

THE CREDIT SHORTAGE: IS IT STIFLING ECONOMIC RECOVERY?

HEARING BEFORE THE TASK FORCE ON URGENT FISCAL ISSUES OF THE COMMITTEE ON THE BUDGET HOUSE OF REPRESENTATIVES ONE HUNDRED SECOND CONGRESS FIRST SESSION

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THURSDAY, NOVEMBER 21, 1991

**HOUSE OF REPRESENTATIVES,
TASK FORCE ON URGENT FISCAL ISSUES,
COMMITTEE ON THE BUDGET,
Washington, DC.**

The Task Force met, pursuant to notice, at 10:10 a.m., in room 210, Cannon House Office Building, Hon. Frank J. Guarini, chairman, presiding.

Mr. GUARINI. We will open the hearing of the Urgent Fiscal Issues Task Force, and our subject matter this morning is the credit crisis, and how it is affecting our economy, and what has to be done to bring about an economic recovery.

The country has now been in a recession for over 16 months, the longest running recession in the post-war period. The apparent recovery of the early summer really has stalled. Investor confidence in the economy has been shaken, as demonstrated by last week's dramatic drop in the stock market. To date, the Federal Reserve's traditional approach of lowering interest rates has failed to spur economic growth.

Several theories have been offered to explain this crisis. Some see the loss of consumer and business confidence leading to reduced demand for credit. Others argue that banks on their own initiative are shying away from real estate and other lending practices because of the past experience with the problem loans.

A third group blames the bank regulators for high capital standards and overzealous supervision, forcing banks to cut out loans to creditworthy borrowers. Still others say that the Tax Reform Act of 1986 has taken away many incentives.

Whatever the cause, no one disputes that additional sources of capital and credit, coupled with increased lending, are needed for America's financial institutions and real estate industry to recover from the current economic downturn. The shortage of credit prevents economic growth. Businesses are unable to take advantage of lower interest rates. Without available credit, even healthy businesses cannot expand.

Nowhere is evidence of a credit shortage more apparent than in the commercial and residential real estate market. The dramatic growth of the real estate market in the 1980's has now completely flattened out. The existing bank portfolios of real estate loans have lost much of their value because property values have dropped so sharply. This loss in the value of loan collateral has forced banks

to absorb the losses of their customers. These losses have also forced banks to rebuild their capital base, rather than engage in new lending.

The real estate industry has lost an estimated 500,000 jobs in some areas of the country, such as the Northeast and the West. The real estate market has simply collapsed. This collapse has had a multiplier effect within our economy. Loans default, bankruptcies increase, business expansion suffers, people are thrown out of work, and the demand for new projects and mortgages plummets even still further.

How we can stop this vicious cycle is what we are going to discuss this morning. Today we will explore the reasons for the current credit shortage and ways to alleviate the problem.

Has the Administration oversimplified the problem by placing the primary blame on bank regulators? Lower consumer and lower business demand caused by the recession could just as easily explain the credit shortage that we have.

In addition, some experts claim that nonbank lending, such as loans from insurance companies and pension funds, has increased just as traditional credit sources are drying up. Should we encourage these nontraditional sources to invest in the real estate market?

Finally, several current tax policies may discourage investing in real estate, including laws regarding passive loss, capital gains, real estate restructuring, and investment tax credits. We will discuss whether these policies should be changed and how they should be changed.

Today, we will hear from those who are experiencing the vagaries of this recession firsthand. Our distinguished witnesses include the former head of the Federal Deposit Insurance Corporation, large real estate developers, small business people, and families struggling to obtain a mortgage loan. We will also speak to bankers and pension fund managers.

I want to thank all of you for taking the time to be here because I know you all have a busy schedule, and you have made sacrifices to be with us this morning.

I would like to turn to Mr. Rogers, Hal Rogers, and ask him if he has a statement to make for the record.

Mr. ROGERS. Thank you, Mr. Chairman. I will be brief, because I think we all want to get to these witnesses.

The economic downturn began in July of 1990 and is now 16 months old. According to the Congressional Research Service, the average length of the eight recessions since World War II has been 11 months. Two of the eight recessions have been long, 16 months.

Some argue that the recession has resulted from a loss of confidence on the part of consumers and business, which led to a reduced rate of spending. The loss of confidence reinforced lower spending due to high debt and the activities of Federal bank regulators which made loans more difficult to obtain. Others argue that the recession has grown worse because of the tight monetary policy of the Federal Reserve.

Whatever the causes of the recession, the rate of growth of real GNP slowed noticeably beginning the second quarter of 1989. From then through 1990, GNP growth has been at an annual rate of

about 1.25 percent. This compares with the 2.5 percent growth rate in 1989 and 4.5 percent growth rate in 1988.

The credit crunch has reached crisis proportions in many parts of the country. The lack of liquidity within our economy adversely affects and impacts everyone, small businessmen and women, farmers, ranchers, rural business owners, the construction housing markets and so forth.

So we welcome our witnesses particularly to today's hearing, and we look forward to hearing your testimony and responding to your testimony with questions, and we thank you for being here this morning.

Thank you, Mr. Chairman.

Mr. GUARINI. Any other statements to be made?

Jim Hayes, I understand you have a statement.

Mr. HAYES. Yes, Mr. Chairman. I am going to put it into the record. But I came over here, and though I am not a member of the committee, at least I came as a guest and not an intruder.

My background is probably unique in the Congress. I have been a state bank regulator, as commissioner of financial institutions for the State of Louisiana, and I have been in the real estate development business, which never was leveraged, never had one office that wasn't 100 percent occupied, and lost a fortune doing it, ranking me as the second to greatest losses probably in this room.

The reason that I came over this morning was to make this point. Having sat in desks in both the business community and the regulatory community, the point that must be made as we go forward in examining fiscal policies is that the fire walls that we speak of in the banking community had better be fire walls that are opened in these buildings.

In 1982, a Banking Committee with most of its members having a background in housing passed an important bill on regulatory institutional matters. Four years later, Ways and Means Committee, with an excellent membership, an excellent staff, but a background in taxation, passed another bill. The two collided and mandated real estate failure, by both having retroactive provisions that impacted upon them, passive loss regulations to dramatically change and an altered notion of the way that partnership income was tried out retroactively.

Those properties I just described to you failed, not through inat-tentativeness, not through highly leveraged, not through any transaction that was not fiscally well thought out. The impact of that failure has now been a driving up of the ability to get loans on ideas. And all ventures are basically ideas. You cannot point to one successful venture in real estate or nonreal estate that was not, in fact, the expectation of return that the product would be sold and purchased by the public.

The credit crunch that we are experiencing now is so great and for so dramatically different reasons that none of the traditional approaches of lowering interest rates will work. They will not be successful. Because the entrenchment of this crunch is a combination of regulatory response and weak institutions that no longer have the ability to lend, where even young people trying to buy a first-time home with income to support the notes are having to

wait a year in some cases for regulatory and bank approvals of what was once the easiest loan to make.

Then you get into a complicated transaction, where, for example, you have a change in the world, the people in my district who have been economically depressed in the oil and gas industry are trying to show that contracts with the Soviet Union, using a commodity as a base with a weak ruble and therefore using oil and gas as a common denominator and using it as a commodity transaction, getting the third party to broker it and putting equipment to work in south Louisiana is impossible to discuss, much less finance, but will absolutely work, bringing jobs and viability to a depressed economy in my state and helping the world move toward a more solid and sound and secure order than the other.

That is what I am asking you to do. As you go forward, look at both pictures. Don't forget tax impact and don't forget the fact that banking, housing and all of those things of jurisdiction are tied together. And in looking at that total picture, I don't say that I envy the position in which you will be, but by looking at all of it, I know that you will do a better job than they did in 1982 and 1986, because if you work at it day and night, you cannot do a worse one.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Hayes may be found at end of hearing.]

Mr. GUARINI. Thank you, Mr. Hayes.

We will call our first witness, L. William Seidman. Mr. Seidman is the distinguished former Chairman of the Federal Deposit Insurance Corporation and is currently a private consultant on investment matters. He is also the chief commentator for the Consumer Business News/Financial News Network.

Mr. Seidman, I thank you for being here, and we really have always appreciated your advice. You have testified many times in the past, and now when things are happening quite quickly in the marketplace, your advice is still more sought after. So you may proceed, and if you have any particular statement, we will put it into the record.

STATEMENT OF L. WILLIAM SEIDMAN, FORMER CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. SEIDMAN. Thank you very much, Mr. Chairman. It is a pleasure to be back before your committee, and Members of the committee, I appreciate the opportunity to talk with you about credit availability. I am particularly pleased by the large crowd that has turned out to see me, of course, an old regulator, but it is nice to have Mr. Trump here with us, another distinguished panelist.

It is clear, of course, that the credit outstanding in the banking system is being reduced. Commercial banks—large commercial bank loans have declined during the year from over 300 billion to under 295 billion, and I have been asked to address this decline.

Sometimes we call it a credit crunch with respect to these particular issues, and I will wander off those just a little bit. First is the extent to which we in the regulatory, bank regulatory world, and in the bank agencies contributed to the credit crunch. The

second is the effect of the recession on credit. And the third is the tax policies which we have just heard a considerable statement on.

One of the nice things about testifying is you get quite a lot—a chance to listen, too.

With regard to the question of whether increased supervision and supervisory rules have contributed to the credit crunch, I would suggest that many factors have contributed to the reduction in the amount of credit outstanding. And certainly overly zealous bank examiners may have discouraged some bankers and are discouraging some bankers from making certain marginal loans, loans that might have been approved just a few years back.

But I have to tell you that I believe this is a small factor when compared to the larger and more fundamental causes of the credit problems in the country. Many areas in the United States are substantially overbuilt, at least in terms of commercial real estate.

I met yesterday with one of the managers of real estate for one of the largest insurance companies with a portfolio in practically every major marketplace. His view was that the overbuilding in the major commercial markets was of such a nature that we would be fortunate in normal economic times to see the commercial real estate back to somewhat normal conditions in five years. And, of course, if the recession continues, that period will be extended.

Now, bankers are aware of this and are understandably cautious when presented with loan applications for new construction. And, as a matter of fact, there aren't really very many new applications for loans to build commercial office buildings in most areas of the country, because it is very clear that vacancy rates approach 20 percent in most of the major markets.

In terms of mortgage applications and extensions of past credit, bankers principally base their decisions on current market price and potential loss exposure. In many areas, real estate markets, and particularly commercial real estate markets, have declined substantially in value. If bankers are more circumspect in their attitudes toward real estate related lending, I would first congratulate them, second, suggest that their circumspection is due more to the economic realities of the marketplace than the fear of bank examiners.

Having said that, I would agree that bank regulators and examiners may have discouraged bankers from making prudent and profitable loans in certain cases. After all, the bank examiners have been burned. FSLIC went broke some years ago; the bank fund is now on the edge of being broke. That is because of bank failures, and bank failures have been because of real estate lending.

If you examine the history of the FDIC, you will see a clear pattern that construction and development loans caused the bank failures that caused the failure of that fund. So when we find bank regulators cautious and perhaps overcautious and bankers cautious and perhaps overcautious, there is a reason.

Now, I think we need to work on making sure that the bank regulators aren't part of the problem, and in this regard I believe the interagency statement made by the FDIC, the OTS, the Federal Reserve and the OCC will be helpful. It is a big, long and very compli-

cated statement. It is going to take a lot of doing, just for everyone to truly understand it.

But the bottom line of the statement is simple. Use common sense and evaluate loans on the basis of whether they will be repaid in accordance with their terms. And if they won't, take appropriate action so that that failure is reflected in the financial reports.

Now, certainly all of that with the regulators will help, but certainly it would be a mistake to look for that as any kind of a cure to the credit problems that we have at this time. And I think there is a danger that if we focus too much on the bank regulators, we may think, one, that we are getting something done that is major, which we are not, and, two, the bank regulators may not do the job which they ought to be doing, which is seeing that banks operate in a safe and sound manner.

So, in my own view, I think we have heard enough about that, and we need to address some more important issues. This brings me to the second issue which you have asked me to address, and that is the effect of the overall recession on the demand for credit.

First, most profitable banks, and we ought to remember that almost 90 percent of the banks in the country are profitable, want to make good loans. That is how banks make money. Whether there is a demand for loans backed by solid collateral and with the expectation of repayment, then there will be banks to extend credit.

However, this creditworthy demand is always reduced in a recession. There are fewer opportunities and fewer institutions with the balance sheets that will support credit. And certainly in the current market there is evidence that the demand has slackened and particularly in the commercial real estate and construction and development area. As I said, this is not surprising, considering the overdevelopment and the vacancy rates in many areas of the country.

It is clear that in 1982 when we removed all the restraints on bank lending with respect to construction and development—there used to be a number of provisions in the law which said a builder had to have a 25 percent equity if he wanted to do a construction and development loan. He had to have a takeout by a long-term lender. There were concentration limits. Those were all taken out in 1982, and it was left to the regulators to do the job. They didn't do the job.

And lending in that area—lending standard that we had had for years were abandoned, and we had an excess of credit. That was combined with very liberal tax provisions, which encouraged building and made a number of deals sound only on the basis of tax benefits, not on the basis of the situation and the environment without considering the tax benefits.

And so we ignited a building boom through Government incentives through the private sector. And, of course, the result was a huge increase in construction and development, and what we did is build the buildings that we will need in 1995 in 1989.

Nevertheless, if you examine the balance sheets, you will see banks are making commercial loans—commercial real estate loans in increasing amounts today. How can that be? They are not

making them because they want to, but because, in their business judgment, they have to make them. The reason is that the short-term loans that were being used to finance long-term construction and development projects are coming due. There is approximately 150 to 200 billion of these loans that are coming due over the next 18 months to 2 years, a huge amount of lending that normally would have been taken over by insurance companies and other long-term lenders. They have now, as you know, retreated from the marketplace.

So the banks are faced with the question of either rolling those loans over and taking them out of construction and development and making them real estate loans, or foreclosing. And, of course, they are doing some of each, but primarily they are rolling them over.

So, in the middle of this, banks are becoming larger and larger real estate lenders. The banks' portfolios continue to increase. Real estate portfolios continue to increase. And the loans, of course, that are not rolled over—the bank takes over, forecloses and takes over as the owner, which means that they are even further involved in real estate lending.

Let me point out to you that 10 years ago banks were essentially not large real estate lenders. In a period of 10 years they went from somewhere around 10 percent of their assets being in this field to somewhere around 35 percent. It is a fundamental change in the banking system, and it has made its strength related to the real estate markets.

Overall, while banks are not making many new commercial loans for the reasons cited, they are actively trying to adjust the real estate portfolios, which is increasing, unfortunately for the safety and soundness of the system. And, of course, industries that are dependent upon real estate construction, and there are a great many, are also affected by this market. And they, too, will take considerable time to recover.

It is very hard to think of a solution to a problem of empty commercial real estate buildings, except to find tenants. Tenants depend upon the economy improving. So the hope for the real estate market in these overbuilt areas is tied directly into the overall economic recovery.

Now, the third subject which you asked me to comment on is tax policies, what should be done to stimulate real estate investment, and let me also say what has been done to bring on the problems we have.

I am proud to say that I was one that in 1986 counseled the Congress not to retroactively eliminate the tax benefits which they had written into the law in 1982. I tried to point out that there were a huge number of deals financed by financial institutions that were dependent upon these tax benefits, and people acted in reliance on the law of the land. When those were retroactively taken out, a great many transactions that would have survived went into default, and that has been a major factor in the problems that the financial institutions have had.

I said at that time that it will cost the Government far more in failed institutions than they will gain in tax benefits. Now I think the incentives in the law were overgenerous and should have been

changed. But to make those—to change the law retroactively was to almost ensure that we were going to have a huge real estate problem in the country.

I think we ought to re-examine the tax law. I think, particularly, the passive losses laws were changed to make them far more harsh than they should be in a sound and evenly balanced real estate economy. I think cutting the capital gains tax will help the real estate markets in the long run, although I certainly do not see that as a short run major beneficiary to the marketplace. So I think taxes should be looked at.

But encouraging real estate investment and work out, without addressing the fundamental problems, the sluggishness in our economy, simply is not going to solve the problem. It should be said that Federal budgetary deficits have an important effect on the availability of credit and an even more important effect on equity available to support debt in the economy. Both kinds of credit, debt and equity, must be available if we are going to get out of the current economic problems that we are experiencing.

While we can look at real estate as a particular problem, and it is probably the worst part of the economy, and certainly in real estate you can say there is a depression, not a recession, but that is a part of the overall economy. And I think the recovery in the overall economy is the only way that we can get out of the real estate problems.

Let me just conclude by saying one thing. When we first took a look at the kind of real estate problems that were hitting the financial institutions, I and many others tried to judge the size, and as doctors, we diagnosed it as a golf ball-sized cancer in a healthy patient. I have to tell you that now that we have seen what has happened, we don't have that situation. We have a basketball-sized cancer in a very unhealthy patient. And I am not sure that the remedies that we prescribed at that time are sound for the current condition of the economy.

I think we have to find ways to deal with institutions without throwing all this additional real estate on the market.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Seidman may be found at end of hearing.]

Mr. GUARINI. Thank you, Mr. Seidman. As always, you have been very clear and very helpful.

We have traditionally had a credit crunch followed by a recession. This time I understand we have a recession followed by a credit crunch. Does this tell us anything?

Mr. SEIDMAN. We had the greatest explosion of debt in the history of this country in the 1980's. For the first time since World War II, every sector of our economy went into debt to a greater extent than they had in the past.

