the third quarter when plans to raise prices dropped to 17 percent of all firms, a two-point decline from the previous quarter. (Table III: Planned Price Changes)

Dunkelberg said the sign is good news for policymakers and is consistent with sluggish demand and stable costs. "This should bring interest rates down over the next six months and keep the inflation rate low for the rest of this year and all of 1992," he said.

Actual lower selling prices were reported by 16 percent

-more-

Page Four: NFIB Survey

during the period, while 18 percent noted higher prices, nine points below a year ago, matching a survey record-low in 1986.

By industry, planned price hikes were uniformly low. Retail and service firms topped the list at 20 percent each. Professional services, which usually figure in the upper levels of frequent price increases, dipped to 18 percent in the third quarter, down 19 points from January.

EMPLOYMENT WEAKNESS SPREADS

Bad news on the employment scene was clearly evident in the small-business survey. Only one-tenth of all firms (10 percent) plan to hire workers in the coming quarter, while 12 percent expect layoffs. Seasonally adjusted, this represents a substantial decline in hiring plans. (Table IV: Industry Employment)

Firms with job openings fell two points to 14 percent. Manufacturing, transportation and non-professional service firms headed the list of those most frequently complaining of hard-to-fill positions.

Small-business employment, on average, fell 0.17 workers per firm during the third quarter, a seasonally-adjusted decline of 0.44 employees per company. Actual hiring increases fell four points to 13 percent, while declines grew three points to 18 percent.

"The job generating power of small business seems to have gone into reverse," Dunkelberg said. "This will mean bad news

Page Five: NFIB Survey

for the unemployment rate for the rest of the year."

Construction and manufacturing companies recorded the largest employment losses during the period (24 percent each), but the services sector had substantial cutbacks as well (19 percent).

The economist said the overall employment gains outlook is not good: hiring plans are continuing to dip, job openings are falling, compensation is stagnant.

CAPITAL SPENDING CONTINUES DOWNWARD

Seasonally adjusted, planned capital outlays approached the second lowest level reached in nearly a decade, Dunkelberg said, noting that demand for capital goods will remain weak throughout 1991 and well into next year.

Slightly more than one-fourth (26 percent) of all small firms plan to spend in the coming six months, down one point from July but 10 points below the expansion-high recorded in early 1989.

Only half (50 percent) reported actual capital outlays during the past half-year, and just a little more than one-third (36 percent) noted spending in excess of \$5,000, the weakest figures in nearly 10 years.

Equipment and vehicle purchases made in the past six months slid two points to 40 percent, while building improvements lost one point to 14 percent. No change was noted in the percentages of those erecting new buildings and adding land, 6 percent and 3

-more-

percent, respectively.

INVENTORY BUYING STALLS

After a very aggressive second quarter, the percentage of firms planning to increase inventories in the next six months declined four points to 13 percent, while those expecting decreases did just the opposite.

The economist said the sharp declines from July and April suggest that small firms have abandoned any hopes that the economy will quickly recover.

Those satisfied with current stock levels held steady: 11 percent said holdings were too high, 10 percent said they were too low.

Actual third-quarter inventory changes also held firm: 15 percent added to their holdings while 22 percent trimmed their shelves. The frequency of inventory liquidation continues to run above any year since the 1980-82 recession.

All industry groups except professional and financial services firms were planning to decrease inventories. Predominant among those trimming stocks were retailers, wholesalers and construction companies.

#

Charts follow

TABLE 1
SMALL BUSINESS OPTIMISM INDEX

Year/ Quarter	Index Components			Optimism Index ⁴		
	General Expect ¹	Current status ²	Spending Plans ³	Basic Index ⁵	1978 = 100 Basic	Seas. Adj.
1984:1	128.5	102.3	119.0	117.8	108.6	108.7
2	125.5	102.0	120.7	117.0	107.8	105.5
3	109.8	106.0	112.0	109.3	100.7	100.5
4	112.5	103.7	111.3	109.5	100.9	103.4
1985:1	119.0	100.7	118.0	113.2	104.3	104.4
2	119.0	98.7	119.0	112.9	104.1	101.8
3	114.8	103.7	112.0	110.6	101.9	101.7
4	105.8	100.0	109.7	105.2	97.0	99.5
1986:1	113.5	99.3	117.0	110.3	101.7	101.8
2	122.3	98.7	117.7	113.8	104.9	102.6
3	112.0	102.3	111.3	108.9	100.4	100.1
4	105.0	102.0	108.7	105.2	97.0	99.5
1987:1	112.0	101.3	116.3	110.1	101.5	101.6
2	117.0	101.0	119.0	112.8	104.0	101.7
3	113.8	106.3	114.3	111.7	103.0	102.7
4	107.5	105.7	112.0	108.3	99.8	102.3
1988:1	108.5	103.0	120.3	110.4	101.8	101.8
2	117.5	101.7	119.7	113.4	104.5	102.2
3	109.3	105.7	113.0	109.3	100.7	100.5
4	107.3	106.3	113.7	108.9	100.4	102.9
1989:1	110.5	104.3	119.7	111.4	102.7	102.8
2	110.3	101.3	120.0	110.5	101.8	99.5
3	107.8	106.0	112.3	108.6	100.1	99.8
4	108.3	104.0	112.0	108.1	99.6	102.1
1990:1	109.3	100.0	118.3	109.2	100.7	100.7
2	114.4	101.3	118.7	111.9	103.1	100.8
3	105.0	103.0	113.0	106.8	98.4	98.2
4	89.3	98.7	107.0	97.4	89.8	92.3
1991:1	97.3	94.0	111.0	100.4	92.5	92.6
2	123.3	94.0	118.0	112.9	104.1	101.8
3	116.0	99.7	111.3	109.7	101.1	100.8
4	108.0	96.7	106.7	104.2	96.0	98.5

- ¹ Expected Business Conditions, The Climate for Expansion
Expected Real Sales Volumes, Expected Credit Conditions.
- ² Current Job Openings, Current Inventory Satisfaction,
Change in Net Earnings from Previous Quarter.
- ³ Plans to Hire, Make Capital Outlays, Add to Inventories
- ⁴ Formula: Sum of [%Favorable Responses - % Unfavorable]
for the ten questions, divided by ten, plus 100.
- ⁵ Weighted average of the first three columns

HIGH AND LOW VALUES DENOTED IN BOLD

TABLE II
PERCENT OF FIRMS REPORTING CREDIT HARDER TO GET

<u>Region</u>	<u>Harder^A</u>	<u>Reg Bor</u>	<u>Industry</u>	<u>Harder^A</u>	<u>Reg Bor</u>
New England	53%	28%	Construction	34%	44%
Mid-Atlantic	27%	30%	Manufacturing	38%	34%
East-South Central	29%	40%	Transportation	39%	31%
South Atlantic	43%	32%	Wholesale	30%	52%
East-North Central	29%	38%	Retail	29%	30%
West-South Central	37%	32%	Agriculture	19%	40%
West-North Central	17%	46%	Financial Serv.	39%	32%
Mountain	41%	32%	Non-Prof. Serv.	39%	23%
Pacific	36%	25%	Professional Serv.	30%	28%
ALL FIRMS	33%	33%		33%	33%

^A The percent of firms **borrowing regularly** [shown under REG BOR] that reported financing was "**harder**" to arrange than in the prior quarter.

Definition of Regions

<u>Region</u>	<u>States</u>
New England	Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island, Vermont
Mid-Atlantic	New Jersey, New York, Pennsylvania
Great Lakes	Illinois, Indiana, Michigan, Ohio, Wisconsin
Plains	Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota, South Dakota
South Atlantic	Delaware, Florida, Georgia, Maryland, North Carolina, South Carolina, Virginia, West Virginia (includes Washington, DC)
East South Central	Alabama, Kentucky, Mississippi, Tennessee
West South Central	Arkansas, Louisiana, Oklahoma, Texas
Mountain	Arizona, Colorado, Idaho, Montana, Nevada, New Mexico, Utah, Wyoming
Pacific	Alaska, California, Hawaii, Oregon, Washington

TABLE III
PLANNED PRICE CHANGES BY INDUSTRY

Industry	Plans to Raise Prices									
	1989	1990				1991				
	Oct	Jan	Apr	Jul	Oct	Jan	Apr	Jul	Oct	
Construction	26%	37%	26%	23%	28%	22%	20%	19%	18%	
Manufacturing	29	30	23	19	30	28	23	19	17	
Transportation	19	23	22	19	44	26	24	15	7	
Wholesale	28	44	24	28	38	34	24	16	16	
Retail	28	33	28	24	35	32	23	23	20	
Agriculture	22	34	12	21	20	13	16	13	18	
Financial Service	8	15	13	10	12	15	15	12	10	
Services	24	35	28	26	29	29	22	23	20	
Prof. Services	29	27	26	27	30	37	22	16	18	

Plans to Lower Prices										
Construction	2%	4%	3%	4%	7%	9%	4%	4%	5%	
Manufacturing	2	3	2	4	3	3	3	3	4	
Transportation	4	6	1	*	4	1	2	3	3	
Wholesale	5	4	4	*	5	3	5	3	2	
Retail	3	4	4	4	4	7	3	4	5	
Agriculture	5	2	6	1	5	6	2	4	3	
Financial Service	8	5	3	6	5	7	7	*	1	
Services	2	1	3	2	4	5	3	2	5	
Prof. Services	*	1	1	3	*	4	1	1	1	

* Less than .5%

TABLE IV
INDUSTRY EMPLOYMENT STATISTICS

<u>Industry</u>	<u>Past Employment Change</u>		<u>Current Job Openings</u>			<u>Employment Plans¹</u>	
	<u>Inc.</u>	<u>Dec.</u>	<u>Skill</u>	<u>Unsk.</u>	<u>Both</u>	<u>Inc.</u>	<u>Dec.</u>
Construction	17%	24%	13%	1%	2%	7%	23%
Manufacturing	20	24	15	1	4	16	10
Transportation	17	17	17	*	3	16	10
Wholesale	13	18	12	1	3	11	9
Retail	11	17	6	3	1	8	13
Agriculture	13	14	8	2	3	4	22
Finance	8	10	7	1	1	6	3
Services	11	19	12	2	2	13	7
Professional	6	10	6	1	2	11	6
 All Firms	 13%	 18%	 10%	 2%	 2%	 10%	 12%

¹ During the next three months.



NATIONAL FEDERATION OF INDEPENDENT BUSINESS

October 1991

**Quarterly Economic Report
For Small Business and the Economy**

**Hold for Release
Tuesday, November 12, 1991**

Reports On: _____

- Small Business Optimism
- Employment and Job Openings
- Inflation
- Inventory Investment
- Capital Expenditures
- Borrowing and Interest Rates

**Contact: Terry Hill
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NATIONAL FEDERATION OF INDEPENDENT BUSINESS
October, 1991 Quarterly Economic Survey

SMALL BUSINESS OPTIMISM

William C. Dunkelberg

OVERVIEW

**** THE NFIB SMALL BUSINESS OPTIMISM INDEX LOST TWO POINTS FROM JULY, FALLING TO 98.5 [SEASONALLY ADJUSTED]. THE INDEX NOW STANDS ONLY SIX POINTS ABOVE YEAR-AGO LEVELS AND HAS STEADILY LOST GROUND SINCE REBOUNDED FROM RECESSION LEVELS IN APRIL.**

SPENDING AND HIRING PLANS ALL LOST GROUND AS THE ECONOMY CONTINUED TO GO NOWHERE, SLOWLY.

**** THE THIRD QUARTER REBOUND HAPPENED AS PREDICTED - THE ECONOMY STOPPED FALLING AND SETTLED INTO THE MUD WITH A TWO-PLUS PERCENT GROWTH RATE SUPPORTED BY HEAVY AUTO PRODUCTION. THE FOURTH QUARTER WILL NOT BE AS GOOD, AND COULD PRODUCE ANOTHER DECLINE IN REAL GNP.**

**** NO "CREDIT CRUNCH" OF THE 1974-75 OR THE 1980-82 TYPE HAS YET APPEARED IN THE SURVEY. ONLY 11% REPORTED THAT FINANCING WAS "HARDER" TO ARRANGE THAN EARLIER IN THE YEAR - DOWN A POINT FROM JULY. 1% REPORTED HIGHER RATES, DOWN FROM 36% IN 1989. IF CREDIT IS IN SHORT SUPPLY, IT'S PRICE DOES NOT REFLECT IT NOR DO REPORTS OF FINANCING DIFFICULTIES. ONLY 5% REPORT FINANCING DIFFICULTIES AS THE NUMBER ONE PROBLEM FACING SMALL BUSINESS TODAY, COMPARED TO OVER 30% IN THE EARLY 1980S.**

**** PLANS TO RAISE PRICES HIT A RECORD LOW, WITH 17% PLANNING PRICE HIKES IN THE NEXT SIX MONTHS, DOWN FROM 27% IN JANUARY AND 30% LAST OCTOBER. PRICE CUTTING WAS WIDESPREAD, WITH 16% REPORTING LOWER SELLING PRICES. 18% ACTUALLY INCREASED SELLING PRICES, DOWN FROM 28% TWO YEARS AGO.**

**** 14% OF ALL FIRMS REPORTED A JOB OPENING THAT WAS HARD TO FILL, 5 POINTS BELOW FOURTH QUARTER 1990 LEVELS. THE UNEMPLOYMENT RATE WILL REMAIN NEAR CURRENT LEVELS AS LABOR MARKET WEAKNESS SPREADS. 10% OF ALL FIRMS PLAN TO HIRE AND 12% PLAN EMPLOYMENT REDUCTIONS IN THE NEXT SIX MONTHS.**

**** REPORTS OF SALES DECLINES WERE AMONG THE WORST IN THE 18 YEAR HISTORY OF THE QUARTERLY ECONOMIC SURVEY. 27% REPORTED HIGHER SALES, BUT 29% REPORTED LOWER VOLUMES. THIS REPRESENTS A SEASONALLY ADJUSTED IMPROVEMENT OVER APRIL AND JULY, AFTER SIX MONTHS OF RECORD SALES DECLINES IN THE FOURTH AND FIRST QUARTERS.**

**** ONLY 17% RAISED LABOR COMPENSATION, AND ONLY 14% PLAN TO INCREASE COMPENSATION OVER THE NEXT SIX MONTHS, BOTH RECORD LOW FIGURES.**

TABLE 1
SMALL BUSINESS OPTIMISM INDEX

Year/ Quarter	Index Components			Optimism Index ⁴		
	General Expect ¹	Current status ²	Spending Plans ³	Basic Index ⁵	1978 = 100 Basic	Seas. Adj.
1974:4	91.0	94.7	100.3	94.9	87.5	90.0
1975:1	95.3	90.0	100.3	95.2	87.7	87.8
2	119.5	89.0	108.3	107.0	98.6	96.3
3	119.8	96.3	106.3	108.7	100.2	99.9
4	112.8	98.7	107.3	106.9	98.5	101.0
1976:1	120.3	99.7	113.3	112.0	103.2	103.2
2	129.3	99.3	114.3	115.8	106.7	104.2
3	118.3	104.0	110.7	111.7	103.0	102.7
4	112.0	99.3	110.0	107.6	99.2	101.7
1977:1	119.0	100.0	117.0	112.7	103.9	104.0
2	124.5	99.7	119.3	115.5	106.5	104.2
3	115.5	105.7	111.7	111.4	102.7	102.4
4	105.0	103.3	109.3	105.8	97.5	100.0
1978:1	111.0	102.3	117.7	110.4	101.8	101.8
2	114.3	98.7	120.7	111.5	102.8	100.5
3	102.0	105.0	113.3	106.3	98.0	97.7
4	101.8	104.3	113.0	105.9	97.6	100.1
1979:1	97.5	101.0	116.7	104.4	96.1	96.2
2	102.5	98.7	118.0	106.0	97.7	95.4
3	88.5	102.0	109.0	98.7	91.0	90.7
4	92.0	100.0	108.0	99.2	91.4	93.9
1980:1	97.0	96.0	112.0	101.2	93.3	93.4
2	83.3	88.3	102.3	90.5	LOW 83.4	81.1
3	109.8	91.33	107.3	103.5	95.4	95.1
4	106.0	94.3	108.3	103.2	95.1	97.6
1981:1	109.0	93.7	112.0	105.3	97.1	97.1
2	117.0	94.0	115.0	109.5	100.9	98.6
3	113.3	96.7	113.3	108.3	99.8	99.5
4	104.3	91.3	104.3	100.4	92.5	95.0
1982:1	110.0	89.7	111.3	104.3	96.1	96.2
2	115.3	89.7	112.0	106.6	98.2	95.9
3	110.3	93.3	105.3	103.7	95.6	95.3
4	112.0	92.7	105.7	104.3	96.1	98.6
1983:1	118.8	94.0	114.0	109.9	101.3	101.4
2	133.8	96.3	118.7	118.0	HI 108.8	106.5
3	130.5	104.0	114.7	117.8	108.6	108.3
4	122.8	103.7	113.3	114.2	105.3	107.7

*SERIES
REVISED
JANUARY
1987*

TABLE 1 [continued]
SMALL BUSINESS OPTIMISM INDEX

Year/ Quarter	Index Components			Optimism Index ⁴		
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2	125.5	102.0	120.7	117.0	107.8	105.5
3	109.8	106.0	112.0	109.3	100.7	100.5
4	112.5	103.7	111.3	109.5	100.9	103.4
1985:1	119.0	100.7	118.0	113.2	104.3	104.4
2	119.0	98.7	119.0	112.9	104.1	101.8
3	114.8	103.7	112.0	110.6	101.9	101.7
4	105.8	100.0	109.7	105.2	97.0	99.5
1986:1	113.5	99.3	117.0	110.3	101.7	101.8
2	122.3	98.7	117.7	113.8	104.9	102.6
3	112.0	102.3	111.3	108.9	100.4	100.1
4	105.0	102.0	108.7	105.2	97.0	99.5
1987:1	112.0	101.3	116.3	110.1	101.5	101.6
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3	113.8	106.3	114.3	111.7	103.0	102.7
4	107.5	105.7	112.0	108.3	99.8	102.3
1988:1	108.5	103.0	120.3	110.4	101.8	101.8
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3	109.3	105.7	113.0	109.3	100.7	100.5
4	107.3	106.3	113.7	108.9	100.4	102.9
1989:1	110.5	104.3	119.7	111.4	102.7	102.8
2	110.3	101.3	120.0	110.5	101.8	99.5
3	107.8	106.0	112.3	108.6	100.1	99.8
4	108.3	104.0	112.0	108.1	99.6	102.1
1990:1	109.3	100.0	118.3	109.2	100.7	100.7
2	114.4	101.3	118.7	111.9	103.1	100.8
3	105.0	103.0	113.0	106.8	98.4	98.2
4	89.3	98.7	107.0	97.4	89.8	92.3
1991:1	97.3	94.0	111.0	100.4	92.5	92.6
2	123.3	94.0	118.0	112.9	104.1	101.8
3	116.0	99.7	111.3	109.7	101.1	100.8
4	108.0	96.7	106.7	104.2	96.0	98.5

¹ Expected Business Conditions, The Climate for Expansion
Expected Real Sales Volumes, Expected Credit Conditions.

² Current Job Openings, Current Inventory Satisfaction,
Change in Net Earnings from Previous Quarter.

³ Plans to Hire, Make Capital Outlays, Add to Inventories

⁴ Formula: Sum of [%Favorable Responses - % Unfavorable]
for the ten questions, divided by ten, plus 100.

