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Folder Title:
Credit Crunch 1991 [1]

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THE WHITE HOUSE

WASHINGTON

November 7, 1991

MEMORANDUM FOR THE ECONOMIC POLICY COUNCIL

FROM: J. FRENCH HILL
EXECUTIVE SECRETARY JFH

SUBJECT: Bank and Thrift Regulators' Follow-up Press Announcement of Additional Steps to Ease the "Credit Crunch"

Please find enclosed a press package being released today, November 7, 1991, at 2:00 p.m., on the first of several commitments for action made by the regulators in the Administration's October 8, 1991, announcement, "Easing the Credit Crunch to Promote Economic Growth."

The steps announced today include:

- o Release of the comprehensive and uniform guidelines on commercial real estate loans.
- o The Federal Reserve Board's proposal permitting noncumulative preferred stock to be included as Tier One capital for bank holding companies. This proposal was sent to the <u>Federal Register</u> on October 31, 1991.
- o A national meeting of bank and thrift examiners, to be held December 16-17, 1991, in Baltimore, MD.
- o The bank and thrift regulators are to implement the random audit program on the use of appraisals by examiners.

In accordance with October 8th release, future announcements by the regulators will include:

- Enhanced Appeals Process	November 15th
- Improved Examination Management	November 15th
- Clarification of the Highly Leveraged Transaction definition	December 1st
- Recommendations to Reduce Appraisal Costs	January 1st

There are several other "credit crunch" related projects, not mentioned in the October 8th release, on which progress is being made. I will keep you apprised of their status as various options develop.

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.

oOo

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:

- <u>National Meeting of Examiners</u>
  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.
- <u>Random Audit Program</u>
  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.
- <u>Holding Company Preferred Stock</u>
  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 Loans[1]

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

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[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.

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[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

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[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; and[2]
- 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.

Attachment 2

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.

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[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 Definitions[1]

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

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[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,

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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 907-910 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, 78l(b), 78l(g), 78l(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:

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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. ***

[3] 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

Withdrawal/Redaction Sheet
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Document No. and Type	Subject/Title of Document	Date	Restriction	Class.
01. Memo	From Nicholas Brady to John Sununu Re: Letter from John Kilroy (2 pp.)	10/4/91	~~P5~~	

Collection:

Record Group: Bush Presidential Records
Office: Chief of Staff, White House Office of
Series: Sununu, John, Files
Subseries: Issues Files
WHORM Cat.:
File Location: Credit Crunch 1991 [1]

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Date Closed: 1/3/2005	**OA/ID Number:** 29151-004
FOIA/SYS Case #: 1998-0004-F[2]	**Appeal Case #:**
Re-review Case #: 2005-0426-S	**Appeal Disposition:**
P-2/P-5 Review Case #:	**Disposition Date:**
AR Case #:	**MR Case #:**
AR Disposition:	**MR Disposition:**
AR Disposition Date:	**MR Disposition Date:**

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P-4 Release would disclose trade secrets or confidential commercial or financial information [(a)(4) of the PRA]
P-5 Release would disclose confidential advice between the President and his advisors, or between such advisors [a)(5) of the PRA]
P-6 Release would constitute a clearly unwarranted invasion of personal privacy [(a)(6) of the PRA]

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Freedom of Information Act - [5 U.S.C. 552(b)]

(b)(1) National security classified information [(b)(1) of the FOIA]
(b)(2) Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
(b)(3) Release would violate a Federal statute [(b)(3) of the FOIA]
(b)(4) Release would disclose trade secrets or confidential or financial information [(b)(4) of the FOIA]
(b)(6) Release would constitute a clearly unwarranted invasion of personal privacy [(b)(6) of the FOIA]
(b)(7) Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA]
(b)(8) Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
(b)(9) Release would disclose geological or geophysical information

MEMORANDUM TO THE CHIEF OF STAFF

FROM: NICHOLAS F. BRADY NFB

THE CHIEF of STAFF has seen -- Brady will draft response

On John ("Jim") Kilroy's September 25 letter to the President which you sent over:

1. As background, you should know that Kilroy has met on at least six separate occasions with senior Treasury officials (and has corresponded with Treasury several times). We have focussed on substantially the same credit crunch and real estate related issues covered in his letter to the President. Our meetings with Kilroy have always been cordial.

2. With respect to the specific issues he raises, some are real problems for which there are no easy government solutions i.e., national oversupply of commercial real estate and some are issues which are politically impossible (reinstatement of passive tax loss on real estate, renegotiating the multilateral BIS bank capital rules). Others are matters on which the regulators have taken action at our urging (the "mini-perm" real estate credit renewal) and some are issues currently being looked at by the EPC-Treasury-regulator group

(such as appraisals and some adjustment of bank capital classifications). But we are committed to keep looking for "doable" ways to address these issues.

3. The various issues around which Kilroy wants to form study groups ("Team A" and "Team B") are those which do affect the credit crunch and are being addressed in the President's EPC meetings. The notion of an outside "shadow cabinet" paralleling the work of the President's senior economic advisors, however is a dangerous one.

4. If you want us to draft a response to Kilroy from the President, let me know. We should point out to Kilroy that we continuously solicit and welcome input from the private sector.

THE PRESIDENT HAS SEEN

10/3 SecyBrady will respond directly

P/

I sent note to him (with other Team 100. sent him clip)

KILROY INDUSTRIES

John B. Kilroy
Chairman of the Board

25 September 1991

The Honorable George Bush
President of the United States
The White House
Washington, DC 20510

Dear Mr. President:

Thank you for taking the time to meet with Don Bren and with me regarding the Credit Crisis and possible techniques to ameliorate and ultimately proceed towards solution of the current crisis and adverse economic conditions.

Neither Don nor I were aware that this issue would be further discussed by our mutual friends and fellow members of Team 100, who are all strong supporters of your Presidency. As was stated at this meeting Governor Pete Wilson, Lod Cook, David Murdock, Burt Sugarman, George Argyros, Alex Spanos, Anwar Soliman, Gerry Parsky and the other members have equally strong feelings about the absolute need to promptly correct the current Credit Crisis and deepening economic recession.

This strong group of executives and owners of diverse business interests across the nation, and the Governor with his view of California, provided forthright comments of the severe impact on various industries. The comments covered conditions from hamburgers and colas, to big oil, real estate, farming, food processing & distribution, finance, entertainment, the NFL, venture capital, and of one of the largest owners of restaurants across the nation.

The comments emphasized the shortage of credit, particularly long-term financing, while at the same time there seemed to be no shortage of overall money supply. The unanimous comment to lowered interest rates was that it is beneficial, but not sufficient if the necessary financing could not be obtained.

While financing is not readily available, substantial money is being invested in quickly convertible, "mark-to-market" assets, which can be moved to another investment on an almost daily basis. In these days of uncertainty and lack of confidence there is great concern about long-term assets due to the many changing conditions of tax law, bank capital requirements, bank loan risk weighting requirements, "marking-to-market" and other worrisome trends. Each issue has impact upon investment practices and policy.

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"Marking-to-market" emphasizes a "need to know" value for many, a short-term measurement, of particular importance to pension trusts and other funds in regard to their reporting desires. Fixed longer term assets are subject to the variable of appraisals which have many transitional aspects, particularly lack of immediate convertibility.

For corporate pension trust sponsors, short-term and other readily marketable securities provide a 90 day review and, if profitable, can reduce the corporate contribution to the pension trust. Investment earnings reduce the need for contributions thereby enhancing corporate profits.

However, failure to provide long-term capital needed by U.S. industry and other necessary capital investments can undermine general earnings potential and thereafter cause a fall in the value of marketable securities, causing the corporations to make up differences in pension trust actuarial funds.

With the current stock markets as high as they are, with earnings generally falling and with PE ratios being fairly high and increasing, failure to have a balance of long-term capital investments may be a risky plan. If the markets fall, corporate pension trust sponsors can have substantial liability to the pension trusts which can further distress earnings.

Mr. President, about 95.5% of investments by pension funds are in short to medium term securities or readily marketable assets. Only about 4.5% are in long-term assets. This large pool of funds, 3.7 trillion dollars, surely has the capacity, if not the will, to increase their long-term asset commitment.

Concurrently, while pension trusts are limiting long-term capital investments, private capital has been substantially driven out of the long-term fixed asset market by the 1986 Tax Reform Act, particularly by the passive and active tax regulations. Further, concern about future retroactive tax rulings is worrisome.

Mr. President, banks have about 400 billion dollars of commercial real estate loans coming due over a short period of time. There is no primary source of repayment. This amount equals 1.72 times total bank capital.

Insurance companies have over 75 billion of GIC backed commercial real estate loans coming due in the same short period of time. This equals about 3.7 times their highest lending year to commercial real estate. They must repay their guaranteed investment contracts unless they can be renewed. There is no primary source for repayment of the real estate loans.

Where is the source of funds for this refinancing? No one knows! Bank Circular 255 recognizes this fact and allows banks to roll (renew) such loans, however, they are subject to classification and as a result many additional real estate loan reserves will be imposed upon bank capital.

Banks are endeavoring to reduce commercial real estate loans to comply with new capital standards and other demands of regulators, and are demanding that borrowers repay their loans. The alternatives for banks and owners are: repay, foreclose, other legal action, renew the loan and suffer the classification and resulting reserves.

However, with current appraisal trends, values of assets and loan amount will not be supported. Appraisals have been artificially lowered by government regulation, examiner pressure in addition to diminution of the market.

A quick comparison of market change and appraisal change of many performing cash flow assets is as follows (based upon loan values as of 1 January 1990):

67% Loan					50% Loan			
Value	Appraisal	Loan	Equity	Year	Value	Appraisal	Loan	Equity
130	130	67.0%	33.0%	1 Jan '90	130	130	50.0%	50.0%
100	---	86.7%	13.3%	July 1991	100	---	65.0%	35.0%
---	70	123.9%	-23.9%	July 1991	---	70	92.9%	7.1%

Needless to say, the above aberration in appraisal destroys the value of the bank or insurance company loan and diminishes owner's equity.

Another "Sword of Damocles" impacting commercial and all real estate is the lack of an organized plan for the RTC. Indiscriminate dumping of RTC assets can further destroy real estate values and create additional failures for banks and real estate owners.