When I say went into debt I don't mean numbers, I mean debt compared to the ability to service debt, because that is the key factor. And everything from GNP to debt for the country as a whole to the private sector, to the real estate sector, to the Government sector, all went to the highest level of debt that we had seen since World War II. As a result of which, we got ourselves into a debt binge for which we are now paying the penalty.

I gave a speech—I hate to—I only mention speeches and good things that I said that were accurate. There are a lot of others that I won't mention. But I did give a speech in 1986 where I pointed out that these figures were at the highest level in our history for each of these sectors and, all at once, and that had never happened before.

And I ended by—I was talking to financial institutions—and I said the yellow caution light is flashing. This was 5 years ago.

Well, first, I should have said the red light was flashing, but, secondly, it was clear even then that we were getting into a serious debt problem. As the result of that and the buildup of debt, we have the kind of recession I think that is going to be much more difficult to get out of than some of the ones we have had in the past.

Mr. GUARINI. It is both the private and the public sector that seem to have gone deeply into debt.

Mr. SEIDMAN. That is right.

Mr. GUARINI. On both scores.

Mr. SEIDMAN. On both. And it is the consumer, it is businesses and corporation, it is the real estate area and the Government, all at once.

Mr. GUARINI. And now the Government is pushing down interest rates, and it seems that banks still aren't lending money. If they keep pushing rates down further, do you think this will finally even itself out such that the banks would be forced to lend for want of having no other place to put their money? Do you think this will work itself out?

Mr. SEIDMAN. Well, I think pushing down the interest rates is going to be helpful, and it is already being helpful. We are seeing some revival in housing construction. We have seen some ups and downs, but leveling off, at least, in housing. Housing affordability is at one of the best levels it has been in the last 25 years. So that certainly is going to help, yes.

Mr. GUARINI. Should we concentrate on interest rates, or should the concentration of the Federal Reserve be on M2, the money supply?

Mr. SEIDMAN. I think that the Federal Reserve needs to look at all of those factors. M2 is certainly a factor to look at. That has been behaving in a very sluggish way and a way that you do not expect to see M2 behave when you are having a recovery, and I know the Federal Reserve has been working very hard on that.

They are also looking at interest rates, and I think they need to look at both. They have gotten short-term rates down. What they have proven is that they cannot get long-term interest rates down. The marketplace determines long-term interest rates. They can affect them to some extent, but the yield curve spread is the widest we have had in many years now, which simply says that the magic black box in the Fed which Mr. Greenspan is poking the buttons on doesn't have one that says, get long-term interest rates down.

Mr. GUARINI. Well, just dealing with the money supply I should imagine will create a concern about inflation, so, therefore, you have to be careful.

Mr. SEIDMAN. Yes, it obviously can be counterproductive. If it is perceived in the marketplace that by trying to get short-term rates

down, we are building in long-term inflation, then long-term rates will go up, not down.

At this moment I have to tell you that I don't think inflation is a major problem, and I don't think it is one we ought to be very concerned about at this point. I happen to have lived through both inflation and deflation, and, let me tell you, the deflation is much the worst of the two.

Mr. GUARINI. We have two things going now. We have inflation with stock equities and deflation with real estate values. We seem to have an anomaly going there at the same time.

Mr. SEIDMAN. Well, we have money in savings. Pension funds get money everyday. They have to look around, and they have got bonds, stocks and real estate. They went for real estate, and they don't like what they see. The bond rate returns are down so low that I think the money is going into the marketplace. But the stock market by any historical standard is very high.

Mr. GUARINI. The Administration said that a lot of the blame for the credit crunch is on regulators, and they came out with a package which you may be familiar with, about guidelines for real estate evaluation and regulating the standards that bank examiners use, et cetera, and allowing banks to issue more preferred stock.

If we just concentrated on regulators, which seems to be part of the reform package that is out there now, would we climb out of this credit crunch that we have? Would we climb out of our problem, or must we do other things in addition do that?

Mr. SEIDMAN. Well, I think the regulators are a very small part of the problem. I mean there are only 8,000 or 9,000 regulators in the country. If they are the problem, we could all put them on vacation for a year and cure the recession just like that. I mean they are simply a part of the problem. That doesn't mean they shouldn't be looked at and there isn't work to be done there, but to look at that as the part of the problem, I think, is simply not making a sound evaluation.

Mr. GUARINI. One of the problems, as I understand it, is that a lot of money is going into checking accounts because the interest in checking accounts is becoming equal to any other interest rate that you can get. And the banks are required to have a 12 percent cash reserve for checking accounts. This dries up possible money that could be lent out. Should that capital reserve requirement be lowered from 12 percent?

Mr. SEIDMAN. I doubt if that will have much effect. The banks really have a lot of money. They have a lot of liquidity overall. There are some banks that don't. I mean the banks are putting their money in government bonds, because they can't find good loans.

So I don't think the problem in most cases is that the banker can't find the money for good loans. John Medlin, the head of Wachovia, was up talking with the President and he came out afterwards and said we got plenty of money for good loans. Show me where the good loans are.

Mr. GUARINI. So you don't think high capital requirements are a problem?

Mr. SEIDMAN. I think high capital requirements have affected certain banks. That is correct. Now most banks in this country are well capitalized. There are certain banks where the higher capital requirements are having an effect, and they are having to shrink, and, those banks, it does affect their lending ability, yes.

Mr. GUARINI. Now we go to full implementation of the Tier 1/Tier 2 system in another year or two, with a maximum 8 percent capital requirement. Should that be scaled back?

Mr. SEIDMAN. For 90 percent of the banks it won't make any difference. They all already meet those standards. It is the 10 percent that you have to examine and determine whether or not we need to relax those standards, given current conditions. I think that is an appropriate subject to review.

It is an international problem, because all the major banks in the world are part of the capital agreement, and I would think that we will see a review of that, probably on an international basis.

Mr. GUARINI. There is a great discussion about the \$100,000 guarantee, whether big banks should be unlimited, whether the number of \$100,000 accounts that people have should be unlimited.

When I look at other countries, I see Germany that insures up to \$30,000, and that is private, not public insurance. So if anything happens, it is a private sector problem, whereas in our system, taxpayers must pay. I see Britain, where only three-fourths of the deposits is guaranteed. In Japan, up to \$63,000 is insured, and it is for just one account per person.

There are great limitations in other industrialized nations that are competing with us concerning the insurance of deposits. Do you think we are overgenerous in what we do with our \$100,000 limit, where we not only insure the principal, but also the interest?

Mr. SEIDMAN. I think we are more generous than any other country if you look at deposit insurance and say that is the government guarantee. But in fact, that is not the case. In Germany, there are three big banks, really. And none of them are ever going to fail because the German government cannot allow them to fail. So in effect, you have got too big to fail. The same in England, there are four. Japan, a few more.

We have thousands of small banks. One of the reasons we have thousands of small banks is that they have deposit insurance. So they can collect funds in competition with large institutions. The judgment, in my view, that you have to make is whether you think it is good for this country to have many small banks or whether you want to duplicate a system that looks like the German system, the English system, the French system and others.

Personally, I think the small banks have been one of the real engines of economic growth in this country. I think that our liability for deposits is no greater than it is in Germany. In fact, in Germany, the guarantee is based on a percentage of capital, and in large banks it goes far higher than 100,000. And in any event, we had a conference on too big to fail, and the European countries came over and said, what is there to talk about?

Of course, we are not going to let any of those big banks fail. And they are not going to fail, because we will fix it so they don't fail ahead of time.

So, in terms of taxpayer liability, I don't think there is the difference that might be evident on the surface. I think you have to make a judgment whether you want a lot of small banks or not.

In my view, the decentralized banking, without the geographic protection that we had, is good for this country. It is good for our economy. It is one of the things I call the American advantage in a book that I wrote on the subject.

Mr. GUARINI. But it can increase our budget deficit, which is one of the points that you made that we are very concerned about, soaking up available cash.

Mr. SEIDMAN. It certainly can. There is no question about that.

Mr. GUARINI. I turn to Hal Rogers. Mr. Rogers.

Mr. ROGERS. Thank you, Mr. Chairman.

Mr. Seidman, I want to focus a minute or two here on if there is anything different about this recession compared to the others.

We are pumping, we are priming the pump to the tune of \$350 billion plus a year now with the Federal deficit. That is, of course, a historic record, that—our Federal dollars being pumped into the economy on an unprecedented scale. Interest rates now are at a—what—a 10 year low or so.

Mr. SEIDMAN. Short term rates, yes.

Mr. ROGERS. And it seems to be having little effect on the sickness. Are we—is there something fundamentally wrong with the American economy that makes this recession resistant to these massive cures that are being poured onto it?

Mr. SEIDMAN. There is a fundamental recovery necessary, because—and it is taking longer—because we were so in debt going into this recession that the normal kinds of recoveries that we look for are going to take longer to appear.

As you say, the Government was not near a balanced budget during days of high prosperity. It was running the hugest deficits in its history. So that when we got to the place now where we want fiscal stimulus—I told Darman the other day, man, you have provided a fiscal stimulus all right, but it came before the recession, not after.

And so everything—the consumer who normally leads the way out is up to here in debt. So he has got to straighten out, and he is. You know consumer credit is going down. They are doing the right thing. They have to do it. They have to get back into a sound financial position.

So do the corporations, the ones that aren't going busted with junk bonds, don't want to go busted, and they are being more conservative.

So we have to get out of it, and when you have been on a bender, no amount of Tobasco sauce and tomato juice is going to make it go away soon. It is going to take time. And I think there are things the Government can do, but this is different for the reasons that I tried to point out in that speech back in 1986.

Mr. ROGERS. I know you have, during your testimony, mentioned what the Government can do. Could you give us a very short version of one, two, three?

Mr. SEIDMAN. Well, I tell you, I have only been out of the banking sector for a few weeks, and to come to you and say I now know

how to run the whole economy I think would be a bit presumptuous.

It seems to me there are some things that need to be looked at. First, our basic tax structure is unbalanced toward debt, and that has gotten us into the kind of problems—I think we need to change that balance. I think there are expenditures that could be made now for infrastructure that ought to be made now, because that will employ the kind of people who are out of work.

One of the private sectors, the highway building, is a good example. I think—don't want to panic into actions that will make your budgetary problems worse.

And, frankly, I don't think the budget agreement works very well. Because it forgot to put any limits on debt. I mean Gramm-Rudman at least had some numbers up there that you had to either meet or find some way to get around. So I think there are a lot of things to look at.

Mr. ROGERS. Why were we so—why are we so debt encrusted, both individuals, corporations, Government, and so on? Are we living beyond our means?

Mr. SEIDMAN. We certainly did in the 1980's, without question. We became the greatest debtor nation in the world during the 1980's. Went from the biggest creditor nation to the biggest debtor nation in the 1980's. The consumers got into debt more than they ever had in their history. So did corporations and so did the Government.

We certainly lived beyond our means, and we didn't have any plan for getting out of it until the system itself, as our wonderful system does, started to self-correct.

Mr. ROGERS. Do you see that the downturn or recession, whatever you call it, has reached its lowest point yet?

Mr. SEIDMAN. Well, that is very hard to know. All I know is that, looking at the real estate markets, it is hard to see that overall they have shown any signs of turning up.

And I said the last banking statistics I looked at, we were bumping along the bottom, and I think we still are. I don't see much in the way of upturn at this point. I think we were misled by the blip that we had after the Gulf war when confidence skyrocketed, people started wanting to buy, and we got a little up indicator which some of us, including—I think I would certainly include myself—thought, well, maybe this shows that we are moving out of this recession. I think that was a false indicator. It wouldn't have happened without the war, and so I don't see a lot of signs yet that we are coming out.

Mr. ROGERS. If you were advising the President today about what he should be doing, what would you say to him?

Mr. SEIDMAN. Well, I would start by telling him not to let Governor Sununu write his speeches. He is an old friend of mine, you know.

Well, I think I would say about the same kinds of things I just told you. I was in the Ford Administration, my job was to get before the President his options when we had problems. Try to get them there ahead of the problem, instead of afterwards, and let the President have a good shot at making a decision among many alternatives.

Right now that is where I would be. I would like to get all those alternatives out, get them evaluated and come up with a coordinated plan which we could stick with, which is good long term, as well as short term. The worst thing we can do is do a short-term fix.

Mr. ROGERS. He suggested that he will probably wait until his State of the Union Address in late January or whenever to announce, if necessary, a package or a program. Is that too late, too soon, or about right?

Mr. SEIDMAN. Well, that implies to me that he has got to get the program up, so I think he ought to have time to do a good job in that regard, and if he sees that as the appropriate time, I don't think one month or whatever that is, a month and a half, is going to make a lot of difference. It might make a little difference in November 1992 how soon you get started.

Mr. ROGERS. Thank you.

Mr. GUARINI. Mr. Huckaby.

Mr. HUCKABY. Thank you, Mr. Chairman.

Welcome to the committee again, Mr. Seidman.

Mr. SEIDMAN. Thank you.

Mr. HUCKABY. In the real estate area, you mentioned that one out of every five buildings in America, commercial real estate, 20 percent, yet in the housing market we seem to have perhaps a tick upward in building, although new housing starts are near record lowest. What percent of the real estate market is commercial versus residential?

Mr. SEIDMAN. I can't give you that right offhand. The larger part is residential.

Mr. HUCKABY. Significantly higher would be residential than commercial.

Mr. SEIDMAN. Oh, yes.

Mr. HUCKABY. We can isolate commercial over here and say, okay, if we could get residential going again, we could perhaps turn around. We have seen over here in the last 18 months, 2 years, an erosion of equity of the average American homeowner of 10 to 30 percent of the value of their house. I think part of the question is, part of the problem is, how do we reestablish this equity in time? Would you agree with that?

Mr. SEIDMAN. That is one of our major problems is to get residential real estate going again, yes.

Mr. HUCKABY. Now the 1986 tax law did away with the passive losses in real estate. Of course, it phased out the capital gains, phased out the passive losses. If you had to choose between restating passive losses for tax purposes or restating capital gains, which would you choose?

Mr. SEIDMAN. I don't know that I have given much thought to that. Off the top of my head, I think the passive loss rules were far stricter and overreacted to the situation, and I would start by looking at those.

Mr. HUCKABY. Because it appears to me that passive losses, if the taxes were reinstated, would encourage people to buy, encourage investors to buy apartments and rental units, which would then escalate the entire real estate market, whereas capital gains encourage people to sell.

Mr. SEIDMAN. Well, I think that is right. But to sell, you have to buy. So the idea of capital gains would be that people would buy more assets from the RTC and so forth. Because if they were right and bought right and had a gain, it would result in a lower tax rate.

So I think both of them, as I said in my testimony, have some—can have some effect on recovery in the real estate field.

Mr. HUCKABY. Let me turn to another area. You say only 10 percent of our banks fail to make capital requirements. What percent of the banking assets is that? Isn't it significantly higher than—

Mr. SEIDMAN. It is somewhat higher, but not—probably 20 percent.

Mr. HUCKABY. 20 percent.

Mr. SEIDMAN. Yes, somewhere in that area.

Mr. HUCKABY. So more than twice as much.

Mr. SEIDMAN. Yes.

Mr. HUCKABY. If I might follow-up on the previous questions regarding how do we get out of the recession—we have this tremendous deficit, as you said, and we really can't apply the typical spending stimulus. It has been suggested that we have tax cuts or tax redistribution. Do you think that would be a good idea that some are calling for Congress to stay in session past Thanksgiving to implement a tax reduction or a tax redistribution plan?

Mr. SEIDMAN. Well, I think the kind of thing that you are doing in tax redistribution is not the kind of thing that is designed to get us out of a recession. It may be designed to make you feel that we have a safer—I mean a fairer—tax system, if that is your judgment, but I don't see that it is a great step toward trying to get us out of a recession. I think a tax cut will stimulate some spending.

I am not convinced, looking at all the money that might be available or what you think you can do, that that is necessarily the best approach. But, again, I really haven't had a chance to look at all those alternatives with any analysis. That certainly should be one of the alternatives to look at.

I must say, if you are going to run the deficit higher, it might be better to look at spending on the infrastructure if you can get it started fast enough. Part of it you can, because you have a highway bill right in front of you that I think ought to be enacted. Right now there are employed, as I understand, somewhere around a million people, and that is right in the heart of where the unemployment is.

Mr. HUCKABY. One final question, Mr. Chairman.

Although it is difficult to pin you down here, you seem to be saying that Congress should take some actions rather than do nothing.

Mr. SEIDMAN. I certainly think we have an economic situation in this country that our Government ought to be paying a lot of attention to, and now. I think it is clear that much of it was brought on by governmental actions, unfortunately, and I think the Government needs to pay full attention to it and right away.

Mr. HUCKABY. Thank you, Mr. Chairman.

Mr. GUARINI. Bill Thomas from California.

Mr. THOMAS. Thank you, Mr. Chairman.

Two observations. One, you look a whole lot better than you did. And I bet you feel better. And two, you have become an expert on a whole lot more subjects than you used to when you were in front of us, which means I think you were restrained in your testimony in previous occasions.

Mr. SEIDMAN. I was.

Mr. THOMAS. And you seem less constrained.

Mr. SEIDMAN. I am.

Mr. THOMAS. The clearing takes a lot less time, doesn't it? It is good to have you. I appreciate your comments. I am obviously one of the Members of the Ways and Means Committee, along with several other Members, including the Chairman. We are hopeful that we don't do the wrong thing and that we do the right thing.