⁵ Weighted average of the first three columns

HIGH AND LOW VALUES DENOTED IN BOLD

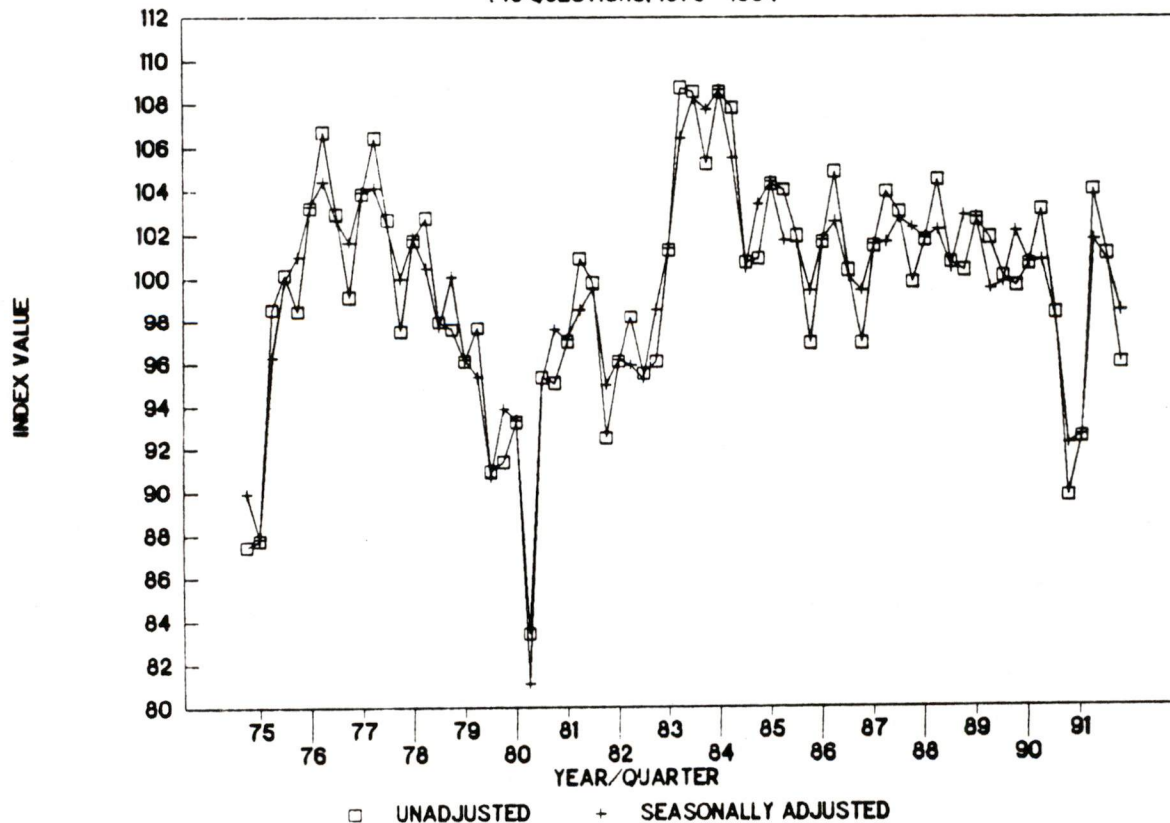
TABLE A

SELECTED CHANGES IN INDEX COMPONENTS
[UNADJUSTED]

Percent of all firms reporting:																	
	1988					1989				1990				1991			
	:4	:1	:2	:3	:4	:1	:2	:3	:4	:1	:2	:3	:4				
Good Time to Expand	16%	17%	16%	17%	15%	15%	17%	13%	5%	5%	14%	11%	10%				
Expected Bus. Conditions																	
Better	19	22	18	15	20	24	22	17	12	27	51	43	35				
Worse	16	12	21	21	13	15	14	22	42	25	8	10	12				
Expected Real Volume																	
Higher	43	44	56	45	43	43	56	43	34	31	58	48	38				
Lower	26	22	17	19	26	24	15	20	38	37	13	17	28				

SMALL BUSINESS OPTIMISM INDEX

[10 QUESTIONS, 1978 = 100]



THE NATIONAL FEDERATION OF INDEPENDENT BUSINESS HAS OVER 500,000
MEMBER FIRMS. A TOTAL OF 2018 FIRMS RESPONDED TO THE QUARTERLY
SURVEY. THE SMALL BUSINESS COMMUNITY IT REPRESENTS EMPLOYS ABOUT
HALF OF THE PRIVATE NON-FARM WORK FORCE AND PRODUCES ABOUT 50% OF
OUR GROSS PRIVATE PRODUCT.

The Small Business Optimism Index continued to fade after rebounding from recession levels in April. Since then, the Index has lost 3.3 points. Seasonally adjusted, the Index stood at 98.5 in October, down from 101.8 in April. The slippage was produced by weak spending plans for new employees, inventories and capital equipment and less optimism about sales gains and a turn in the economy.

After restoring their role as job creators in the second quarter, small firms made no contribution to employment growth in the third.

[SEE CHARTS FOR PLOTS OF SEASONALLY ADJUSTED VALUES]

The Administration is feeling the pressure to do something. Re-election concerns appear to be forcing the President to pressure the Federal Reserve into action. However, there is little that monetary policy can do to stimulate the economy at this point. Lower interest rates may reduce the cost of financing new capital, but even with lower rates, firms are not likely to add to or upgrade capacity when there is no demand for their output. The present value of a negligible cash flow is 0 regardless of what interest rate one uses for discounting. It is expected revenue, and not the cost of funds that will drive spending decisions.

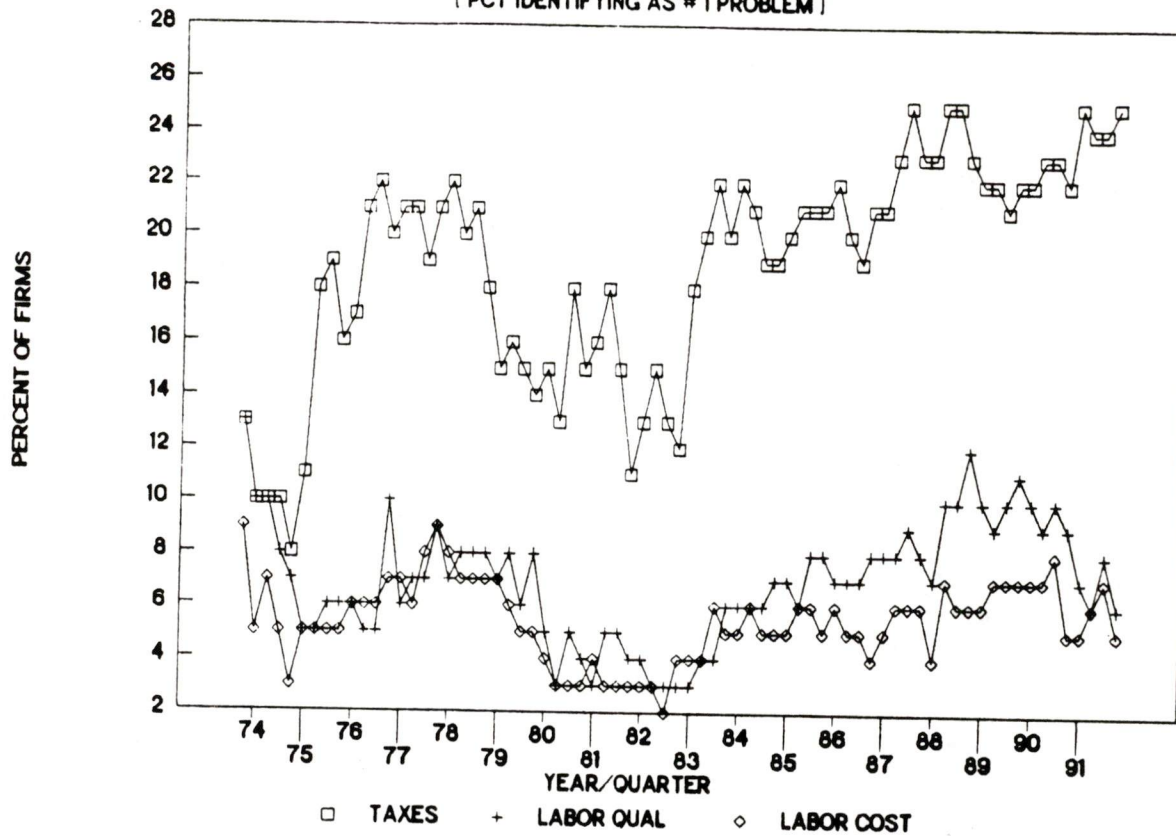
No two recessions are the same, of course. But this one seems to carry with it a large array of structural problems that will help insure that the decade of the 1990s will be the slowest growth decade in history.

MOST IMPORTANT PROBLEM

TAXES received more votes for "MOST IMPORTANT PROBLEM" than any other factor [25%]. REGULATION, another form of taxes, came in second with 18% of the votes. WEAK DEMAND was cited as #1 by 17% of all firms, followed by COMPETITION from large firms with 8% of the votes. LABOR QUALITY drew 6% of the votes and LABOR COST received 5%. FINANCING difficulties were named by just 5% as the most important problem. Nope, no CREDIT CRUNCH. 5% cited INFLATION as the top problem.

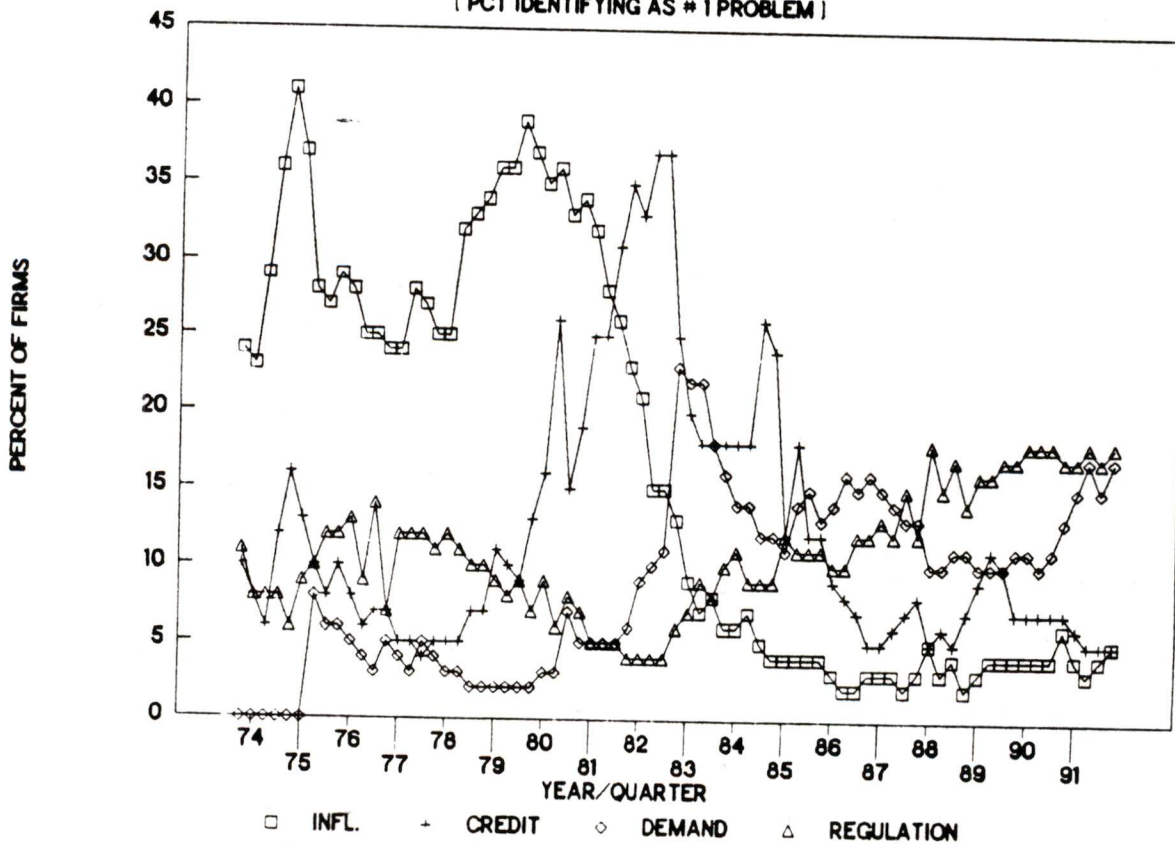
MOST IMPORTANT PROBLEMS

[PCT IDENTIFYING AS #1 PROBLEM]



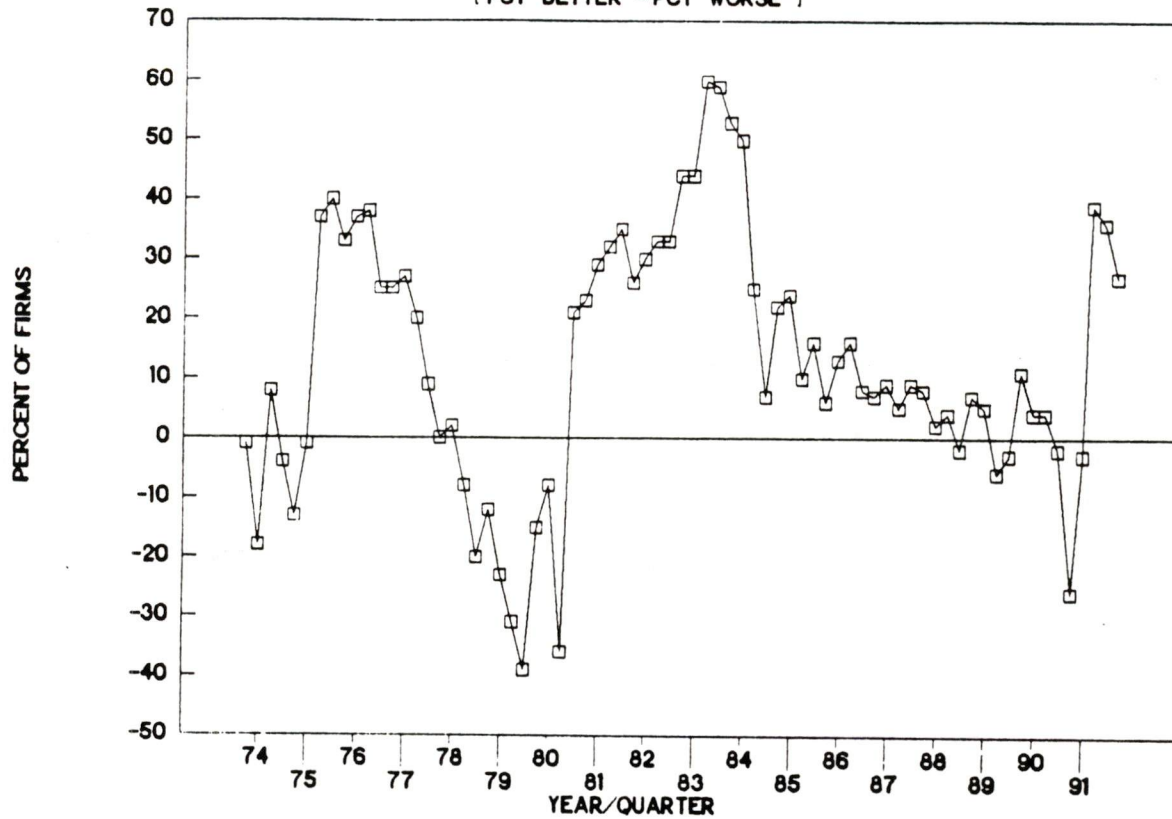
MOST IMPORTANT PROBLEMS

[PCT IDENTIFYING AS #1 PROBLEM]



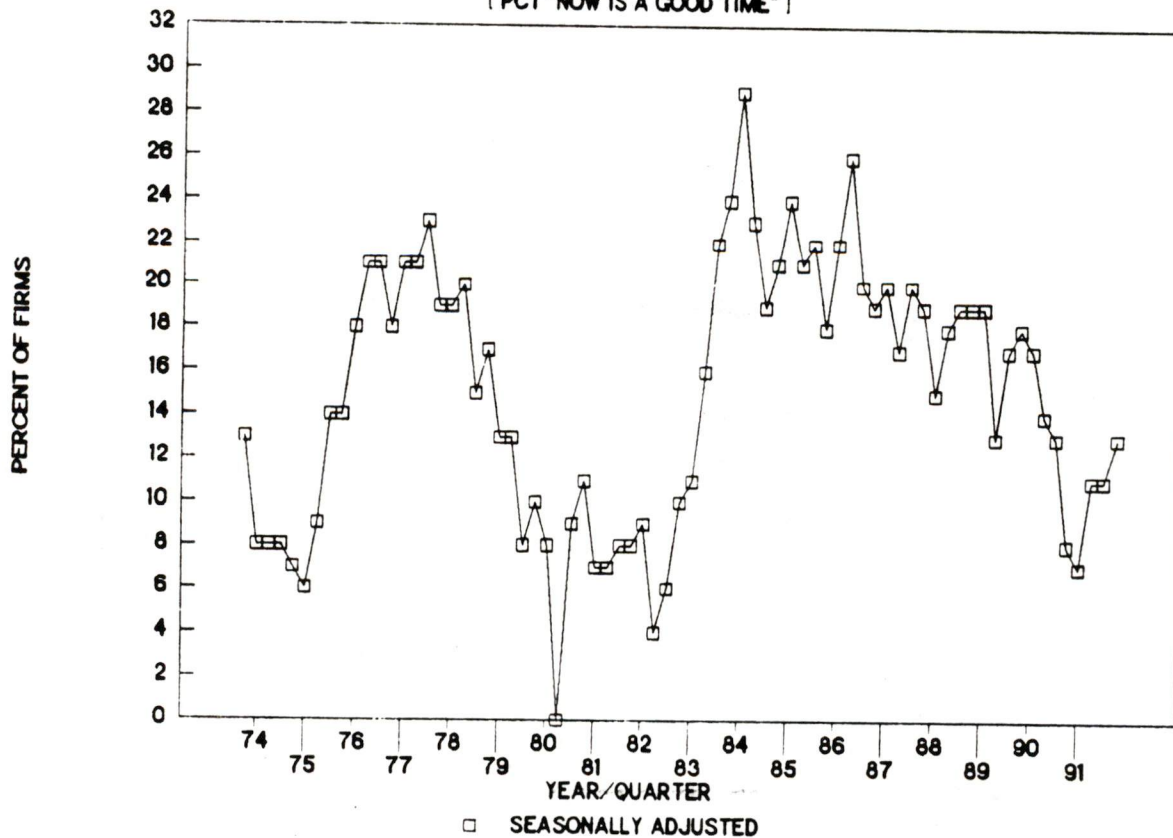
OUTLOOK FOR GENERAL BUSINESS CONDITIONS

[PCT "BETTER" - PCT "WORSE"]