As an example, a recently proposed sale of an office complex at a fraction of its cost with a down payment to the RTC of about 8 million and a cash flow mortgage could easily destroy the economics of adjacent real estate having mortgages of over 200 million. The idea of selling under market, with little cash down, a cash flow mortgage with no minimal rental rate protection is obviously destructive to existing performing assets. The new owners of the RTC property will have the ability and incentive to slash rental rates for their own benefit while impacting the rental rate market and appraised values of every asset in the area.

Will RTC next inherit failed mortgages on buildings subsequently destabilized by the initial RTC actions? In the case recited, the potential mortgage failures could be about 25 times the cash taken as a down payment by RTC. There are other proposed sales of a similar nature.

If we criticize "dumping" in foreign trade, we must certainly not allow it to happen in our own country, particularly by our own government.

Mr. President, the BIS Capital Standards Agreement as well as the weighted loan risk analysis, as now written are very likely in conflict with our current need to correct the Credit Crisis. Is the imposition of these standards and its current timing essential to the nation? Is the weighted loan risk analysis consistent with past history of lending and loss? The very nature of the overall Agreement restricts the banks from performing what seems essential and changes historic and safe lending practices.

A few questions as to the weighted loan risk analysis:

1. Single to four family occupied homes are weighted at 50%. Could this be 33%?

2. Single to four family home construction loans are weighted at 100%. Could this be 50-75%?

3. Leased, investment grade commercial real estate for either construction or permanent lending is weighted at 100%. Could this be 50-60 or 75%?

4. Many other questions can be asked about each weighting category.

Mr. President, most banks do not want to hold or to make 100% weighted loans at this time. Housing construction has virtually stopped. The majority of available financing for housing construction today occurs when banks have a land Acquisition & Development (A&D) loan, and the only way to repay the A&D loan is to build and sell homes.

I have particularly emphasized real estate credit in this memo because the value of real estate in this country is about ten times the value of all listed stock on the various exchanges, and represents about 10-20% of the economy in most states around the nation. Such negative impact on real estate not only has a huge financial impact upon the nation's economy, it has a further psychological impact upon the confidence of the nation as home values, personal security and jobs are diminished.

Mr. President, after all of this rhetorical foundation, I do have a recommended plan. It is based upon the fact that most people have begun to define the problems and are concerned about the answers.

This is certainly true of the many people I have talked to in the agencies who tell me that they generally agree with the information contained in my prior letters and conversations.

I believe that the many people I have talked to could answer many specific questions, in a team review format, if asked to disregard political aspects and concentrate on technical aspects toward the resolution of the various credit issues.

TEAM SELECTION - CHARGE OF RESPONSIBILITY & REPORTS:

Mr. President, I suggest that two different teams be formed to review a number of issues -- one team from the Administration and one team from the business and finance community.

These teams would be charged with the same responsibilities and would have availability to the same resources. Their reports, however, would be separate, and minority reports can be written by each team, if desired.

I would suggest that the two teams be as follows:

TEAM A:

Nicholas Brady - Secretary of the Treasury
Alan Greenspan - Chairman, Federal Reserve Board
Richard Darman - Director, OMB
Michael Boskin - Chairman, Counsel of Economic Advisors
Robert Mosbacher - Secretary of Commerce
Jack Kemp - Secretary of Housing & Urban Development
One member selected from either: FDIC, OCC, OTS
New Head of RTC

TEAM B:

Money Center Banker
Major Pension Trust Manager
Major Insurance Company Executive
Leading Appraiser
Real Estate Executive
Corporate Leader
Senior Accounting Executive
Financial Advisory Executive
State Governor
Member RTC Oversight Committee

I would recommend each team be asked in a separate meeting to analyze, without respect to what they believe the current political bias or preference may be, and to provide a technical response to the following:

BIS - BANK CAPITAL REQUIREMENTS:

1. Is it essential to the nation to achieve the new capital requirements by 31 December 1992?

2. Would it help relieve the Credit Crisis if further implementation was deferred until a later date?

BIS - RISK WEIGHTING FOR BALANCE SHEET ASSETS:

1. Does the risk weighting match the historical loss ratios over time of the assets set forth in each category?

2. Category III includes single to four family residences at 50%. Would 33% be acceptable?

3. Category IV, 100% includes construction loans for single to four family homes. Could this be reduced to a lower weighting, say 50-75%?

4. Category IV, 100% includes preleased, investment grade real estate. Could this be reduced to a lower weighting?

5. What inducement is there for banks to loan against Category IV, 100% weighted assets?

6. Compare economic benefits or loss to banks from making comparative risk weighted investments.

7. What is the change of investment category by banks since the establishment of the Current Risk Weight Measurement formula?

APPRAISALS:

1. What changes have been made to appraisal instructions and appraisal liability under FIRREA?

2. What changes have been made by FDIC and the Appraisal Committee instructions?

3. Has any consumer protection been considered to protect appraisals from being too low, thereby depriving property owners of asset value?

4. What direction is being given appraisers by bank examiners whether directly or through bank personnel?

BANK EXAMINERS AND REGULATORS:

1. Are examiners exceeding their authority?

2. Do examiners understand and have they been briefed on agency guidelines?

3. Are examiners rejecting appraisals or insisting that appraisals be modified or reduced?

4. To whom do bankers address objections regarding examiners exceeding their authority, and is there a record of examiners response?

1986 TAX REFORM ACT:

1. Provide estimate of capital withdrawn from long-term fixed asset investment by active and passive regulations.

HOUSING CONSTRUCTION FINANCING:

1. Provide economic analysis of the effects of reduction in housing construction and forecast of probable 1992 construction.

REAL ESTATE:

1. Overall impact on economy - 5 years & 10 years

2. State-by-State impact

3. Negative impact on overall domestic industry by diminution of new construction

UNEMPLOYMENT - TO DATE AND ESTIMATED 1991:

1. General information and by industry

2. Real estate general
   - Housing construction
   - General construction

3. Banking - financial services

4. Industry - general except automotive and aerospace

5. Aerospace

6. Automotive

7. Unemployment not counted because off unemployment rolls, but no jobs

PENSION TRUST INVESTMENT:

1. Can long-term capital investment be increased as a percentage of total?

2. Under what conditions?

R.T.C.:

1. Impact on current economy and long-term ramifications

2. Preliminary guidelines so as not to diminish existing real estate values

3. General policy - variables:

   a. Hold and manage to stabilization

   b. Gifts to cities, counties and states for needed justifiable facilities

   c. Market at any price and on any terms?

   d. Market with defined non-stabilization restrictions

SECURITIZATION:

1. Steps to be taken to strengthen the secondary market for commercial real estate mortgages and commercial mortgage-backed securities.

2. Impact on banks

3. Impact on the economy and Credit Crisis

The President could direct Team A and Team B, in separate sessions, to review on an urgency basis and to report within thirty days their preliminary but substantial findings.

A statement somewhat like the following may be beneficial:

STATEMENT OF THE PRESIDENT TO TEAM A & TO TEAM B - CHARGE OF RESPONSIBILITY:

- We have a problem of substantial proportions. Unforeseen problems have occurred.

- The current Credit Crisis and economic downturn must be corrected and I need your immediate attention and recommendation as to how this problem may be reduced and corrected.

- I do not want political opinions, I want sound technical advice. In this regard I have framed several preliminary questions to which I want your response.

- I want to know the need for the many changes in banking policy. This need should be based upon historic and sound financial theory.

- I continue to hear that examiners at banks are exceeding their authority and that they are requiring competent appraisals to be reduced. I want this issue thoroughly investigated and corrected.

- Have clear and concise written instructions been given, with additional verbal instructions to all bank examiners in the field? Are their activities appropriately audited?

- I need your recommendations as to how long-term capital investments may be increased from pension trusts, individual investors and overseas investors.

- I need specific statistics on the impact of the passive and active tax regulations of the 1986 Tax Reform Act.

- We need to get this nation moving. We need to restore confidence. I do not want the value of owners homes taken away. I want new homes to be constructed in areas of firm needs.

- I need a defined plan for management of RTC assets. I do not want a plan that will further destabilize the market.

- Team members, I want a quick if preliminary response in 30 days. Certainly ample data is already available.

- Thank you. If resources are required to supplement available data, please let us know and we will endeavor to fulfill your needs.

PHASE II: REVIEW AND COMMENT ON REPORTS - JOINT RECOMMENDATIONS

Upon receipt of reports from Team A and Team B, it would be appropriate for each team to comment on the findings of the other team, allowing fifteen days for comment. A team report or individual reports would be acceptable.

Upon receipt of the comments after a 3-4 day review, a joint meeting could be held for overall discussion, and thereafter smaller working parties formed to further refine specific issues and make final recommendations.

These meetings should not consume a great deal of time, perhaps no more than three days, and should be as informal as possible with chair leadership alternating between Team A and Team B.

After the first reports are submitted, team members should be allowed to include a technical assistant, if necessary, upon prior request.

Team B should be voluntary. Recording and secretarial services should be provided by the Administration when necessary.

PHASE III: IMPLEMENTATION - MANAGEMENT REVIEW

At this point, Mr. President, you have the best thinking of Team A and Team B, their areas of agreement/disagreement, if any, and options in between.

Decisions on how to proceed are solely yours, and more information will undoubtedly be required along with the need to manage the information and monitor its implementation.

An implementation and management review advisory committee may be appropriate and could be composed of members of Team A and Team B, with staff, to assure that your decisions and instructions are implemented and administered with the possibility of ongoing review of field audit procedures.

Mr. President, this proposal was quickly prepared in response to our discussions of Thursday, 19 September 1991.

I believe this proposal will permit major cards to be put on the table so that the complex components creating the Credit Crisis can be collectively and individually reviewed and understood. There is a conflict of major proportions between the components which needs to be moderated and priorities need to be established. We have a systemic problem which needs to be appropriately reassembled and fine tuned.

As to real estate, there is much more good real estate than bad; it is a major component of our economic structure. It should be protected and not destroyed to the detriment of the nation, as well as the major destruction of banking and the fundamental value of property ownership. Currently real estate seems to be heading towards a "black hole".

If you desire, I am available to offer my services to you and your Administration in any way possible toward a resolution of this current crisis. It is, I believe, our nations most urgent priority.

Should you desire to proceed with my suggestion, I will be pleased to serve on Team B or an appropriate committee.