I happen to think that we did a number of wrong things in 1986 to the point that I could not vote for the bill. One of the major wrong things I thought we did was in the passive loss area, so that since that time I have worked to try to change it and am now one of the two sponsors along with my colleagues on the committee, Republican and Democrat, trying to change it.

I think it is probably the single cheapest thing that we can do to have an impact in the area. I know you didn't like the choices that my colleague from Louisiana presented to you, but don't you think that in the context of us making a decision in the tax area, were we to spend just \$3 to \$5 billion, which seems like the number that we would be looking at, that perhaps the passive loss choice would be better than some kind of a middle-class tax break that would go into consumption in terms of long-term improvement? I think that is an easy one to make, don't you agree?

Mr. SEIDMAN. I do agree with that.

Mr. THOMAS. The capital gains passive loss choice might be more difficult. I happen to think, again, passive loss is probably the best choice, along with you.

Mr. SEIDMAN. That was my view too.

Mr. THOMAS. We have a number of things that are occurring at the same time, not just domestically, but externally. Do you think that we could have any impact, even if it were psychological and perhaps also financial, if we could clear up this general agreement on tariff and trade, long-term trade agreement and move as quickly as possible on a good North American free trade agreement with Mexico, would that have a stimulative effect in the market, in your opinion, in a positive way?

Mr. SEIDMAN. I think it would. I think it is very important. However, in supporting that kind of further entry into world trade, we have got to get our own system in shape in terms of productivity. And that means in terms of savings and capital. And that is why, since you are on the Ways and Means Committee, I would again suggest to you that our system is not designed in a way that really enhances savings and capital, and I think we badly need that to be examined.

Mr. THOMAS. I am also the principal cosponsor, along with J.J. Pickle from Texas, of the super-IRA and a number of others ways in which we can produce incentives for people to save. I happen to think that those are the approaches that we should be taking.

One last observation. You indicated that Tabasco sauce and tomato juice probably doesn't offer a quick cure on the bender that we have been on. Don't you agree the first thing that you do is quit drinking?

Mr. SEIDMAN. Well, there is some argument about that, but I think if you look—

Mr. THOMAS. I believe the references were to long-term cures, not short term.

Mr. SEIDMAN. If we are looking for a long-term solution, I would buy onto that.

Mr. THOMAS. Something along the line of, don't spend more than you make.

The second thing I think that you dwelt on that we have not focused on enough is that we have already done our investment in commercial real estate and, to a certain extent, in private real estate. The infrastructure areas that we haven't dealt with are highways and others. And that we need the long-term investment in those areas, not just for jobs, but to get that part of the infrastructure caught up, not ahead, but caught up with other areas in the society.

And then, finally, I think we have missed the mark in terms of where we invest, and that is that you don't jiggle the Tax Code to give some and take away from others, principally for political purposes, but that I think we could get far more out of the system if we would truly invest in people, in terms of education and in opportunities to work.

Mr. SEIDMAN. I think that is all part of what I put under the term competitiveness or productivity. The key is to do things that will create a more productive and competitive society here. Things like infrastructure and savings and others things you have referred to.

Mr. THOMAS. But if you get down to this real world business, if I have between three and five billion dollars to spend and I would like to spend it before this Congress adjourns, you can probably think of no better area from the Tax Code provision than to repeal the passive loss changes that occurred in 1986 tax bill?

Mr. SEIDMAN. Well, I haven't, you know, studied them all, and there has already been some comment about my expertise being overextended here, but from what I know, I would certainly put that at the top or near the top of the list.

Mr. THOMAS. Thank you very much, Bill.

Mr. GUARINI. Thank you, Mr. Thomas. Don Pease.

Mr. PEASE. Thank you very much, Mr. Chairman.

Thank you, Mr. Seidman. Appreciate your testimony.

I have two brief questions. We have heard a lot of talk over the past few months, especially from President Bush, about the regulators being overzealous in discouraging banks from making loans that they might otherwise make. You addressed that subject in your formal remarks, and I appreciate that.

Each of those times that I heard that comment made I was nervous because it is a small step from not being overzealous to being underzealous, and it seems to me that there was a precedent set from the 1980's when President Reagan was determined to get private regulators off the backs of private business. You have been in-

timately involved in trying to prevent the savings and loan and banking situations from getting worse. To what degree do you worry at all that calls for the regulators not to be overzealous could lead to further or increased problems in the banking and savings and loan industry?

Mr. SEIDMAN. There certainly is potential for scaring our regulators out there in the field. Most of them are young people, have been with us 3, 4, 5 years. When they hear people saying that they are the cause of the entire financial problems we have, they could go too far the other way. It is the job of the management of the various regulatory agencies to see that they strike a reasonable balance, and I think they are trying to do that.

But if you politicize that particular factor, you do take the chance, I think, of creating some further problems in the system.

Mr. PEASE. Would you advise the President and others to back off from statements like the ones we have heard?

Mr. SEIDMAN. Well, you have to look at those statements very carefully. Most of the statements, if you look at them, were fairly balanced. I mean in the end, the Secretary of the Treasury said, I want you supervisors to use commonsense. I certainly support that.

However, there have been all kinds of other statements from others around that have gone beyond that, and I think that can create a problem. I think right now the problem is under control, and we would be well advised to start looking at some of the real problems.

Mr. PEASE. Thank you.

In your statement you mentioned, I believe, that the basic tax structure of this country is tilted toward debt. Could you elaborate on that, please?

Mr. SEIDMAN. Because of the deductibility of interest and the nondeductibility of dividends, which is unlike much of the rest of the world, and also because of the high capital gains taxes, we have a system that promotes debt. It was put in at a time when consumption was our biggest problem. So it is hard to fix it right now when we have that problem again.

But, longer term, it was one of the reasons that junk bonds, in my view, got out of control. I don't think junk bonds were a bad idea. I think they got out of control partly because, in my view, the market was rigged.

But, in any event, we have a system that I believe ought to be changed. As a matter of fact, Congressman Vander Jagt proposed to try to get the Ways and Means Committee to focus on that the last couple years, and he did that with my aid and counsel, and I think it is something that needs to be addressed for the long-term benefit of the country.

Mr. PEASE. Mr. Seidman, I am a member of the Ways and Means Committee as well. Do you have any specific steps that you would advise the Ways and Means Committee to take either in the near term or the long term? Would you advise, for example, that we restrict the deductibility of interest?

Mr. SEIDMAN. I think the answer is that we need to treat interest and dividends in the same way. And how you do that is a complex and difficult problem. I have my own little plan which I drew up and gave to the Treasury, and somewhere it resides now in the

Treasury, and I think there are ways to do that. I think it is a very important subject, and I would hope that the Ways and Means Committee would address it.

Mr. PEASE. Thank you very much. Thank you, Mr. Chairman.

Mr. GUARINI. Thank you, Mr. Pease. John Spratt.

Mr. SPRATT. Mr. Seidman, thank you for your testimony, and since we have other witnesses, I will be brief.

The first question goes back to something Don Pease asked, and this is in your area of expertise. And I think you believe that some of your examiners are young and scared and zealous, have probably erred on the side of being overconservative as they have looked at assets and tried to determine whether or not they were—

Mr. SEIDMAN. I have no doubt that that has happened.

Mr. SPRATT. What has the FDIC done and what can it do to create more judgment, more discrimination among its examiners and to let up on some of this overzealous supervision?

Mr. SEIDMAN. We have joined in the statement which is a long and detailed statement about how they should evaluate and reserve against real estate loans. We have held and are holding meetings with their examiners in the field, and, believe me, they come in and say, what do we do about this? Tell us how to do this. They are not out there with the intention of destroying credit or banks.

They have a terribly difficult job, and that is to try to evaluate whether a loan is any good under current circumstances.

So I think that when I was there and Mr. Taylor, we both have the view that we want them to use commonsense, not to panic, to talk to their supervisory people, and to tell the banks if they don't agree to appeal to the supervisors.

Mr. SPRATT. One other point. I don't really know what is happening with the RTC, but I have run into people who are working for them and other people who would like to buy assets from them, and encountered two attitudes. No. 1 is that they are driven by a liquidation mentality, that they are not into forbearance and work-outs and trying to realize the longer term value. They want to move it and liquidate it. Would you agree with that?

Mr. SEIDMAN. In general, I think that is the mandate that was given the RTC by the Congress.

Mr. SPRATT. Do you think it is costing the Government money in the long run?

Mr. SEIDMAN. Under current circumstances, I would, as I said before, I would think that it is something that ought to be reviewed. Both in the amount of real estate and the need for liquidation.

But as you know, you are being asked for \$80 billion more, and everybody would like to see that reduced. And one way to reduce it is to liquidate assets. You have to realize that the Government is not—has not historically been a good asset manager of assets in the private sector. So it is somewhat of a no-win situation. I mean you have to—but it certainly is designed towards liquidation.

This whole, the whole RTC was designed to take institutions, close them down and liquidate them. And that has been a substantial additional factor ingressing the economy, because the size of the problem was three times as big as any of us thought.

Mr. SPRATT. Thank you very much.

Mr. GUARINI. Mike Parker.

Mr. PARKER. Thank you, Mr. Chairman.

Mr. Seidman, whenever you were here I think, around February, there was a lot of talk about how short term this whole recession was going to be. And everybody came before us, and they said, oh, it is going to be short, it is shallow. We have got a strong bottom.

There were some of us who felt that that was for public consumption in trying to tell everybody how rosy things were, that it really wasn't that rosy. But now I think it is proved out that we were right, that the bottom was not as solid as everybody thought it was.

But now you hear a lot of political talk about the problem being that we in this country don't have the largest banks anymore.

Well, I am from Mississippi. We never have had the largest banks, but all our banks are strong. They are solid. And one of the problems that I see is so many times people are talking about from a global standpoint that we don't have the largest banks, but it is really our smaller banks that give us our basis as far as our economy, especially in the small business community.

Is there any validity to this thing about a lot of the other nations taking over the No. 1 spot as far as being the largest bank? Should we be concerned about that at all?

Mr. SEIDMAN. They are taking over in world competition, and we should be concerned about it. Very definitely. I mean I wish all the banks in the country were run by Mississippians. We would be better off.

Mr. PARKER. We really would.

Mr. SEIDMAN. But the fact of the matter is that our larger banks have been handicapped, competitively, because they are not really banks for the United States. They are banks for New York or Mississippi. We don't have a national banking system. Therefore, our banks are really not representing our country. They represent wherever it is that you by law require them to operate.

So I think it is a very definite problem. That is why it is, to me, very sad that the end result of all the discussion and votes on banking legislation has been to come up with a bill that is, if one thing can be said for sure, it is going to further restrict credit, because it puts all kinds of new restrictions on banks and gives them no way to move out to extend credit. Anybody who studies that bill has got to say it is a bill that is not going to help the credit crunch.

Mr. PARKER. You have made statements, and everybody has been asking questions about things like passive loss, capital gains. Have you looked at anything as far as a targeted capital gains cut?

Mr. SEIDMAN. I have looked a little bit at that, yes, and I think there are some, there are some good suggestions that need to be examined there. I haven't done anything in detail. I am ever conscious of the fact that my expertise must spread, you know, slowly throughout the economy, even though I am now a TV commentator, so I should be able to know everything about everything.

Mr. PARKER. You look like a TV commentator.

But how should it be structured, if you were looking at a targeted capital gains cut, how would you structure it? To touch the most—

Mr. SEIDMAN. Well, I think we wanted to structure it for long-term investment, and we want to structure it for new and innovative investment. Those would be my goals.

Mr. PARKER. What would you limit?

Mr. SEIDMAN. I think—I mean if you are talking about trading profits and so forth, I think those should probably stay where they are. What we are looking at is investments that will be the kind that will make us more productive, more competitive. I think you can—that is not only new little high tech companies; I mean real estate can also be in that category.

Mr. PARKER. One other question, Mr. Chairman.

You made a statement the market was rigged. That is the reason the junk bonds went the way they did. Expound on that just a tad.

Mr. SEIDMAN. We are currently—not we, I mean—forget it. The FDIC and the RTC are currently suing Drexel-Burnham, Mr. Milken and so forth, and in that suit they allege that the market was rigged by them, and that that rigging was used to cause S&Ls to buy junk bonds that they wouldn't have bought if they had known the whole situation, and if other things hadn't been done. And as a result of that, the whole market was distorted. There was a daisy chain among the various S&Ls, including Centrex, Silverado, and others.

The closest—I can refer you to the book Den of Thieves if you want to read something that reads pretty much, and much more interesting, and is much more interesting, but reads pretty much like our allegations in the suit that has been filed against Mr. Milken. And it is my belief that our allegations are true.

Mr. PARKER. Thank you, Mr. Seidman. Thank you, Mr. Chairman.

Mr. GUARINI. Jim Hayes.

Mr. HAYES. Thank you, Mr. Chairman.

Because of time I will be brief, but I will say that I received a telephone call after my opening statement from my mother telling me to lighten up, so I will attempt to do that now.

The second call I received was from the Maxwell Henry family in New Iberia, LA, that is in my district. They make Tabasco. They want to thank you for your remarks.

Mr. SEIDMAN. Louisiana needs a lot of help right now, so I am happy to contribute.

Mr. HAYES. The third call I received was from my executive assistant, Louis Pered, in our district office in Lafayette, LA, asking me to get the name and address of the blond in the second row. So with these tremendous incentives to come back—

Mr. SEIDMAN. I just met her. She is going to testify instead of her husband.

Mr. HAYES. Earlier in days of my association with regulators—I would like to ask you a question if this is still true, because I haven't done this for 6 years. Instead I have been here. I am not sure which was worse, closing banks here or there.

But, anyway, I always found that the most experienced regulators, the ones that were the best, that the salaries that either the State of Louisiana was paying or that you were able to pay, or that the FSLIC was able to pay, were soon recruited by financial institutions, because they didn't know the rules, and they left that system

very early, leaving us as a training ground, rather than having seasoned professionals who could look at it as a longer term career because of salary incentives. Is that still true?

Mr. SEIDMAN. The turnover rate in the FDIC is low. We have had some of that, but that has not been the major problem that it was in the States, clearly, and also was true, I think, of some of the other regulators. One of the reasons is that we were not under the standard Government pay scale.

Mr. HAYES. My second question regarding the regulators would be that I did find that among those who were there, they were of a personality that adhered to rules and regulations, reminding me of my National Guard days more than anything, and that, in effect, when regulations are promulgated as a consequence of legislation, that what they took to heart was following rules, and, therefore, knowing that the reports they had reviewed by others would be in conformity with those rules.

That, to me, takes a judgmental position away from latitude at a local level where you are able to look at a transaction and feel freer to make a judgment that, by the way, a banking officer would make, taking all factors in, and was more constrictive upon them, were more like a military structure. Even if the loan might be better than it appeared to be, it didn't conform to the rules promulgated and, therefore, they would take the position of writing up the loan.

Do you still find that to be the case, where there is less latitude for a local examiner in an institution to at least have the opportunity to state broader conclusions, rather than specific guidelines promulgated here?

Mr. SEIDMAN. I think if you read the new statement that we just pointed out, it was done by all the regulatory agencies, you will see that there is a lot of room in there for them to exercise their judgment, some of us may worry even a little too much room, but it has been rewritten to make it very clear that they are to exercise judgment.

Mr. HAYES. You said earlier, you talked about 10 percent of institutions and maybe 20 percent of assets. But one of the things that struck me when I was not in Congress and watching testimony on the S&L bailout is that the Members of Congress who were listening to that testimony, not by you, were not really getting the facts that I was seeing happen in Louisiana and knew were happening in Texas and Oklahoma, and that it was painted as a much more contained problem, and, therefore, not really giving them the options they should have had in dealing with a much larger magnitude problem.

So I will ask you a different question that ought to be provided to every committee in Congress with jurisdiction.

Rather than a conclusion of 10 percent of institutions meeting a vague definition of capital structure, they still rate banks one, two, three for five; with fives being in big trouble and fours and threes, down to ones being the best. I think you ought to deliver, or that we should ask the appropriate agencies to deliver, how many are ones and what are their assets, how many are fives and what are their assets and all the way up the scale. Because then we will be getting a look at the financial strength that is not revealed in a

conclusion report, but rather see how many of these—and, by the way, let's take a look at history—how many threes become fives? Over what period of time in the past? And how many ones become threes? So that we can see both a trend line of where we are going and where we really are from a regulatory standpoint.

Mr. SEIDMAN. The FDIC will supply you with that information. We publish now the assets and problem banks. It is, the last I saw, about 450 billion, something like that, out of 2½ trillion, something like that. So it gives you some idea. I mean, it is not minuscule.

Mr. HAYES. All right.

And my last question has to do with RTC properties. Would it be your opinion that if we can save money to taxpayers by enhancing the value of any former collateral from institutions that have failed or in some matter have been transferred to RTC, would it be your opinion that if we were to be able to configure, either legislation or regulations, it would enhance the value—we have talked about passive losses—but what if we could enhance the value for assets held by RTC where those bidding would be able to have certain tax provisions that were previously available on properties held by RTC? That would be a market advantage, there is no question, but they can't do anything with them now.

Would that kind of analysis where we targeted RTC for treatment other than what is available currently, would that be good, bad, indifferent, or do you think that—

Mr. SEIDMAN. I think, generally, that would be bad, because these same assets are held by life insurance companies, by sound banks, and if you raised the value of the RTCS, you are going to lower the value of those same kinds of assets which are for sale and private sector institutions that are making it.