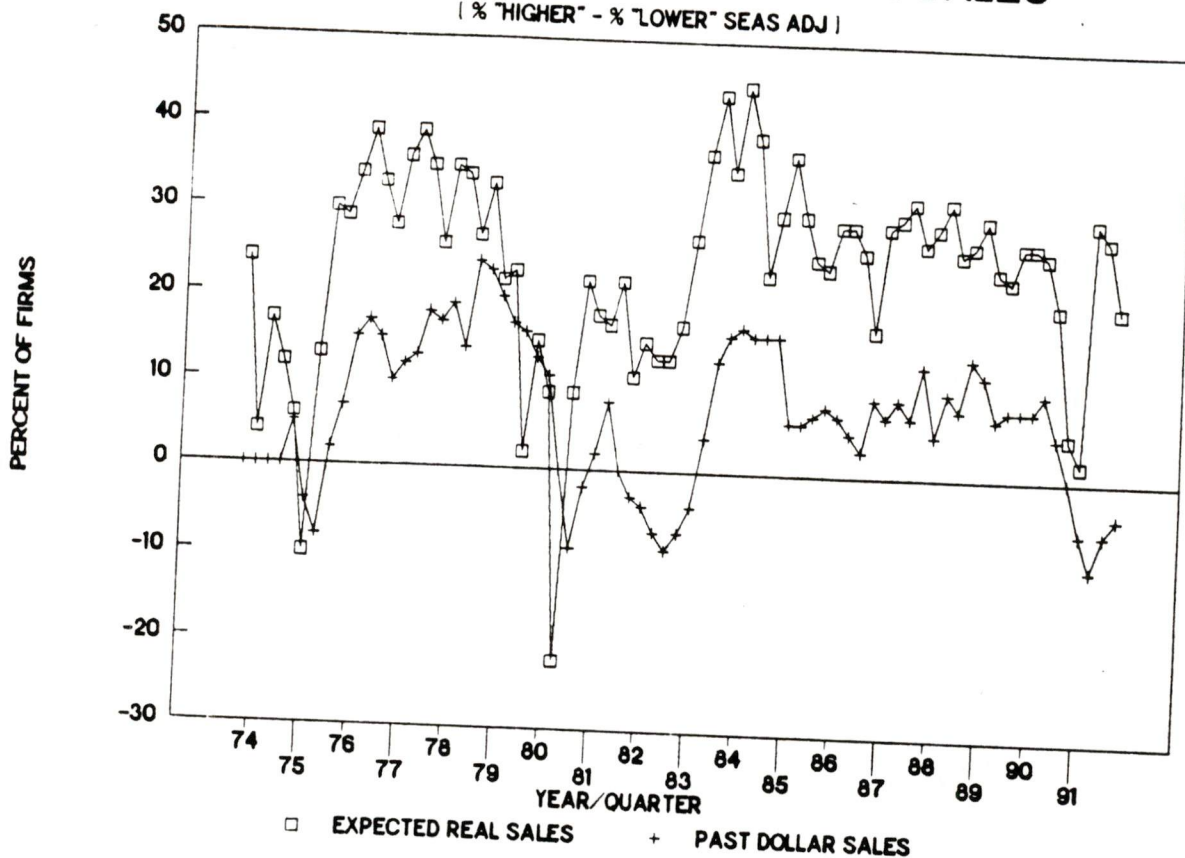
OUTLOOK FOR BUSINESS EXPANSION

[PCT "NOW IS A GOOD TIME"]



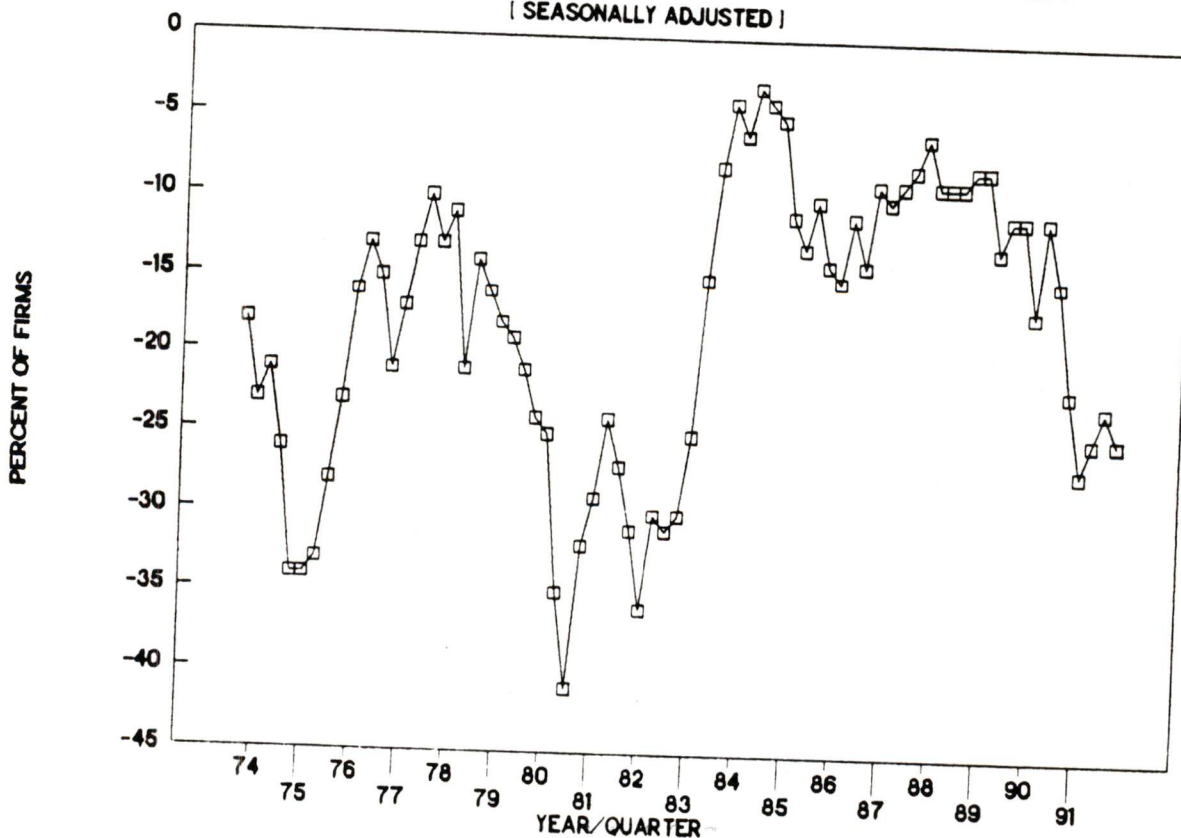
PAST SALES & EXPECTED REAL SALES

(% "HIGHER" - % "LOWER" SEAS ADJ)



EARNINGS TRENDS: NET PERCENT HIGHER

(SEASONALLY ADJUSTED)



NATIONAL FEDERATION OF INDEPENDENT BUSINESS
October, 1991 Quarterly Economic Report

BORROWING ACTIVITY AND INTEREST RATES

William C. Dunkelberg

THE AVERAGE INTEREST RATE PAID BY SMALL FIRMS FELL 50 BASIS POINTS TO 10.5% IN THE THIRD QUARTER OF 1991. 51% OF ALL SHORT-TERM LOANS WERE TIED TO THE PRIME RATE.

THE PERCENT OF FIRMS BORROWING ON A REGULAR BASIS FELL TO 33%, A RECORD-LOW LEVEL.

LOOKING AHEAD, THE PERCENT OF FIRMS EXPECTING IT TO BE MORE DIFFICULT TO BORROW HELD AT 12% OF ALL FIRMS. THE PERCENT EXPECTING IT TO BE "EASIER" TO GET NEEDED FINANCING STOOD AT 1%.

JUST 1% REPORTED HIGHER RATES ON THEIR LOANS [DOWN FROM 36% IN EARLY 1989] AND 11% SAID LOANS WERE HARDER TO GET, DOWN A POINT FROM JULY. 19% REPORTED PAYING LOWER INTEREST RATES.

The average interest rate paid for short-term money fell to 10.5%, a decline of 50 basis points [Table 1]. This will bring some relief to the bottom lines of borrowing firms. 51% of the loans made were tied to the prime rate. Recent declines in the prime will provide immediate interest rate relief to over a million small employers borrowing on a regular basis.

Regular borrowing activity was reported by 33%, a record low level [Table 2]. It appears that the firms banks would like to lend to are not interested in borrowing. [Chart]

Once again, about one-third of the borrowers reported that they found credit more difficult to arrange in their last attempt relative to the quarter before. New England was a "stand-out" again, with 53% of the regular borrowers reported increased difficulty [down from nearly 90% last fall].

The real concern is that higher interest rates will result from administered inflation from Congress [regulatory costs]. There is little that Chairman Greenspan can do about this and it is unwise to target fundamental monetary policy at inflation generated by regulations, the Oil Gang, or the weather.

The hope that lower interest rates will stimulate the economy is a faint one. A lower cost of funds will not induce a firm to buy new equipment when current capacity is under-used, or to

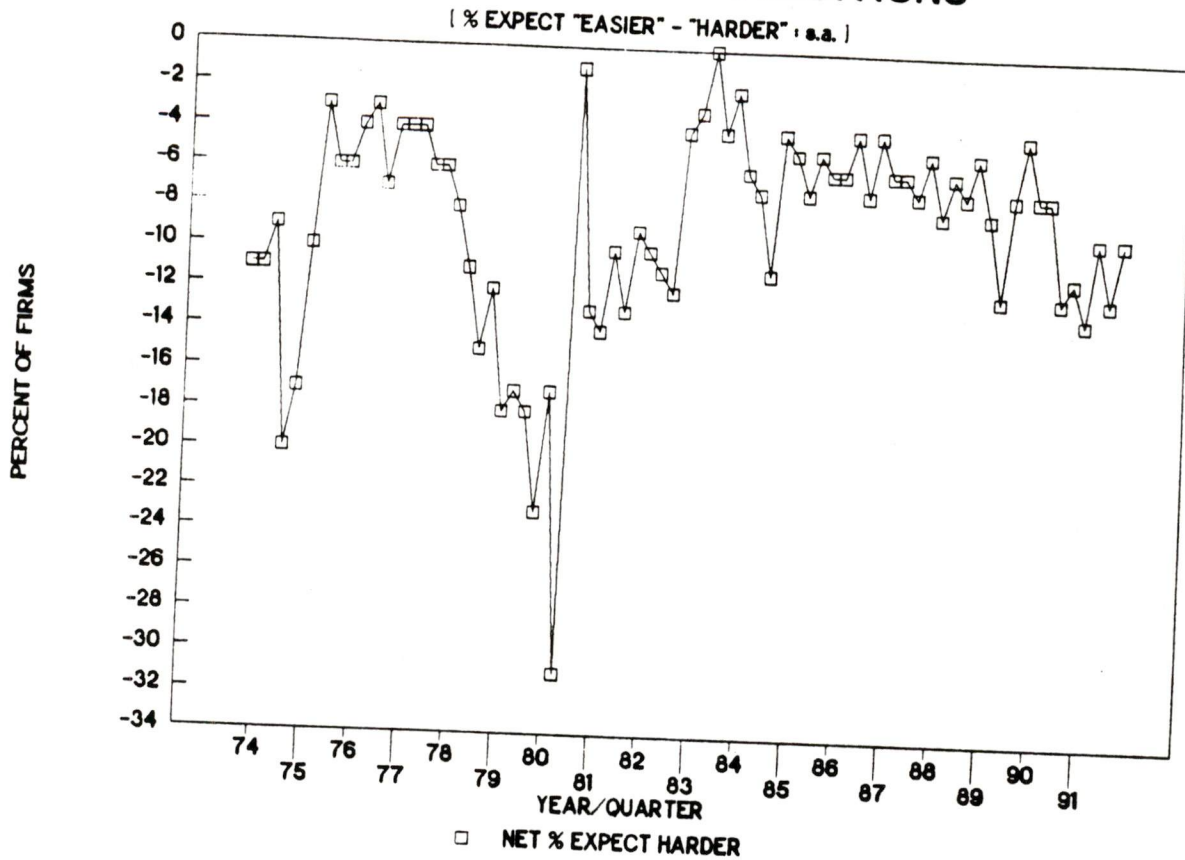
build another office building that no one will occupy. The economy is simply over-loaded with "stuff" financed by a lot of debt. Until this overhang is worked off, expected revenues from new activities will be low. No matter how low interest rates become, the present value of 0 is 0.

PERCENT OF FIRMS REPORTING CREDIT HARDER TO GET

<u>Region</u>	<u>Harder^A</u>	<u>Reg Bor</u>	<u>Industry</u>	<u>Harder^A</u>	<u>Reg Bor</u>
New England	53%	28%	Construction	34%	44%
Mid-Atlantic	27%	30%	Manufacturing	38%	34%
East-South Central	29%	40%	Transportation	39%	31%
South Atlantic	43%	32%	Wholesale	30%	52%
East-North Central	29%	38%	Retail	29%	30%
West-South Central	37%	32%	Agriculture	19%	40%
West-North Central	17%	46%	Financial Serv.	39%	32%
Mountain	41%	32%	Non-Prof. Serv.	39%	23%
Pacific	36%	25%	Professional Serv.	30%	28%
ALL FIRMS	33%	33%		33%	33%

^A The percent of firms **borrowing regularly** [shown under REG BOR] that reported financing was "**harder**" to arrange than in the prior quarter.

EXPECTED CREDIT CONDITIONS



REGULAR BORROWING ACTIVITY

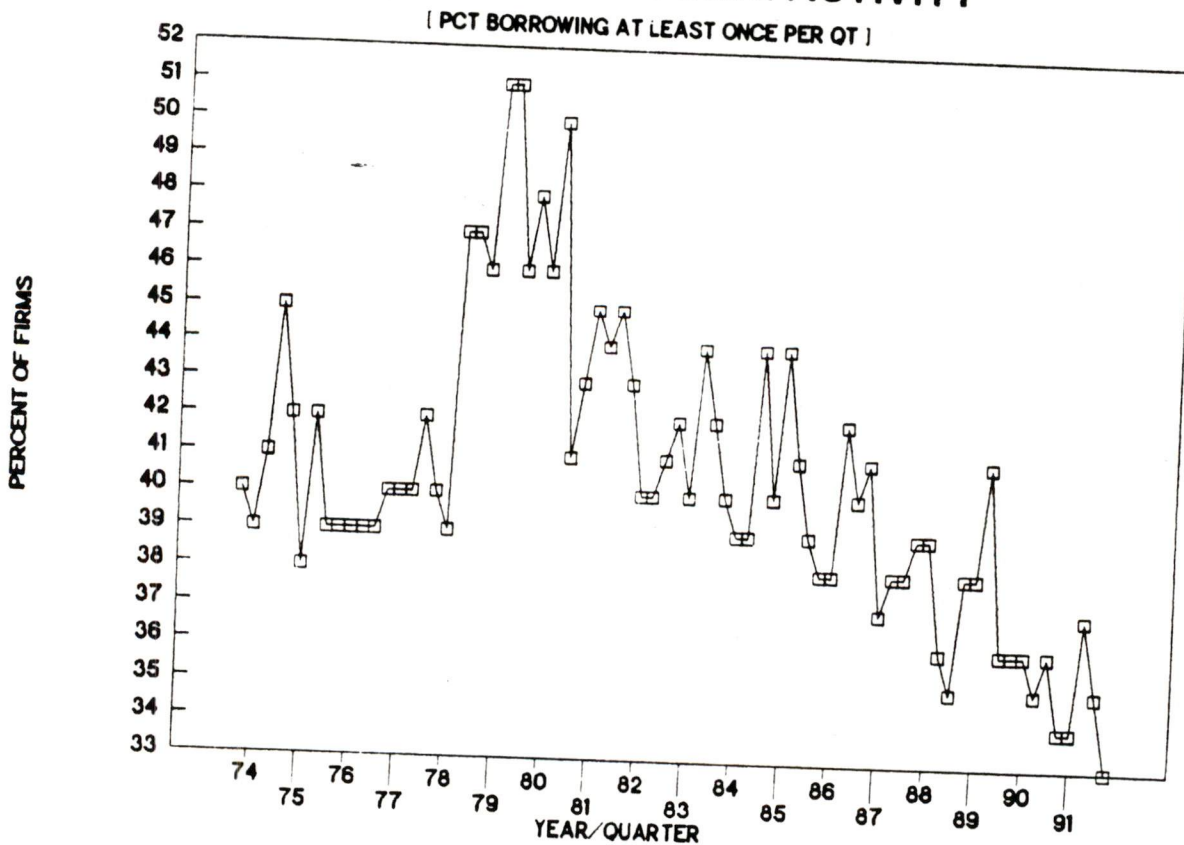


TABLE 1

INTEREST RATES PAID ON SHORT-TERM LOANS^A

Rate Paid	1988		1989				1990				1991		
	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q
Under 13%	42%	38%	33%	25%	32%	33%	39%	42%	40%	38%	42%	44%	41%
13% - 15%	7	10	13	17	14	14	12	11	9	9	7	8	6
16% - 18%	2	2	2	2	2	2	3	1	2	2	1	3	2
19% or more	1	2	1	*	*	1	*	1	*	1	*	1	*
Prime ^B , +1	26	27	25	29	31	29	25	25	31	26	30	26	28
Prime ^B +2	18	18	21	23	18	17	17	17	16	21	18	16	19
Prime ^B +3													
or more	4	3	5	4	3	4	4	3	2	3	2	2	4
TOTAL	100	100	100	100	100	100	100	100	100	100	100	100	100
Average													
Rate Paid:	11.5%	12.5%	12.2%	12.0%	11.9%	11.2%	10.5%						
	12.0%	12.8%	12.2%	11.9%	11.9%	11.0%							

^A Less than .5 percent

^A Borrowing firms that did not report the interest rate are excluded. Data for the third quarter of 1991 were collected in the October, 1991 survey.

^B Beginning in 1982, the category "prime + _____" was added to the interest rate question. In prior quarters, the information was volunteered or the conversion was made by the respondent.

TABLE 2

BORROWING STATISTICS^D

Year/Qtr.	Percent Borrowing ^A	<u>Last Quarter Credit</u>		<u>Next 6 Months</u>	
		<u>Higher Rates^B</u>	<u>Harder To Get^B</u>	<u>Expect it to be:</u>	
				<u>Harder^C</u>	<u>Easier^C</u>
1973:4	40%	33%	13%	15%	2%
1974:1	39	22	9	13	3
2	41	21	7	10	1
3	45	37	16	20	1
4	42	28	19	20	1
1975:1	38	12	12	13	4
2	42	6	7	9	6
3	39	6	6	9	4
4	39	14	8	10	2
1976:1	39	7	5	6	3
2	39	5	5	6	3
3	39	11	5	8	2
4	40	7	6	8	2
1977:1	40	5	4	7	4
2	40	5	4	7	3
3	42	10	5	7	2
4	40	14	6	9	1
1978:1	39	14	5	8	1
2	47	22	9	12	1
3	47	33	11	15	1
4	46	35	11	15	1
1979:1	51	45	16	18	1
2	na	na	na	na	na
3	46	32	15	19	2
4	48	45	19	25	*
1980:1	46	40	19	17	1
2	50	48	27	31	*
3	41	11	9	7	7
4	43	26	13	16	1
1981:1	45	41	15	15	2
2	44	17	11	12	2
3	45	30	11	14	2
4	43	22	12	13	2
1982:1	40	7	9	11	2
2	40	10	11	12	1
3	41	10	11	13	2
4	42	3	8	10	3
1983:1	40	2	6	7	4
2	44	2	7	6	6
3	42	5	6	7	4
4	40	11	6	7	3
1984:1	39	7	6	7	2
2	39	20	7	9	2
3	44	35	9	12	2
4	40	17	7	7	2

TABLE 2 [continued]

Year/Qt.	Percent Borrowing ^A	Last Quarter Credit		Next 6 Months	
		Higher Rates ^B	Harder To Get ^B	Expect it to be: Harder ^C	Easier ^C
1985:1	44	3	7	9	5
2	41	5	9	10	2
3	39	2	6	8	4
4	38	2	9	10	2
1986:1	38	2	7	8	3
2	42	1	9	9	5
3	40	2	8	8	2
4	41	2	7	9	3
1987:1	37	3	7	8	3
2	38	6	7	8	2
3	38	19	8	8	2
4	37	26	8	9	2
1988:1	39	12	7	9	2
2	36	7	7	8	2
3	35	17	7	8	2
4	38	23	7	9	2
1989:1	38	27	8	9	2
2	41	36	11	9	2
3	36	15	8	13	1
4	36	10	8	8	2
1990:1	36	7	7	7	1
2	35	9	7	8	2
3	37	8	9	9	1
4	34	8	11	12	1
1991:1	34	9	11	14	1
2	37	4	11	13	1
3	35	3	12	11	2
4	33	4	12	12	1
		1	11	12	1

SURVEY IS TAKEN IN THE FIRST MONTH OF EACH QUARTER. 1991:4 DATA ARE FROM THE OCTOBER, 1991 SURVEY OF NFIB MEMBER FIRMS.