Thank you for providing me with the opportunity to make this presentation and forthrightly outline concerns that I and many of my associates believe should be addressed.

Chantal and I send our sincere regards to you and to Mrs. Bush.

Respectfully,

John B. Kilroy
Chairman of the Board

JBK/gle

Capital Markets in the United States

Leading Indicators

U.S. Securities and Exchange Commission

October , 1991

DRAFT...DRAFT

THE WHITE HOUSE

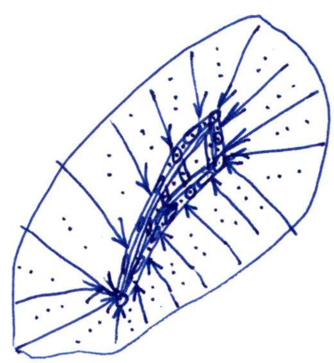
Office of the Press Secretary

For Immediate Release October 8, 1991

approved?

The President today endorsed a plan put forward by his Economic Policy Council aimed at easing the credit crunch and ensuring the continued economic recovery.

The plan, part of an ongoing effort begun more than a year ago to ease the credit crunch, is designed to achieve balanced bank regulatory practice and complements the President's comprehensive economic growth package.



DRAFT OCTOBER 7, 1991

(TREASURY DEPARTMENT)

borrowers & lenders alike OK

For Immediate Release
October 8, 1991

Contact:
Claire Buchanan
566-8773

EASING THE CREDIT CRUNCH TO PROMOTE ECONOMIC GROWTH

Secretary of the Treasury Nicholas Brady today announced new steps in the Administration's ongoing efforts to address "credit crunch" problems identified by ~~bankers, regulators, and business people.~~ The steps build on the President's economic agenda and are aimed at sustaining the economic recovery.

starts ind. production

"Maintaining the economic recovery depends on banks making sound loans, businesses making investments, and consumers purchasing goods and services," Brady said. Recent statistics show employment levels, housing ~~sales~~, and ~~automobile sales~~ rising. The Administration wants to insure that proper balance in the regulation of the banking sector continues the upward trend and that Congress passes other Administration economic growth proposals.

Developed in consultation with the Federal Reserve Board, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and the Office of Thrift Supervision, the Administrations's program is designed to promote confidence and balance in the lending environment, and help businesses and consumers in their economic activity.

The Administration's program builds on the prior work of the Treasury Department and financial regulators to encourage lenders to make prudent loans and assure that examiners perform their reviews in a balanced, sensible manner so that sound businesses and consumers can get needed credit. The federal banking and thrift regulators have stated that they do not want the availability of credit to sound borrowers to be adversely affected by supervisory policies or depository institutions' misunderstandings about them.

In particular, the Administration, while avoiding any encouragement of regulatory laxity, wants to insure that the specific guidance issued by the regulators over the past several months is being fully implemented by examiners in the field, and that additional opportunities for assuring balanced regulation are pursued. Among the areas addressed are:

- Directives that bankers should work constructively with borrowers experiencing temporary difficulties and facilitate the orderly restructuring of credits;

- Prudent refinancing of economically sound commercial real estate loans;

- Improved verification by regulatory supervisors that recent policy changes and clarifications are appropriately applied in each examination;

- Enhancements in the process for appeals of alleged misapplication of regulatory standards;

- Harmonization of the treatment of preferred stock in U.S. capital standards with other signatory countries under the Basle capital accord;

- Appropriate application of valuation standards especially in real estate credits so as to avoid a liquidation approach to valuation;

- Improved guidance in the appraisal process and steps to reduce excessive appraisal costs for lenders;

- Legislative action to make permanent recent EPA regulations to limit lender liability for environmental cleanup of loan collateral properties;

This program is in addition to the President's comprehensive economic growth package, which has been stalled in the Congress. These proposals designed for increasing job-creating investment include: reducing the capital gains tax, permanently extending the research and experimentation tax credit, establishing enterprise zones, and promoting saving through Family Savings Accounts and expanded Individual Retirement Accounts. These proposals should be voted upon without delay.

Congress can also help by passing the Administration's comprehensive banking reform legislation and approving its nominees for top financial regulatory positions which are currently before the Senate. Holding up these measures and appointments creates further uncertainty about fiscal, monetary, and regulatory policies.

Details of the Administration program are found on the attached fact sheet.

DRAFT 10-7-91

EASING THE CREDIT CRUNCH TO HELP PROMOTE ECONOMIC GROWTH

FACT SHEET

I. NEW REGULATORY ACTIONS TO BE IMPLEMENTED

A. Efforts to Improve Lending Environment

Conform U. S. Implementation of Basle Capital Standards

Remove the 25% limit on Preferred Stock in Tier One capital to conform the U. S. with other countries.

Removing this ceiling will give bank holding companies an additional method of raising Tier One capital, as there are investors who prefer preferred stock to common shares.

This could result in an increase in Tier One capital and thus expand lending capacity.

The target date for completing this conforming change is October 31, 1991.

B. Build Banker Confidence

1. Enhanced Examination Appeal Process

Each agency has an existing appeal process for bankers who believe that examiners have made an error in their evaluation of loans. Although the March 1st guidelines encouraged bankers to take advantage of this mechanism, few bankers have done so.

Thus, it is recommended that the appeals process be strengthened by allowing a banker to appeal directly to the agency head or Reserve Bank President -- not through the supervision chain of command. Investigations would be conducted in a confidential manner.

Each regulatory agency will implement this system by November 15, 1991.

2. Improve Examination Management

In order to further build confidence that bankers will receive balanced, fair examination standards, agencies will take the following steps:

a. Regional supervisory management will be required to:

i) make sure that the March 1st policy changes and clarifications, and all subsequent guidelines, have been effectively communicated to each examiner;

ii) make sure that these policy changes and guidelines have been explained to the banker by the examiner in each examination; and

iii) certify that these policy changes and clarifications, and all subsequent guidance, have been followed by examiners in each exam.

These policy changes and clarifications include the instruction that:

- bankers should work in an appropriate and constructive fashion with borrowers who may be experiencing temporary difficulties;

- income producing property loans are to be assessed on the income-producing capacity of the properties over time. Examiners should take into account the lack of liquidity and cyclical nature of real estate markets. Liquidation appraisal values are to be used only if the property is to be liquidated;

- banks with real estate concentrations should not automatically refuse new credit to sound real estate developers or to work with existing borrowers.

- regulatory agencies do <u>not</u> have rigid rules (or percentages) on asset concentrations, as bankers and regulators know well the benefits of adequate portfolio diversification;

- institutions attempting to raise capital by shrinking assets should avoid actions such as the sale of all high-quality assets. Such actions by themselves, or the refusal to make sound, new loans, fail to achieve an important goal of improving the quality of the institution's loan portfolio;

- bankers and examiners should not lump all real estate together: Distinctions should be made. For example, credit for a residential builder, should not be automatically penalized by local oversupply conditions in commercial office development;

- bankers should facilitate the orderly restructuring of troubled credits by using established techniques under

FASB 15, "Troubled Debt Restructurings"; and

- o banks should be able to prudently refinance commercial real estate loans without fear of regulatory retribution ("mini-perm" guidance).

b. The agencies will develop a method for regular communication with bankers by central office and/or regional senior personnel to determine banker views on the fairness and balance of examination standards and practices. Examples of this communication would include polling and regular meetings with bankers.

The agencies will implement these changes by November 15, 1991.

C. Improve Real Estate Guidance

1. Real Estate Valuation Policies

The bank and thrift regulatory agencies have drafted a uniform and comprehensive set of real estate examination guidelines, especially for real estate in troubled markets. These detailed guidelines cover loan classification procedures, indicators of troubled loans, proper analysis of appraisals and loan values, and proper reserve analysis.

These guidelines will be released by October 31, 1991 and will be distributed to all examiners -- and bankers.

2. Use of Appraisals

As a part of Subsection 1 above, a letter will be sent by the primary regulator to every bank chief executive outlining the guidelines for using appraisals emphasizing balance and appropriate time lines.

3. Random Audit Program

The regulatory agencies would establish quality control through a random audit program to determine how examiners are using appraisals in the loan documentation process.

This can be implemented by October 31, 1991.

4. Appraisal Costs

The Administration supports the actions taken recently by the regulatory agencies to limit the costs of appraisals on residential real estate loans by raising the minimum loan size subject to appraisal requirements to $100,000 from $50,000.

The Administration calls on the regulatory agencies to consider additional steps that can be taken administratively to lower the burden of appraisal costs, especially for home buyers and small business.

The agencies will report their recommendations to the Secretary of the Treasury by January 1, 1992.

D. Further Clarify the Definition of Highly Leveraged Transaction (HLT)

Leveraged borrowers in businesses such as cable television or broadcast media have cited the HLT definition as unreasonably restraining credit to their industries.

The agencies published their definition for public comment in the Federal Register. The comment period concluded on September 23, 1991, resulting in over 200 comment letters.

The regulatory agencies will review the comments and propose improvements to the definition by December 1, 1991.

E. Convene National Meeting of Examiners

The Treasury Secretary has requested that by mid-November, 1991, the regulatory agencies convene a meeting of all key supervisory management and senior field examination professionals.

Examiners would participate in a series of meetings about the economy, their important role in economic growth, the status of the President's banking reform proposals, and a thorough briefing on the policy changes and guidelines and their application.

II. PROPOSALS THAT WOULD HELP CURE THE CREDIT CRUNCH WHICH REQUIRE ACTION BY CONGRESS

The Administration supports a number of legislative proposals that would promote savings and economic growth, make the financial sector more efficient and create a better climate for lending. These include:

A. Banking Reform

The President's Banking Reform bill will spur confidence for investment by assuring that the United States has a modern banking system with stronger, safer banks.

Stronger, more competitive banks would have greater flexibility in working with borrowers to avoid future credit crunches.

B. Lender Liability Reform

Banks have been reluctant to make certain loans because of recent court cases that have found lenders liable for environmental clean-up costs, even when the bank's only interest in a property is a security interest to secure a loan.

To address this uncertainty concern, the EPA issued a proposed regulation interpreting the Superfund Act which would properly limit lenders' liability for any Superfund clean-up costs as long their participation is merely that of a lender, and not a long term operator.

To make this certainty permanent, the Administration is working with the leadership of the appropriate committees to craft acceptable statutory changes in the pending banking reform legislation.