So what you are doing is taking those that have made it and are making it and handicapping them. And so I don't think that targeted approach would be desirable.

Mr. HAYES. I agree with you. Therefore, we are left with having to help RTC properties in a way that would benefit everyone, and wouldn't that reach the conclusion that changes in passive loss limitations—and by the way, let me add the word active loss, just so everybody understands that in 1986 we didn't limit this to passive losses. Developers were not able to take actual losses as well, and that gets lost quite often in the discussions.

But wouldn't, therefore, that be the most inviting target with the greatest help to RTC properties, which would benefit taxpayers, and the greatest help to those who currently are everything from small businesses to landowners, and offset by a Treasury loss in taxation that I don't think would quantitatively resemble the improvement made in the marketplace and the improvement in the economy?

Mr. SEIDMAN. Well, as I said, I think that would be very helpful and would be high on my list of things to look at if I were on the committee.

Mr. HAYES. Thank you very much. Thank you, Mr. Chairman.

Mr. GUARINI. Mr. Seidman, I just wanted to ask one last question.

There are four agencies that are currently regulating the banking industry: the FDIC, the Federal Reserve, the OCC, and the

OTS. Should these be restructured? Is there overlapping jurisdiction? Is it cumbersome to have four agencies regulating the banking industry, or should we leave it just as it is?

Mr. SEIDMAN. It is clearly inefficient, cumbersome, and means that the agencies spend an awful lot of time in turf fights and other things. It could be eliminated.

I recommended when this legislation came up that we go to one Federal regulator. And I think in the long run that would be desirable.

I think in the middle of the problem we are in right now, I would be hesitant to try to shake the whole system up, simply because of what might fall through the cracks during the period when you are getting a more efficient system in place.

Mr. GUARINI. Thank you very much, Mr. Seidman. Our profound thanks for your appearance here today, and your advice and testimony. We wish you well in your new career as chief commentator of business and news reports.

Mr. SEIDMAN. Thank you.

Mr. GUARINI. Look forward to seeing you again.

Mr. SEIDMAN. Thank you very much.

Mr. GUARINI. I would like to call our next witness, Donald Trump, who certainly needs no introduction. Your fame and reputation precede you, Donald.

Mr. TRUMP. Thank you.

Mr. GUARINI. We are very happy to have you here. We know you to be very frank and outspoken, and you have had extensive experience, not only in large real estate developments, but also in the sports, gaming, and entertainment industries.

I am glad you were able to be here this morning and appreciate your waiting and being so patient as you have been. So we welcome you, especially, to listen and to learn from your experiences as we know you have been very much involved in regard to this credit crunch that we have before our Nation today. So you may proceed.

STATEMENT OF DONALD J. TRUMP, PRESIDENT, THE TRUMP ORGANIZATION

Mr. TRUMP. Thank you very much, sir.

Well, first of all, I think I could say to Mr. Seidman, who I believe has done a really fantastic job while he was in government, that had the 1986 catastrophe of the Tax Reform Act not been passed, I am not sure that you would know Mr. Seidman in the capacity of RTC. You would know him in perhaps some more positive capacity, but not in the Resolution Trust. And I think in bringing that point up to Mr. Seidman before he tended to agree with me, I think?

Mr. SEIDMAN. Yes.

Mr. TRUMP. Good. So this taxability was just an absolute catastrophe for the country, for the real estate industry, and I really hope that something can be done, as Congressman Thomas recently said, that something can be done to change at least parts of it, because it has taken all incentive away from investing in real estate, and real estate really means so many jobs.

I mean you have a city called New York City, you have a city called Boston, you have other cities and so many other cities. But I can tell you from very personal knowledge, New York City has virtually no construction right now. We are not only talking about office buildings, of which there are many, we are talking about housing, moderate-income housing, low-income housing, even high-income housing where you create jobs, you create so many other things. They buy carpet. They buy furniture. They buy refrigerators. They buy other things that fuel the economy.

And incentive has to be put back into the construction of things that are needed, such as housing of all kinds. I heard this morning that we have had the lowest number of houses built in terms of housing since 1946 or 1947, and that is not much of a tribute to this group of folks that are representing the country, unfortunately. I feel very badly about it. Everybody feels very badly about it.

The fact is that the one word that nobody up on the panel has mentioned is the word depression, and I truly feel that this country right now is in a depression. It is not a recession. People are kidding themselves if they think it is a recession.

You look at what is happening in the automobile business, in the retailing business. The retailing business in any part of the country virtually is a total disaster.

But the real estate business, we are in an absolute depression. And one of the reasons we are there is what happened in 1986—in addition to what Mr. Seidman said, is what happened in 1986 with the changes.

So I really came on the basis that I wanted to—I will answer questions on it, but I wanted to discuss the Tax Act of 1986. Active, passive, you are absolutely right, 100 percent right, and something has to be done. It has to be brought back. It has to be reformed. It has to be taken care of.

I think for certain types of building, such as housing, depreciation schedules should be very severely limited, cut, so that people have incentive to build housing as opposed to commercial, which really again, the commercial is probably taken care of for a long while. The reason is, however, unfortunately, is the fact that the economy is so bad that there is no reason for the commercial. And I think that gets taken care of and gobbled up very quickly, if the economy improved.

One of the big things that we don't have today that we used to have and that was a very good thing for real estate and that is the whole world of syndication and investment. And if you are a dentist and you are making \$200,000 or \$300,000 a year, and you can't invest now in real estate—the reason the stock market is artificially high, in my opinion, is that there is no other form of investment. I mean, you can't put it into real estate and you can't put it into bonds, so people are putting it into the stock market. All the companies in the stock market are doing lousy, but their stock is high.

I think what we have is when the stock market goes down by, let's say, 1,000 points in two days, which perhaps it might, then we are in a full-scale depression, then everybody admits it. Then the politicians admit it. The President is going to admit it. Everybody is going to admit it.

And right now the only thing that sort of keeps the word depression off their lips is the fact that we really have a 3,000 stock market, and people are surprised to see it, because the companies certainly aren't doing very well within the market itself.

But the syndication of real estate was a very positive thing. And you can't syndicate, you can't have people putting up equity. That would take a lot of the strain off the banks, if people could put up equity in the form of equity money for syndication where you used to be able to go out and syndicate a piece of real estate. Today, you can't.

A lot of the strain that we are talking about, liquidity crisis, a lot of the strain comes off the banks, and I think it could really open up a whole new market.

And the other thing is, frankly, by having cut the high income tax rates to 25 percent, as an example, people don't have the incentive anymore to invest. They are saying, why should I take a chance on investing in low or moderate income housing? I might as well just pay the tax.

But the fact is that 25 percent for high-income people—for high-income people, it should be raised substantially with the understanding that, if you invest, you can get it down and down substantially below that number.

The incentive was taken away when the tax rates came down for high-income people. And I say leave the middle, leave the low, lower them. But people with money have to have the incentive, the dentists, the doctors, they have to have the incentive to invest, and there is no incentive.

So New York City desperately needs housing. There is no housing being built. Every city needs housing now. There is no housing being built.

I hope in Ways and Means they are going to be able to do something with respect to housing. Because if it is not done, you are just not going to have any construction jobs in this country. New York City has the lowest number of construction workers, I think, since the Depression.

I was with a very, very capable firm the other day, the biggest construction firm in New York City, HRH, and it is called HRH Construction, and we were discussing what they had planned. They said they have not one building planned in New York City for the next 2 to 3 years.

Now you think of that. Not one building planned. So you say, that means not one electrical worker. I mean they are just finishing up some buildings, and, when those buildings are finished, there is going to be nobody employed in the biggest industry in the country, because construction is the biggest industry in the country, and there is going to be virtually nobody employed.

So I just come—I was asked to come by the Chairman, and I make this plea that if something isn't done to put the incentive back—I mean we are not different right now than the Soviet Union. They have no incentive, and we have no incentive. If something isn't done to quickly put the incentive back, this country is going to be in very deep problems. It already is, but it is going to get far worse.

Mr. GUARINI. Well, let me ask you, If Congress does nothing, doesn't take any course of action whatsoever, how long do you think it would take our country to climb out of the economic crisis that it is in today?

Mr. TRUMP. Well, I think if incentives aren't given through taxing and others means, I believe that this country could be in this deep recession/depression for years. For years. I see no—no sign of any kind of an upturn at all. There is no incentive to do anything. There is no incentive to invest. Everyone is doing badly, everyone.

The wealthiest people are doing badly. Poor people are doing badly. Everybody is doing badly. I mean, you walk around the cities today, very, very few are doing well.

And unless the incentive is given back to this country, and it has been taken away with 1986, unless it is given back, I really think you could—there is an expression that we are using, survive until 1995. I think it is maybe longer than that. Survive until 1995. I think we are being generous. It is really, really bad, and you folks are going to have to do something to fix it and to get people moving.

Mr. GUARINI. How did we get here as we are? Has it been the mountain of debt that has been created in the public and private sector? Has it been the generosity, as Mr. Seidman said, of our tax laws, allowing interest payments to be deducted, so that it encourages a debt-driven economy?

Mr. TRUMP. Well, I think we got here by the fact that at the time certain things were done, I can speak in terms of the real estate business, certain deals were made, predicated on a certain tax policy, and then that tax policy was changed.

I mean, I truly believe that you wouldn't have had the savings and loan crisis—I mean you save minutia compared to the money that you have wasted on bailing out the savings and loans.

Now, if your insurance companies are in deep trouble, and I think they are going to get much worse because some—much of their portfolio is in real estate, and I think you better save the real estate now.

I can tell you, I bought things that were great deals in the middle 1980's and even the later 1980's, but when that tax law kicked in, you know, really kicked in, all of a sudden, those deals which were good economic deals were no longer good economic deals, because they changed the game on me, and they changed the game on everybody else. And it is pretty unfair. You make a deal predicated on a certain tax law, and then they change the rules.

So a lot of the problems that you have experienced are because of the fact that some very foolish people, in order to save a small amount of money because they heard the word tax shelter, and they thought the word tax shelter was a bad thing as opposed to saying it is an investment in real estate—I mean, an investment in low income housing they call a tax shelter. And the word tax shelter is like the word junk bond. It is very bad-sounding word, even though it isn't necessarily a bad thing.

So they heard the word tax shelter, and, politically, they didn't like that word, and they said let's get rid of tax shelters. When they got rid of tax shelters, they got rid of people investing in low

and moderate income housing and lots of other good things. And I think you are going to have to go back.

They could have corrected 1982, the law, 1982. They could have corrected it, gotten rid of the abuse and had a great situation today. You wouldn't have had the savings and loans problems. I don't think you would have had many of the banking problems. You wouldn't have had what is going to befall you now, I think.

I think the insurance companies are going to be in very deep trouble because of the values of their real estate have been eroded because of what Congress has done. So you have some very deep problems that can be corrected fairly simply by putting the incentives back.

Mr. GUARINI. Real estate has always been one of America's favorite industries. The Tax Code has long favored real estate to a great extent because the industry employs so many people and is so important for the welfare of our economy.

In 1981, we became very generous with real estate. We cut depreciation schedules in half. We gave tax credits. Would you say that this is where we started to go wrong? Is that where the beginning of building shopping centers and commercial buildings that were not filled?

Mr. TRUMP. I think that is where you started to go right, but maybe there was an excess. I think if it was channeled more toward the housing, which has always been—I mean there has never been enough housing. You need it desperately, and I am talking all forms of housing. You need it desperately.

Mr. GUARINI. Including low-income housing?

Mr. TRUMP. Including low-income housing, absolutely, and including senior citizen housing and dormitory housing and other forms of housing. There has never been—it is an insatiable thing, and you could really get that going.

But what you are also getting going is jobs. Because I tell you what—New York unemployment and other cities' unemployment is astronomical. I think it is much higher than the numbers are indicating. I just don't think it has been reflected yet.

If you look at what is going to happen with the construction industry within the next few years, forget it. There is not going to be anybody working. So I really think you need that for a lot of reasons, but also to spur jobs.

Mr. GUARINI. Passive losses, one thing that many people draw attention to, as Mr. Seidman did. Members of this committee did, when we passed it, and we had no hearings to my knowledge on it. It happened almost overnight, and it was a surprise, so that it was never given the full thought and attention it should have had before we made such a bold and important move.

There is a bill now that Mike Andrews has with several hundred, I understand, cosponsors that hasn't moved through the Ways and Means Committee yet. It says that developers should, if their full-time occupation is real estate development, be excluded from the passive law rules law. I assume you agree with this, and I am wondering whether or not you think it should even go beyond real estate developers.

Mr. TRUMP. I think it has to go beyond developers because we are going to get a lot of the liquidity from people outside that are making money and can invest in real estate. Right now they can't.

As far as the passive laws, I did hear something about—in 1986—passive laws, but nobody ever thought it would be possible for something like this to get passed. And all of a sudden it is passed, and everybody, including the U.S. Government, is left holding the bag, and a lot of other governments, by the way.

Mr. GUARINI. And now it is very difficult to get rid of, because of the revenue loss that would ensue. The marginal rates of our income tax would have to go up so high. The passive loss deduction was eliminated so that they could bring the marginal rates down.

Mr. TRUMP. I don't think they would go up. I think you would end up bringing much more money into the system so that you may look at a specific list. But I think the⁺ the incentives and everything else would bring so much money into the system that the numbers—and everybody that says that would just be far, far better than anybody really understands or knows.

Mr. GUARINI. Hopefully, we can cure these excesses.

Just let me, lastly, turn to capital gains. President Kennedy brought our capital gains tax down to 20 percent. Now, of course, it seems to be a bad word in certain corners of Capitol Hill. Would you say that we should go back to the traditional type of capital gains where all kinds of equities in real estate be given the normal deduction that we had pre-1986, or should we just target our capital gains to capital ventures, to resources that we need to have particular growth in?

Mr. TRUMP. I think it could be targeted, but I think that capital gains is important, and I think real estate in particular in this country really needs help, because it is such a dominant force. It just gets everything else going. And if you can get real estate going, if you can get construction going in the country, I think that is the way you get out of the recession or depression.

Mr. GUARINI. And for savings, super-IRAs like Senator Bentsen has over in the Senate side, you are for that?

Mr. TRUMP. Absolutely.

Mr. GUARINI. Thank you very much, Mr. Trump.

Mr. TRUMP. Thank you.

Mr. GUARINI. Hal Rogers.

Mr. ROGERS. Thank you, Mr. Chairman, and thanks for being here, Mr. Trump.

Mr. TRUMP. Thank you.

Mr. ROGERS. What would prevent—if we restored the loss provision of the 1986 Act, what would prevent excesses under a reinstated passive loss provision that led to over commercial building previous to 1986?

Mr. TRUMP. Well, I think one thing that could be done is you could re-examine this over the years, so that if in 2 or 3 or 4 years you saw a great deal of housing, and I think that would be unlikely, because it does seem to be insatiable, but if you saw, and I hope you have this problem, frankly, but if you saw so much housing being created by the reinstatement or the cessation, I think that you could probably take another look at it and maybe terminate it at that point for the future.

But I just feel that you really—I mean that that was a tremendously negative provision, and it really hurt this country. It truly hurt the country.

Mr. ROGERS. Would you limit its reinstatement to residential properties?

Mr. TRUMP. Well, it just seems that that is what is really needed now. I mean everyone agrees that you need housing, and you probably always will need vast amounts of housing, so it seems that that is what is needed.

But you have to understand, when the economy comes up, you know, these buildings, many of the buildings built right now, when they were built it seemed like a good idea by a lot of people, a lot of honest people.

The banks that loaned the money weren't all bad. And what happened to a lot of people is that the economy went bad. Now everybody says, how could they have built this much space. But the fact is, this space, if the economy had stayed like it was in 1986 and 1985, that space would have been gobbled up, and they would have been building more, and everybody would be happy right now.

The economy went very, very bad. You look at various cities, they are cutting back on space. I am seeing things where they had less space this year than they had two years ago. It is unheard of statistics. So nobody could have predicted what was going to happen with the economy.

So it would be nice to have it across the board. It would be nice to say that the banking system and various other controls will take care, but you, certainly, at a minimum, you should have it for the housing industry, in my opinion.

Mr. ROGERS. Mr. Seidman seemed to say, and he is behind you and can correct me if I am misstating his testimony, or part of it, he, in essence, said that a recovery in the overall economy is the only way to cure the real estate problem. You seem to say that the reinstatement of the passive loss provision of 1986 TEFRA would lead us out of the recession.

Mr. TRUMP. No, I am not saying that alone. I am agreeing with Mr. Seidman, except I will take the word only out. I think that the Government can do quite a bit also, including the shortening of depreciation schedules, power to syndicate, the right to syndicate, which also has to do with the active passive if we were able to syndicate development or able to syndicate even buildings that are built and successful and good that you can't get a mortgage on.

I mean, I have a friend, he has got a building with an IBM Triple Net lease, he can't get a mortgage on the building. And it is a perfect, beautiful, nice little building with IBM as a tenant, and he can't get a mortgage because it is real estate, because the banks are allowed a certain amount of real estate. And they want to cut down on the real estate. So even a good loan like that, they don't want to put it, because they don't want to be associated this year for real estate. This is a bad year. Hopefully, in 2 years from now everyone is going to want real estate. It runs in cycles.

But you really can do things other than just economy, I mean I think you can—I would like to say that you can spur the economy through taxes so that the economy actually gets good.

Mr. ROGERS. Now, we are operating under the Budget Act, the budget agreement, which has a paygo provision, pay as you go. If you reduce taxes, you got to make up the revenue somewhere else, so that we have a revenue neutral action.