* less than .5 percent

^A At least once every three months

^B Last quarter compared to the previous quarter

^C During the next three months

^D Percent of ALL firms, including those not borrowing regularly

***** series corrected 12/90 *****

NATIONAL FEDERATION OF INDEPENDENT BUSINESS
October, 1991 Quarterly Economic Report

EMPLOYMENT

William C. Dunkelberg

10% OF ALL FIRMS PLAN TO INCREASE TOTAL EMPLOYMENT IN THE NEXT THREE MONTHS, WHILE 12% PLAN REDUCTIONS. SEASONALLY ADJUSTED, THIS REPRESENTS A SUBSTANTIAL DECLINE IN HIRING PLANS, AFTER APRIL'S STRONG RESURGENCE WHICH REVERSED 5 QUARTERS OF DECLINE.

THE PERCENT OF FIRMS WITH JOB OPENINGS THAT ARE DIFFICULT TO FILL LOST 2 POINTS TO 14% OF ALL FIRMS [THE EXPANSION HIGH IS 25% AND THE LOW WAS 9% RECORDED IN THE FIRST QUARTER OF 1983].

FIRMS REDUCED EMPLOYMENT AN AVERAGE OF $-.17$ [$-.44$ SEASONALLY ADJUSTED] EMPLOYEES PER FIRM IN THE THIRD QUARTER. THE JOB GENERATING POWER OF SMALL FIRMS APPEARS TO BE BACK IN REVERSE AFTER A SHIFT TO FIRST GEAR IN THE SECOND QUARTER. THIS REVERSAL INDICATES CONTINUED BAD NEWS ON THE UNEMPLOYMENT RATE FOR THE BALANCE OF THE YEAR.

On average, small firms reduced employment by $-.17$ employees per firm in the third quarter of 1991. This represented a loss of $-.44$ per firm on a seasonally adjusted basis [Table 1]. In the second quarter, average employment gains were positive, suggesting that the job generation machine might be shifting into first gear. However, the third quarter results indicate that the machine is back in reverse. 13% of all firms added an average of 3.3 workers to payrolls but 18% cut employment by an equal magnitude.

Employment losses were largest in construction and manufacturing, but the services industries recorded substantial reductions as well. It appears that the service sector is a more active participant in this recession than in the 1980-82 reversal [Table 2].

Plans to increase employment fell again [seasonally adjusted] after an April surge that lifted hiring plans out of recession levels. 10% plan labor force additions in the next three to six months, and 12% plan labor force reductions [Tables 3, 5]. Net hiring plans were strongest in manufacturing and transportation and in non-professional services.

Job openings that are difficult to fill were reported by 14% of all firms [Table 4]. Manufacturing, transportation and non-professional service firms most frequently complained of hard-to-fill positions.

Overall, the outlook for employment gains is not good. Hiring plans are approaching levels recorded a year ago when the economy moved into recession. Job openings are falling, indicating weak labor markets. And, compensation isn't going anywhere. There are many tough quarters ahead.

TABLE 1

EMPLOYMENT CHANGE PER FIRM DURING THE LAST THREE MONTHS

	Per Firm Change in Employment ^A		Percent of Firms With Employment Change ^A		Average	
	Seas.		Percent			
	Unadj	Adju.	Increase	Decrease	Increase	Decrease
1977:3	.31	.04	19	13	3.9	3.3
1978:3	.42	.15	19	12	4.0	2.8
1979:3	.18	-.09	14	13	4.5	3.1
1980:3	-.22	-.49	12	17	3.1	3.4
1981:3	-.12	-.39	12	17	4.8	4.1
1982:3	-.19	-.46	11	19	4.6	3.7
1983:1	-.28	-.30	13	16	2.6	3.8
2	.30	-.04	20	12	3.7	3.8
3	.30	.03	17	11	3.9	3.2
4	-.09	.01	14	14	3.7	4.7
1984:1	.16	.14	16	11	3.8	4.3
2	.51	.17	22	9	3.7	3.2
3	.43	.16	18	11	4.2	2.9
4	-.09	.01	14	14	3.2	4.0
1985:1	.03	.01	14	13	2.9	2.9
2	.53	.19	22	12	4.3	3.4
3	.17	-.10	15	12	3.5	3.0
4	-.07	.03	13	13	3.4	3.7
1986:1	-.07	-.09	16	15	3.6	4.3
2	.30	-.04	22	13	3.7	3.8
3	.15	-.12	16	15	4.1	3.4
4	-.16	-.06	12	15	4.4	4.5
1987:1	-.06	-.08	13	13	3.8	4.2
2	.25	-.09	20	11	3.8	4.7
3	.13	-.14	16	13	4.0	3.9
4	-.01	-.09	13	17	4.0	3.2
1988:1	.06	.04	15	13	3.7	4.0
2	.44	.10	20	10	3.9	3.3
3	.10	-.17	16	13	3.6	3.7
4	.05	.15	14	13	3.9	3.7
1989:1	-.03	-.05	14	13	3.6	4.2
2	.53	.19	21	11	4.2	3.1
3	.12	-.15	17	15	3.3	3.0
4	-.39	-.29	12	18	3.3	4.6
1990:1	.02	.00	16	15	3.0	3.1
2	.36	.02	21	13	3.8	3.3
3	.01	-.26	14	17	3.8	3.2
4	-.45	-.35	11	18	2.9	4.1
1991:1	-.37	-.39	12	19	2.9	4.1
2	.10	-.24	17	15	3.7	3.3
3	-.17	-.44	13	18	3.3	3.3

^A Survey taken in the first month of each quarter. Data for employment change in 1991:2 were collected in July, 1991.

TABLE 2

Net Change in Employment Per Firm

	<u>84:3</u>	<u>85:3</u>	<u>86:3</u>	<u>87:3</u>	<u>88:3</u>	<u>89:3</u>	<u>90:3</u>	<u>91:3</u>
Construction	+1.3	+0.5	+0.2	0.0	0.0	+0.4	+0.1	-0.5
Manufacturing	+0.6	+0.6	-0.2	0.0	+0.1	+0.1	0.0	-0.3
Wholesale	+0.2	-0.2	+0.3	+0.3	+0.1	-0.1	+0.4	-0.1
Retail Trades	+0.2	+0.1	+0.1	+0.3	0.0	-0.2	0.0	-0.0
Financial								
Services	+0.1	+0.3	+0.2	+0.2	0.0	+0.2	0.0	-0.2
Non-Professional								
Services	+0.2	+0.1	0.0	0.0	0.0	+0.3	-0.2	-0.2
Professional								
Services	+0.3	+0.4	-0.1	-0.2	0.0	+0.3	+0.2	-0.2
ALL FIRMS ^A	+.43	+.17	+.15	+.13	+.10	+.12	+.01	-.17

^A Includes firms in transportation and agriculture which have too few cases to report separately.

The October 1990 survey provides employment data for the third quarter of 1990.

HIRING PLANS AND JOB OPENINGS

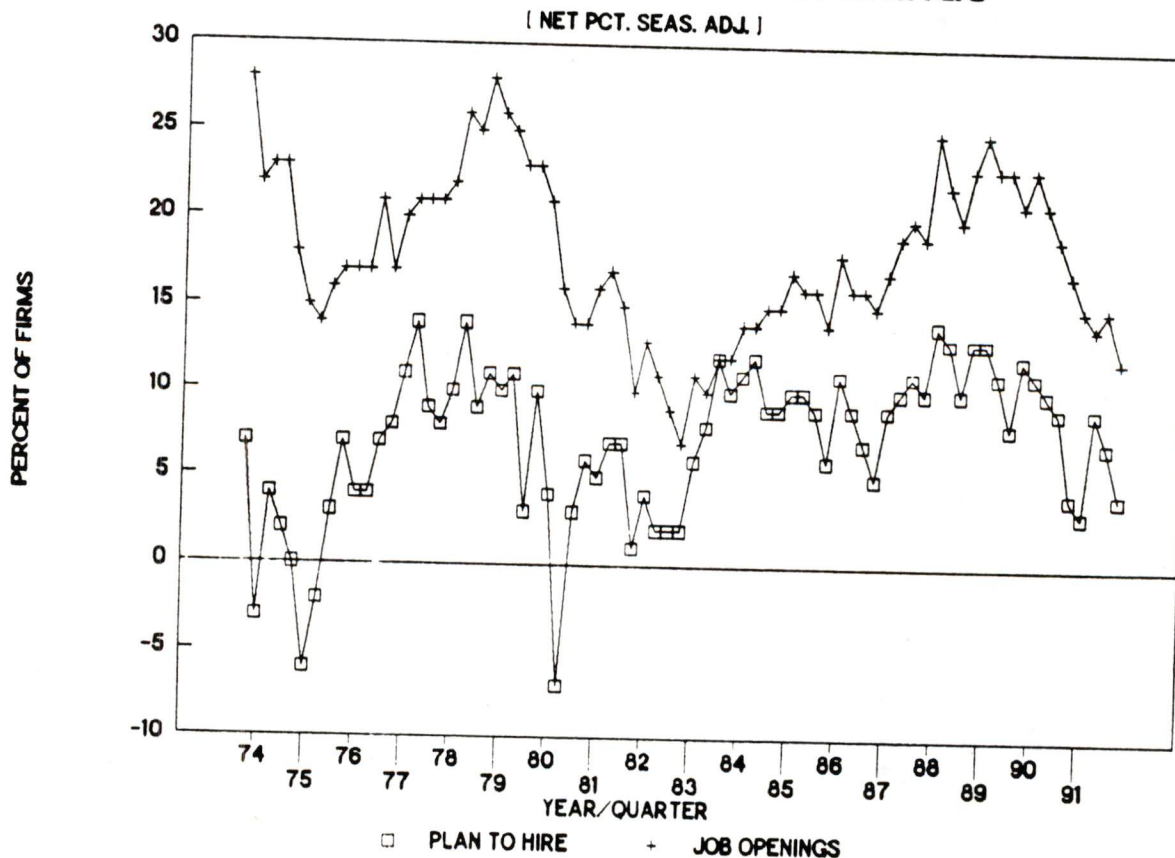


TABLE 3
INDUSTRY EMPLOYMENT STATISTICS

Industry	Past Employment Change		Current Job Openings			Employment Plans ¹	
	Inc.	Dec.	Skill	Unsk.	Both	Inc.	Dec.
Construction	17%	24%	13%	1%	2%	7%	23%
Manufacturing	20	24	15	1	4	16	10
Transportation	17	17	17	*	3	16	10
Wholesale	13	18	12	1	3	11	9
Retail	11	17	6	3	1	8	13
Agriculture	13	14	8	2	3	4	22
Finance	8	10	7	1	1	6	3
Services	11	19	12	2	2	13	7
Professional	6	10	6	1	2	11	6
All Firms	13%	18%	10%	2%	2%	10%	12%

¹ During the next three months.

TABLE 4
CURRENT JOB OPENINGS

YEAR:QTR	Type of Opening:			Any Opening
	Skilled	Unskilled	Both	
1981:4	9%	1	2	12%
1982:4	7%	1	1	9%
1983:4	11%	1	2	14%
1984:4	12%	2	3	17%
1985:4	12%	2	2	16%
1986:4	12%	3	2	17%
1987:1	11%	2	2	15%
2	12%	3	4	19%
3	14%	3	4	21%
4	14%	3	4	21%
1988:1	14%	2	7	23%
2	15%	4	3	22%
3	15%	3	3	21%
4	16%	4	5	25%
1989:1	15%	5	3	23%
2	15%	4	4	23%
3	17%	3	4	24%
4	15%	3	5	23%
1990:1	15%	3	3	21%
2	14%	4	4	21%
3	15%	2	3	20%
4	14%	2	3	19%
1991:1	10%	1	2	13%
2	10%	2	2	14%
3	12%	2	2	16%
4	10%	2	2	14%

TABLE 5
PLANS TO INCREASE EMPLOYMENT

<u>Year:Qtr</u>	<u>Employment Plans:</u>	
	<u>Increase</u>	<u>Decrease</u>
80:3	12%	12
4	12%	12
81:1	14%	9
2	20%	7
3	14%	10
4	10%	15
82:1	14%	10
2	17%	8
3	10%	11
4	10%	14
83:1	14%	8
2	21%	6
3	16%	7
4	14%	10
84:1	18%	7
2	24%	5
3	15%	9
4	14%	11
85:1	18%	8
2	23%	6
3	15%	9
4	13%	13
86:1	18%	7
2	23%	7
3	14%	10
4	12%	13
87:1	16%	7
2	22%	5
3	16%	8
4	15%	11
88:1	19%	5
2	25%	5
3	16%	9
4	18%	11
89:1	20%	7
2	23%	5
3	21%	11
4	16%	10
90:1	19%	8
2	23%	6
3	16%	10
4	12%	14
91:1	13%	10
2	22%	6
3	13%	9
4	10%	12

NATIONAL FEDERATION OF INDEPENDENT BUSINESS
October, 1991 Quarterly Economic Report

INFLATION

William C. Dunkelberg

PLANS TO RAISE PRICES FELL TO 17% OF ALL FIRMS, THE RECORD LOW FOR THE 19 YEAR HISTORY OF THE NFIB SURVEYS.

16% REPORTED LOWER SELLING PRICES IN THE SECOND QUARTER. 18% REPORTED ACTUALLY RAISING PRICES, 9 POINTS BELOW YEAR-AGO LEVELS. IN 1974, **70% OF ALL FIRMS WERE RAISING PRICES!**

THE OVERALL PICTURE IS EXCEPTIONALLY GOOD FOR MODERATION IN THE INFLATION RATE FOR THE BALANCE OF 1991 AND FOR ALL OF 1992.

The percent of firms planning to raise prices fell to 17% of all firms [Tables 1 and 3], the record low level for the 19 year history of the NFIB surveys. The decline is good news for policy-makers, and consistent with the sluggish demand and reasonably well-behaved costs now observed in the economy. Good news on inflation will bring interest rates down over the next 6 months.

By industry, plans to raise prices were uniformly low. Professional services, usually high on the frequency of planned price increases, showed only 18% planning to raise prices, down from 37% in January [Table 2].

16% reported lower selling prices in the third quarter. Only the 1980-82 period produced higher percentages of firms cutting selling prices. Only 18% reported raising selling prices, matching the record-low for the NFIB 19 year survey history set in 1986. The outlook for lower inflation is exceptionally good.

The threat of structural inflation remains strong. With mandated cost increases such as mandatory leave, job security [including non-replacement of strikers], day care, health insurance, access for the handicapped [rather broadly defined!], pollution controls, and the related "paperwork" that will eat up valuable entrepreneurial time, costs are bound to rise. The FED cannot reduce this kind of inflation through monetary policy. Only Congress can do it with some responsible legislation and some common sense.

PAST AND PLANNED PRICE INCREASES

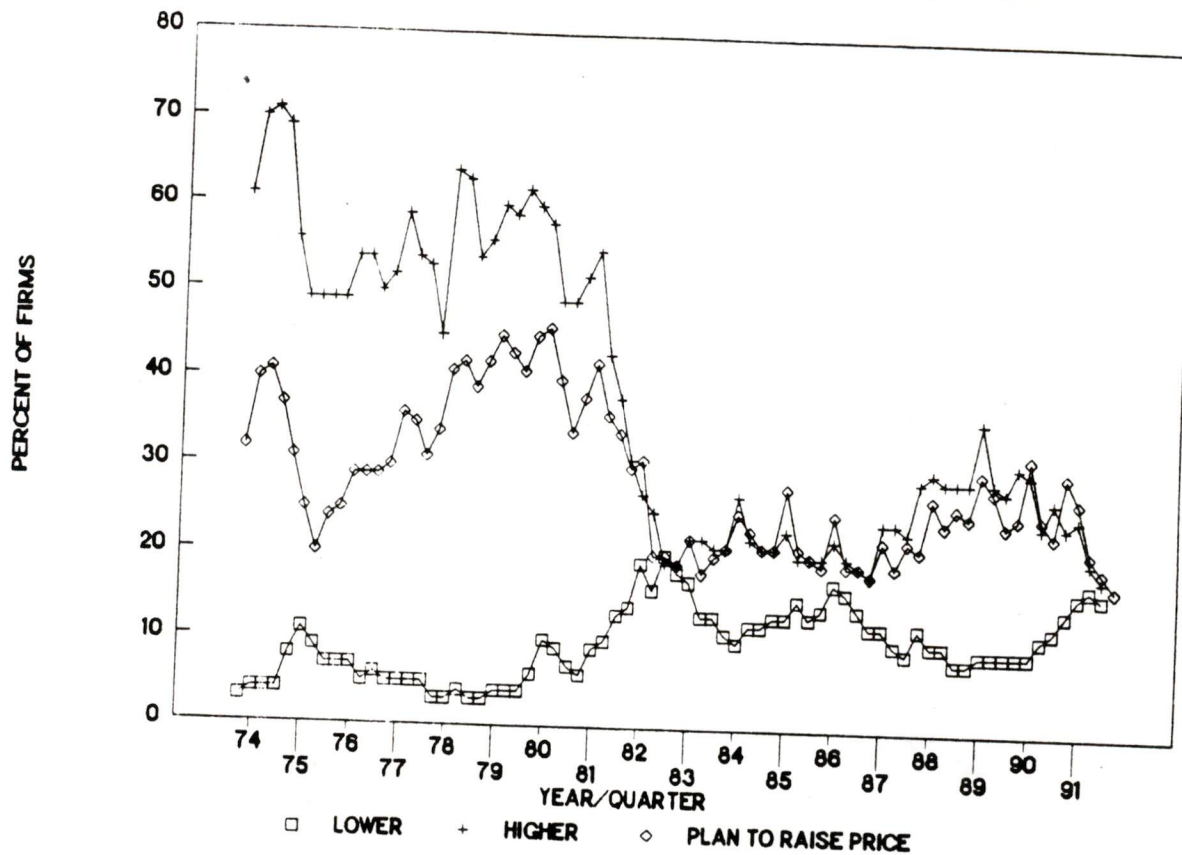


TABLE 1

PLANNED PRICE CHANGES

Planned Increases In Average Prices	1989		1990		1991		1991		1991	
	Oct	Jan	Apr	Jul	Oct	Jan	Apr	Jul	Oct	Oct
Under 3%	7%	10%	8%	7%	8%	7%	6%	6%	4%	
3%-4.9%	7	9	6	6	9	7	6	5	5	
5%-7.9%	6	7	6	5	7	8	5	5	4	
8%-9.9%	1	1	1	1	1	1	1	1	1	
10% or more	3	3	2	3	3	2	2	2	2	
Don't Know Amount	1	2	2	1	2	2	1	1	1	
Pct. Planning Increases	25%	32%	25%	23%	30%	27%	21%	19%	17%	
Index of Planned Price Increases:^A	1.07	1.41	1.03	.96	1.34	1.09	.90	.77	.70	
Pct. Planning Decreases	3%	3%	3%	3%	4%	6%	3%	3%	4%	

^A Weighted average of planned price increases and planned price decreases.