C. The President's Growth Initiatives

To enhance demand and boost asset values, including real estate, the Administration continues to urge Congress to pass the President's growth package. The program would:

- reduce the capital gains tax rate;
- enhance personal savings through an expanded Individual Retirement Account (IRA) and Family Savings Account;
- make the Research and Experimentation (R&E) tax credit permanent;
- increase federal investment in science, technology and infrastructure;
- reform the education system; and
- keep the discipline of the budget agreement.

D. Nominees for Regulatory Positions

Three out of four bank and thrift regulatory agencies are without a Senate-confirmed head. Presidential nominees for regulatory positions awaiting Senate confirmation, include two members and the Chairman of the Federal Reserve Board, as well as the Comptroller of the Currency and the Chairman of the FDIC.

Congress has created tremendous uncertainty about the direction monetary policy and regulatory leadership with their inexcusable procrastination. Congress' preoccupation with constantly second guessing regulators has continued to exacerbate the credit crunch through regulatory harshness.

E. <u>Bankruptcy Reform</u>

Some in Congress and the American Bankers Association point out that recent court decisions, a developing social acceptability of bankruptcy, and aggressive tactics by borrowers have weakened bankruptcy practices and thus, reduced the willingness of bankers to lend.

The Justice Department has recently undertaken a comprehensive review of the bankruptcy law and practice. The President has asked the Attorney General to complete this review, analyze pending legislative initiatives, and, together with the Secretary of the Treasury, evaluate their impact on credit extensions by financial institutions.

This report will be made to the Economic Policy Council in January 1992.

III. CREDIT CRUNCH PROPOSALS REQUIRING FURTHER CONSIDERATION

The Administration and the regulatory agencies are also reviewing other steps that might be taken to help alleviate the regulatory effects of the credit crunch. A brief summary and time table for review follows:

A. Uniform Approach for Treatment of Intangibles

Currently, institutions regulated by the FDIC and the OTS must deduct from Tier One capital the value of mortgage servicing rights and credit card premiums in excess of 50% of Tier One capital. The Federal Reserve and the OCC have more restrictive limits on the amount of these intangible assets that may be held without deduction from Tier One capital.

While these items are intangibles, they are generally considered to have specific market value as distinct from goodwill. Including them as capital (that is, not deducting them from capital) could result in higher, though not necessarily stronger, supervisory capital ratios.

A uniform agency position will be developed by October 31, 1991.

B. Approach to Certain Residential Construction Loans

Allow residential construction loans secured by one-to-four-family residences that are pre-sold to pre-approved (with a firm loan commitment) buyers to qualify for the 50% risk-weight category in the capital standards.

A uniform agency position will be developed by October 31, 1991.

C. Rotation of Examiners

As an effort to further enhance the examination process, the agencies will consider a regular system for rotating examiners-in-charge. A proposal will be developed after consultation with bankers.

The intent of this proposal would be to increase examiner objectivity.

D. Insubstance Foreclosure Clarifications

Accountants and bankers have expressed concern that some loans which: (1) need loss reserves set aside; (2) have a banker that wants to keep them on the books; and (3) have a borrower willing to stay with the loan and work it out, are being forced into premature non-performing status. In some cases, these loans are being forced into foreclosure because of the interpretation by some examiners and bankers of a SEC financial reporting standard rule (known as FRR #28). This accounting rule is applicable to all types of lending institutions.

The SEC has agreed to work with the bank regulators to develop supplemental examples of how these standards should be applied in order to reduce the chance of misinterpretation.

The agencies will propose these additional examples by November 1, 1991.

D. <u>EPC Working Group on Pension Investment</u>

The Economic Policy Council will create a working group on pension fund investment. The group will review the extent to which pension funds make long term investments in industry and real estate. The group will report on any regulatory or other barriers to long term investment faced by fund managers.

E. <u>Review of Collateral Guidelines</u>

The bank and thrift regulatory agencies will review their current guidelines on collateral accepted by banks.

F. <u>Liability Faced by Bank Officers and Directors and Others</u>

Bankers and others have claimed that recently enacted laws, including FIRREA and the 1990 crime bill, have had a chilling effect on officers and directors of financial institutions. They assert that even officers and directors of well managed institutions may become more reluctant to perform their traditional roles of risk takers in the economy due to greater fear of enforcement actions. In this regard it is important to keep in mind that industry leaders are not quarreling with any instance of criminal prosecution.

The intent of this legislation was to increase the penalties for those who would recklessly and willingly take actions that result in losses to bank shareholders and the deposit insurance funds. While the Administration is committed to and applauds the pursuit of criminal wrongdoers, the Administration does not want these statutes applied or interpreted by regulatory officials or bank lawyers in a manner which would unduly chill the legitimate actions of bank officers and directors to the detriment of their local economy.

The Administration is also concerned that such over-reaction not cause local business people to abandon bank and thrift boards of directors. Moreover, the Administration is concerned that this fear of legal liability could cause others such as, appraisers and accountants, to issue unduly pessimistic valuations.

Therefore, the President has asked the Attorney General, the Secretary of the Treasury, and the regulatory agencies to present a set of recommendations by December 1, 1991, as to how to achieve a balanced implementation of these acts.

SECOND NATIONAL Federal Savings BANK

Phillip Morris Drive and Route 50, P.O. Box 2558, Salisbury, Maryland 21802-2558 / 301-749-8415

October 4, 1991

cc

The Honorable Nicholas F. Brady
Secretary
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Room 3330
Washington, D.C. 20220

Re: "The Regulator-Induced Credit Crunch"

Dear Secretary Brady:

As an early George Bush supporter (and the only savings and loan executive appointed by this Administration to 33 advisory positions on the savings and loan clean-up), I am responding to your call for "suggestions for easing the credit crunch" ("Administration Seeks Ways to Spur Lending - Regulations a Factor in Squeeze, Brady Says," The Washington Post, October 3, 1991, page B11).

There is a great disparity between what was being reported as recently as September 30 as Administration policy ("workout problem loans"; "ease pressure on banks to set aside large reserves on real estate loans"; "the job of bankers is to take risks", The Wall Street Journal, September 30, 1991); and what is happening every day in the field. Three examples are:

1. Appraisal Policy. Because commercial real estate financing is not available in the private sector, the number of buyers is sharply limited, thereby artificially depressing prices well beyond the admitted oversupply and the limited demand. As a consequence, "as is" appraisals are made at fire sale prices and examiners are building in abnormally long absorption rates into their appraisals due to the lack of sales over the past 24 months. The result is unrealistically low asset valuations requiring massive loan write downs.

2. Borrower in Bankruptcy. Many borrowers have sought the protection of Chapter 11 reorganization often because lenders feel the pressure from regulators to take foreclosure action. The FDIC's and OTS' policy is to require 100% loss reserves on unsecured bank lines irrespective of the character of the bankruptcy. For example: Dominic Antonelli, a major Washington developer's sworn statement in

Bankruptcy Court reflects approximately $1.2 billion in assets and $1.13 billion in liabilities. FDIC and OTS examiners are requiring banks to write off 100% of Antonelli's unsecured loans; that no recovery at all is to be credited to the banks.

3. Reserves for Real Estate Owned. Under generally accepted accounting principles, when a property is taken into real estate owned through foreclosure or as an "in-substance foreclosure" the bank is required to appraise the property and write it down to its net realizable value. Nevertheless, the examiners are requiring the asset to be written down below its present net worth by requiring that all REO be further classified as "substandard" and assessed a 10% additional loss reserve.

These are only three examples, but when all the actions of examiners are taken into account, they result in huge additions to loan loss reserves which must be drawn from the bank's existing capital. When that core capital is transferred to loss reserves, the financial institution finds itself short of desired capital ratios. Since there is no appetite for investment of new capital in financial institutions, a bank's only recourse is to shrink in size thereby increasing its percentage of existing capital to total assets.

Assuming a required 5% capital ratio, a $1 billion financial institution that seeks to raise its capital by one percent or $10 million will have to shrink its loan portfolio by 20% or $200 million to maintain its desired ratio. In addition to the denial of all new credit, e.g. to small businesses, this requires calling $200 million of existing loans. Is there any wonder there is a "credit crunch?"

As to the above issues, here are some proposed solutions:

1. Direction to Field Examiners. It is not enough for the FDIC, OTS, Federal Reserve and OCC to hold press conferences and issue statements with respect to the Administration's intentions. What is required are specific guidelines issued to regional directors who disseminate those guidelines to field examiners.

2. Utilize GAAP. In the present environment, regulatory policy should not be more stringent than generally accepted accounting principles. When an asset has been written down to net realizable value, or where a basket of loans is performing, there should not be a regulatory imperative for additional reserves.

3. Realistic Loan Appraisals for a Normalized Market and the Presumption of Regularity. In appraising assets, or in evaluating the likelihood of recovery from a borrower in reorganization, banks should not be required to take a doomsday approach to valuation. Appraisals based upon today's aberrational real estate recession, or a presumption that a bank will recover nothing from a solvent but illiquid borrower, are unduly harsh. The test of a loss reserve policy should be whether the bank's approach is a rational and reasoned one, not whether it agrees with the approach the examiner would have taken. Current policy is to place the presumption on the examiners' judgement and not the bank's, and with no avenue of appeal.

4. Allocation of Credit. Risk-based capital standards are synonymous with regulator-allocated credit. It requires twice as much capital set aside to reserve for the construction of a home as it does to fund a permanent mortgage on the same property. If the Administration wants to promote a specific type of lending, whether it be residential housing, small business, consumer, or the financing of RTC-held real estate, it is wholly within the regulators' power to change the risk-based capital requirements for such lending. I can assure you that banks will respond readily to the signal.

Thank you for taking these views into consideration. No acknowledgement is necessary.

Sincerely,

Henry A. Berliner, Jr.
President & Chief Executive Officer
Chairman Region One and Member National Advisory Board to the Oversight Board of the Resolution Trust Corporation

HABJr/pgw

cc: The Honorable Robert A. Mosbacher
The Honorable John E. Robson
The Honorable John Sununu

AMERICAN
BANKERS
ASSOCIATION

1120 Connecticut Avenue, N.W.
Washington, D.C.
20036

PRESIDENT
Richard A. Kirk
Chairman of the Board
United Bank of Denver
National Association
1700 Broadway
Denver, Colorado 80274-0005

October 7, 1991

The President
The White House
Washington, D.C. 20500

Dear Mr. President:

I am writing to you on behalf of the American Bankers Association (ABA) to present some suggestions for improving the availability of credit to businesses and households. Your recently expressed concerns about the relationship between the availability of credit and the economy are well placed. Bank credit availability is crucial to economic well-being. Millions of American businesses and households depend on banks for growth-generating credit and other financial services.