Are you saying that if we reinstate the passive loss provision, we are going to have some lost revenues because of that? Am I hearing you say that you would increase the income tax rates of the higher-income people?

Mr. TRUMP. Well, I would do that. Yes, sir. I would do that because I believe strongly that people don't have enough incentive to invest right now at 25 percent. I just don't believe they have enough incentive to take the risk of investment with recapture and all of the other problems of investing in real estate and other things.

And I would absolutely do that with the understanding that, if they do make the investments, they can go down to the minimum level. And I feel very strongly about that.

As far as the \$5 billion that we are talking about, that \$5 billion in loss of taxes may contribute \$100 billion because of the incentives that it gives. See, I don't look at that as a loss in taxes. I think that so much work could be created by getting rid of that horror show that you may take in a hundred billion.

Now an accountant will tell you, well, we are going to lose \$5 billion. But in actuality it could spur hundreds of billions of dollars worth of work.

Mr. ROGERS. I thank you for your testimony. You have been very helpful.

Mr. TRUMP. Thank you, sir.

Mr. GUARINI. Mr. Huckabee.

Mr. HUCKABY. Thank you, Mr. Chairman.

Mr. Trump, you mentioned the Soviet Union and no incentives there. You know, for the last 45 years we have been engaged in cold war with the Russians. Clearly, I think a year ago it became apparent that we had won that war. We spent tremendous dollars in the 1980's, as did the Russians in the military buildup. It broke their system, in my opinion, left us with a big debt. But, clearly, we are the surviving superpower today.

And here we find ourselves taking a microlook at this economy. Inflation is very low, running around 3 percent, interest rates, lower than they have been in 19 years. No shortage of food, no shortage of oil, but things that have put us in recessions in our lifetime.

And you seem to be saying, and I believe I agree with you, that you can trace this recession totally to the 1986 Tax Act and the devastating effect it had on real estate. But yet, prior to 1986, the tax laws were so generous that it seems to me that an awful lot of building was being driven by the Tax Code rather than a demand. What is your comment on this?

Mr. TRUMP. I agree with that, and I agree that there was abuse, and there were openings in that law which could have easily been stopped and that could have been corrected.

But what they did is they took an overall picture of the entire tax—with the new Tax Reform Act of 1986—and they totally destroyed the incentive that was proper in 1981. There were a lot of

good things in 1981, and there were some bad ones, and the bad things should have been corrected. But they could have been corrected without having destroyed all of the incentive.

For instance, we have had recessions before during my lifetime, which is now getting a little bit older and older, but in 1975 we had a recession, but that was a picnic compared to this. That was an absolute picnic. That was a question of some liquidity, some of this, some of that.

Nobody knows when this is going to end. You know, you saw some smiles, when do you think it is going to end? Nobody has the faintest idea. There is absolutely no hope, insight, unless something is done by the government to spur the economy, because the economy is not going to spur itself.

Mr. HUCKABY. I think all of the Members here have seemed to imply that they favor the changes in the passive losses. You mentioned a change in depreciation schedules, I guess reverting back to accelerated depreciation. I think that was one of the areas, looking back in the past, that was perhaps of greatest abuses where one could recover their entire investment, perhaps 3 years as a result of tax writeoffs. Which of these areas do you think would be more important?

Mr. TRUMP. Well, I think the accelerated depreciation and the shortening of schedules is very important in terms of getting something done. And, again, we really need something going now. You can come back in 2 or 3 years, if it starts moving, and you can terminate that. But you have to get something going. If it is not started soon, we are just going to be in a free-for-all.

Mr. HUCKABY. I agree with you that there is probably an infinite demand for housing out there and that we certainly should change our tax laws to encourage investment there, from low-income housing all the way up the scale. But you have suggested a new twist here that is necessary to raise the top tax bracket from the 31 to 33 percent up to 40 or 50 percent, and in order to encourage people to invest in these areas. Is that really correct? If we had the passive losses and the accelerated depreciation and one could anticipate future increases in the value, do you think it is necessary to increase the tax rate?

Mr. TRUMP. I think it would be a big help for the upper-income taxpayer to have incentive rather than paying taxes to invest. I think that the accelerated depreciation, depreciation schedules being shortened, would be a tremendous help for the obvious reason, that you would be able to get, assuming the active passive and assuming the right to syndicate, you would be able to get investors to come into real estate transactions.

And I am not talking about only new building. I am talking about existing. Because you have existing buildings with mortgages on them where the mortgages are coming due, and there is no bank in the world—I am talking good buildings that are making money—there is no bank in the world that will give you refinancing.

If you could bring in equity money through syndication, that would be a great thing, that would be a really great thing, because you would open up the liquidity of the system so that banks can loan not only to real estate but to other things. If you brought in

noninterest-bearing equity, that would be a tremendously positive boost for the economy.

Mr. HUCKABY. How high do you think you would have to take the top tax brackets in order to make this happen?

Mr. TRUMP. The higher it is, the more incentive there would be. I guess it was 50 and 60 at one point, and it was, obviously, even higher than that. But the higher it is, the more incentive.

I don't mean middle income or low income. Anybody that could stay the same would be lowered. I am talking about the people that are making a great deal of money should have an incentive to invest, and I know it was 50, and I am talking about a substantial increase, with the ability to get it down to the minimum number.

Mr. HUCKABY. All right. Thank you.

Mr. TRUMP. Create a lot of jobs.

Mr. GUARINI. Mr. Thomas.

Mr. THOMAS. Thank you, Mr. Chairman.

It is a pleasure to meet you, Mr. Trump.

Mr. TRUMP. Nice meeting you, sir.

Mr. THOMAS. I have never really heard you in terms of your professional expertise, I have only read about you in terms of other activities, and I have to say that I admire you in terms of your professional expertise.

I have been fighting the 1986 tax bill ever since it was passed. I think there were three really pernicious provisions along with all of the other onerous ones. We have been talking about one in particular, changing of the rules, and I will spend some time talking about passive loss in a minute.

The second one that we haven't dwelt on was the change which almost invited, literally invited, the American homeowner to exchange equity for debt, because we removed the tax deductibility of consumer debt, and then changed the rules to allow them to squander the equity in their homes.

Mr. TRUMP. Absolutely.

Mr. THOMAS. And then, thirdly, a point that Mr. Seidman mentioned, that most people don't realize, was the retroactive aspect of that bill, where many people had made decisions about pensions and their retirement tied to real estate in which the Government changed the rules after the fact. You could not believe the decision that the Government made prospectively and, I think, psychologically that significantly damaged us.

In terms of passive loss, I know there are a lot of people watching who don't really understand what we are talking about. We are talking about the rules under which people make decisions to invest their money.

There is no question that there were tax strategies built into the code that allowed people to take advantage of so-called shelters. We have talked about the excesses of the early 1980's. The cry for 1986 was, don't let the Tax Code dictate economic behavior.

But I think you have quite rightly pointed out that one of the reasons the stock market is overly priced is that, because of the Tax Code, that is the only game in town, that we are dictating economic behavior today. The loss of equity in terms of the homeowner is the Tax Code structure. We are continuing to dictate economic behavior. And I think the thing you have to understand, which I

know you appreciate, is that the Tax Code is going to dictate economic behavior. There is no way for it not to, if you have a Tax Code.

Mr. TRUMP. That is right.

Mr. THOMAS. And what you have asked for is the Tax Code to create incentives for behavior. I agree with you.

The problem is, I think people are overstating the correction necessary for passive loss changes. The bill that I originally sponsored and that I agreed to join in a cosponsorship with Mike Andrews of Texas has been honed down to only cost about \$2.8 billion over 5 years.

The problem with the passive loss rules changes, as you well know, was not just to get rid of tax shelters. That is people who were not materially participating in real estate, like the dentists and the doctors that you have suggested would reinvest, were investing for purposes of tax shelters. There is nothing wrong with allowing them to invest if they believe they can earn an economic gain. You don't have to tilt the Tax Code in their direction if there is an opportunity to make money in the real estate area.

The problem with the passive loss rules changes was that people who were literally actively involved in real estate aren't allowed to take losses against their activities.

And we railed long and hard—the Chairman is not here—behind closed doors in the committee, whether this provision was put in the bill. It was an attempt by people who did not understand the real world to take an academic definition and stick it into the Tax Code.

We have lived under this academic definition, I think, far too long, and I really appreciate your real-world plea that we make the kinds of adjustments that won't lead us to the overexcesses of the early 1980's but will allow those who want to participate and to create an active real estate market to be able to do so.

One last comment on depreciation. You need to know that the requirement under the 1986 tax bill was that it be revenue neutral, that we make these multi-billion dollar adjustments within the Tax Code, but that we come out even dollars. The depreciation schedule was literally an accordion that was squeezed or stretched to produce the dollar numbers necessary to make the package revenue neutral. It was not designed to create an honest return on investment in the real world. It was a political gimmick to fill revenue gaps.

And I just, I just want to thank you. You have had to live with it. I think the American people have had to live with it far too long. We aren't talking about recreating 60 or 70 percent tax levels to fund a passive loss change.

I agree with you. If people are going to have their money eaten up by the Tax Code, they are going to look for ways to invest and make money; incentives need to be built in, they don't need to be built that high. We could use some of that money to adjust the schedule so we don't create a massive tax loss. Your reaction?

Mr. TRUMP. I agree with you 100 percent.

Mr. THOMAS. We have over 300 Members who have co-sponsored our passive loss legislation. It is not on the front burner in terms of tax changes.

What is being contemplated by the committee are political responses of adjustments within brackets to create a, quote, unquote, tax break for the middle class, and if you would urge people who are in the private sector to contact the Chairman of the Ways and Means Committee, Dan Rostenkowski, contact myself—for \$3 to \$5 billion, I can think of no better immediate shot in the arm for our recovery.

It is an enormous advantage, and I agree totally with you, that when you try to construct a model that says it will lose \$3 billion to \$5 billion in the Tax Code, yes, because we will change definitions in the code. But what we also change is behavior.

When that behavior exhibits itself in the real estate market, I also agree with you, there will be billions of dollars of exchange, of circular flow of economic activity, of jobs, and there will be no loss of revenue to the government.

Mr. TRUMP. You are absolutely right.

Mr. THOMAS. I wish I had a lot of questions for you. You already said everything for me that needed to be said. I just wanted to put it in the context of where we are; a relatively simple change to correct a serious error in the 1986 tax bill could go a long way structural, but I think also psychologically to indicate we are doing something, we do understand the problem, and we are responding.

Mr. TRUMP. Thank you, Congressman. It is a shame, Congressman, that this very powerful and important industry doesn't have a better lobby, because I watch legislation being lobbied that should never be passed, and it gets passed; and I look at things like this, and as you say, it is on the back burner.

And you know how important it is, and the real estate industry is a group of thousands of people, some wealthy, some not wealthy, most not wealthy right now. And I tell you they have absolutely the most pathetic lobby in the history of the U.S. Congress. It is so bad, and I don't know how many of these people behind me are lobbyist, but they are not doing a very good job, I can tell you that.

Mr. THOMAS. I was just telling the gentleman that if he would appear before the committee, or several others like him, we wouldn't need lobbyists.

Mr. GUARINI. The name of the game in Washington is to have an effective lobby, and then you get the laws passed that need to get passed for that particular industry.

Mr. John Spratt?

Mr. SPRATT. Thank you for your testimony. In the interests of time, I have but one question to you.

Obviously, you operate on a scale vastly higher than I did when I was involved in real estate investment. When we syndicated a project, what drew the participants and limited partners to the syndication was not just the pass through of losses, but the fact that they could leverage their returns by writing off losses below the actual cash investment.

Do you think that is a good rule and should continue?

Mr. TRUMP. I think it is a rule that works in terms of getting people started, and it certainly had an effect, and it can be limited to an extent if need be, but right now we don't need limits, we need action. If there is no action we are not going to have a real estate industry.

I am really talking, to a large extent, because we talked about overbuilding done during the 1980's, but I am really talking about things that are existing, not just for new construction, but things that are existing, because you cannot get financing for any building, now matter how good it is or how good your tenant is, you cannot get financing for it under any circumstances, anybody. If it has real estate associated with it can you not get financing.

And that is a pretty pathetic situation. Maybe that changes, but I think you people are going to be the ones that have to make a change.

Mr. SPRATT. The point was, when you described the syndication, you were talking about nearly an all-equity syndication, and I rarely saw an all-equity syndication.

Mr. TRUMP. I am sorry. I meant there would be a mortgage and a certain amount of debt and there may be 20 or 25 percent of debt infusion. You would have a lower rate of mortgage and 25 percent of essentially interest-free equity. That is a real positive.

The bank could make up the other 75 percent, or again, it varies. You could have from 50 to almost a 100 percent, but you could have a large amount of equity infusion, and I think that is a real positive thing. But right now, under the existing laws, you can't do that.

Mr. SPRATT. I have got developer clients who still survived, they think this has been a shakeout and the fit have survived. They look back on the period from 1981 to 1986 who say there are a lot of characters in business who shouldn't have been. They had no economic reality.

Would you agree with that assessment?

Mr. TRUMP. I would partially. I think there were a lot of good people in the market who got whacked and a lot of bad people who deserved to get whacked.

Mr. GUARINI. Thank you. Mrs. Bentley.

Mrs. BENTLEY. Thank you, Mr. Chairman.

Mr. Trump, I want to thank you for being here today and for your stand on American manufacturing over the years. I was one of those with Mr. Thomas who early on when the 1986 Tax Act was under consideration, opposed it. In fact, I described it as, "it stinks," and I think that is the best description I still give to it today.

You have been talking about real estate here, but that Tax Act also eliminated investment tax credits.

Mr. TRUMP. Yes.

Mrs. BENTLEY. It eliminated interest deductions on the purchase of items. And we have a little bank in my area which just this past week has reduced by 1 percent the interest on anybody who wants to buy an American car.

The number of phone calls that that bank had had since that ad was put in has been phenomenal. What do you think would happen if efforts were made to push manufacturing upward and which then would help your real estate, et cetera, if we would give some inducements to investment tax credits on American manufactured products?

Mr. TRUMP. I think it is a truly spectacular idea.

Mrs. BENTLEY. Are you going to join me, Mr. Thomas?

Mr. GUARINI. I already have a bill in for tax credits, so I agree with you.

Mrs. BENTLEY. Very good. I need to persuade some of my good Republicans to agree with me on that, too. But I think what one of our problems has been that we talk far too much about free trade instead of fair trade. And as a result, we are all suffering from the negative effects of such free trade.

I think some of those behind you are some of the people who have been hurt from the result of one-way free trade, that of exporting jobs overseas. Again, Mr. Trump, thank you for being here today.

I would some day like to pursue your thoughts on manufacturing further.

Mr. TRUMP. Thank you, ma'am.

Mr. GUARINI. Thank you, Helen. Jim Hayes?

Mr. HAYES. Thank you, Mr. Trump. I want to take this opportunity to perhaps outline things in a way that might seem somewhat moronic, but realizing this is an opportunity because of someone with your high profile, to have people who do not deal with financial markets to understand some of the dilemmas we find ourselves in and some of the ways we get out of it.

Explain in very simple terms how an developer, such as yourself, with an idea for a project takes the cost of the project prior to 1986--and the impact of that act, takes that project cost, proposes a financing mechanism, and goes about getting investors. Just briefly outline anything, whether it is commercial or residential real estate.

Mr. TRUMP. That could be a pretty long answer, but just briefly, you conceive of a development on a site. It usually starts with a piece of land. You conceive of this, you go and get your zoning or you have your zoning, you get your architects, your engineers, your planners, you design something you think is going to be nice and economic and all of the things it is supposed to be. You then go out and get your financing.

Ideally, you used to go out and get your financing. Today you don't even think about it. You then go out and get your financing, you build your job, hopefully have your success. You have created a lot of jobs for people that are buying lots of things for their families, including other homes, et cetera, et cetera.

That really is the process, but that process is now circumvented because it is impossible to get financing for any development in this country, I would say, right now.

Mr. HAYES. Explain to them also that at the end of the trail, when you have an interim lender, someone who gave you a construction loan, and a permanent lender who looked at the project long term, that projects that you did prior to 1986 that were either in the stage of an interim lender or had been completed, that even though those had been completed and conceived under tax laws that then allowed for depreciation, that it would appear that the loan was economically viable by a loan officer who looked at it, it made sense to them.

Explain how even though it was done under previous rules, the subsequent rules were applied to you and the kind of economic impact they had for a completed transaction.

Mr. TRUMP. They weren't grandfathered, essentially. You bring up a great point. Because I have never understood how this is possible. I have never understood how somebody throughout this country didn't sue the United States Government and have that overturned.

You had people, investors, investing over a 10-year period for a set of—under a set of conditions, and this is, as I was talking about, playing the game. We are all playing by a certain set of rules. The rules were changed for the Government but not for us. It was an incredible circumstance that happened.

People went bust by the hundreds of thousands. I hope you weren't one of them in terms of that, but obviously you know people who were, they changed the rules on taxes.

And you have some incredible situations. People guaranteed personally a stream of payments paid over a 10-year period for perhaps a very good job, like a low income housing development. Nothing wrong with. That is a very positive thing.

And after 2 years they got wiped out on the taxes, yet they still owed all of this money, and all of these people had to declare bankruptcy, they couldn't pay it. How it wasn't grandfathered for those people, I have never understood.