TABLE 2
PLANNED PRICE CHANGES BY INDUSTRY

Industry	Plans to Raise Prices							
	1989				1990			
	Oct	Jan	Apr	Jul	Oct	Jan	Apr	Jul
Construction	26%	37%	26%	23%	28%	22%	20%	19%
Manufacturing	29	30	23	19	30	28	23	19
Transportation	19	23	22	19	44	26	24	15
Wholesale	28	44	24	28	38	34	24	16
Retail	28	33	28	24	35	32	23	23
Agriculture	22	34	12	21	20	13	16	13
Financial Service	8	15	13	10	12	15	15	12
Services	24	35	28	26	29	29	22	23
Prof. Services	29	27	26	27	30	37	22	16

Plans to Lower Prices								
Construction	2%	4%	3%	4%	7%	9%	4%	4%
Manufacturing	2	3	2	4	3	3	3	3
Transportation	4	6	1	*	4	1	2	3
Wholesale	5	4	4	*	5	3	5	3
Retail	3	4	4	4	4	7	3	4
Agriculture	5	2	6	1	5	6	2	4
Financial Service	8	5	3	6	5	7	7	*
Services	2	1	3	2	4	5	3	2
Prof. Services	*	1	1	3	*	4	1	1

* Less than .5%

TABLE 3

REPORTED PRICE CHANGES
[percent of firms]

<u>Year/Qt</u>	<u>Actual Price Changes</u>			<u>Planned Price Changes Previous Quarter</u>
	<u>Lower</u>	<u>Same</u>	<u>Higher</u>	
1974:1	4	24	70	40
2	4	23	71	41
3	4	25	69	37
4	8	34	56	31
1975:1	11	38	49	25
2	9	39	49	20
3	7	40	49	24
4	7	42	49	25
1976:1	7	37	54	29
2	5	39	54	29
3	6	41	50	29
4	5	41	52	30
1977:1	5	33	59	36
2	5	38	54	35
3	5	38	53	31
4	3	38	45	34
1978:1	3	27	64	41
2	4	30	63	42
3	3	37	54	39
4	3	35	56	42
1979:1	4	30	60	45
2	4	33	59	43
3	4	30	62	41
4	6	30	60	45
1980:1	10	30	58	46
2	9	39	49	40
3	7	41	49	34
4	6	38	52	38
1981:1	9	37	55	42
2	10	44	43	36
3	13	46	38	34
4	14	52	31	30
1982:1	19	51	27	31
2	16	55	25	20
3	20	59	19	20
4	18	61	19	19

TABLE 3 [cont]

<u>Year/Qtr</u>	<u>Actual Price Changes</u>			<u>Planned Price Changes Previous Quarter</u>
	<u>Lower</u>	<u>Same</u>	<u>Higher</u>	
1983:1	17	58	22	22
2	13	62	22	18
3	13	64	21	20
4	11	65	21	21
1984:1	10	60	27	25
2	12	63	22	23
3	12	65	21	21
4	13	63	21	21
1985:1	13	62	23	28
2	15	62	20	21
3	13	65	20	20
4	14	63	20	19
1986:1	17	59	22	25
2	16	61	20	19
3	14	63	19	19
4	12	65	18	18
1987:1	12	57	24	22
2	10	61	24	19
3	9	63	23	22
4	12	57	29	21
1988:1	10	57	30	27
2	10	58	29	24
3	8	59	29	26
4	8	58	29	25
1989:1	9	52	36	30
2	9	59	29	28
3	9	61	28	24
4	9	59	31	25
1990:1	9	59	30	32
2	11	63	24	25
3	13	58	27	23
4	14	59	24	30
1991:1	16	57	25	27
2	17	62	20	21
3	16	64	18	19
4	--	--	--	17

Data for each calendar quarter are collected in the survey taken in the first month of the following quarter.

NATIONAL FEDERATION OF INDEPENDENT BUSINESS
October, 1991 Quarterly Economic Report

LABOR COSTS FOR SMALL BUSINESS

William C. Dunkelberg

Past Compensation Changes [Table 1]

17% of all firms reported increases in employee compensation in the third quarter of 1991, the lowest figure since the series was initiated in 1984. 2% reported actually lowering average compensation. Job openings are weak, reflecting the impact of the recession on labor demand. 73% of the firms that increased compensation reported gains under 7%, producing an average increase of 5.7% for those raising compensation. Including those firms not changing compensation, the overall increase in compensation was 1.0% for all firms for the quarter, about 4% at an annual rate.

Planned Changes in Compensation [Table 2]

Plans to increase compensation held at a record-low 14% of all firms. The average planned increase stood at 5.3% for those intending to raise compensation. Including firms not planning any increases, the overall planned increase is 0.7%, under 3% at an annual rate if firms can "stick to plan". This is great news for unit labor costs and inflation.

PLANNED & ACTUAL LABOR COST CHANGES

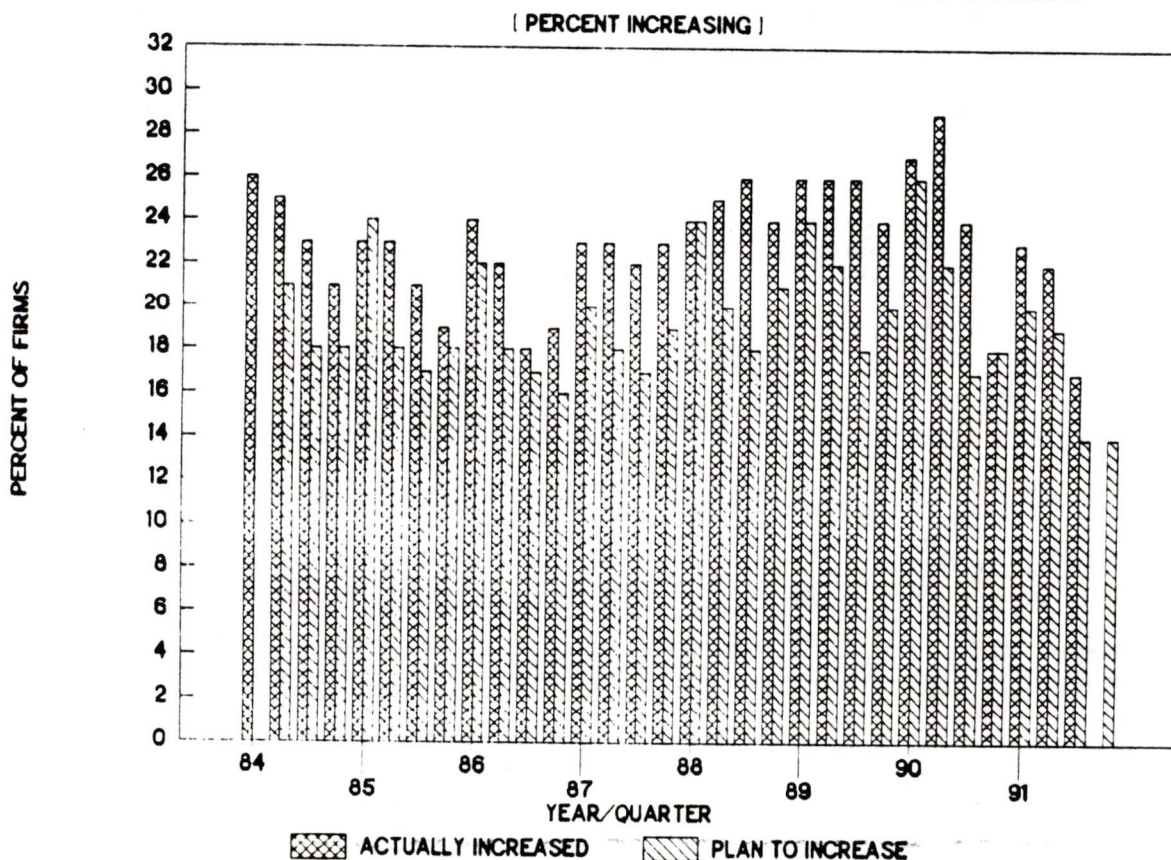


TABLE 1

PAST COMPENSATION CHANGES
[percent of firms]

Actual ^A Change In Average Wages	1988		1989				1990				1991		
	3	4	1	2	3	4	1	2	3	4	1	2	3
Increase	26%	24%	26%	26%	26%	24%	27%	29%	24%	18%	23%	22%	17%
Decrease	1%	1%	1%	1%	1%	1%	1%	2%	2%	2%	2%	3%	2%
<u>Percentage Change^B</u>													
Under 3%	13%	12%	14%	14%	14%	14%	12%	13%	12%	14%	12%	16%	14%
3 - 4%	29	28	27	22	31	26	28	26	28	29	28	28	26
5 - 6%	27	30	28	33	27	30	31	29	29	27	33	27	33
7 - 8%	11	11	11	11	10	12	9	8	12	13	9	9	9
9 - 10%	10	10	10	10	8	8	8	9	9	9	9	10	11
Over 10%	7	7	8	8	8	7	9	12	8	6	6	6	5
Don't know	3	2	2	2	2	3	3	3	2	2	3	4	2
	100	100	100	100	100	100	100	100	100	100	100	100	100
<u>Average Actual Increase^C</u>													
Those													
Raising[%]:	5.8	5.9	5.9	6.0	5.7	5.8	5.9	6.0	5.9	5.7	5.5	5.6	5.7
All Firms[%]	1.5	1.4	1.5	1.5	1.5	1.4	1.6	1.7	1.4	1.0	1.0	1.2	1.0

^A Question Asked: Over the *past three months*, did you increase *average* employee compensation [wages and benefits but NOT Social Security, U.C. taxes, etc]?

^B Firms increasing compensation only.

^C Based on number of firms reporting an increase in each category and mean category values of 1.5%, 4%, 6%, 8%, 9.5%, 12%. Firms not providing the amount are assigned at the mean.

TABLE 2
PLANNED COMPENSATION CHANGES

Planned ^A	1988			1989			1990			1991			
Changes in Compensation	4	1	2	3	4	1	2	3	4	1	2	3	4
Increase	21%	24%	22%	18%	20%	26%	22%	17%	18%	20%	19%	14%	14%
Decrease	1%	1%	1%	1%	1%	1%	1%	1%	1%	2%	1%	2%	3%
<u>Percentage Change^B</u>													
Under 3%	9%	9%	10%	11%	11%	9%	11%	11%	11%	9%	11%	12%	12%
3 - 4%	34	28	28	30	26	35	30	31	31	36	32	31	31
5 - 6%	34	35	31	31	36	33	35	37	35	35	30	36	38
7 - 8%	6	7	11	11	8	10	8	8	7	7	8	7	6
9 - 10%	7	10	8	8	8	7	6	6	9	6	6	5	4
Over 10%	3	6	5	3	3	3	4	3	3	4	5	4	4
Don't know	7	5	7	6	8	3	6	4	4	3	8	3	5
	100	100	100	100	100	100	100	100	100	100	100	100	100
<u>Average Planned Increase^C</u>													
Those													
Raising[%]:	5.4	5.9	5.8	5.6	5.6	5.5	5.5	5.4	5.5	5.5	5.5	5.3	5.3
All Firms[%]	1.1	1.4	1.3	1.0	1.1	1.4	1.2	.9	1.0	1.1	1.0	0.7	0.7

^A Question Asked: Do you plan to increase *average* employee compensation [wages and benefits but NOT Social Security, U.C. taxes, etc.] during the *next three months*?

^B Firms planning to increase compensation only.

^C Based on number of firms reporting an increase in each category and mean category values of 1.5%, 4%, 6%, 8%, 9.5%, 12%. Firms not providing the amount are assigned at the mean.

NATIONAL FEDERATION OF INDEPENDENT BUSINESS
October, 1991 Quarterly Economic Report

INVENTORY INVESTMENT

William C. Dunkelberg

13% OF ALL FIRMS PLAN TO INCREASE INVENTORY HOLDINGS AND 17% PLAN INVENTORY REDUCTIONS IN THE NEXT SIX MONTHS. SEASONALLY ADJUSTED, THIS REPRESENTS A SUBSTANTIAL DECLINE FROM WHAT IN JULY WAS A VERY AGGRESSIVE INVENTORY PICTURE.

SATISFACTION WITH CURRENT INVENTORY HOLDINGS REMAINED HEALTHY, WITH 11% REGARDING INVENTORIES TOO HIGH, BUT 10% VIEWING CURRENT STOCKS AS TOO LOW.

IN THE THIRD QUARTER, 15% OF ALL FIRMS INCREASED INVENTORY HOLDINGS, WHILE 22% REDUCED STOCKS. THE FREQUENCY OF LIQUIDATION REPORTS IS STILL RUNNING HIGHER THAN IN ANY YEAR SINCE THE 1980-82 RECESSION.

Inventory accumulation plans fell sharply from July and April levels as firms began to abandon the hope that the economy would quickly recover and that sales would re-start. [Chart - seasonally adjusted]. 13% reported plans for inventory accumulation during the next three to six months, while 17% planned reductions. In the third quarter, 15% increased holdings while 22% reduced stocks. The percentage of firms reporting reductions in stocks in 1991 has run far ahead of past years. Clearly, major inventory liquidations are still being implemented [Table 1].

Net plans to add to inventory are predominantly negative in the heavy-inventory industry groupings [Table 3]. Liquidations were also heavy in these industries in the third quarter.

Inventory holdings still don't appear to be excessive. Firms have been managing their operations "conservatively" for years, expecting the expansion to end at any moment. The longer the recovery lasted, the higher became the percentage of owners and managers that felt the economy could not continue to grow.

The problem in areas such as New England is not that individual firms became "excessive", but rather that individual entrepreneurs failed to see that the collective summation of their many separate decisions to expand, start a new firm, build a new building etc. was increasing the "supply" of goods and services at a pace that even the relatively high New England growth experience could not have utilized had it been able to continue indefinitely.

TABLE 1

SMALL BUSINESS INVENTORIES [percent of firms]

LAST QUARTER CHANGE	1988	1989				1990				1991			
	Oct	Jan	Apr	Jul	Oct	Jan	Apr	Jul	Oct	Jan	Apr	Jul	Oct
Increased	20	17	20	20	18	16	19	19	15	13	14	15	15
Decreased	14	19	17	15	16	21	18	16	20	25	23	21	22
INVENTORY STATUS													
Too High	10	12	11	12	12	13	10	11	13	13	11	11	11
Too Low	10	10	10	10	10	9	10	8	10	9	10	10	10
INVENTORY PLANS													
Add	17	22	21	16	16	22	19	17	15	18	19	17	13
Decrease	17	12	12	15	17	13	12	13	19	15	12	13	17

INVENTORY SATISFACTION & INVESTMENT

(% TOO LO - % TOO HI: NET % S.A.)

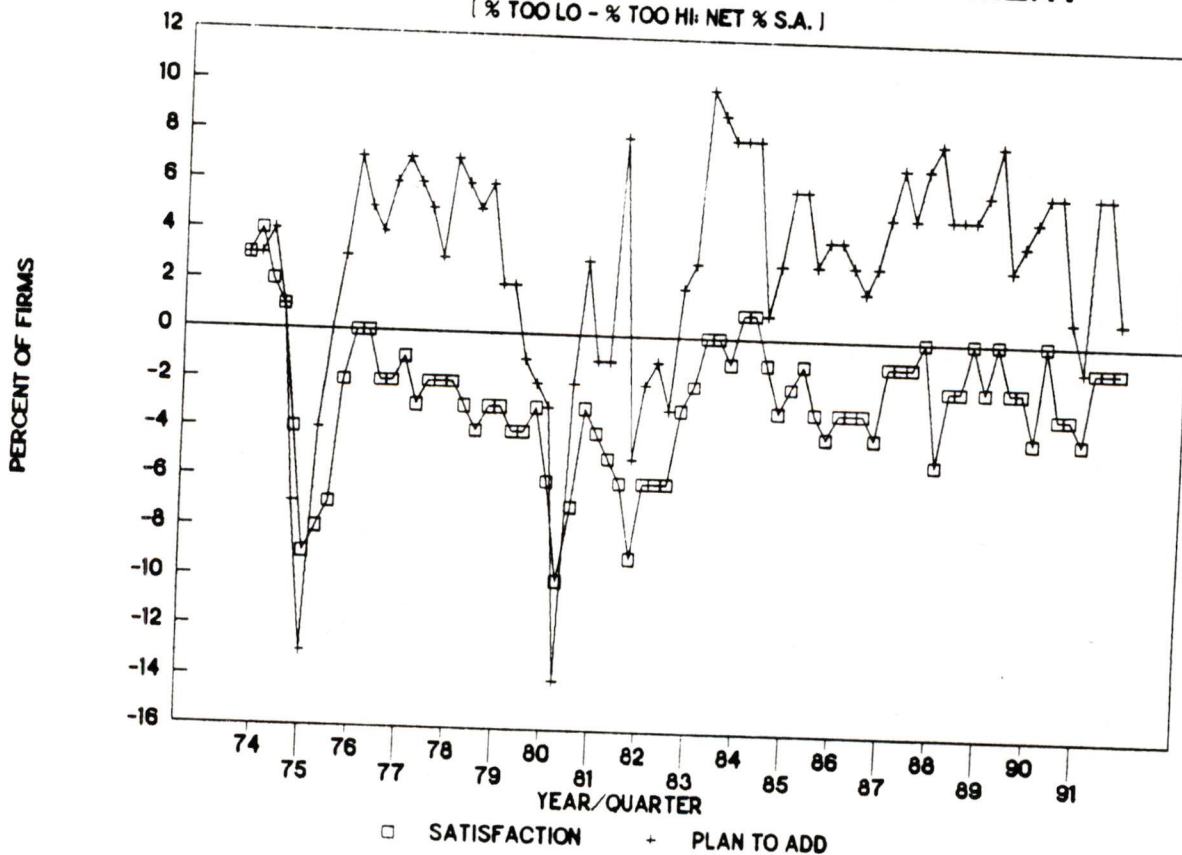


TABLE 2

NET INVENTORY CHANGE PLANS^A

Industry	Oct:									
	81	83	84	85	86	87	88	89	90	91
Retail	-18%	- 2%	- 6%	- 5%	- 2%	+ 4%	- 1%	- 6%	- 5%	- 8%
Wholesale	-12	+10	-12	- 7	- 8	+ 2	+ 2	-13	-16	- 8
Manufacturing	- 2	+10	+ 4	+ 1	+ 2	+ 5	- 1	+ 4	-14	- 6
Construction	-22	- 1	- 6	- 9	-10	- 7	- 4	+ 4	- 9	- 7
Non-Professional Services	- 3	+ 9	+ 9	+ 9	+ 9	+ 6	+ 7	+ 9	+ 3	0
Professional Services	- 4	+ 4	+ 4	+ 0	+ 1	+ 2	- 1	+ 4	+ 3	+ 2
Financial Services	+ 6	+ 2	+ 5	+ 5	+ 2	+ 4	+ 6	+ 8	+ 8	+ 5
ALL FIRMS ^B	-10%	+ 3%	- 2%	- 1%	- 1%	+ 2%	+ 0%	- 1%	- 4%	- 4%

^A Percent planning to increase inventories minus the percent planning to decrease inventories. Excludes firms not answering the question.

^B Includes Transportation and Agriculture firms which have too few cases to report separately.

TABLE 3

PAST INVENTORY CHANGE [PREVIOUS QUARTER]^A
[% that increased less % that decreased]

NET PERCENT OF FIRMS ADDING TO INVENTORY:													
Industry	1988					1989				1990			
	4	1	2	3	4	1	2	3	4	1	2	3	
Retail	+ 0	+ 8	+11	+ 4	- 7	+ 9	+10	- 2	-14	- 7	- 4	+ 2	
Wholesale	+ 1	+10	+12	+ 9	- 4	+ 9	+ 1	-14	-15	- 5	- 4	- 8	
Manuf.	- 7	+ 4	+ 4	+ 1	- 7	+ 0	+ 5	- 9	- 2	- 7	-11	-15	
Constr.	- 8	-12	- 1	- 6	-13	-15	- 6	- 7	-23	-20	-13	-16	
Non-Prof.	- 1	+ 7	+ 3	+ 7	- 1	+ 4	+ 3	- 9	-14	-10	- 8	- 9	
Profess.	+ 1	- 0	- 2	+ 2	+ 1	- 3	+ 0	- 1	- 2	- 0	- 1	+ 0	
Financial	- 5	+ 4	+ 8	- 6	- 3	+ 1	- 1	- 0	4	1	- 2	- 5	
ALL FIRMS ^B	- 2%	+ 3%	+ 5%	+ 2%	- 5%	- 1%	+ 3%	- 5%	-12%	- 9%	- 6%	- 7%	

^A Percent increasing inventories in the quarter minus percent reducing inventories. Survey taken in the month following the calendar quarter.