Certainly recent rates of credit growth are lower than in past years. As you know, the credit trends of the 1980's were unsustainable, particularly in some sectors of the real estate market; therefore, some moderation of those trends was to be expected and is, in fact, constructive. However, certain factors are at work that are slowing the flow of credit more than is appropriate.

The primary focus of the September 27 meeting at the White House of the Economic Policy Council was on bank supervision as a cause of reduced credit availability. While bank examination procedures may well be a contributing factor, there are a number of other factors, discussed below, which are affecting the flow of credit. With respect to examination procedures, the ABA has received a number of varying reports from bankers across the country. Many report that examiners have been tough, but fair. However, others report that some examiners are indeed inhibiting the flow of sound credit by over-reacting to recent problems. As you correctly noted, this is a matter which requires communicating with examiners in the field to ensure consistent application of policy.

Other factors at work both in reducing the ability of banks to lend and in increasing the costs of credit to businesses and households include high regulatory compliance costs, risks to bank officers and directors, unduly lenient bankruptcy laws, environmental lending risks, rising appraisal costs, bank competitiveness, and the holding of sterile reserves.

✓

Regulatory Burden -- The volumes of government regulations and reports with which banks, and banks alone, must comply increase bank operating costs, reduce credit availability and increase the cost of credit that is available. The steady growth of bank regulatory and reporting requirements has made regulatory compliance the number one cost concern in banking. As these costs mount, lending becomes less and less profitable. In addition, the rapid increase in the time management must devote to regulatory matters has decreased the time available for conducting business, including making new loans.

Officer and Director Liability -- The most important aspect of any business is its management, and this is certainly true of banking. Top quality officers and directors are essential for a well-run, sound bank. The personal risk to bank officers and directors from regulatory penalties and suits, however, is skyrocketing. FIRREA and the so-called S&L crime law enacted last year greatly increased the liability of officers and directors, and pending legislation could further increase this burden. Because of these changes, legal counsel are increasingly advising officers and directors that prudence and vigilence in overseeing a bank's affairs may no longer protect such officers and directors from personal liability of such magnitude as to drive them into bankruptcy. The result is two-fold. First, this avalanche of new rules and liabilities is causing bank officers and directors to make their banks safer than safe, inhibiting the prudent taking of limited risk which is vital to our economy. As a consequence, there is a tendency toward restrictive loan standards and less credit. Second, we are beginning to see valuable directors resigning from banks, even the best run and strongest banks.

Bankruptcy Laws -- U.S. bankruptcy laws and their application enable borrowers to escape legitimate responsibility for debts to a degree unimaginable only a few years ago. The likelihood of greater loan losses as a result of unduly lenient bankruptcy rulings is having a chilling effect on lending in general and particularly bank lending. The Congress has begun the long process of addressing this issue, but a greater effort is needed to enact bankruptcy reform legislation.

Environmental Liability -- If a bank has to foreclose on a building that later turns out to have been built on the site of an old gasoline station which had leaky underground gas tanks, the bank, although totally innocent, could be held responsible for all the costs of the environmental clean-up -- an amount that could be many times the amount of the original loan on the building. This is an example of the risk that bankers face on many types of loans -- particularly small business loans. This clean-up cost risk is huge and is deterring banks from making loans to small businesses that have any conceivable environmental risk potential. Your Administration has addressed an important part of this issue through a proposed EPA rule, which we hope will be finalized soon. However, further action is needed in the form of legislative relief. The Senate Banking Committee's version of banking reform contains provisions, Title X, which, if enacted, would address lenders' concerns and improve the flow of credit.

Appraisal Costs -- As a result of recently enacted legislation, the cost of obtaining residential and commercial real estate loan appraisals is rising sharply. Recently, the bank regulatory agencies have proposed regulations to limit the new requirements to appraisals on residential real estate loans over $100,000. This is an important proposal which deserves strong Administration support. In addition, we are very concerned that an insufficient number of licensed and certified appraisers will be available as of January 1, 1992, the implementation date of the new law, resulting in a tremendous increase in appraisal costs, as well as lengthy delays in the lending process.

Bank Competitiveness -- As a result of advances in information and financial technology, the customer base of the banking industry has shrunk dramatically over the past decade, causing reduced earnings and slower capital growth. Bank competitors, not subject to the same regulatory costs and antiquated restrictions on activities, have been growing rapidly at banks' expense. These competitors, such as money market funds, do not generally provide credit to the sectors served by banks -- particularly small and medium size businesses. Banking institutions must be given the authority to offer a competitive range of financial services in order that they may compete effectively in today's marketplace, maintain their customer base, and generate capital to sustain growth. Your Administration, of course, has been a strong advocate of permitting banking institutions to offer such services.

Interest on Reserves -- Another major reason the banking industry finds it difficult to compete and attract capital to back loan growth is the large hidden tax on the industry in the form of non-interest-bearing reserves held at the Federal Reserve. Since 1981 alone, this hidden tax has amounted to $35.5 billion. This cost, particularly at a time when deposit insurance premiums are rising rapidly, also increases the cost of gathering deposits, thereby slowing deposit growth and lessening the amount of funds available for lending. The ABA has long advocated that banks be given credit for these sterile reserves.

Mr. President, under your leadership actions are being taken to correct or reverse the adverse effects of several of these factors. However, the ABA believes that further action, in some cases including Congressional action, on these issues would be of tremendous value in improving the availability of credit, which, in turn, will lead to greater economic growth. In most cases, our concerns about these issues are shared by important sectors of the business and real estate communities. We would be pleased to work with the Administration on any of these issues.

Sincerely,

Richard A. Kirk

cc: The Vice President
The Honorable Nicholas F. Brady
The Honorable Robert A. Mosbacher
The Honorable Richard G. Darman
The Honorable Michael J. Boskin
The Honorable Alan Greenspan

JOHN B. KILROY
Chairman of the Board

KILROY INDUSTRIES
2250 E. Imperial Highway
El Segundo, CA 90245

(213) 772-1193
FAX (213) 414-0010

KILROY INDUSTRIES

John B. Kilroy
Chairman of the Board

4 October 1991

The Honorable John Robson
The Deputy Secretary of the Treasury
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Dear John:

The Managing Director of a major Italian state owned bank, who is a personal friend, relayed to me how the Italian banks were increasing their capital to comply with the Basel Agreement. I will outline the steps as follows:

1. Italian banks over years have accumulated real estate holdings for investment and for office purposes. Some holdings may be from prior centuries or prior years. Their book value is at cost and well below current market.

2. The Italian government passed a law that said these assets can be revalued to market and shown in their capital accounts at the full revalued amount with no deferred tax. The law also allows these assets to be sold with no tax.

3. The probable next step, in the future, is to sell or contribute the assets to a quasi-government corporation, who will then sell shares to the public. This is not immediate, however.

An interesting way to increase capital without increasing current liquidity.

While flying home from Italy on 2 October, I read two interesting articles.

1. Wall Street Journal, 1 October 1991, regarding the credit crunch in Sweden, which is enclosed. It is not occasioned by an excess of property with vacancies at 4% or under according to the article. It is occasioned by a lack of long-term capital per Wall Street Journal.

2250 EAST IMPERIAL HIGHWAY / EL SEGUNDO, CALIFORNIA 90245 / (213) 772-1193 / FAX: (213) 414-0010

2. International Herald Tribune. An interesting article on Japanese banks being allowed to cut bank reserve requirements due to the credit crunch.

It appears that this systemic problem is virtually worldwide and is not necessarily an over building problem. It may instead be a capital problem. Articles referred to above are enclosed.

I also noted, according to the Wall Street Journal, 1 October 1991, that one of the major investment banking firms, Salomon, is having a potential capital problem. I mention this because of our prior discussions regarding 25:1 leverage in the investment banking activities.

It has been interesting to read about the Economic Council activities this past week and the many articles about the credit crunch. It seems that substantial review is in process.

I will be in Washington on the 16 and 17 of October. May I impose upon you for another visit, at your convenience. I will call next week to see what might be arranged.

Thank you for your courtesy.

Sincere regards,

John B. Kilroy
Chairman of the Board

JBK/jrl
Enc.

bcc: John Sununu

October 2, 1991

Discount-Rate Cut Expected in Japan After Easing of Bank Reserve Rules

Compiled by Our Staff From Dispatches

TOKYO — The decision Tuesday by the Bank of Japan to cut bank reserve requirements by as much as 60 percent, freeing up to 2 trillion yen ($15.1 billion) of bank deposits, points to the likelihood of a cut in the official discount rate within the next month, economists said.

"The easing of the reserve requirements is the next move toward a further easing," said Jesper Koll, economist with SG Warburg Securities.

The central bank said it had decided to lower the ratios for reserves that must be deposited at the central bank by commercial banks and other financial institutions, effective Oct. 16. Reserve ratios vary by type of institution and size of time deposits.

The move, which is the first such reduction by the Bank of Japan in more than five years, is intended to free money for investment and prevent the lagging Japanese economy from slowing even further.

"Today's decision will help, but basically the credit crunch will still get bigger and bigger," said Masaru Takagi, chief economist at Fuji Research Institute.

Said Mr. Koll: "In its money market operations, we have seen the BOJ guide short-term rates lower. Now, we have an easing of reserve requirements. I would expect the ODR cut will follow in the next three to four weeks," he added, referring to the discount rate. In July, the bank reduced that rate by a half-point, to 5.5 percent.

Other economists noted that by cutting bank reserve requirements now, the BOJ is ensuring it does not dampen enthusiasm for the yen.

The dollar closed in Tokyo at 133.18 yen, up 0.23 yen from Monday's closing in both Tokyo and New York. The move helped boost Tokyo stock prices in active trading. The Nikkei average gained 460.57 points, or 1.93 percent, to close at 24,377.01.

(AFX, Reuters, AP)

Nomura's Expensive Apologies

Reuters

TOKYO — The world's biggest brokerage apologized Tuesday — and its humility did not come cheap.