How it wasn't overturned by the courts—and I am sure many people must have brought lawsuits—is just beyond me, because it is probably the most unfair thing I have seen in terms of business and government. Great point.

Mr. HAYES. And another point, I will be specific and use an office building that I am familiar with, unfortunately, but to make the point with the change in configuration of interest deductions.

There was a building in my home town that generated \$242,000 in rentals. It had been done through a partnership, not a leverage deal, fully collateralized, 100 percent occupied, not outside investors, only two partners, but because of the change in the 1986 code—the building was completed prior to the 1986 code—the \$246,000 was treated all as personal income to the taxpayer, but the interest deduction to the insurance company that financed it was allowed only at \$10,000.

Whereas the actual economic activity was a slight gain of 10 to \$10,000 between rent and debt service. But the tax impact of \$240,000, with only a \$10,000 deduction, gave an income tax bill of \$60,000 or \$70,000. And that is what took them down, not a dishonesty, not a deduction, not a building that fell down or one that wasn't occupied.

Mr. TRUMP. He did a beautiful job. They did everything right, and they got wiped out.

Mr. HAYES. That would explain your previous comment about good buildings that had good tenants but lenders don't want them for two reasons. One is because of uncertainty, since people who did good planning and fair planning got killed retroactively, they are not trusting of a government that might not, in search of revenues, do something in addition, even on new buildings coming in, because the rules apply retroactively.

Mr. TRUMP. Absolutely correct.

Mr. HAYES. And secondly because it doesn't have a collateral value under that circumstance, since it is uncertainty. I will make three points.

One is, at no cost to taxpayers. If we do some of the things you have outlined, collateral value will be improved. If a bank is carrying a building such as the one I have described, whether it is interim or permanent, if it is set at a value of \$1 million, because of current tax law, if tax law were changed, that building alone might be \$3 billion or \$4 billion, which on their collateral carried by the bank gives them less pressure from regulators, because asset values would increase, but it doesn't cost the taxpayer or revenue payer one cent.

Mr. TRUMP. You might even make a profit on RTC after all. You could probably take RTC and end up starting to make some real sales instead of taking away for 5 cents on the dollar. You are selling property that is much better than that.

If you made the proper changes in the tax law, if you made some of smart changes, your RTC property could even—you wouldn't have to contribute 10 cents to it, in my opinion.

Mr. HAYES. Secondly, I represent people who are being foreclosed on, who never missed a payment. They have made every monthly payment through other income and this were able to do so, but because the collateral value was depressed, even though they never missed bank payments, those loans are being called because the regulatory scheme is saying, this property is worthless, therefore we are demanding \$3 million or \$4 million in additional collateral they don't have.

And they are being placed either into bankruptcy or tremendous economic adversity, having never missed one monthly or one quarterly payment.

Mr. TRUMP. It is a very unfair circumstance. There are hundreds of thousands—and I guess beyond that—people exactly in that circumstance.

Mr. HAYES. And the second point is on property tax. If we keep current law, we are just not having enough years passed where corporations and individuals are recognizing that if their property is lower because of changes in the tax code, they should go to their assessors, because it lowers the tax receipts and makes them suddenly have to come up with alternative tax packages for their own revenue measures.

Is that not—in New York, for example, are there not people trying to get property tax adjusted automatically because of the impact on real estate ventures?

Mr. TRUMP. There are indeed.

Mr. HAYES. On economic activity—I come from southwest Louisiana which people refer to as oil and gas community. I used to hear people say constantly we were recession-proof, which I thought was an interesting phrase.

I used to hear constantly, "I am not in the oil and gas business." Well, when it collapsed from \$40 to \$8, and bounced for a while, everybody that sold shoes found out they were in the oil and gas business.

I think the point you are making is: I am not in the real estate business—and I no longer am, by the way; don't own one square inch of anything.

Mr. TRUMP. You are lucky.

Mr. HAYES. I am not in the real estate business can't be said, because it is such a large segment that fuels the economy. If you are a shop owner, if you are in medical practice, if you are an attorney, you are in the real estate business, because if your community hasn't collapsed, as mine did, it didn't just take down real estate developers, it took down everyone.

Three out of four of the kids that go out with graduate degrees from my university leave the State for employment. They didn't have the oil and gas industry either. They weren't realtors, but they can't stay and get a job.

For those who think it goes away cyclically, my community has been in the grips of a deep depression for 9 years. It doesn't have a term limitation on depression, and we had better have an affirmative action from Congress or I guarantee you there is no guarantee that New York City won't have 9 years or 19 years or that we will ever turn it around.

I would ask if you wouldn't agree with that, and then I will be quiet and hope this time I haven't been too strident.

Mr. TRUMP. Beautifully said. I agree 100 percent.

Mr. GUARINI. I thank the gentleman from Louisiana for the many suggestions he made. Perhaps you would be a great candidate for the Ways and Means Committee.

With regard to nonperforming loans, the value to loan ratio should be changed, and many people get trapped because of the banking regulations. They are unfair and unjust. Mr. Thomas.

Mr. THOMAS. Just briefly, a question, Mr. Trump. We have all been wringing our hands about the RTC and the property it has on hand and the inability to move it, taking 5 cents on the dollar. As an investor, what would your opinion be of the Congress making those kinds of changes in the tax code, as you have indicated, passive loss, modified depreciation, and so on, and having the RTC simply batch properties on the basis of some criteria, chronological listing or whatever, some good with the bad, and put them out there, and see what would happen in terms of the market? I think you would move a lot of property that way.

Mr. TRUMP. I agree. I think you should make the changes. You shouldn't sell another property. You should make the changes and then sell the property, and then you would get money like you wouldn't believe.

Mr. THOMAS. Batch them and let the private sector sort it out.

Mr. TRUMP. I agree with what you just said. But I think you should stop selling property until such time as you fix the tax code. Those properties are being sold at an artificially low rate because of the tax code.

Mr. GUARINI. The real estate industry is 20 percent of our GNP, employs 8 million people, and I understand, according to a statement you filed contributes \$200 billion in tax revenues. You have spoken up for a very important sector of our economy, and the sector that took the biggest hit in the Tax Reform Act of 1986. There are a number of corrections that should be made for the

sake of the growth of our economy. Otherwise, it will be too late if we don't move soon.

I want to thank you for your insights. I thank you for being here. I hope sometime soon we will have the advantage of your thoughts and your suggestions and your contributions before the Ways and Means Committee, because I think some of the tax suggestions you make have a great deal of validity to them.

I thank you for the hour or so you have spent with us. I wish you well on your way back to New York.

Mr. TRUMP. Thank you very much. Thank you all.

Mr. GUARINI. I would like to call on my good colleague in Congress, Ron Marlenee from Montana. Mr. Marlenee.

Mr. MARLENEE. Thank you, Mr. Chairman. I noted on my monitor that you were having hearings, and I cannot commend too highly you and the committee for addressing the problem that exists, not only in real estate, but all across America.

I also note we have regulators here, and I hope they have not left, because I deem one of the great problems we have in America can be laid at the feet of the regulators. In spite of what Mr. Seidman may say, in spite of what Bob Clark had said—and I might add that Bob Clark is no longer with us because of the inflexibility that he showed toward the regulation of the community.

I did a survey, because I had had a lot of complaints, a tremendous number of complaints from both the lenders and the borrowers, and I have been both, personally—I understand the business world very, very well, and I have had a tremendous number of complaints, so I did a survey, a polling of my bankers.

We had some 130 bankers that were polled in the State of Montana. They developed the questions. They developed the questions, and I submitted them so that they could respond anonymously.

I wanted to know why our people that had good loans—and some of the kinds of situations were mentioned here this morning already—were not being allowed to secure enough operating capital, so that we could continue with commerce and business. They were not even getting operating capital, to say nothing of speculative capital, and it is drying up the economy across America.

This is not indigenous to Montana. So if you will allow me, Mr. Chairman, just a couple of minutes to enlarge upon the questions and maybe review what some of the regulators have been saying about it is the fault of the bankers, it is the fault of the real estate industry, it is the drop in values.

Let me tell you what the lenders and the borrowers receive from the regulators.

First of all, the No. 1 question: What is your organization or your primary bank examiner? We won't go into that.

No. 2, are you being confronted with overzealous examiners that refuse to listen to all facts presented to them? Sixty-six percent of the bankers responded yes or sometimes.

Do many of the examiners lack the necessary expertise to evaluate agricultural or commercial credits? Sixty-eight percent responded yes, and sometimes.

No. 4, do you feel as if bank regulators are more concerned with protecting themselves than with ensuring the safety and soundness of banks? Sixty-six percent said yes, and sometimes.

Have you adjusted your bank's lending period as a direct or indirect result of the activity of bank examiners? If so, please explain. Sixty-one percent had adjusted their lending practices because of the stringent and overstringent and combativeness of the regulators.

Do you feel as if the bank examiners have an unresponsive, combative or defensive attitude if their findings are challenged? That broke out about even, with 54 percent feeling yes, and 45 percent saying no.

How would you assess the training level? Forty-three percent said it was unsatisfactory.

During your last examination, how would you describe the overall communication between the bank examiners and your staff? These were highly—these were varied, and the response were generally written, so that would complicate that.

Do you find, number nine, bank examiners are consistent? Forty-eight percent said no. In other words, they come in one day and demand one thing, the next day they demand something else, and they are not consistent, and I think that is one of the problems we have.

Do you find that examiners are classifying loans that they have never or rarely classified in the past? Fifty-six percent said no; 43 percent said yes. Very significant.

Have you been advised that the extension of a loan for any reason is an indication of financial weakness? Forty-five percent said yes, they have been advised that any extension of a loan is an indication of weakness of that borrower.

That is not, Mr. Chairman, sound financial practice.

Mr. Chairman, for the record, I dealt with the farm credit system collapse. The basic reason that farm credit system collapsed was the fact that the underpinning collateral dropped in value.

We had to walk in and prop up the farm credit system because the real estate values collapsed entirely. The S&L, we had a lot of scoundrels in the S&Ls. There is no question about it. But the basic reason that the great bailout of those depositors had to take place in the S&L system was the fact that the collateral value disappeared, and there was no recourse.

Now we have the FDIC, we have the Comptroller of the Currency making it impossible for people to secure operating capital, so commerce can roll, and to say nothing of securing some investment capital whereby they might purchase real estate. We have the tax laws which have been flip-flopped, which have tremendous impact on agriculture in the country, and we are going to do the same thing to the commercial banking community, and it will be the fault of the regulators and the fault of the Congress. If we don't take the action to address the problem, we will have a bank bailout. I don't think we need a bank bailout.

I think with a few corrective measures taken by Congress, falling off the jobs of the regulators, in other words, telling these people sitting at the table down there and those downtown that they had better loosen up and allow good verifiable loans that have never had any problem, those portfolios, those people to secure the money they need to carry on commerce.

I think we will prop up the real estate values, we will keep those values up, we will keep the underpinnings up, and we will keep Congress going.

One final thing on capital gains. There is a dearth of young people that are not getting into agriculture. They would like to get into agriculture.

The average age of the producer is getting older and older. We are making it less attractive. But when mom and dad—when mom and dad want to pass that farm on, and they want to pass it on to the kid that is going away to the university, and he is ready to come home, they find that the capital gains tax is so punitive that they can't pass that on to their offspring without some very severe consequences.

Mr. Chairman, I said I would like 5 minutes, and I hope I can send this message to the regulators. I hope that I am going to send them the results of this survey. The bankers were afraid to respond because of retaliation. I think you will find that to be the case.

So I had them respond anonymously. I think that tells the story. Thank you, Mr. Chairman.

Mr. GUARINI. Thank you very much, Ron. I think we can place the results of your survey in the record so you have the exact numbers. Thank you for your statement.

[The survey referred to above may be found at p. 129.]

Mr. GUARINI. I would like to call to the table David M. Walker, on behalf of the Association of Private Pension and Welfare Plans. He is with the accounting firm of Arthur Andersen, and is the former Assistant Secretary of Labor for Pension and Welfare Benefits.

Also Robert C. Baker, chairman and CEO of the National Realty and Development Corp. He is a developer and manages 70 shopping centers here on the east coast. George Vallone, vice president of West Bank Construction Corp., cofounder and officer of the West Bank Construction Corp. and president of West Bank Realty, Inc. His company has developed residential property, especially in inner cities, and he is currently building low-income and two-family modular houses in New Jersey. Also, Eliu Rivera, who is the director of PACO, a local community organization in Jersey City which assists members of the Hispanic community in housing matters, including mortgages and other social services.

We thank all of you gentlemen for being here.

STATEMENT OF DAVID M. WALKER, NATIONAL DIRECTOR, COMPENSATION AND BENEFITS PRACTICE OF ARTHUR ANDERSEN & CO. ON BEHALF OF THE ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS, INC.

Mr. WALKER. Thank you, Mr. Chairman. I am national director of the Compensation and Benefits Practice of Arthur Andersen & Co. Prior to my current position I served as Assistant Secretary of Labor for Pension and Welfare Benefit Programs for the Department of Labor. I am also chairman of the Association of Private Pension and Welfare Plans' Investment and Accounting Issues Committee. The APPWP's over 400 members sponsor or provide

services to employee benefit plans providing pension and health care benefits to over 100 million participants.

Some might ask why is the APPWP testifying before this hearing. I think there are three reasons for it.

First, we hope our appearance here will advance congressional appreciation of the critical role that pension funds play in providing capital to fuel economic growth, provide jobs, and enhance our competitive posture.

We have also come to express our concern that certain tax policies put into place in the 1980's may seriously erode America's capital needs. I am here to express our support for the basic fiduciary standards under ERISA which serve to protect these plans and opposition to any proposals that would serve to mandate any particular investments by pension plans.

I have provided a copy of my statement and certain material for the record, which I would commend to you at some point in time. In particular the APPWP report entitled Return on Investment: Pensions Are How America Saves. That report contains lot of valuable data which I would commend to you and other Members of the committee. The report was put together by Prof. John Shoven from Stanford University.

[The report referred to above may be found at end of hearing.]

Mr. WALKER. The role of private and public pension systems is well understood. What is less appreciated outside of the benefits community is the critical role that pensions play in the American economy. This can best be demonstrated by reviewing the size and growth of pension assets in the last several decades.

In 1950 the pension system contained \$17 billion and accounted for approximately 2 percent of national wealth. Today it is estimated to comprise about \$3 trillion, and constitutes 17 percent of all national wealth. About three-quarters of these assets are held by private pension plans, and about one-quarter are held by public plans, excluding the Federal Government.

The growth was stimulated in part by enlightened legislative policies, most notably the passage of the Employment Retirement Security Act of 1974. Importantly, the growth in pension assets during the past four years has coincided with what otherwise has been a general collapse in America's domestic savings rate.

While aggregate net savings as a fraction of GNP was remarkably constant between 1950 and 1980, the 1980's tell a very different story. Net national savings were a little over 3 percent of GNP during the first half of the decade and approximately 2 percent of GNP in the second half. That is down to approximately 7 to 8 percent from 1950 to 1980. About 2 percentage points of this 5 point drop was caused by increasing Government deficits and the balance was split between households and business.

The one bright spot in this otherwise dismal savings and capital formation rate has been the growth of private pension assets. And, in fact, to quote from the Return on Investment publication that I referred to: "For the decade of the 1980's, the real value of pension assets went up by more than did the real value of national wealth."

This is one of the most amazing and unappreciated facts about the performance of the U.S. economy and the importance of pension plans in that economy.

Despite this remarkable record of capital formation by pension funds, the future presents a less than rosey picture.

While the rest of the economy was being deregulated during the 1980's, the budget reconciliation process of the last few years has in our view, resulted in unreasonably curtailing appropriate funding of pension funds. While the ultimate outcome of this activity would be a reduction of pension security for retirement purposes, there are also profound effects on national savings and capital formation that can be achieved through the private pension system.

Specifically, there are three reductions in the 1980's including some as part of the Tax Reform Act of 1986 where I understand that about 15 percent of all the revenues that were generated through that act were the result of reductions of preferences accorded to pension and employee benefit plans. There are three specific reductions in the 1980's that occurred that are noteworthy. First, a reduction in the maximum amount of pension benefit and contribution limits; secondly, a reduction in the full-funding limitations for defined pension benefit plans; and thirdly, additional changes in complexity in applicable tax rules related to qualified plans.

This area of tax law has become so complicated that had the sheer complexity and administrative expense associated with maintaining a pension plan has become a significant barrier to those who wish to start or maintain a plan, and we are seeing resulting effects on significant increases in the number of terminations as compared to establishments of plans.

In our opinion, many of these additional limitations or reductions in what have been called tax expenditures, which personally I believe should be referred to more as investments, many of these additional limitations which withdrew funding associated with pensions were based on, in our view, a flawed analysis.

For example, the method of revenue analysis used by the Congress to calculate the cost of today's private pension system ignores the present value of future associated tax revenues, which will ultimately be recovered by the Federal Government; some \$750 billion.

The revenue numbers used by the Congress serve to mislead decisionmakers into believing that pension incentives actually cost a great deal more than they actually do.

And, in addition, they also take attention away from the fact that pensions were our single largest form of domestic savings during these last several decades.

Additionally, I think it is important to note that there is an emerging trend that is occurring which I think you need to be aware of. It is a matter of concern. It should be noted that employers during the 1980's maintained total employee benefit costs as a percentage of payroll at a relatively constant level. This occurred despite the fact that medical costs, as a percent of payroll, rose substantially. While pension costs, as for the reasons I discussed before, declined.