NATIONAL FEDERATION OF INDEPENDENT BUSINESS
October, 1991 Quarterly Economic Report

CAPITAL INVESTMENT

William C. Dunkelberg

26% OF ALL SMALL FIRMS PLAN TO MAKE CAPITAL OUTLAYS IN THE NEXT 6 MONTHS, DOWN 1 POINT FROM JULY AND OFF 10 POINTS FROM THE HIGH FOR THE EXPANSION.

SPENDING REMAINED ANEMIC IN THE THIRD QUARTER, WITH 50% REPORTING OUTLAYS IN THE LAST SIX MONTHS, THE LOWEST LEVEL OF SPENDING ACTIVITY SINCE 1982. 36% REPORTED OUTLAYS IN EXCESS OF \$5,000, THE LOWEST FIGURE IN THE LAST TEN YEARS.

Seasonally adjusted, planned capital outlays held at their second lowest level since 1983. The demand for capital goods will remain weak for the balance of the year and on into 1992.

An unadjusted 26% plan outlays in the next six months, 10 points below the expansion high of 36% reached in January, 1989 and down 5 points from April, 1991 when optimism rebounded, indicating a stabilization of the economy. [Table 1].

Actual expenditures remained weak. 50% reported outlays in the past six months and 36% reported outlays in excess of \$5,000, the weakest figures since 1982.¹

40% reported outlays on equipment and vehicles in the last six months. 6% began constructing new facilities and 14%

=====

1 Although these numbers seem small, a one percentage decline in the percentage making capital outlays, assuming a median expenditure of \$15,000, translates into a reduction in aggregate plant and equipment expenditures of \$675 million. This assumes 4.5 million employers in the U.S., based on the number of firms paying Social Security taxes on one or more employees.

expanded or improved existing facilities. 3% of all firms acquired land for later expansion [Table 2]. 5% reported outlays of \$100,000 or more [Table 3].

It appears that capital spending will remain weak, keeping the capital goods industry in recession. The passage of the environmental regulations will stimulate some large scale activity held hostage by uncertainty created by Congressional inaction, but small firms are not yet ready to add to their capacity to produce more output.

PLANNED CAPITAL OUTLAYS, NEXT 6 MONTHS

[SEASONALLY ADJUSTED]

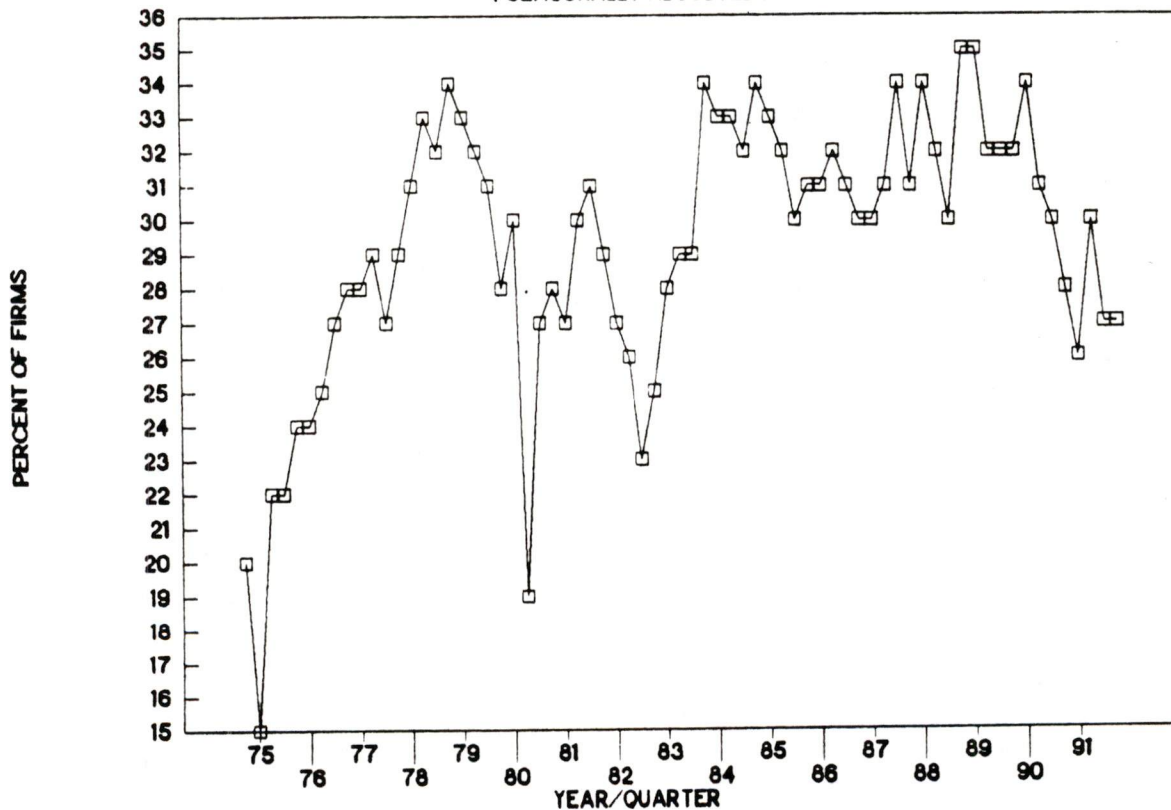


TABLE 1
CAPITAL EXPENDITURES

<u>Year</u>	<u>Planned, Next 3 to 6 Months</u>	<u>Made, Last 6 Months</u>	<u>Made, Last 6 months (\$5000 or more)</u>
1979: 4	27	60	42
1980: 1	31	59	43
2	20	56	41
3	26	53	36
4	27	53	37
1981: 1	28	51	36
2	31	53	39
3	26	53	36
4	28	53	37
1982: 1	28	53	38
2	27	52	38
3	30	53	38
4	24	48	33
1983: 1	29	50	34
2	30	49	35
3	28	53	37
4	33	55	39
1984: 1	34	55	40
2	34	52	39
3	31	55	41
4	33	57	42
1985: 1	34	58	43
2	33	55	42
3	29	54	40
4	30	55	41
1986: 1	32	57	42
2	33	56	41
3	30	51	38
4	29	54	38
1987: 1	31	54	37
2	32	53	39
3	33	55	39
4	30	56	39
1988: 1	35	55	41
2	35	55	41
3	29	56	41
4	34	55	40
1989: 1	36	57	41
2	33	57	43
3	31	55	42
4	31	56	41
1990: 1	35	57	43
2	32	55	40
3	29	55	40
4	27	56	42
1991: 1	27	54	40
2	31	53	38
3	27	51	37
4	26	50	36

TABLE 2

TYPE OF EXPENDITURE
[Made in Last Six Months]

<u>Year</u>	<u>Equip & Veh</u>	<u>New Bldgs</u>	<u>Imp Bldgs</u>	<u>Add Land</u>	<u>% Making a Least One Type of Expenditure</u>
1981:2	44%	7%	16%	4%	53%
3	43	7	17	5	53
4	42	7	19	4	53
1982:1	43	8	17	4	53
2	41	7	16	4	52
3	37	6	16	4	47
4	38	7	15	3	48
1983:1	40	6	15	3	50
2	40	6	14	4	49
3	42	7	15	4	53
4	43	8	17	5	55
1984:1	46	7	16	4	55
2	42	6	14	4	52
3	45	7	15	4	55
4	46	7	17	4	57
1985:1	46	8	17	4	58
2	44	7	16	4	55
3	43	7	17	5	54
4	45	7	16	3	55
1986:1	47	7	16	4	57
2	45	7	15	4	56
3	41	7	14	4	51
4	42	6	16	3	54
1987:1	43	7	15	4	54
2	41	7	14	4	53
3	43	7	16	4	55
4	44	7	16	4	56
1988:1	45	8	15	6	55
2	45	6	16	3	55
3	44	7	16	3	56
4	44	7	18	4	55
1989:1	49	7	14	4	57
2	46	8	16	4	57
3	45	7	15	4	55
4	46	6	16	4	56
1990:1	48	5	17	4	57
2	46	6	16	4	55
3	46	6	16	3	55
4	47	6	17	3	56
1991:1	43	6	15	3	53
2	43	6	15	3	53
3	42	6	15	3	51
4	40	6	14	3	50

TABLE 3
TOTAL CAPITAL OUTLAYS

<u>Year/Qtr.</u>	<u>Under \$5000</u>	<u>\$5000- \$19999</u>	<u>\$20000- \$49999</u>	<u>\$50000- \$99999</u>	<u>\$100000 or More</u>	<u>None</u>
1981:2	14%	19%	9%	4%	7%	47%
3	14	19	9	5	6	47
4	16	18	8	5	6	47
1982:1	15	18	9	5	6	47
2	14	20	8	5	5	47
3	15	17	6	4	5	48
4	14	18	6	4	5	53
1983:1	16	18	7	4	6	52
2	13	19	8	4	5	50
3	15	20	8	4	5	51
4	16	21	8	4	5	47
1984:1	15	20	9	5	6	45
2	14	20	9	4	5	45
3	14	20	9	5	7	48
4	15	21	9	5	7	45
1985:1	15	20	10	6	7	43
2	13	21	9	5	7	42
3	14	18	9	6	7	45
4	14	21	10	5	5	46
1986:1	15	20	10	6	6	45
2	15	19	10	5	7	43
3	13	16	11	5	6	44
4	16	19	9	4	6	49
1987:1	17	18	8	5	6	46
2	14	19	9	5	6	46
3	16	19	9	5	6	47
4	16	17	10	5	6	45
1988:1	14	18	10	5	7	44
2	15	19	10	5	8	45
3	15	19	9	6	6	44
4	16	20	10	5	6	45
1989:1	14	19	10	6	6	43
2	13	20	10	5	8	43
3	15	20	9	5	7	45
4	14	20	10	6	7	44
1990:1	15	19	10	5	7	43
2	15	18	10	5	6	45
3	15	19	10	5	7	45
4	14	18	11	5	7	44
1991:1	15	19	9	4	6	46
2	14	19	8	4	6	47
3	14	19	8	4	6	49
4	14	17	10	4	5	49
						50

TREASURY NEWS



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

EMBARGOED FOR RELEASE
November 7, 1991
2:00 PM

Contact: Claire Buchan
(202) 566-8773

Statement of Secretary of the Treasury
Nicholas F. Brady
on Credit Crunch Guidelines

I am pleased with today's announcement by the financial institutions regulators on guidelines for certain regulatory policies. The new guidelines will increase flexibility and improve consistency in bank regulation.

Treasury has been working with regulators, business leaders and bankers for more than a year to develop a coordinated, sensible approach to alleviate the credit crunch. Today's guidelines demonstrate the regulators' continued commitment to evenhanded, common-sense supervisory policies, and follow through on the goals outlined by the Economic Policy Council in October.

Improving credit availability is necessary to sustaining economic recovery. Passage by Congress of the Administration bank reform and the President's economic growth package are also vital to ensuring that the recovery is vibrant.

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NFB-1540

Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board
Office of Thrift Supervision

NEWS RELEASE

EMBARGOED FOR RELEASE at 2 p.m. EST
Thursday, November 7, 1991

FINANCIAL REGULATORS ISSUE JOINT SUPERVISORY POLICY STATEMENT

WASHINGTON, D.C., Nov. 7, 1991 -- The four federal regulators of bank and thrift institutions issued a joint statement today on the review and classification of commercial real estate loans. Today's action is another step by the agencies to ensure that misunderstandings about supervisory policies do not impede the availability of credit to sound borrowers. Development of this document was announced in the Administration's October 8th statement on "Easing The Credit Crunch To Promote Economic Growth."

The policy statement provides clear and comprehensive guidance on the review and classification of commercial real estate loans. The detailed guidelines, which will be sent to the chief executive officer of each depository institution and each bank and thrift examiner, cover loan portfolio review procedures, indicators of troubled loans, analysis of loans and collateral values, and the review of institutions' loss allowances.

The four regulatory agencies that issued today's guidelines are the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Board

-more-

(FRB), and the Office of Thrift Supervision (OTS). Together, the four agencies supervise the activities of the nation's 12,000 commercial banks and 2,200 thrift institutions.

In addition to today's issuance, the regulatory agencies are undertaking three other actions:

- o National Meeting of Examiners

The agencies will hold a national meeting of senior examination personnel in Baltimore, Md., on December 16 and 17 to review the policy statement and other initiatives related to credit availability.

- o Random Audit Program

To assess the quality of examiners' review of collateral value, the regulatory agencies will implement a random audit program to determine how examiners review and analyze the assumptions contained in appraisals as part of their loan review process.

- o Holding Company Preferred Stock

The Federal Reserve Board, in a move designed to grant bank holding companies greater flexibility in raising capital, has issued for public comment a proposal to lift the limit on the amount of noncumulative perpetual preferred stock that bank holding companies may include in Tier 1 capital. This proposal, if adopted, can assist organizations in strengthening their capital positions and expanding their ability to extend credit to sound borrowers.

All of these steps follow previous actions by the regulatory agencies in March and July to address credit availability concerns.

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**Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board
Office of Thrift Supervision**

**Interagency Policy Statement on the Review and
Classification of Commercial Real Estate Loans**

November 7, 1991

The recent decline in credit extended by depository institutions has been attributed to many factors. These factors include the general slowdown in the economy, the overbuilding of commercial real estate properties in some markets, the desire of some household and business borrowers, as well as some depository institutions, to strengthen their balance sheets, changes by lenders in underwriting standards, and concerns about the potential impact of certain supervisory policies or actions. To ensure that regulatory policies and actions do not inadvertently curtail the availability of credit to sound borrowers, the four Federal regulators of banks and thrifts have taken a number of steps to clarify and communicate their policies. The attached policy statement is a further step in this effort.

On March 1, 1991, the four agencies — the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the Office of Thrift Supervision — issued general guidelines that addressed a wide range of supervisory policies. Included in the March issuance were brief discussions of the workout of problems loans, lending by undercapitalized institutions, and a general statement on the valuation of real estate loans.

The attached policy statement expands upon the March 1 and subsequent guidance as it relates to the review and classification of commercial real estate loans.

The intent of the statement by the agencies is to provide clear and comprehensive guidance to ensure that supervisory personnel are reviewing loans in a consistent, prudent, and balanced fashion and to ensure that all interested parties are aware of the guidance.

The policy statement emphasizes that the evaluation of real estate loans is not based solely on the value of the collateral, but on a review of the borrower's willingness and capacity to repay and on the income-producing capacity of the properties.

The policy statement also provides guidance on how supervisory personnel analyze the value of collateral. In general, examiners consider the institution's appraisals of collateral (or internal evaluations, when applicable) to determine value and they review the major facts, assumptions and approaches used in determining the value of the collateral. Examiners seek to avoid challenges to underlying assumptions that differ in only a limited way from norms that would generally be associated with the property under review. Nonetheless, when reviewing the value of the collateral and any related management adjustments, examiners ascertain that the value is based on assumptions that are both prudent and realistic, and not on overly optimistic or overly pessimistic assumptions.

The policy statement covers a wide range of specific topics, including:

- the general principles that examiners follow in reviewing commercial real estate loan portfolios;
- the indicators of troubled real estate markets, projects, and related indebtedness;
- the factors examiners consider in their review of individual loans, including the use of appraisals and the determination of collateral value;
- a discussion of approaches to valuing real estate, especially in troubled markets;
- the classification guidelines followed by the agencies, including the treatment of guarantees; and
- the factors considered in the evaluation of an institution's allowance for loan and lease losses.

This statement is intended to ensure that all supervisory personnel, lending institutions and other interested parties have a clear understanding of the agencies' policies.

Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans¹

Introduction

This policy statement addresses the review and classification of commercial real estate loans by examiners of the federal bank and thrift regulatory agencies.² Guidance is also provided on the analysis of the value of the underlying collateral. In addition, this policy statement summarizes principles for evaluating an institution's process for determining the appropriate level for the allowance for loan and lease losses, including amounts that have been based on an analysis of the commercial real estate loan portfolio.³ These guidelines are intended to promote the prudent, balanced, and consistent supervisory treatment of commercial real estate loans, including those to borrowers experiencing financial difficulties.

The attachments to this policy statement address three topics related to the review of commercial real estate loans by examiners. The topics include the treatment of guarantees in the classification process (Attachment 1); background information on the valuation of income-producing commercial real estate loans in the examination process (Attachment 2); and definitions of classification terms used by the federal bank and thrift regulatory agencies (Attachment 3).

Examiner Review of Commercial Real Estate Loans

Loan Policy and Administration Review. As part of the analysis of an institution's commercial real estate loan portfolio, examiners review lending policies, loan administration procedures, and credit risk control procedures. The maintenance of prudent written lending policies, effective internal systems and controls, and thorough

¹ For purposes of this policy statement, "commercial real estate loans" refers to all loans secured by real estate, except for loans secured by 1 - 4 family residential properties. This does not refer to loans where the underlying collateral has been taken solely through an abundance of caution where the terms as a consequence have not been made more favorable than they would have been in the absence of the lien.

² The agencies issuing this policy statement are the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

³ For analytical purposes, as part of its overall estimate of the allowance for loan and lease losses (ALLL) management may attribute a portion of the ALLL to the commercial real estate loan portfolio. However, this does not imply that any part of the ALLL is segregated for, or allocated to, any particular asset or group of assets. The ALLL is available to absorb all credit losses originating from the loan and lease portfolio.

For savings institutions, the ALLL is referred to as the "general valuation allowance" for purposes of the Thrift Financial Report.

loan documentation are essential to the institution's management of the lending function.

The policies governing an institution's real estate lending activities must include prudent underwriting standards that are periodically reviewed by the board of directors and clearly communicated to the institution's management and lending staff. The institution must also have credit risk control procedures that include, for example, prudent internal limits on exposure, an effective credit review and classification process, and a methodology for ensuring that the allowance for loan and lease losses is maintained at an adequate level. The complexity and scope of these policies and procedures should be appropriate to the size of the institution and the nature of the institution's activities, and should be consistent with prudent banking practices and relevant regulatory requirements.

Indicators of Troubled Real Estate Markets and Projects, and Related

Indebtedness. In order to evaluate the collectibility of an institution's commercial real estate portfolio, examiners should be alert for indicators of weakness in the real estate markets served by the institution. They should also be alert for indicators of actual or potential problems in the individual commercial real estate projects or transactions financed by the institution.

Available indicators, such as permits for — and the value of — new construction, absorption rates, employment trends, and vacancy rates, are useful in evaluating the condition of commercial real estate markets. Weaknesses disclosed by these types of statistics may indicate that a real estate market is experiencing difficulties that may result in cash flow problems for individual real estate projects, declining real estate values, and ultimately, in troubled commercial real estate loans.

Indicators of potential or actual difficulties in commercial real estate projects may include:

- An excess of similar projects under construction.
- Construction delays or other unplanned adverse events resulting in cost overruns that may require renegotiation of loan terms.
- Lack of a sound feasibility study or analysis that reflects current and reasonably anticipated market conditions.
- Changes in concept or plan (for example, a condominium project converted to an apartment project because of unfavorable market conditions).
- Rent concessions or sales discounts resulting in cash flow below the level projected in the original feasibility study or appraisal.
- Concessions on finishing tenant space, moving expenses, and lease buyouts.

- Slow leasing or lack of sustained sales activity and increasing sales cancellations that may reduce the project's income potential, resulting in protracted repayment or default on the loan.
- Delinquent lease payments from major tenants.
- Land values that assume future rezoning.
- Tax arrearages.

As the problems associated with a commercial real estate project become more pronounced, problems with the related indebtedness may also arise. Such problems include diminished cash flow to service the debt and delinquent interest and principal payments.

While some commercial real estate loans become troubled because of a general downturn in the market, others become troubled because they were originated on an unsound or a liberal basis. Common examples of these types of problems include:

- Loans with no or minimal borrower equity.
- Loans on speculative undeveloped property where the borrowers' only source of repayment is the sale of the property.
- Loans based on land values that have been driven up by rapid turnover of ownership, but without any corresponding improvements to the property or supportable income projections to justify an increase in value.
- Additional advances to service an existing loan that lacks credible support for full repayment from reliable sources.
- Loans to borrowers with no development plans or noncurrent development plans.
- Renewals, extensions and refinancings that lack credible support for full repayment from reliable sources and that do not have a reasonable repayment schedule.⁴

Examiner Review of Individual Loans, Including the Analysis of Collateral Value.