Nomura Securities Co., in full-page advertisements in nine daily newspapers, told readers: "Following the recent brokerage scandal, we have resolved to wipe clean all of our past errors and re-start as the 'New Nomura Securities.'"

A full-page ad in the national edition of the Yomiuri Shimbun, Japan's biggest daily, costs 44.6 million yen ($336,000), compared with $45,360 for a business section page in The New York Times.

Officials indicated Monday that Nomura was likely to be suspended from certain businesses yet again after it accepted government charges that it had violated Japan's Securities Exchange Law.

The Finance Ministry said Nomura had manipulated customers to send Tokyu Corp. stock soaring briefly two years ago to benefit a crime boss.

Japan's Footwork Buys Hamacher

Agence France-Presse

TOKYO — The Japanese parcel delivery company Footwork International Corp. has acquired the German transport group Harry W. Hamacher Spediteur GmbH for about 10 billion yen ($75 million), a company spokesman said Tuesday.

The Osaka-based Footwork said in a statement that it "aims to establish an international distribution network and a strategic foothold in Europe" through the purchase.

The Berlin-based Harry W. Hamacher group is one of Germany's biggest garment distributors and has cargo plus air and sea freight-forwarding activities, the statement said. Sales this year are estimated at 940 million Deutsche marks ($564 million).

In addition to 14 subsidiaries in Germany, the company has eight units abroad including Austria, Hong Kong, the United States and Canada.

■ Kawasaki Kisen Halts Service

Kawasaki Kisen Kaisha Ltd. is suspending its freighter service with Hong Kong and Singapore lines on the Atlantic coast of the United States to focus on Pacific ports, a spokesman said Tuesday.

The last voyage of the joint service with Orient Overseas Container Lines Ltd. of Hong Kong and Neptune Orient Lines Ltd. of Singapore will embark on Nov. 27, when the freighter Rainbow Bridge sets sail from Japan.

THE WALL STREET JOURNAL EURO

TUESDAY, OCTOBER 1, 1991

MONEY & MARI

Eroding Swedish Property Prices Make Banks Seek Firmer Footing

By STEPHEN D. MOORE
Special to THE WALL STREET JOURNAL EUROPE

STOCKHOLM

BOOMING SWEDISH PROPERTY MARKETS fanned an unprecedented lending explosion by big Stockholm banks in the late 1980s. Banks' profits ballooned along with their balance sheets until, about 12 months ago, a deepening economic recession finally knocked property prices into a tailspin. And as prices fell in recent months, a number of debt-laden real-estate tycoons and highflying finance companies have come crashing down as well.

The resulting havoc is rippling through Sweden's financial system, forcing banks to report losses and igniting squabbles between bankers and insurers. And while the shock waves aren't powerful enough to swamp the system, they do promise to give financiers rough times for the next several years and profoundly change their attitudes about the potential benefits — and dangers — of property loans.

The impact of the property market's collapse was most apparent last week when the country's No. 2 bank, Nordbanken, reported a whopping 6.6 billion Swedish-krona ($1.1 billion) pretax loss for this year's first eight months. The 71% state-owned bank predicted its full-year loss would be roughly the same — the biggest ever incurred by a Swedish commercial bank.

IN A BITTER OUTBURST at a news conference, Nordbanken's chief executive, Hans Dalborg, blamed the loss on ballooning speculative credit, "blown up during the carnival years of the late 1980s" but burst by the property market's plunge. Mr. Dalborg said prices for commercial property in central Stockholm have tumbled as much as 35% so far this year. And he warned that further deterioration is virtually certain unless big institutional investors can be coaxed back into property markets soon.

Insurers and pension funds are staying aloof, however, despite unusually aggressive arm-twisting from Swedish politicians and banking regulators. When Finansinspektionen, Sweden's main banking regulator, assembled presidents of big banks and insurers last month to discuss the property malaise, things quickly got out of hand, one participant recalls. "People started tossing old tomatoes and trying to pin blame on each other. It wasn't very fruitful."

INSURERS ARE STILL MIFFED over the euphoric price surge, fueled by easy bank credit, which drove them out of property markets the past couple of years. "It's unrealistic to ask us to come actively into the market to bail out banks and finance companies that financed property purchases at such ridiculously high prices. Banks will just have to show some staying power now," says Bjoern Hall, chief financial officer of AB Skandia, Sweden's No. 1 insurer.

"The real problem is simply that potential sellers still have price expectations that are much higher than potential buyers are willing to offer," he adds. "That's why you see very few property transactions."

As property markets languish, investors here are bracing for more bad news today when two big banks, Svenska Handelsbanken and the Gota Bank unit of financial services group Gota AB, present their eight-month results. The Stockholm Stock Exchange's index of bank issues plummeted 5% Thursday in response to Nordbanken's record red ink. It is now off nearly 20% during the past month and 5% for the year to date. By contrast, Stockholm's Affaersvaerlden general index has climbed about 18% so far this year.

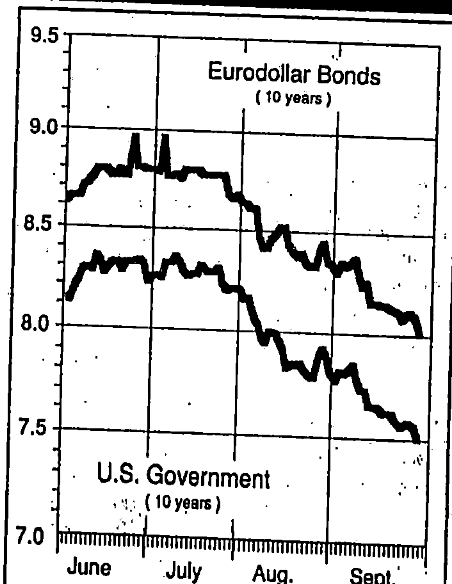
SENIOR STOCKHOLM BANKERS FRET that no quick relief is in sight. Overall, credit losses in Sweden's financial services industry more than quadrupled last year to a record 17.2 billion kronor from 3.7 billion kronor a year earlier. Banks' loan losses in 1990 surged to 10.7 billion kronor, or 1.15% of total loans outstanding, from an annual average of 0.4% of loans outstanding the preceding five years. Many analysts expect banks' losses to exceed 20 billion kronor this year.

"We'll see banks' loan loss provisions peak this year but remain at a very high level for another two to 2½ years," says Gabriel Urwitz, Gota's chief executive. The attitude among major Stockholm banks, he adds, "is that we'll just have to ride this out."

But it promises to be a bumpy ride. A growing number of jittery

Please Turn to Page 16, Column 1

BOND YIELDS



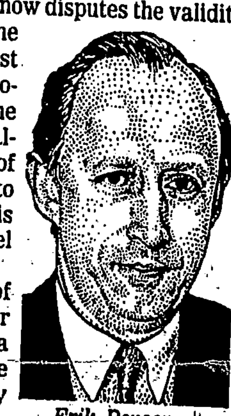
Semiannual yields. Source: Salomon Brothers Inc.

Penser Fights August Accord Ceding Nobel

By STEPHEN D. MOORE
Special to THE WALL STREET JOURNAL EUROPE

STOCKHOLM — Swedish financier Erik Penser stepped up the pressure in his bid to regain control of Nobel Industrier AB from Nordbanken, the country's No. 2 bank.

In a letter to Nordbanken dated Sept. 27, Mr. Penser said he now disputes the validity of an agreement he signed in late August ceding control of Nobel to the bank. The financier also challenged the legality of a recent transfer to Nordbanken of his former 70% Nobel stake.



Erik Penser

The existence of Mr. Penser's letter was disclosed at a news conference here Monday by Claude Hankes-Drielsma, an independent adviser hired by Nobel's board last week. According to Mr. Hankes-Drielsma, Mr. Penser in his letter also repeated an earlier pledge to fully repay a 3.5 billion-krona ($574 million) credit facility outstanding from Nordbanken. Mr. Penser's alleged default on that credit was the reason Nordbanken gave for seizing control of Nobel from the financier.

Potential Legal Defenses

In a brief interview Monday, Mr. Penser declined to discuss his grounds for disputing the earlier transactions with Nordbanken. But the move appears to be the latest in a spate of potential legal defenses being assembled to thwart Nordbanken's plan to oust Mr. Penser, Nobel's chairman and other current directors — and complete its takeover of the chemicals and defense conglomerate.

The Nobel board kicked off the legal skirmishing late Sunday night by unanimously agreeing to postpone for one month the special shareholder...

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Four Berlin Banks Are Proposing

Tumbling Land Prices Upset Swedish Banks

Continued From Page 11

Swedish bankers cite neighboring Norway and Finland as ominous examples of how plunging property values and resulting bank losses can feed on each other in an accelerating downward spiral.

After years of escalating bank losses, Norwegian banking authorities this year have been forced to inject more than seven billion Norwegian kroner ($1.1 billion) in new preference capital from various guarantee funds to rescue sinking commercial banks. And in Helsinki on Sept. 18, Finland's central bank seized control of foundering Skopbank in a costly, pre-emptive move to buttress international confidence in Finland's financial system.

However, few international analysts expect Swedish banks to fall as far as their counterparts in Oslo or Helsinki. Swedish banks are better capitalized than their Norwegian rivals, analysts argue, and risk capital is far more readily available in Stockholm than in thin Oslo markets. Moreover, though the current Swedish recession is shaping up as one of the deepest since World War II, it still pales by comparison to Finland, where gross national product is expected to plummet 5% this year.

"Swedish banks have lived through boom times, and despite growing problems they're nowhere near a Norwegian situation," says Simon Adamson, a Scandinavia analysts for London-based rating agency IBCA Banking Analysis Ltd.

Indeed, some blue-chip Swedish investors have moved quickly to buttress the capital base of banks where they are dominant owners. Oestgoeta Enskilda Bank, a medium-sized regional bank, disclosed in September that it expects to incur a pretax loss of 500 million Swedish kronor this year as a consequence of hefty provisions against potentially bad real-estate loans. But the bank's dominant owner, L.E. Lundbergfoeretagen AB, stepped in immediately to guarantee a 500-million-krona equity injection.

Nevertheless, IBCA's Mr. Adamson worries that "some Swedish banks apparently haven't come to terms with problems that lie ahead, and still aren't being realistic about credit losses they're destined to incur."