As health care costs continue to expand—and assuming that employers will not be willing to devote additional percentages of their

compensation—of their overall expenses to benefits, which is reasonable to assume given the competitive climate today, both domestically and internationally, it is likely we will see pensions crowded out by increased medical costs.

With regard to ERISA's standards, under current law, employers are subject to three principal standards imposed by ERISA which govern the investment of private pension funds. First, plan fiduciaries are obligated to establish and maintain retirement plans for the exclusive benefit of employees and their beneficiaries.

Second, fiduciaries must act with the same care that a prudent person familiar with such matters would use if acting in a similar capacity and a similar enterprise having a similar purpose. That is the statute, not my language.

Third, fiduciaries must diversify plan investment so as to minimize the risk of large losses unless under the circumstances it is clearly imprudent to do so.

Over the years these standards have been challenged by those who wish to see greater pension investment in, for example, low interest mortgages, corporate enterprises, or even real estate. Most recently, a number of States and cities have sought and in some cases succeeded to borrow from State and municipal pension funds which are not subject to ERISA standards in order to help lessen budget deficits.

APPWP members strongly support the basic fiduciary standards espoused in ERISA and the protections they accord the American workers and retirees and would vigorously oppose any effort to dilute these standards, as has occurred in the public sector, or any attempts that would serve to mandate that pension funds must invest in certain types of investment vehicles.

In our view, professional plan fiduciaries, acting in the best interests of plan participants, are in a better position to judge the kind of investments appropriate for their participants. For example, a plan covering younger workers and relatively few retirees could invest in lower time horizons and lower liquidity, and, in fact, arguably pension plans represent—as long term investors who are investing for many years in the future, represent a very valuable and viable form of capital that can invest in prudent real estate opportunities in appropriate circumstances.

And yet, some plans have heavy ratios of retirees to actives and couldn't accept longer investment horizons or reduced or limited liquidity sometimes associated with real estate.

In conclusion, Mr. Chairman, the future economic growth of America depends in part on readily available capital for expansion.

Moreover to, the extent we seek to finance our capital needs with assets from abroad, we sell our children's birthright to future profits from today's investments. Our most important ally in increasing our capital pool is pension funds.

By restoring incentives to establish a pension fund, to permit reasonable funding of obligations, and providing a more stable and less complex set of operating requirements, we cannot only increase the retirement security of Americans, we will increase the economic well-being of the nation, the savings rate, and capital formation.

But while we need to encourage greater pension savings, any attempts to loosen ERISA's investment standards to favor one industry over another would be inappropriate, or any attempts likewise to mandate investments would likewise in our view be inappropriate in that it would put at risk not only the economic future of America but also the retirement security of millions of American workers and retirees.

At the same time, given the current credit crunch and the current conditions within the real estate industry, Congress may wish to explore ways to eliminate certain factors which serve to discourage pension plans from investing in certain types of alternative investments such as real estate.

For example, there are currently a number of provisions within the tax law relating to unrelated business income tax, which serve as a significant economic disincentive for pension plans to invest in certain types of real estate, including RTC properties.

Elimination of certain of these types of disincentives would remove a current barrier to selective investments by plans, in real estate investments which are prudent and have long term growth potential.

I thank you, Mr. Chairman, and I look forward to hearing the other witnesses.

[The prepared statement of Mr. Walker may be found at end of hearing.]

Mr. GUARINI. Mr. Walker, before you leave, I understand that pensions are certainly one way to produce savings, and our country is lower than any of our competitors or industrialized nation as far as savings are concerned. We probably are at the bottom of the list, but pensions do help considerably in collecting together capital as savings.

We have heard this morning that the real estate industry is perhaps taking the biggest hit in this economic downturn. I understand that all the pension funds that we have, and I think you may have thrown out a number of \$750 billion—

Mr. WALKER. \$3 trillion.

Mr. GUARINI. Only a small percent of that is involved in real estate investment. Am I correct when I say that only 5 percent of all those pension funds is invested in real estate?

Mr. WALKER. Mr. Chairman, if you are speaking of direct investment by pension funds in real estate, I think that is correct. However, I think it is important to note that pension funds also indirectly invest in real estate in various forms.

For example, to the extent that a pension fund would invest in a guaranteed investment contract issued by an insurance company, or in another type of investment arrangement, a bank investment contract, then indirectly, pension funds may have a much greater participation in real estate because the insurance company or the bank may be more heavily invested in that form of investment, which backs their promises to the pension funds.

Mr. GUARINI. That is indirectly. But directly you only have 5 percent, which is a very small amount; is that correct?

Mr. WALKER. Less than 5 percent, but that is a lot of money.

Mr. GUARINI. There is the other 95 percent of the money out there, and I am wondering whether or not, having been here this

morning and listened to Mr. Seidman and Mr. Trump, you feel that the credit crunch that we have could be alleviated in part by larger investment from pension funds?

Certainly there are a number of sound investments that are out there, and the amount of money that you have tied up in pension funds could go a long way to alleviate some of the credit crunch that is really dragging our country down today. We are going down into a very deep recession, if not depression, the worst since World War II.

Can you make any statement or comment as to how pension funds could help the present crisis?

Mr. WALKER. Well, clearly pension funds represent a tremendous pool of capital. I think the important point is that to the extent that the Congress can focus on certain aspects of the tax laws which I mentioned, it might serve to eliminate an economic disincentive for pension funds to invest in certain forms of real estate. I believe it would be fruitful for the Congress to look at trying to eliminate those disincentives.

I think they can and would, possibly, invest more in real estate, if that economic disincentive was eliminated. They have the ability to do so if it is approved investment, because they are long-term investors.

Mr. GUARINI. But all the tax laws favor investment because of tax reinvestment opportunities. I wonder whether other investors are treated as generously as pension funds?

Mr. WALKER. In general, Mr. Chairman, you are correct that we have significant tax preferences which I call investments associated with pension funds. However, pension fund earnings can be subject to tax under the unrelated business income rules.

Mr. GUARINI. I understand that.

Mr. WALKER. And many of those provisions affect real estate investments by pension funds. And so to the extent that you are looking to try to encourage greater participation of pension funds and real estate investments, I think it would be worthwhile for the Congress to look at the VBIT area.

What I would be very concerned about, Mr. Chairman, is while I think it makes sense to try and eliminate any inappropriate disincentives, at the same point in time not to lose sight of the fact that these funds have to be managed prudently, in the interests of beneficiaries, and using sound economic principles so we don't end up compromising long-term retirement security.

Mr. GUARINI. I agree with you. If we are on the verge of a depression, which may go on for many years, the rest of your pension funds have to be affected by what happens in our overall economy. So I think it would be worthwhile to take a broad look at the picture instead of investing in only narrowly defined areas as you do now. If there is any way the Congress can be of help, let us know. I understand you have a fiduciary relationship that has to be honored and respected so that pension funds are secure, and that there are should be no risks taken that are unwarranted. Still, I feel that there is some latitude where you could help with this credit crunch considerably. Mr. Rogers.

Mr. ROGERS. Thank you. Mr. Walker, you may have mentioned this in your testimony. I didn't catch it. But are there any of the funds in economic difficulty during this frame of time?

Mr. WALKER. Any of the pension funds? Economic difficulty?

There are a number of defined pension plans which, as you know, Congressman, are insured by the Pension Benefit Guaranty Corporation, that are underfunded in that their liabilities exceed their assets. In general, most defined benefit pension plans are well funded, but they are becoming less well funded because of some of the restrictions that I mentioned before that are being placed on their ability to fund on a tax deductible basis.

But they are generally not leveraged. Pension funds are generally not engaging in debt-oriented investment activity. By that, I mean leveraging their investments, if you will.

Mr. ROGERS. We heard Mr. Seidman this morning and later Mr. Trump in even more pronounced fashion say that the one thing that they would change, if they could, was the 1986 law to reinstate the passive loss for real estate. How important do you think that is in coming out of our economic problems?

Mr. WALKER. It is not an issue that bears as directly on pension funds, obviously, as it does on investors who are taxed on their gains, if you will.

So clearly I think from a macro viewpoint it is an important issue. It is less of a matter of concern to pension funds.

Mr. ROGERS. Thank you very much.

Mr. GUARINI. Thank you very much, Mr. Walker. I thank you for having waited. I hope you catch your plane.

Mr. WALKER. Thank you.

Mr. GUARINI. Mr. Baker, chairman and CEO, National Realty and Development Corp. We welcome you here. If you have a statement, you may put it in the record.

STATEMENT OF ROBERT C. BAKER, CHAIRMAN AND CEO, NATIONAL REALTY AND DEVELOPMENT CORP.

Mr. BAKER. Thank you, Mr. Chairman and members of the committee. I have a statement that I request be put into the record. I see no reason to take the committee's time to read the statement.

I could furnish you the name and phone number of the intelligent lady in the second row.

Mr. GUARINI. Who I understand is your wife.

Mr. BAKER. Who is my wife. I will take the risk of being held in contempt of Congress by not furnishing this information.

I would like to comment on two points that have been discussed, and possibly take them from a slightly different viewpoint. The banks are not only reluctant to make real estate loans, they refuse to make real estate loans. The only kind of loans that the banks want to make are loans that are fully collateralized with liquid assets. In effect, the banks would like to lend you back your own money.

In today's world, your banker is someone who lends you an umbrella when the sun is shining. Recently a bank, one of our lead lenders to whom we had repaid \$65 million in construction money over the past few years, wrote us a letter in connection with the

last \$600,000 that was due in connection with this loan. The money was due on November 3. It was a form letter advising us into what account, to wire the funds.

If we had continued to owe them the \$65 million, they would have invited us into lunch, wined us and dined us, and extended the loan. Since it was \$600,000 that we were readily able to repay, all they wanted was the money back. There was no question of extending the loan, notwithstanding the fact that it was a good loan, that we had the capability to repay the loan, and that we had the capability to continue paying interest on the loan.

When we had a subsequent meeting with them, they explained to us that they were under a mandate to reduce their outstanding real estate loans by \$8 billion, and that it didn't make any difference what type of past relationship they had, it didn't make any difference as to the quality of the loan. They just wanted the loan repaid.

The net result of this type of policy is that they will reduce the amount of their outstanding real estate loans, but they will hurt the quality of their portfolio, which will come back to haunt them in future years.

Somehow Congress must not only encourage the banks to lend, but they must make a difference in classification between good loans and bad loans. It is not just a matter of indicating to the bank that they must reduce their outstanding real estate loans; the banks should be rewarded for good loans as well as penalized in their reserve requirements for bad loans.

Without going into all of the reasons that have already been stated, yes, of course, lower interest rates are good. They have been helpful, certainly, in encouraging the residential real estate market.

Yes, of course lower capital gains rates are good. And of course, most important, yes, the passive loss provisions must be reworked.

But we really don't need any more vacant office buildings. We don't need any more vacant shopping centers. We don't need any more housing built in the wrong places without considering the needs of the area. These incentives somehow have to be limited to sound real estate types of transactions.

Much of the problems that we face today result from greed and ignorance. Traditionally, the public doesn't understand real estate, and time and time again is brought into real estate transactions that they don't understand for the wrong reasons which permits real estate projects to be built that never should have been built in the first place.

We learn our lesson, then we forget our lesson and we end up you with problems again.

These changes must be made, but they must be made in such a way as to solve the old problems, not to create new ones.

[The prepared statement of Mr. Baker may be found at end of hearing.]

Mr. GUARINI. Thank you very much.

Mr. BAKER. It was brief, but it was where I wanted it to go, Mr. Chairman.

Mr. GUARINI. We'll have a question and answer period right after we have Mr. Vallone and Mr. Rivera testify. Mr. Vallone?

STATEMENT OF GEORGE VALLONE, WEST BANK CONSTRUCTION CORP., HOBOKEN, NJ

Mr. VALLONE. Thank you, Mr. Chairman.

Unfortunately, my reputation doesn't precede me, so I will take a minute to tell you that I started a real estate back in 1980 with a partner that I had met while in college. And we were very lucky to have picked not only the right place, what they call the Gold Coast of New Jersey, where your home district is, but also the right time.

Tax laws were changed in the early 1980's, the economy revved up, jobs were created, and there was an enormous expansion of office space and jobs, all of which were filled in the early to mid-1980's. There was a tremendous housing demand.

It was in supplying that housing demand that we concentrated our efforts. We went into large projects involving mid-rise and ended up in the mid-1980's developing some high-rise projects. Our successes at that time was in no small way attributed to the tax law changes at the time.

As Mr. Trump had mentioned, we had doctors and lawyers literally contacting us and asking us if there were developments that they could participate in that would help to shelter some of their income, and at the same time generate, good projects, good housing.

And it was around the mid-1980's that our banks actually approached us and said, look, why are you doing syndications and giving your limited partners, these doctors and lawyers and professionals such large shares of the money?

We are putting up 80, sometimes 90 percent of the financing, and we would like to put up 100 percent and share in some of those profits. So our growth path was faster because we didn't even have to go through syndication at that point. We were working strictly with banks.

After the Tax Reform Act of 1986, we had already in the pipeline enough work that carried us right through until 1988. So its immediate effects were not apparent to us.

First of all, I just want to mention that the statement I am submitting, I would like entered into the record, as well as my oral comments to it.

The effects are pretty nicely illustrated on a chart which is the last page of the statement that I submitted to you, and it talks about—there is two charts. Chart 1 talks about total credit activity, and chart 2, credit activity by source between commercial banks and thrifts.

It is interesting to note that on chart 1, it is quite clear that by the time we hit 1988, thrift activity started dropping, and depository activity started dropping off dramatically, so by the third quarter of 1989 it went negative for the first time in recent history.

If you look at chart 2, it is even more telling. Thrift lending began dropping off in the second quarter of 1987, and by the second quarter of 1989, it went negative. And you can see by looking at the other trend line which is commercial banking, there was no make-up of the credit activity. In fact, commercial banking activity also trailed off beginning in 1989.

And so while the thrifths were retracting and making less and less credit available, you had no private syndication ability, you couldn't go to the equity markets because of the tax reform changes, and the commercial banks weren't stepping in and increasing their lending activity at all, and, in fact, were trailing off in step with the thrifths.

So the crunch was quite apparent at that point, and the lines on the chart just are even more compelling at making the point. We are deeply mired in the real estate industry, in an economic depression, and particularly real estate in the northeast.

All of the States around us, New Jersey, New York, Connecticut, are doubling their budget deficit projections now, and that is after significant tax increase. Things are still going worse than they even anticipated when they enacted the tax increases.

The vicious cycle of slow lending activity leading to slower economic activity, which reduces lending activity and further slows economic activity is just spiraling away. I think a hearing like this, as well as efforts that were taken in March, October, and in November of this year, initiatives to try and relieve the regulatory credit crunch, show there is an awareness, a proper awareness coming.

Most of the comments that were said earlier regarding the different tax law changes I am completely in agreement with, and I think we need to reemphasize that. The statement—I don't want to read the statement, I just want to point out that there are a number of recommendations that were prepared by the National Association of Home Builders who worked with me on preparing this statement.

I am a member, have been for 10 years, wish Donald Trump would be, because in one hearing he can get more press and attention than all our lobbyists can get working day and night, 365 days a year.

There are a number of suggestions regarding fine tuning the capital requirements. We are looking for a delay in the scheduled implementation of the phase-in of new capital ratios.

As recently as, I believe, a week ago, the Banking Committee said that this was "out of order," and that they didn't want to hear these types of suggestions. I would urge you to consider anything that can help pull us out of the credit crunch we are in right now as not "out of order," and in fact, if it is possible, that if this issue comes to a floor vote, you seriously consider voting for it.

The study goes on for about four or five pages of real nuts and bolts suggestions that I think would go a long way to relieve the credit crunch and the credit crisis we are in right now. All of them, taken by themselves, are small improvements, but taken together, packaged together, I think they would have a dramatic impact.

How do we in the real estate industry hope to lead the economic recovery? Well, many of the things have been said already and I will touch on them briefly. The repeal of the passive loss restrictions for real estate investors. We have got to allow them to participate, the small investor, to participate in rental real estate, deducting their losses without limitations and thereby encourage investment in multi-family housing.

We need a package of incentives creating tax credits for moderate income, low income, first-time home buyers, allowing the penalty free withdrawals of IRAs for home purchases. Most people's biggest investment and biggest savings and, in fact, their estate, if you will, is their home. They pay it off and pass it on to their children, and that is usually one of their biggest savings. So an IRA, which is that same type of saving for the future, should be convertible to a housing asset used for yourself to buy a home.

The low-income housing tax credit, the mortgage revenue bond programs, all have to be extended and continued, or there is going to be no source for the low income, and of course the reinstatement of the capital gains rate for the real estate and other types of assets.

Recently, there was a report to Congress from HUD on rent control, the effects of rent control in the country. I would urge you to read the report. I just finished it, and I think what it proves is that rent control doesn't really serve the people it is trying to protect. It is really protecting people in middle and upper income brackets, and it is not protecting the poor people.

I would urge that rent control be phased out on a national basis with the last section of the phaseout being the poor people who need it most. Life estates in rent controlled properties for the poor is an important safety net that we can put under poor people for housing, but it certainly isn't required for middle income and upper income people.

In New Jersey, government is trying to encourage the construction of rental housing. Some years ago, the State passed an exemption on new rental housing, exempting it from all municipal rent controls. We are also looking to put an exemption from any condo conversion restrictions on new rental housing.

By taking away the two major uncertainties of a developer who wants to build rental housing, am I going to get rent controlled? am I not going to be able to convert the property if it is not working as a rental to a for sale format? If we can eliminate those two negatives, I think it is going to go a long way to encouraging new rental housing.