The focus of an examiner's review of a commercial real estate loan, including binding commitments, is the ability of the loan to be repaid. The principal factors that bear on this analysis are the income-producing potential of the underlying collateral and the borrower's willingness and capacity to repay under the existing loan terms from the borrower's other resources if necessary. In evaluating the overall risk associated with

⁴ As discussed more fully in the section on classification guidelines, the refinancing or renewing of loans to sound borrowers would not result in a supervisory classification or criticism unless well-defined weaknesses exist that jeopardize repayment of the loans. Consistent with sound banking practices, institutions should work in an appropriate and constructive manner with borrowers who may be experiencing temporary difficulties.

a commercial real estate loan, examiners consider a number of factors, including the character, overall financial condition and resources, and payment record of the borrower; the prospects for support from any financially responsible guarantors; and the nature and degree of protection provided by the cash flow and value of the underlying collateral.⁵ However, as other sources of repayment for a troubled commercial real estate loan become inadequate over time, the importance of the collateral's value in the analysis of the loan necessarily increases.

The appraisal regulations of the federal bank and thrift regulatory agencies require institutions to obtain appraisals when certain criteria are met.⁶ Management is responsible for reviewing each appraisal's assumptions and conclusions for reasonableness. Appraisal assumptions should not be based solely on current conditions that ignore the stabilized income-producing capacity of the property.⁷ Management should adjust any assumptions used by an appraiser in determining value that are overly optimistic or pessimistic.

An examiner analyzes the collateral's value as determined by the institution's most recent appraisal (or internal evaluation, as applicable). An examiner reviews the major facts, assumptions, and approaches used by the appraiser (including any comments made by management on the value rendered by the appraiser). Under the circumstances described below, the examiner may make adjustments to this assessment of value. This review and any resulting adjustments to value are solely for purposes of an examiner's analysis and classification of a credit and do not involve actual adjustments to an appraisal.

A discounted cash flow analysis is an appropriate method for estimating the value of income-producing real estate collateral.⁸ This approach is discussed in more detail in Attachment 2. This analysis should not be based solely on the current performance of the collateral or similar properties; rather, it should take into account, on a discounted basis, the ability of the real estate to generate income over time based upon reasonable and supportable assumptions.

⁵ The treatment of guarantees in the classification process is discussed in Attachment 1.

⁶ Department of the Treasury, Office of the Comptroller of the Currency, 12 CFR Part 34 (Docket No. 90-16); Board of Governors of the Federal Reserve System, 12 CFR Parts 208 and 225 (Regulation H and Y; Docket No. R-0685); Federal Deposit Insurance Corporation, 12 CFR 323 (RIN 3064-AB05); Department of the Treasury, Office of Thrift Supervision, 12 CFR Part 564 (Docket No. 90-1495).

⁷ Stabilized income generally is defined as the yearly net operating income produced by the property at normal occupancy and rental rates; it may be adjusted upward or downward from today's actual market conditions.

⁸ The real estate appraisal regulations of the federal bank and thrift regulatory agencies include a requirement that an appraisal (a) follow a reasonable valuation method that addresses the direct sales comparison, income, and cost approaches to market value; (b) reconcile these approaches; and (c) explain the elimination of each approach not used. A discounted cash flow analysis is recognized as a valuation method for the income approach.

When reviewing the reasonableness of the facts and assumptions associated with the value of the collateral, examiners may evaluate:

- Current and projected vacancy and absorption rates;
- Lease renewal trends and anticipated rents;
- Volume and trends in past due leases;
- Effective rental rates or sale prices (taking into account all concessions);
- Net operating income of the property as compared with budget projections; and
- Discount rates and direct capitalization ("cap") rates.⁹

The capacity of a property to generate cash flow to service a loan is evaluated based upon rents (or sales), expenses, and rates of occupancy that are reasonably estimated to be achieved over time. The determination of the level of stabilized occupancy and rental rates should be based upon an analysis of current and reasonably expected market conditions, taking into consideration historical levels when appropriate. The analysis of collateral values should not be based upon a simple projection of current levels of net operating income if markets are depressed or reflect speculative pressures but can be expected over a reasonable period of time to return to normal (stabilized) conditions. Judgment is involved in determining the time that it will take for a property to achieve stabilized occupancy and rental rates.

Examiners do not make adjustments to appraisal assumptions for credit analysis purposes based on worst case scenarios that are unlikely to occur. For example, an examiner would not necessarily assume that a building will become vacant just because an existing tenant who is renting at a rate above today's market rate may vacate the property when the current lease expires. On the other hand, an adjustment to value may be appropriate for credit analysis purposes when the valuation assumes renewal at the above-market rate, unless that rate is a reasonable estimate of the expected market rate at the time of renewal.

When estimating the value of income-producing real estate, discount rates and "cap" rates should reflect reasonable expectations about the rate of return that investors require under normal, orderly and sustainable market conditions. Exaggerated, imprudent, or unsustainably high or low discount rates, "cap" rates, and income projections should not be used. Direct capitalization of nonstabilized income flows should also not be used.

Assumptions, when recently made by qualified appraisers (and, as appropriate, by institution management) and when consistent with the discussion above, should be

⁹ Attachment 2 includes a discussion of discount rates and direct capitalization rates.

given a reasonable amount of deference. Examiners should not challenge the underlying assumptions, including discount rates and "cap" rates used in appraisals, that differ only in a limited way from norms that would generally be associated with the property under review. The estimated value of the underlying collateral may be adjusted for credit analysis purposes when the examiner can establish that any underlying facts or assumptions are inappropriate and can support alternative assumptions.

Classification Guidelines

As with other types of loans, commercial real estate loans that are adequately protected by the current sound worth and debt service capacity of the borrower, guarantor, or the underlying collateral generally are not classified. Similarly, loans to sound borrowers that are refinanced or renewed in accordance with prudent underwriting standards, including loans to creditworthy commercial or residential real estate developers, should not be classified or criticized unless well-defined weaknesses exist that jeopardize repayment. An institution will not be criticized for continuing to carry loans having weaknesses that result in classification or criticism as long as the institution has a well-conceived and effective workout plan for such borrowers, and effective internal controls to manage the level of these loans.

In evaluating commercial real estate credits for possible classification, examiners apply standard classification definitions (Attachment 3).¹⁰ In determining the appropriate classification, consideration should be given to all important information on repayment prospects, including information on the borrower's creditworthiness, the value of, and cash flow provided by, all collateral supporting the loan, and any support provided by financially responsible guarantors.

The loan's record of performance to date is important and must be taken into consideration. As a general principle, a performing commercial real estate loan should not automatically be classified or charged-off solely because the value of the underlying collateral has declined to an amount that is less than the loan balance. However, it would be appropriate to classify a performing loan when well-defined weaknesses exist that jeopardize repayment, such as the lack of credible support for full repayment from reliable sources.¹¹

These principles hold for individual credits, even if portions or segments of the industry to which the borrower belongs are experiencing financial difficulties. The evaluation of each credit should be based upon the fundamental characteristics

¹⁰ These definitions are presented in Attachment 3 and address assets classified "substandard," "doubtful," or "loss" for supervisory purposes.

¹¹ Another issue that arises in the review of a commercial real estate loan is the loan's treatment as an accruing asset or as a nonaccrual asset for reporting purposes. The federal bank and thrift regulatory agencies have provided guidance on nonaccrual status in the instructions for the Reports of Condition and Income (Call Reports) for banks, and in the instructions for the Thrift Financial Report for savings associations, and in related supervisory guidance of the agencies.

affecting the collectibility of the particular credit. The problems broadly associated with some sectors or segments of an industry, such as certain commercial real estate markets, should not lead to overly pessimistic assessments of particular credits that are not affected by the problems of the troubled sectors.

Classification of troubled project-dependent commercial real estate loans.¹² The following guidelines for classifying a troubled commercial real estate loan apply when the repayment of the debt will be provided solely by the underlying real estate collateral, and there are no other available and reliable sources of repayment.

As a general principle, for a troubled project-dependent commercial real estate loan, any portion of the loan balance that exceeds the amount that is adequately secured by the value of the collateral, and that can clearly be identified as uncollectible, should be classified "loss."¹³ The portion of the loan balance that is adequately secured by the value of the collateral should generally be classified no worse than "substandard." The amount of the loan balance in excess of the value of the collateral, or portions thereof, should be classified "doubtful" when the potential for full loss may be mitigated by the outcomes of certain pending events, or when loss is expected but the amount of the loss cannot be reasonably determined.

If warranted by the underlying circumstances, an examiner may use a "doubtful" classification on the entire loan balance. However, this would occur infrequently.

Guidelines for classifying partially charged-off loans. Based upon consideration of all relevant factors, an evaluation may indicate that a credit has well-defined weaknesses that jeopardize collection in full, but that a portion of the loan may be reasonably assured of collection. When an institution has taken a charge-off in an amount sufficient that the remaining recorded balance of the loan (a) is being serviced (based upon reliable sources) and (b) is reasonably assured of collection, classification of the remaining recorded balance may not be appropriate. Classification would be appropriate when well-defined weaknesses continue to be present in the remaining recorded balance. In such cases, the remaining recorded balance would generally be classified no more severely than "substandard."

A more severe classification than "substandard" for the remaining recorded balance would be appropriate if the loss exposure cannot be reasonably determined, e.g., where significant risk exposures are perceived, such as might be the case for bankruptcy situations or for loans collateralized by properties subject to environmental hazards. In addition, classification of the remaining recorded balance would be appropriate when sources of repayment are considered unreliable.

¹² The discussion in this section is not intended to address loans that must be treated as "other real estate owned" for bank regulatory reporting purposes or "real estate owned" for thrift regulatory reporting purposes. Guidance on these assets is presented in supervisory and reporting guidance of the agencies.

¹³ For purposes of this discussion, the "value of the collateral" is the value used by the examiner for credit analysis purposes, as discussed in a previous section of this policy statement.

Guidelines for classifying formally restructured loans. The classification treatment previously discussed for a partially charged off loan would also generally be appropriate for a formally restructured loan when partial charge-offs have been taken. For a formally restructured loan, the focus of the examiner's analysis is on the ability of the borrower to repay the loan in accordance with its modified terms. Classification of a formally restructured loan would be appropriate, if, after the restructuring, well-defined weaknesses exist that jeopardize the orderly repayment of the loan in accordance with reasonable *modified terms*.¹⁴ Troubled commercial real estate loans whose terms have been restructured should be identified in the institution's internal credit review system, and closely monitored by management.

Review of the Allowance for Loan and Lease Losses (ALLL)¹⁵

The adequacy of a depository institution's ALLL, including amounts based on an analysis of the commercial real estate portfolio, must be based on a careful, well documented, and consistently applied analysis of the institution's loan and lease portfolio.¹⁶

The determination of the adequacy of the ALLL should be based upon management's consideration of all current significant conditions that might affect the ability of borrowers (or guarantors, if any) to fulfill their obligations to the institution. While historical loss experience provides a reasonable starting point, historical losses or even recent trends in losses are not sufficient without further analysis and cannot produce a reliable estimate of anticipated loss.

In determining the adequacy of the ALLL, management should also consider other factors, including changes in the nature and volume of the portfolio; the experience, ability, and depth of lending management and staff; changes in credit standards; collection policies and historical collection experience; concentrations of credit risk; trends in the volume and severity of past due and classified loans; and trends in the volume of nonaccrual loans, specific problem loans and commitments. In addition, this analysis should consider the quality of the institution's systems and management in identifying, monitoring, and addressing asset quality problems. Furthermore, management should consider external factors such as local and national economic conditions and

¹⁴ An example of a restructured commercial real estate loan that does *not* have reasonable modified terms would be a "cash flow" mortgage which requires interest payments *only* when the underlying collateral generates cash flow but provides no substantive benefits to the lending institution.

¹⁵ Each of the federal bank and thrift regulatory agencies have issued guidance on the allowance for loan and lease losses. The following discussion summarizes general principles for assessing the adequacy of the allowance for loan and lease losses.

¹⁶ The estimation process described in this section permits for a more accurate estimate of anticipated losses than could be achieved by assessing the loan portfolio solely on an aggregate basis. However, it is only an estimation process and does not imply that any part of the ALLL is segregated for, or allocated to, any particular asset or group of assets. The ALLL is available to absorb all credit losses originating from the loan and lease portfolio.

developments; competition; and legal and regulatory requirements; as well as reasonably foreseeable events that are likely to affect the collectibility of the loan portfolio.

Management should adequately document the factors that were considered, the methodology and process that were used in determining the adequacy of the ALLL, and the range of possible credit losses estimated by this process. The complexity and scope of this analysis must be appropriate to the size and nature of the institution and provide for sufficient flexibility to accommodate changing circumstances.

Examiners will evaluate the methodology and process that management has followed in arriving at an overall estimate of the ALLL in order to assure that all of the relevant factors affecting the collectibility of the portfolio have been appropriately considered. In addition, the overall estimate of the ALLL and the range of possible credit losses estimated by management will be reviewed for reasonableness in view of these factors. This examiner analysis will also consider the quality of the institution's systems and management in identifying, monitoring, and addressing asset quality problems.

As discussed in the previous section on classification guidelines, the value of the collateral is considered by examiners in reviewing and classifying a commercial real estate loan. However, for a performing commercial real estate loan, the supervisory policies of the agencies do *not* require automatic increases to the ALLL solely because the value of the collateral has declined to an amount that is less than the loan balance.

In assessing the ALLL during examinations, it is important to recognize that management's process, methodology, and underlying assumptions require a substantial degree of judgment. Even when an institution maintains sound loan administration and collection procedures and effective internal systems and controls, the estimation of anticipated losses may not be precise due to the wide range of factors that must be considered. Further, the ability to estimate anticipated loss on specific loans and categories of loans improves over time as substantive information accumulates regarding the factors affecting repayment prospects. When management has (a) maintained effective systems and controls for identifying, monitoring and addressing asset quality problems *and* (b) analyzed all significant factors affecting the collectibility of the portfolio, considerable weight should be given to management's estimates in assessing the adequacy of the ALLL.

Attachment 1

TREATMENT OF GUARANTEES IN THE CLASSIFICATION PROCESS

Initially, the original source of repayment and the borrower's intent and ability to fulfill the obligation without reliance on third party guarantors will be the primary basis for the review and classification of assets.¹ The federal bank and thrift regulatory agencies will, however, consider the support provided by guarantees in the determination of the appropriate classification treatment for troubled loans. The presence of a guarantee from a "financially responsible guarantor," as described below, may be sufficient to preclude classification or reduce the severity of classification.

For purposes of this discussion, a guarantee from a "financially responsible guarantor" has the following attributes:

- The guarantor must have *both* the financial capacity and willingness to provide support for the credit;
- The nature of the guarantee is such that it can provide support for repayment of the indebtedness, in whole or in part, during the remaining loan term; and²
- The guarantee should be legally enforceable.

The above characteristics generally indicate that a guarantee may improve the prospects for repayment of the debt obligation.

Considerations relating to a guarantor's financial capacity. The lending institution must have sufficient information on the guarantor's financial condition, income, liquidity, cash flow, contingent liabilities, and other relevant factors (including credit ratings, when available) to demonstrate the guarantor's financial capacity to fulfill the obligation. Also, it is important to consider the number and amount of guarantees currently extended by a guarantor, in order to determine that the guarantor has the financial capacity to fulfill the contingent claims that exist.

Considerations relating to a guarantor's willingness to repay. Examiners normally rely on their analysis of the guarantor's financial strength and assume a willingness to perform unless there is evidence to the contrary. This assumption may be modified

¹ Some loans are originated based primarily upon the financial strength of the guarantor, who is, in substance, the primary source of repayment. In such circumstances, examiners generally assess the collectibility of the loan based upon the guarantor's ability to repay the loan.

² Some guarantees may only provide for support for certain phases of a real estate project. It would not be appropriate to rely upon these guarantees to support a troubled loan after the completion of these phases.

based on the "track record" of the guarantor, including payments made to date on the asset under review or other obligations.

Examiners give due consideration to those guarantors that have demonstrated their ability and willingness to fulfill previous obligations in their evaluation of current guarantees on similar assets. An important consideration will be whether previously required performance under guarantees was voluntary or the result of legal or other actions by the lender to enforce the guarantee. However, examiners give limited credence, if any, to guarantees from obligors who have reneged on obligations in the past, unless there is clear evidence that the guarantor has the ability and intent to honor the specific guarantee obligation under review.

Examiners also consider the economic incentives for performance from guarantors:

- Who have already partially performed under the guarantee or who have other significant investments in the project;
- Whose other sound projects are cross-collateralized or otherwise intertwined with the credit; or
- Where the guarantees are collateralized by readily marketable assets that are under the control of a third party.

Other considerations. In general, only guarantees that are legally enforceable will be relied upon. However, all legally enforceable guarantees may not be acceptable. In addition to the guarantor's financial capacity and willingness to perform, it is expected that the guarantee will not be subject to significant delays in collection, or undue complexities or uncertainties about the guarantee.

The nature of the guarantee is also considered by examiners. For example, some guarantees for real estate projects only pertain to the development and construction phases of the project. As such, these limited guarantees would not be relied upon to support a troubled loan after the completion of those phases.

Examiners also consider the institution's intent to enforce the guarantee and whether there are valid reasons to preclude an institution from pursuing the guarantee. A history of timely enforcement and successful collection of the full amount of guarantees will be a positive consideration in the classification process.

THE VALUATION OF INCOME-PRODUCING REAL ESTATE

Approaches to the Valuation of Real Estate

Appraisals are professional judgments of the market value of real property. Three basic valuation approaches are used by professional appraisers in estimating the market value of real property -- the cost approach, the market data or direct sales comparison approach, and the income approach. The principles governing the three approaches are widely known in the appraisal field and were recently referenced in parallel regulations issued by each of the federal bank and thrift regulatory agencies. When evaluating the collateral for problem credits, the three valuation approaches are not equally appropriate.

1. **Cost Approach.** In the cost approach, the appraiser estimates the reproduction cost of the building and improvements, deducts estimated depreciation, and adds the value of the land. The cost approach is particularly helpful when reviewing draws on construction loans. However, as the property increases in age, both reproduction cost and depreciation become more difficult to estimate. Except for special purpose facilities, the cost approach is usually inappropriate in a troubled real estate market because construction costs for a new facility normally exceed the market value of existing comparable properties.
2. **Market Data or Direct Sales Comparison Approach.** This approach examines the price of similar properties that have sold recently in the local market, estimating the value of the subject property based on the comparable properties' selling price. It is very important that the characteristics of the observed transactions be similar in terms of market location, financing terms, property condition and use, timing, and transaction costs. The market approach generally is used in valuing owner-occupied residential property because comparable sales data are typically available. When adequate sales data are available, an analyst generally will give the most weight to this type of estimate. Often, however, the available sales data for commercial properties are not sufficient to justify a conclusion.
3. **The Income Approach.** The economic value of an income-producing property is the discounted value of the future net operating income stream, including any "reversion" value of property when sold. If competitive markets are working perfectly, the observed sales price should be equal to this value. For unique properties or in markets that are thin or subject to disorderly or unusual conditions, market value based on a comparable sales approach may be either unavailable or distorted. In such cases, the income approach is usually the appropriate method for valuing the property.