The overwhelming majority of shaky credits can be traced back to property transactions. Banks' lending grew increasingly property-related in the late 1980, a time when sweeping deregulation was heating up competition across the financial services industry. One Stockholm banker estimates that up to 80% of new loans by banks in the late 1980s was property-related. "We knew at the time it wasn't prudent but there simply were no other borrowers," he recalls.

Banks also indirectly financed billions of kronor in additional property loans through Sweden's so-called finance companies. Such finance companies — effectively non-bank banks — grew explosively in the latter half of the 1980s, mainly through risky credits to real-estate and stock market speculators.

~~But many big independent finance com~~panies have been on the ropes since Sweden's commercial paper market — a major source of their funding — dried up last year. Despite misgivings, banks kept the finance companies afloat temporarily by refinancing the billions of kronor previously raised through commercial paper programs sponsored by the banks.

One of the biggest finance companies, AB Nyckeln, was declared bankrupt early this year and is in liquidation. Huge losses at another finance company, Gamlestaden AB, triggered the acute liquidity squeeze that toppled the corporate empire of Swedish financier Erik Penser recently. Creditor banks have taken control of Gamlestaden, which will be liquidated in an orderly fashion over the coming two years.

Acute Distress

Yet some analysts warn Nyckeln and Gamlestaden could be just the beginning. A recent Swedish government study estimated that finance companies in acute financial distress still have 27 billion kronor in credits outstanding, much of it backed by poor collateral or completely unsecured. Big Swedish banks have 18.8 billion kronor in loans outstanding to those faltering finance companies, the government study said.

The plunge in property prices is responsible for much of the finance companies' miseries. Analysts estimate that, during the past 18 months, 10 property companies with combined assets of 20 billion kronor have gone bust. Property representing another 20 billion kronor has been foreclosed and sold by executive auction. In recent months, banks have bailed out several other big property concerns on the verge of insolvency by offering debt moratoriums or other refinancing options, these analysts say.

"How creditors behave in this situation is crucial for the timing of a possible market recovery," Skandia's Mr. Hall says. "If banks throw a lot of property on the market, they'll create a tricky situation. So far, the tendency has been to try and hold on. If that continues, I think a normalization could come within a half year or so."

Some bankers also anticipate help before long from a new center-right government expected to take office this week. One such move would be dismantling the present ban on foreign purchases of Swedish commercial property, says Jacob Palmstierna, deputy chairman of Nordbanken. Mr. Palmstierna doesn't expect an immediate influx of foreign buyers. "But if one or two Japanese investors bought one or two properties in Stockholm, it might have a very positive psychological effect," he says.

Sweden First

Reflecting on the flood of investment by Swedes abroad the past two years following abolition of a 50-year-old system of exchange controls, Mr. Palmstierna argues that "the time has come for people to stop investing in Frankfurt and Brussels and instead save their own interests in the Swedish market. I can assure you that property companies we have an influence over aren't going to invest one damn krona outside Sweden any longer."

The surge in foreign investment, he adds, continues to distort property prices despite what by international standards is a modest vacancy rate.

"The vacancy rate in Stockholm is 4%, and if it hits 7% it's still not the end of the world," Mr. Palmstierna says. "People here have been spoiled by having an arficially low vacancy rates. There hasn't been a functioning market."

Liberty Mutual Advances Cash

NEW CASTLE, Pennsylvania – Galaxy Cheese Co. said its insurer, Liberty Mutual Insurance Co., would advance Galaxy $2.5 million related to the fire at Galaxy's headquarters on June 29.

Liberty had conducted an investigation into the cause of the fire and earlier refused to advance any insurance proceeds, a situation that created a severe cash flow problem for Galaxy. *(Staff)*

[redacted]

THE WHITE HOUSE
WASHINGTON

10/8/91

Credit Crunch

TO: ROGER PORTER

FROM: **PHILLIP D. BRADY**
Assistant to the President and
Staff Secretary

[redacted]

Please prepare a response to the attached letter. (It was handed to the President during his meeting with CEO's on 10/7/91.) Thank you.

cc: Chief of Staff
Director Darman
Michael Boskin

[redacted]

AmericanAirlines

October 7, 1991

R.L. CRANDALL
CHAIRMAN AND PRESIDENT

The President
The White House
Washington, DC 20500

Dear Mr. President:

You have asked why the economic recovery has not been more robust and what I think can be done about the problem.

I think the answer is that the American people are concerned about, and frightened by:

- The continuing, long term deterioration in our economy.
- The dramatic worsening in their personal circumstances caused by the massive deflation of asset values during the last 18-24 months.
- An apparent change in value systems that is reshaping American life in many unhappy ways.
- The failure of our political, business, and academic communities to produce leaders able to either correct or even seriously address these problems.

What should be done -- now, and in the long term?

First, I think you should acknowledge the problem! The American people are much smarter than most of us give them credit for being; they know our economy has been and is in trouble. There is lots of evidence to support their intuition:

		Pre 1973	Post 1973
A.	Real income after taxes	+2.5 Annually	+0.5 Annually

This goes a long way towards explaining why savings and confidence are down. For nearly a generation, people have realized that their lives aren't getting better very fast, if at all.

P.O. Box 619616, Dallas/Fort Worth Airport, Texas 75261-9616

		Pre 1973 (Annually)	Post 1973 (Annually)
B.	Output per man hour	+2.0-2.5%	+0-1.0%

This is the worst performance among the world's Big Seven economies.

C. After tax corporate profits — Down 30% as a percent of national income versus 1965-1985

Lower profits, plus lower savings, plus ever higher government expenditures as a percentage of Gross National Product mean a low investment, slow growth economy,

		1948-1973	1979-1989
D.	Private sector capital per employee	+2.6% Annually	+.6% Annually

The American people sense that events are driving them -- and their children -- towards an unhappy future.

People know that our children aren't being properly educated, know that American goods and services are not competitive in world markets, know that there has been no serious effort to cut government spending, know that the tidal wave of litigation is costing us more than we can afford, know that we cannot keep borrowing more and more to pay current bills -- and don't know why their leaders don't seem to know those things as well.

During the last year, those concerns have been magnified by a dramatic worsening of economic conditions:

E. Falling residential real estate values have decimated household net worth:

° Household Net Worth
(See Charts 1 and 2)

Annual Change 1945-1989	Annual Change 1970-1979	Annual Change 1980-1989	Annual Change 1989-1990
+8.3%	+12.3%	+6.0%	- 1.1%

In 1990, the median price of U.S. residential real estate declined by 6%. As a consequence, household net worth declined by 181 billion dollars! 1990 was the only year in which household net worth has declined since 1945 -- when records were first kept.

F. Declining property values have undermined the collateral and capital foundation of the banking system. The result is that there are virtually no loans available for small business, which created more than 100% of all net new jobs during the 1980s. (See Charts 3 and 4.)

G. Asset price deflation is accelerating. The Economist Commodity Price Index has fallen by 17.1% in the past twelve months. Industrial commodity prices are down 23.8%, and metals prices are down 30.2%. None of this is relevant to the CPI, which measures prices -- including such service prices as health care -- but is directly relevant to the businessman or woman, who cannot earn a profit if real values are declining.

The bottom line, Mr. President, is that we have a major long term problem which has gotten much worse in the last 18 months. Consumers will not be back until the fear is gone!

Having acknowledged the problem, I think you should take the lead in resolving it.

You should announce that with international affairs in better order (partially as a consequence of your successes) you are going to make the job of getting America growing again your number one priority. Tell the people -- who know it already -- that we can only be a world leader, enjoy a rising standard of living, pay off the debt and meet our social obligations if we have a powerful, growing economy (you might point out that if we had grown as fast between 1970 and 1990 as we did between 1950 and 1970, we would have a budget surplus this year, not a deficit.)

Third, you should specify the things you are going to do -- and ask Congress to do -- to make things better <u>now</u>. These should include:

A. Stopping the decline of asset prices. This will require coordinating the efforts of the Treasury and the Federal Reserve. The money supply must increase fast enough to stabilize the price of real assets, including real estate. We should simply print enough money to allow the RTC to clear its books without further depressing market values. Changes in the tax law, mentioned later in this letter, will also help achieve this objective.

   You should also tell the people that the 1986 Tax Fairness Act was, at least in part, a mistake. While no one defends abusive tax shelters, people will not invest in real estate if they are required to pay taxes on income they never get nor if they are required to pay taxes when they make money but are not allowed to write off losses against other income. The present "heads I win, tails you lose" law has done much to destroy the real estate business in America and to exacerbate our economic problems.

B. Fixing the credit crunch. This will require coordinating the efforts of the Treasury, the FDIC and the Federal Reserve, and gaining Congressional support, to:

   ° Modify bank capital requirements and change property appraisal regulations. Today's rules are eroding the capital base of the banking system by requiring banks to write off good loans, build excessive reserves and dispose of their best assets.

- Create tax incentives to make it more economically rewarding for banks to make loans than to invest in securities.

- Stop the pernicious practice of making successful banks pay for failed ones. Imposing huge insurance premiums on successful banks does nothing but raise the cost of capital, thus preventing the formation of new business, slowing the growth of existing ones, and reducing the number of jobs available.

- Create new U.S. banking regulations. Today, all twenty of the world's largest banks are either Japanese or European. To be a great nation, we need great banks -- great manufacturing companies -- great service institutions -- and a business and political environment in which great institutions flourish.

To build support for these steps, it will be important to explain that the term "bail out," as applied to either S&Ls or banks, is simply wrong. The American people need to understand that we are not "bailing out" those who invested in or lent money to banks; all we are doing is meeting the obligations to depositors undertaken by an unwise act of Congress.

C. Urging legislation to encourage investment --- because investment is required to put America back to work. Specifically, I think you should urge:

- A reduction in the <u>long term</u> capital gains tax rate.

- Restoration of the pre-1986 passive loss rules with respect to investments made before 1986.

- Creation of an investment tax credit.

- An immediate end to the imposition of further fees, charges, and regulations on U.S. business. The business community is struggling under an ever increasing burden as the government shifts social responsibilities from itself to the private sector. Businesses unable to earn profits cannot undertake the growth needed to create the jobs which will rebuild public confidence in the future.

In my judgment, these steps will alleviate the short term problem and encourage a faster recovery. They will not, however, correct the longer term problem. Thus, having established a short term recovery program, you should lay out a plan to fix the long term problem.