The income approach converts all expected future net operating income into present value terms. When market conditions are stable and no unusual patterns of future rents and occupancy rates are expected, the direct capitalization method is often used to estimate the present value of future income streams. For troubled properties, however, examiners typically utilize the more explicit discounted cash flow (net present value) method for analytical purposes. In that method, a time frame for achieving a "stabilized", or normal, occupancy and rent level is projected. Each year's net operating income during that period is discounted to arrive at the present value of expected future cash flows. The property's anticipated sales value at the end of the period until stabilization (its terminal or reversion value) is then estimated. The reversion value represents the capitalization of all future income streams of the property after the projected occupancy level is achieved. The terminal or reversion value is then discounted to its present value and added to the discounted income stream to arrive at the total present market value of the property.

Valuation of Troubled Income-Producing Properties

When an income property is experiencing financial difficulties due to general market conditions or due to its own characteristics, data on comparable property sales often are difficult to obtain. Troubled properties may be hard to market, and normal financing arrangements may not be available. Moreover, forced and liquidation sales can dominate market activity. When the use of comparables is not feasible (which is often the case for commercial properties), the net present value of the most reasonable expectation of the property's income-producing capacity — not just in today's market but over time — offers the most appropriate method of valuation in the supervisory process.

Estimates of the property's value should be based upon reasonable and supportable projections of the determinants of future net operating income: rents (or sales), expenses and rates of occupancy. Judgment is involved in estimating all of these factors. The primary considerations for these projections include historical levels and trends, the current market performance achieved by the subject and similar properties, and economically feasible and defensible projections of future demand and supply conditions. To the extent that current market activity is dominated by a limited number of transactions or liquidation sales, high "capitalization" and discount rates implied by such transactions should not be used. Rather, analysts should use rates that reflect market conditions that are *neither* highly speculative nor depressed for the type of property being valued and that property's location.

Technical Notes

In the process of reviewing a real estate loan and in the use of the net present value approach of collateral valuation, several conceptual issues often are raised. The following discussion sets forth the meaning and use of those key concepts.

The Discount Rate. The discount rate used in the net present value approach to convert future net cash flows of income-producing real estate into present market value terms is the rate of return that market participants require for this type of real estate investment. The discount rate will vary over time with changes in overall interest rates and in the risk associated with the physical and financial characteristics of the property. The riskiness of the property depends both on the type of real estate in question and on local market conditions.¹

The Direct Capitalization ("Cap" Rate) Technique. The use of "cap" rates, or direct income capitalization, is a method used by many market participants and analysts to relate the value of a property to the net operating income it generates. In many applications, a "cap" rate is used as a short cut for computing the discounted value of a property's income streams.

The direct income capitalization method calculates the value of a property by dividing an estimate of its "stabilized" annual income by a factor called a "cap" rate. Stabilized income generally is defined as the yearly net operating income produced by the property at normal occupancy and rental rates; it may be adjusted upward or downward from today's actual market conditions. The "cap" rate — usually defined for each property type in a market area — is viewed by some analysts as the required rate of return stated in terms of current income. That is to say, the "cap" rate can be considered a direct observation of the required earnings-to-price ratio in current income terms. The "cap" rate also can be viewed as the number of cents per dollar of today's purchase price investors would require annually over the life of the property to achieve their required rate of return.

The "cap" rate method is appropriate if the net operating income to which it is applied is representative of all future income streams or if net operating income and the property's selling price are expected to increase at a fixed rate. The use of this technique assumes that either the stabilized income or the "cap" rate used accurately captures all relevant characteristics of the property relating to its risk and income potential. If the same risk factors, required rate of return, financing arrangements, and income projections are used, explicit discounting and direct capitalization will yield the same results.

¹ Regulatory policy of the Office of Thrift Supervision specifies that, for supervisory purposes, thrifts are to use discount rates that are consistent with generally accepted accounting principles for thrifts (which allow the use of an average-cost-of-capital-funds rate to calculate net realizable value) or discount rates that are consistent with the practices of the federal banking agencies.

This method alone is not appropriate for troubled real estate since income generated by the property is not at normal or stabilized levels. In evaluating troubled real estate, ordinary discounting typically is used for the period before the project reaches its full income potential. A "terminal" "cap" rate is then utilized to estimate the value of the property (its reversion or sales price) at the end of that period.

Differences Between Discount and Cap Rates. When used for estimating real estate market values, discount and "cap" rates should reflect the current market requirements for rates of return on properties of a given type. The discount rate is the required rate of return including the expected increases in future prices and is applied to income streams reflecting inflation. In contrast, the "cap" rate is used in conjunction with a stabilized net operating income figure. The fact that discount rates for real estate are typically higher than "cap" rates reflects the principal difference in the treatment of expected increases in net operating income and/or property values.

Other factors affecting the "cap" rate used (but not the discount rate) include the useful life of the property and financing arrangements. The useful life of the property being evaluated affects the magnitude of the "cap" rate because the income generated by a property, in addition to providing the required return on investment, must be sufficient to compensate the investor for the depreciation of the property over its useful life. The longer the useful life, the smaller is the depreciation in any one year, hence, the smaller is the annual income required by the investor, and the lower is the "cap" rate. Differences in terms and the extent of debt financing and the related costs must also be taken into account.

Selecting Discount and Cap Rates. The choice of the appropriate values for discount and "cap" rates is a key aspect of income analysis. Both in markets marked by lack of transactions and those characterized by highly speculative or unusually pessimistic attitudes, analysts consider historical required returns on the type of property in question. Where market information is available to determine current required yields, analysts carefully analyze sales prices for differences in financing, special rental arrangements, tenant improvements, property location, and building characteristics. In most local markets, the estimates of discount and "cap" rates used in income analysis should generally fall within a fairly narrow range for comparable properties.

Holding Period vs. Marketing Period. When the income approach is applied to troubled properties, a time frame is chosen over which a property is expected to achieve stabilized occupancy and rental rates (stabilized income). That time period is sometimes referred to as the "holding period." The longer the period before stabilization, the smaller will be the reversion value included in the total value estimate.

The holding period should be distinguished from the concept of "marketing period" — a term used in estimating the value of a property under the sales comparison approach

and in discussions of property value when real estate is being sold. The marketing period is the length of time that may be required to sell the property in an open market.

Glossary

Appraisal. A written statement independently and impartially prepared by a qualified appraiser setting forth an opinion as to the market value of an adequately described property as of a specific date(s), supported by the presentation and analysis of relevant market information.

Capitalization rate. A rate used to convert income into value. Specifically, it is the ratio between a property's stabilized net operating income and the property's sales price. Sometimes referred to as an overall rate because it can be computed as a weighted average of component investment claims on net operating income.

Discount rate. A rate of return used to convert future payments or receipts into their present value.

Holding period. The time frame over which a property is expected to achieve stabilized occupancy and rental rates (stabilized income).

Market value. The most probable cash sale price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:

1. buyer and seller are typically motivated (i.e., motivated by self-interest);
2. both parties are well informed or well advised, and acting in what they consider their own best interests;
3. a reasonable time is allowed for exposure in the open market;
4. payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and
5. the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

Marketing period. The term in which an owner of a property is actively attempting to sell that property in a competitive and open market.

Net operating income (NOI). Annual income after all expenses have been deducted, except for depreciation and debt service.

Attachment 3

Classification Definitions¹

The federal bank and thrift regulatory agencies currently utilize the following definitions for assets classified "substandard," "doubtful," and "loss" for supervisory purposes:

Substandard Assets. A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Doubtful Assets. An asset classified doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

Loss Assets. Assets classified loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.

¹ Office of the Comptroller of the Currency, *Comptroller's Handbook for National Bank Examiners*, Section 215.1, "Classification of Credits;" Board of Governors of the Federal Reserve System, *Commercial Bank Examination Manual*, Section 215.1, "Classification of Credits;" Office of Thrift Supervision, *Thrift Activities Regulatory Handbook*, Section 260, "Classification of Assets;" Federal Deposit Insurance Corporation, *Division of Supervision Manual of Examination Policies*, Section 3.1, "Loans."



FEDERAL RESERVE press release

For immediate release

October 31, 1991

The Federal Reserve Board today requested public comment on a proposal to permit bank holding companies to raise additional tier one risk-based capital through the sale of perpetual preferred stock.

Comment should be received by the Board by November 22.

Under present risk-based capital guidelines, bank holding companies are permitted to count perpetual preferred stock up to 25 percent of their tier one capital. The proposal would remove the limitation for noncumulative perpetual preferred stock but continue to limit cumulative perpetual preferred to 25 percent of tier one capital.

A copy of the Board's order is attached.

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Attachment

FEDERAL RESERVE SYSTEM**12 CFR Parts 208 and 225****[Regulation H, Regulation Y; Docket No. R-0740]****Capital; Capital Adequacy Guidelines****AGENCY: Board of Governors of the Federal Reserve System.****ACTION: Notice of Proposed Revisions to Capital Adequacy Guidelines.**

SUMMARY: The Board is proposing to remove the limit on the amount of noncumulative perpetual preferred stock bank holding companies may include in Tier 1 capital. Cumulative perpetual preferred stock would continue to be included in Tier 1 capital for bank holding companies, up to a limit of 25 percent of Tier 1 capital.

DATE: Comments on the proposed revisions to the Federal Reserve Board's risk-based capital guidelines and leverage capital guidelines should be submitted on or before November 22, 1991.

ADDRESS: Comments, which should refer to docket No. R-0740, may be mailed to Mr. William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenues, N.W., Washington, D.C. 20551; or delivered to Room B-2223, Eccles Building, between 8:45 a.m. and 5:15 p.m. weekdays. Comments may be inspected in Room B-1122 between 9:00 a.m. and 5:00 p.m. weekdays, except as provided in section 2612.8

of the Board's Rules Regarding Availability of Information, 12 CFR 261.8.

FOR FURTHER INFORMATION CONTACT: Roger T. Cole, Assistant Director (202/452-2618), Rhoger H Pugh, Manager (202/728-5883), Norah M. Barger, Supervisory Financial Analyst (202/452-2402), Robert E. Motyka, Senior Financial Analyst (202/452-3621), Division of Banking Supervision and Regulation; and Michael J. O'Rourke, Senior Attorney (202/452-3288), Legal Division. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), Dorothea Thompson (202/452-3544).

SUPPLEMENTARY INFORMATION

I. BACKGROUND

The international bank capital standards (Basle Accord)¹ allow banks to include noncumulative perpetual preferred stock-place in Tier 1 capital and place no formal limit on the amount of such instruments that may be included in Tier 1.² The Basle framework, which by its terms applies only to

¹ The Basle Accord is a risk-based capital framework that was proposed by the Basle Committee on Banking Regulations and Supervisory Practices and endorsed by the central bank governors of the Group of Ten (G-10) countries in July 1988. The Committee is comprised of representatives of the central banks and supervisory authorities from the G-10 countries (Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, the United Kingdom, and the United States) and Luxembourg.

² Noncumulative perpetual preferred stock is perpetual preferred stock whose dividends, if missed, do not accrue and will never be paid. Cumulative perpetual preferred stock is preferred stock whose dividends, if missed because of insufficient earnings.

internationally active banks, was adopted by the Federal Reserve for state nonmember banks. In addition, the Board chose to apply a risk-based capital framework similar to the Basle Accord to U.S. bank holding companies generally on a consolidated basis.³ Under the Federal Reserve's bank holding company capital guidelines, holding companies are allowed to include both noncumulative and cumulative perpetual preferred stock in Tier 1 capital, but the total of all perpetual preferred stock includable in Tier 1 capital is limited to 25 percent of Tier 1.⁴ Amounts of such stock in excess of the limitation may be included in Tier 2 capital. The limit on preferred stock is consistent with the Board's long-standing view that common equity should remain the dominant form of a banking organization's capital structure.

A principal reason for the Board's decision to limit the amount of perpetual preferred stock in bank holding Tier 1 capital is the fact that cumulative preferred, the type of perpetual preferred most prevalent in U.S. financial markets,

or any other reason, accumulate until all arrearages are paid out. Cumulative preferred dividends have preference over common dividends, which cannot be paid out as long as any cumulative preferred dividends remain unpaid.

³ For bank holding companies with consolidated assets of less than \$150 million in assets, the risk-based capital guidelines generally are applied on a bank-only basis.

⁴ Under the risk-based capital guidelines, certain types of perpetual preferred stock do not qualify for inclusion in Tier 1 capital. For example, perpetual preferred stock in which the dividend is reset periodically based, in whole or in part, upon the banking organization's credit standing is excluded from Tier 1 capital, but may be included in Tier 2 capital.

normally involves preset dividends that cannot be cancelled, but only deferred. An institution that passes dividends on cumulative preferred stock must pay off any accumulated arrearages before it can resume payment of its common stock dividends. Thus, undue reliance on cumulative perpetual preferred stock and the related possibility of large dividend arrearages could complicate an organization's ability to raise new common equity in times of financial difficulty. On the other hand, dividends on noncumulative preferred, like dividends on common stock, may be cancelled. Thus, with respect to dividends, noncumulative preferred stock has characteristics that are consistent with common stock, the principal component of Tier 1 capital.

Conditions in the banking industry underscore the desirability of affording banking organizations greater flexibility in raising capital. This can assist organizations in strengthening their capital positions and expanding their ability to extend credit to sound borrowers. In view of these considerations, the Board is proposing to lift the limit on the amount of noncumulative preferred stock that bank holding companies may include in Tier 1 capital. This proposal is consistent with other steps initiated by the Federal bank regulatory agencies, in conjunction with the Treasury Department, to address concerns relating to the availability of credit to sound borrowers.

II. Proposal

The Board is proposing to remove the limit on the amount of noncumulative perpetual preferred stock a bank holding company may include in its Tier 1 capital. Cumulative perpetual preferred stock would continue to be included in Tier 1 capital for bank holding companies, up to a limit of 25 percent of Tier 1 capital.

By removing the limit for noncumulative perpetual preferred stock, this proposal will achieve parity with regard to the treatment of noncumulative perpetual preferred stock between the U.S. risk-based capital guidelines for bank holding companies and the Basle framework for banks. Thus, the proposal will place U.S. bank holding companies on a more equal footing with foreign banks subject to the Basle Accord with regard to their ability to augment Tier 1 capital through the issuance of noncumulative perpetual preferred stock. The additional flexibility provided by this step may assist bank holding companies to strengthen their capital positions and expand their lending capacity.

Although the Board is proposing to lift the limit on noncumulative perpetual preferred stock, it continues to believe that bank holding companies should avoid overreliance on preferred stock within Tier 1 capital. In proposing this step, the Board notes that the capital structure of a bank holding company is subject to quarterly review (through the analysis of financial reports filed with the Federal Reserve), and the composition of an organization's capital base and its capital

plans are subject to in-depth assessment during annual inspections and as part of the Federal Reserve's consideration of applications. The language of the Federal Reserve's risk-based capital guidelines makes clear the Board's long-standing belief that banking organizations should avoid overreliance on nonvoting equity instruments, including preferred stock, in Tier 1 capital. Capital structures that are inconsistent with this principle may result in supervisory or enforcement actions, including possible denial of applications filed with the Federal Reserve. In addition, rating agencies take the amount of common equity and preferred stock an organization has, as well as the overall composition of the organization's core capital, into account in determining the organization's financial ratings. Thus, there are a number of mechanisms in place to monitor banking organizations' use of preferred stock and to discourage undue reliance on such instruments.

III. Regulatory Flexibility Act Analysis

The Federal Reserve Board does not believe adoption of this proposal would have a significant economic impact on a substantial number of small business entities (in this case, small banking organizations), in accord with the spirit and purposes of the Regulatory Flexibility Act (5 U.S.C. 601 et seq.). In addition, because the risk-based and leverage capital guidelines generally do not apply to bank holding companies with consolidated assets of less than \$150 million, this proposal will

not affect such companies.

List of Subjects

12 CFR Part 208

Accounting, Agricultural loan losses, Applications, Appraisals, Banks, Banking, Branches, Capital adequacy, Confidential business information, Currency, Dividend payments, Federal Reserve System, Flood insurance, Publication of reports of condition, Reporting and recordkeeping requirements, Securities, State member banks.

12 CFR Part 225

Administrative practice and procedure, Appraisals, Banks, Banking, Capital adequacy, Federal Reserve System, Holding companies, Reporting and recordkeeping requirements, Securities, State member banks.

For the reasons set forth in this notice, and pursuant to the Board's authority under section 5(b) of the Bank Holding Company Act of 1956 (12 U.S.C. 1844(b)), and section 910 of the International Lending Supervision Act of 1983 (12 U.S.C. 3909), the Board is amending 12 CFR Parts 208 and 225 to read as follows:

PART 208 - MEMBERSHIP OF STATE BANKING INSTITUTIONS IN THE
FEDERAL RESERVE SYSTEM

1. The authority citation for Part 208 continues to read as follows:

AUTHORITY: Sections 9, 11(a), 11(c), 19, 21, 25, and 25(a) of the Federal Reserve Act, as amended (12 U.S.C. 321-338, 248(a), 248(c), 461, 481-486, 601, and 611, respectively); sections 4 and 13(j) of the Federal Deposit Insurance Act, as amended (12 U.S.C. 1814 and 1823(j), respectively); section 7(a) of the International Banking Act of 1978 (12 U.S.C. 3105); sections 907¹, 910 of the International Lending Supervision Act of 1983 (12 U.S.C. 3906-3909); sections 2, 12(b), 12(g), 12(i), 15B(c) (5), 17, 17A, and 23 of the Securities Exchange Act of 1934 (15 U.S.C. 78b, 781(b), 781(g), 781(i), 78o-4(c) (5), 78q, 78q-1, and 78w, respectively); section 5155 of the Revised Statutes (12 U.S.C. 36) as amended by the McFadden Act of 1927; and sections 1101-1122 of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (12 U.S.C. 3310 and 3331-3351).

Appendix A - [Amended]

2. The footnote designator in the text is removed and footnote 6 is removed and reserved.

PART 225 - BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL

1. The authority citation for Part 225 continues to read as follows:

AUTHORITY: 12 U.S.C. 1817(j) (13), 1818, 1831i, 1843(c) (8), 1844(b), 3106, 3108, 3907, 3909, 3310, and 3331-3351.

Appendix A - [Amended]

2. Appendix A is amended by revising paragraphs (ii) and (iii) and adding paragraph (iv) in II.A.1., and by removing the last three sentences in the third paragraph and the entire fourth paragraph in II.A.1.b. and replacing them, to read as follows:

II. ***

A. ***

(i) ***

(ii) qualifying noncumulative perpetual preferred stock (including related surplus).

(iii) qualifying cumulative perpetual preferred stock (including related surplus), subject to certain limitations described below.

(iv) minority interest in the equity accounts of consolidated subsidiaries.

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b. *** However, the aggregate amount of cumulative perpetual preferred stock that may be included in a holding company's tier 1 is limited to one-third of the sum of core capital elements, excluding the cumulative perpetual preferred stock (that is, items i, ii, and iv above). Stated differently, the aggregate amount may not exceed 25 percent of the sum of all core capital elements, including cumulative perpetual preferred stock (that is, items, i, ii, iii, and iv above). Any cumulative perpetual preferred stock outstanding in excess of this limit may be included in tier 2 capital without any sublimits within that tier (see discussion below).

While the guidelines allow for the inclusion of noncumulative perpetual preferred stock and limited amounts of cumulative perpetual preferred stock in tier 1, it is desirable from a supervisory standpoint that voting common equity remain the dominant form of tier 1 capital. Thus, bank holding companies should avoid overreliance on preferred stock or nonvoting equity elements within tier 1.*****

Appendix D - [Amended]

3. Appendix D is amended by removing the first two sentences in footnote 3 and replacing them, to read as follows:

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II. ***

At the end of 1992, Tier 1 capital for bank holding companies includes common equity, minority interest in the equity accounts of consolidated subsidiaries, qualifying noncumulative perpetual preferred stock, and qualifying cumulative perpetual preferred stock. (Cumulative perpetual preferred stock is limited to 25 percent of Tier 1 capital.)***

Board of Governors of the Federal Reserve System,
October 31, 1991.

(signed) William W. Wiles

William W. Wiles
Secretary of the Board