There is clear evidence that to rebuild the underlying strength of our economy, we must reduce the percentage of economic output devoted to government expenditures. To do so without massive reductions in government spending, we must devise programs to assure that U.S. businesses are competitive in an ever more global economy, to assure an adequate supply of competitively priced capital, to stem the flood of litigation which is crippling business innovation and pushing costs so high as to make our products and services non-competitive, to restructure the tax system's present bias towards debt vs. equity and to ameliorate the attitude of distrust and suspicion which has crippled relationships between the business and political communities.

Mr. President, you can -- and in my opinion you should -- make an examination of, and debate about, these economic issues the centerpiece of your 1992 campaign. A strong economy is essential -- to every American individually, to our aspirations for our society and to our ambitions in the world community.

The American people need to understand:

1. That we cannot solve our social problems -- drugs, education, homelessness, the infrastructure of our cities -- without a strong and growing economy!

2. That spending more and more of GNP in an attempt to solve social problems without the benefit of a growing economy only makes our economic problems worse -- and in the long run, will reduce our ability to address our society's ills!

3. That profits are the only possible source of funding for the humane and just society most Americans want -- and that profits have nothing to do with greed. We simply must restore the respectability of enterprise.

You enjoy very broad support among the American people, who will, I believe, follow your lead and accept your guidance.

The time is ripe to rekindle our economic growth and thus make America able to fulfill its promise -- for our people and for the world.

Very truly yours,

cc: The Honorable Nicholas F. Brady

<u>**Chart 1**</u>

Household Net Worth Growth

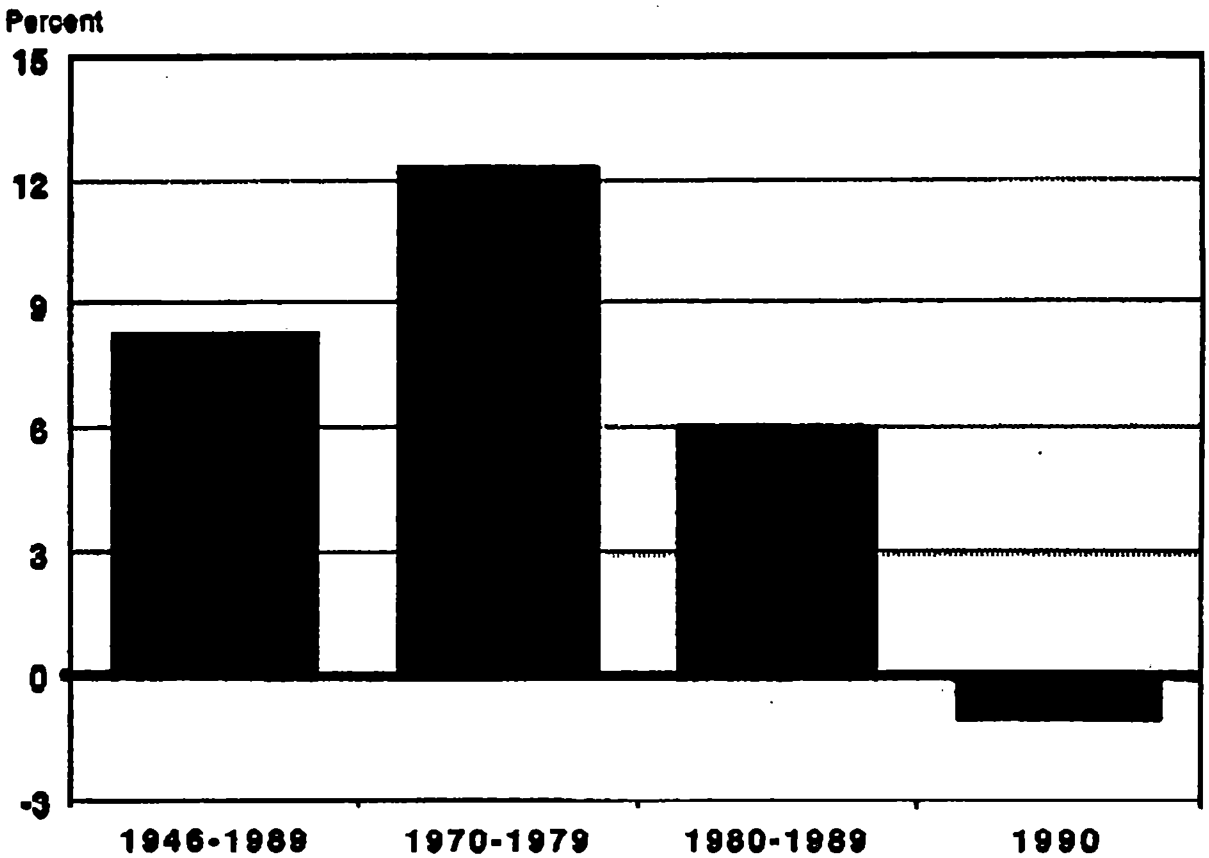

Chart 2

Change in Household Net Worth 1970-1990

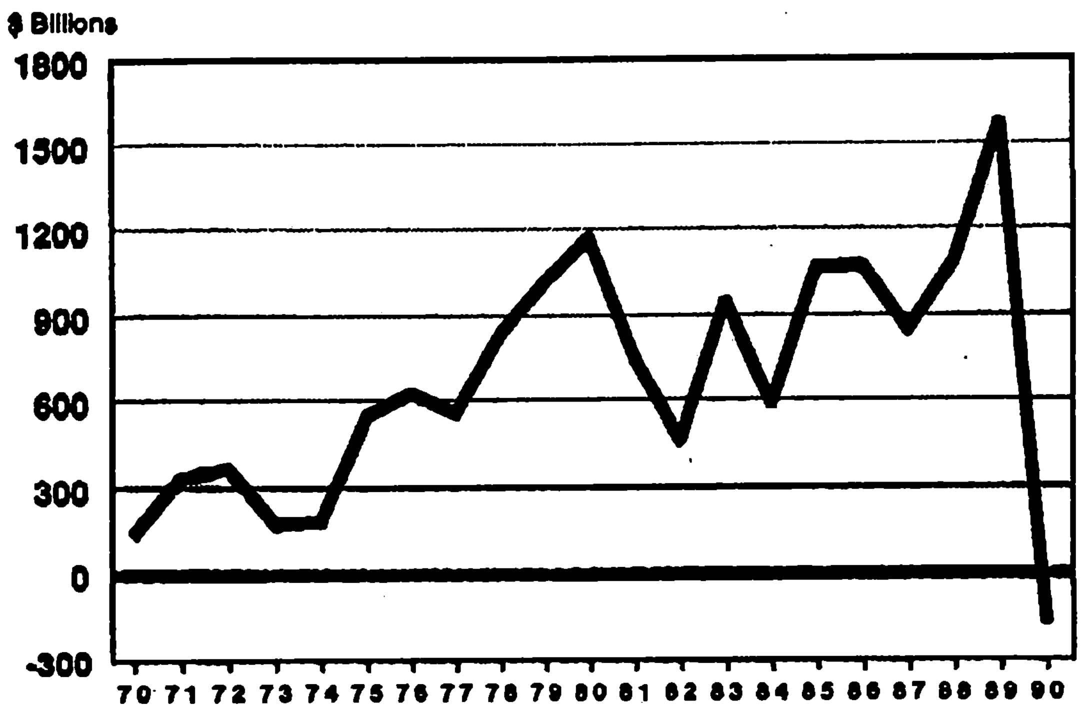

Chart 3

Commercial Bank Loans And Investments

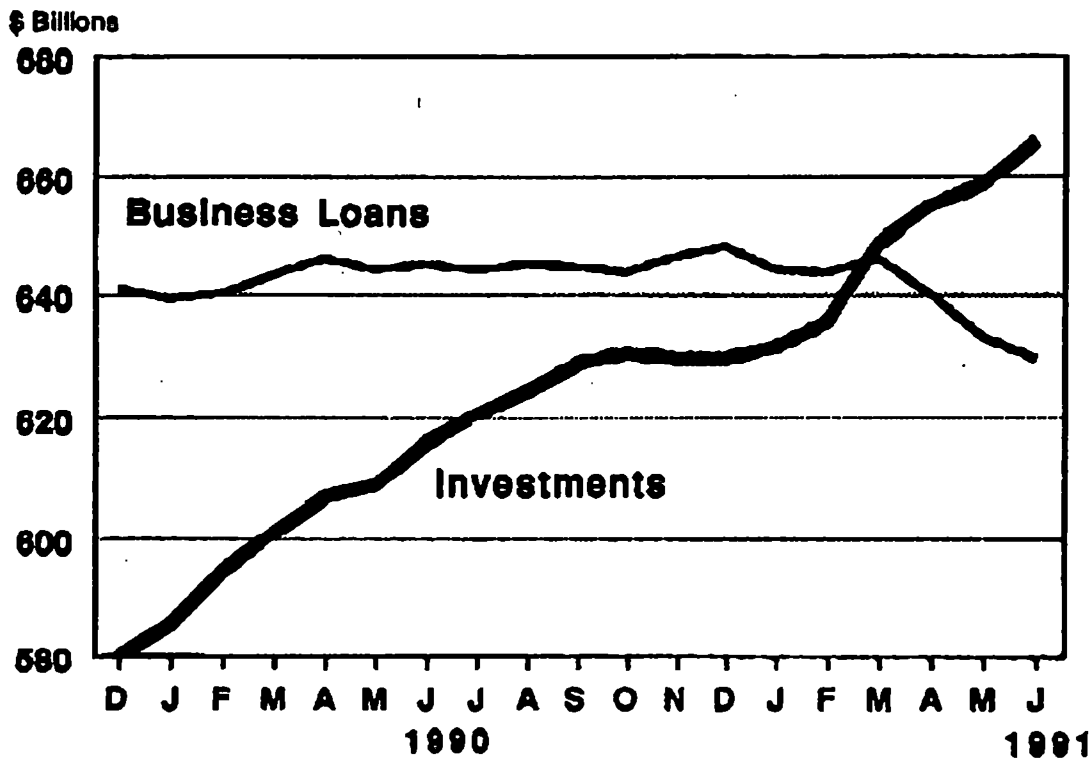

Chart 4

Large Commercial Banks