I want to take a minute or two to tell you what I think is at stake if this credit crunch—

Mr. GUARINI. Could we, Mr. Vallone, do this in a question and answer period that we will have shortly? We will put all your remarks into the record, your report, and then in the question and answer period we will be able to address the other issues we wanted to address.

Mr. VALLONE. Well, I would like to finish making the two or three points I wanted to make.

Mr. GUARINI. Please do so.

Mr. VALLONE. If the credit crunch isn't resolved, we are going to lose our cities. Seventy-three percent of Americans live in urban areas versus suburban and rural areas. Now they are places people want to escape from.

If they can get out, they move out and what is left behind is the working poor and the unemployed. Those people have no choice. The working poor struggle to remain within the system. Credit available to buy houses is practically nonexistent, subsidized hous-

ing is nonexistent, and what is happening is that the people that fall outside of the system become unemployed or unemployable, they become the burglars, robbers, muggers and drug dealers.

And the cost, in terms of the budget deficit in these types of locations—people that are inside the system being forced outside of the system—is a tremendous cost and its going to aggravate the budget deficit tremendously. We have to give them a stake in society, the poor people.

All tax regulations, all monetary and fiscal policy, almost—I would almost be tempted to say regardless of the impact on the deficit right now—has to be brought to bear, because we are not going to save the cities, we are not going to save these people and we are not going to give them an opportunity to work within the system.

We have an annuity choice to make right now. If we make the kinds of decisions that bring people inside the system, then rather than spending money every year on police, chasing down criminals who are forced to work outside of the system, the justice system, paying for their room and board while they are in jail because they couldn't get a job and no other way to make money, the annuity will go out. The other way there will be payroll taxes coming in, sales taxes coming in, income taxes coming in, all the different things they purchase. Most of these suggestions do cost money. The budget deficit may widen.

But where do we want to spend our money right now? We want to spend it on an investment in the future. If 30 years from now our children inherit as large a budget deficit as we have now, but we have taken care of the cities, we have gotten people good housing, we have given people jobs, they will understand why we did what we did.

Seventy-three percent of Americans are going to judge the Congress of today by the efforts they make in effecting the quality of life of their life in American cities. So we need to open up credit, target the credit to jobs and homes for the poor and the working class and create an opportunity for these people to join in on the American dream.

Thank you.

[The prepared statement of Mr. Vallone may be found at end of hearing.]

Mr. GUARINI. Thank you very much. That was a very fine statement.

We have Robert Baker, who has a farflung shopping center empire in 15 different states, and you, George Vallone, work in the inner city, and are involved with some low-income housing trying to work the problems of the inner city out. And Eliu Rivera, who is also a longstanding friend of mine, is a minority person who is in the front trenches of the credit crunch. His people are very much affected by the fact that there are no loans available, particularly in regard to minorities. So Mr. Rivera, if you will, start your statement.

STATEMENT OF ELIU RIVERA, HOUSING COUNSELOR, PUERTORRIQUENOS ASOCIADOS FOR COMMUNITY ACTION, JERSEY CITY, NJ

Mr. RIVERA. Thank you, Chairman Guarini, good afternoon, and Members of the Congress.

My name the Eliu Rivera, and I am the executive director of Puertorriquenos Asociados for Community Organization, better known as PACO. Our organization, which has been in existence for over 20 years, works with the Hispanic community in downtown Jersey City.

Most of the members of our community are low and middle income residents, members of the community that run and operate PACO since our inception and first days in a cold water flat in Jersey City. We have strived to improve the quality of life for Hispanics and all residents of the downtown Jersey City.

In addition to the many social service programs we have put together, one of the most pressing needs that PACO tries to help is housing. We have worked with other community groups and government programs to build affordable housing units. We offer assistance for those looking to secure affordable housing, or those with housing problems.

Finding affordable housing and getting financing for our housing has never been particularly easy in our communities. We have many low-income residents. Added to this has been the language and cultural barriers that confront Hispanics.

During the past year, as the recession has taken a heavy toll on our area, the problems in getting housing and financing have increased greatly. We live in a county that has the highest unemployment rate in the state of New Jersey. There have been record numbers of foreclosures. Banks are not doing well in our area, so they make it tougher for our residents to get the financing they need to either buy a home, refinance a mortgage, or improve their properties.

Some of the reasons—some of the reasons for the new toughness on the part of the bank is because they are tightening the requirements and taking less risks. This is to be expected. Someone who has defaulted on loans or shot their credit rating cannot expect to have the bank throw money at them. But in many instances, we are seeing residents rejected for loans, for nitpicking reasons. One late payment on a previous loan is sometimes enough to reject a mortgage request.

In an area of high unemployment, low income precedents, you have to understand that there is a great chance that those conditions have lead to a person of our own to come into problems at one time or another. But this shouldn't affect those that have gotten back on their own feet.

While we can't expect the banks to take risks that don't make sense, they also shouldn't be so risk adverse that it makes it impossible for people to get the financing they need. And some of the reasons that the banks are tightening are beyond the control of the average resident like myself. Property values have skyrocketed in our community in the late 1980's. With the recession, they have fallen. Combined with higher taxes due to overvaluing of the prop-

erty lower incomes because of the recession, many property owners have defaulted on their mortgages.

As more people default and the bank gets stuck with the mortgages—as more default on the bank and the—more properties, the banks are so afraid of more defaults that they make it tougher for those of us who are not bad risks.

Every day at PACO I see people who need financing, but their attitude now is, not to even try going to the bank for a conventional mortgage. They figure they don't have a chance. I, myself, have discovered how tough it is to get financing.

Less than 2 years ago, as the banks were starting to tighten up, I and my wife applied for a loan to do home improvements. We wanted to refinance our existing mortgage so we could fix the roof, weatherize the house, and improve the general conditions of our property.

I and my wife both work; we both have good credit ratings, but our loan application was rejected. Why? Because more than 8 years ago she had a problem with a loan, she cosigned a loan with her brother, he skipped town and stuck her with it. She eventually repaid the loan, but this is one problem that has been held against her.

Because people can't get conventional loans, they turn to us and ask us for help in finding affordable housing to government programs. This puts a strain on the limited subsidized housing that is available. Government funding for new projects is shrinking.

We in PACO have had some success in building affordable housing projects, but there is not nearly enough housing for those who can't afford a conventional mortgage. In the end, the government and the taxpayers end up paying because the banks are so reluctant to lend.

This reluctance to lend also effects the overall value of properties in our community. People can get the money to improve their homes or businesses. This means that the community slides, businesses leave, and money goes out of the area. This leads to more foreclosures which leads to the banks becoming even more reluctant to lend money in our community.

It is a vicious circle and the average working people are the ones that are getting hurt. The banks cannot take stupid risks, but they have to look to encourage home ownership and improvement within the community. And government has to work with the banks to develop programs that help people obtain conventional mortgages. If not, government will have to spend even more money in providing housing, social services for residents.

Thank you.

[The prepared statement of Mr. Rivera may be found at end of hearing.]

Mr. GUARINI. Thank you very much, Mr. Rivera.

George Vallone, you work in inner cities, you deal with the banks directly, and you are involved in housing. You have heard Mr. Rivera's story. Is there that much more of a problem in inner cities from your experience in getting bank loans than one would expect in other areas of the country?

Mr. VALLONE. Yes, there is, Mr. Chairman. I think the problem is that the values and the trend lines in the city are that values

are less and less year after year, so you are running into a problem where the bank wants to fix a loan value and then lend against that value. But they know, or at least they think, that in subsequent years the value will go down. So what they think they are buying into is a slowly declining collateral value and it scares them away.

Mr. GUARINI. Well, Mr. Rivera says that he and his wife both have jobs, and they only applied for a home improvement loan, and they got turned down.

Mr. RIVERA. Yes.

Mr. GUARINI. Now, is this a common situation that you see in the inner cities, or is it because he is a member of a minority? Can you comment on how minorities do and how other people in inner cities do?

Mr. VALLONE. Well, because of the flight of the middle class and the upper class, I think mostly you have minorities left in the cities right now, because they haven't been able to raise themselves to the level where they can escape.

The programs we are working with right now, and the housing we are building, wouldn't be possible without government subsidies. We have state subsidies, county subsidies; the housing and mortgage finance agency provides the mortgage financing. It is a package of subsidies that I don't think your average developer could work his way through the system and put the package together to create and deliver the housing at the kind of prices we are doing.

It is just a tremendous, tremendous regulatory nightmare, co-ordination of all the agencies. The bank is funding about 50 percent of the cost of the housing, and the rest of it is coming from all these different sources; city, state, county.

Mr. GUARINI. Well, is there a trend that is getting tighter and tougher in getting housing loans in the cities?

Mr. VALLONE. Since we started doing these low income modular housing—what we are seeing now is that I think we have turned attitudes around. We have taken several neighborhoods in what was one of the worst parts of Jersey City and where there used to be repossessed, vacant properties with crack vials and rubble and condoms all over the place and now you are seeing two-family housing where people go out to work everyday, they come home, they clean the street in front of them, they cut their lawn, and you are starting to see a turnaround now in what I hope will be perceived as neighborhood values.

And through an accumulation of these kinds of activities going on, we may even get to the point where regular market rate housing, without the subsidies, will become feasible in these neighborhoods, because we will have turned the perception of the lenders around.

Mr. GUARINI. Are banks doing less red-lining than they traditionally did before? Has that changed very much?

Mr. VALLONE. Well, I think the whole awareness levels now about the Community Reinvestment Act has caused bankers to be a lot more wary about red lining. There are now people out hunting for them and doing studies, red lining studies. So they are not

going to get away with it anymore the way they used to, just by ignoring the problem.

But they have to be brought to the table kicking and screaming. They are not putting up signs that we are looking to build lower income housing in the ghettos anywhere.

Mr. GUARINI. Mr. Rivera, I understand that it is not only minorities who have difficulty getting loans, but women also have difficulty getting loans. What happens to the people in the community after they fail to secure a mortgage loan, a conventional mortgage?

What have you seen—because you deal with many people, and I understand that you have helped people try to get loans—besides trying to get loans for yourself?

Mr. RIVERA. Once the people have tried all means of getting the loan or mortgages approved to buy their property and they are turned down, what happens is they turn to us for the possibility of us getting them affordable housing. How it stands, affordable housing, there is no—not that many available, and we also have to turn them down.

In turn what happens is, we wind up having then moving out of our areas, moving out of our city, either going to Florida or to their mainland, but that has been the case, Mr. Chairman, when people have been turned down for the mortgages.

I think that we need to stress the fact that more Federal funding is needed to supply the demand of affordable housing, especially in Jersey City and Hudson County. I think without those mechanisms, the cooperation of the lending institutions and the Federal Government working, both together, to try to meet the needs of those people that want to become homeowners, we certainly have to have them both work together to assure the possibility of getting the—meeting their needs.

Mr. GUARINI. Thank you.

Robert Baker, what should Government do? There is tremendous overbuilding in commercial property, and shopping centers, and some have alleged that it is a matter of the Tax Code; some say it is the banking regulators who are too stringent, overzealous. What do you think should be done? If you had a wish list that could correct the present situation that we are in, whay would it look like?

Mr. BAKER. Giving specialized treatment to the properties held by the Resolution Trust is certainly not the answer, as it was suggested here earlier today. To permit those properties to go out on the market at even lower prices than they would go out at at the present time would just put them in competition with the properties held by the banks and the properties held by individuals.

Mr. GUARINI. Some people have said that tax credits should be given in order to spur the liquidation of the RTC properties. Do you think this would be an unnecessary governmental expense?

Mr. BAKER. It would not necessarily be an unnecessary Government expense; it would hurt everything else, because those properties would then go out and compete with the other properties on the market, forcing those properties to go into foreclosure, back into the hands of the RTC.

The problem is is that everyone is chasing too few tenants. Somehow one has to either encourage the economy to expand so that

there will be more tenants, or to take some of the inventory off the market.

It has been suggested that some of the RTC properties should be temporarily warehoused. Politically, that is probably unacceptable; something that certainly isn't going to happen, because the mandate is to push the properties out, just as the mandate to the insurance companies and banks that hold real estate is liquidate.

The banks are not in the business of lending money; they don't want to make fees, they don't want to earn interest. What they want to do is take a loan which was once \$20 million that they have written down to \$8 million and they want to push it out on the market at \$11 million and claim that they made \$3 million. That is not the true solution.

The passive loss provisions would certainly help to encourage the real estate market—

Mr. GUARINI. Are the asset managers capable of managing these huge portfolios? The Government is the biggest owner of real estate in the world as a result of the savings and loan fiasco. Are these asset managers doing an adequate job, in your opinion?

Mr. BAKER. We own some 70 shopping centers. We have 80 very, very experienced professionals that work for our company, and we have a very, very difficult time in today's world to properly manage the real estate that we have, because it is no longer a matter of plowing parking lots and fixing roofs.

The management of real estate under present market conditions require a tremendous amount of experience, time, and money. One has to rerent buildings that have been vacated; one has to tear down existing buildings and build new ones. One has to get new approvals for properties that once had approvals. There is no question that the RTC does not have the capability, nor do the banks.

Mr. GUARINI. Have insurance companies and pension funds, with their resources, helped the credit crunch enough? Have you been able to go to these sources instead of the traditional conventional banking sources?

Mr. BAKER. There are no sources of money, Mr. Chairman, at the present time. If we wish to improve a shopping center, or if we wish to demolish a building we must fund it out of our own funds. We recently had a 20-year lease with WalMart in an upstate New York community to replace an old tenant who had recently filed Chapter 11. We were able to demolish a 20-year-old building and build a new building for WalMart. We had a permanent take-out commitment and we went to our lead bank. Our lead bank said that they could not give us \$1 of construction funds for this project. We went elsewhere and the funds were not available.

Mr. GUARINI. I have to leave for a vote. I will leave the chair in the hands of Hal Rogers and I will be right back.

Mr. BAKER. Thank you, Mr. Chairman.

Mr. ROGERS [presiding.] Well, thank you, Mr. Chairman. I'll take up from there.

Mr. Baker, in your statement you talked about the need for the reinstatement of the passive loss provisions in the '86 act. But you had some cautionary words; I don't recollect the exact words. I think you were referring to perhaps some excesses that took place before 1986, and you said that we should make sound investments.

And I underline the word sound. How do we release—in the event we reinstate the passive loss provision, how do we release, if at all, these investments so that we don't get ripped off?

Mr. BAKER. Very difficult question, Congressman. Certainly one can use words and suggest that they should not have merely tax shelter aims, they should not be tax gimmicks, they should have sound economic aims. This eliminates projects on this side and projects on this side, but the definition of the projects in the not easily defined middle is very, very difficult to come by.

Does one restrict these benefits against office buildings being built in a market that is saturated with vacant office buildings? How does one define what is saturated? You raise the very, very difficult questions that a Solomon would sit and solve. We don't have a Solomon.

You had Bill Seidman who is probably as bright and capable a person as you possibly could have had to take over the RTC, and when I met with him at lunch two years ago he said, it is mind boggling, the problem, which it was. And if he wasn't able to do it, who can do it?

But yet, suggestions like raising the income tax rates so high that people will be encouraged to go into real estate transactions may just encourage the wrong type of real estate. You don't want to make it so easy that people are going to go out and start building bad real estate projects all over again.

Mr. ROGERS. Well, and I think that is the central point there. You know, some of our large cities are full of high-rise, beautiful glass buildings that are empty, as a result, I would assume, of perhaps speculative building under the old passive loss provisions.

And then like yourself and many others like you, you did not speculate beyond expectations. I mean you were reasonable about it, you were prudent. But for every prudent investor, there were some others who were not so prudent, and we wind up paying the bill in the RTC now.

Is there a way in reinstating the passive loss provision that we can protect all of us from those excesses? And if so, how?

Mr. BAKER. That is a very difficult question. You certainly can, you certainly can create more realistic depreciation schedules, and remove the passive loss provisions without making them so permissive that the write-offs would be so—would be so large that they would encourage people to enter real estate projects merely for the sake of entering into the real estate projects.

You could prevent the projects from being over leveraged so that they would be creating losses that could not possibly be covered by gains in later years, no matter what the expectations are. Again, one of the reasons that our company does not have this problem is that we use our own money. We didn't do syndications; we didn't do limited partnerships. It mitigates toward us being much more careful than other people might be.

We were offered shopping center projects, the promoters ran them into a computer, and they projected that the rents were going to go up so much every year, and that the percentage rents were going to go up so much every year, and that the property was going to be worth so much in 3 years, so much in 5 years, so much in 8

years, so much in 10 years. It didn't matter what you paid for it initially, the more you paid, the bigger your tax writeoffs were.

But yet if anyone knowledgeable looked at the real estate deal, one could see it was not economically sound and whether it took 3 years or 5 years, the expectations were unreasonable, the property would run into economic problems, the projects would be foreclosed on, and the investors, the doctors, the lawyers and others who bought the limited partnership shares would end up having to pay large amounts of taxes without having the income in order to defer them.

Mr. GUARINI. What percent—can you tell us what your vacancy rate is now, overall, in your shopping centers, or is that classified?

Mr. BAKER. No, it is not classified. It is not classified at all. With the exception of approximately six or seven shopping centers that have large vacancy rates as a result of tenants that have recently gone Chapter 11 and have not been recycled yet, the vacancy rate is probably in the 5 percent range; very, very low.

Mr. ROGERS. What would be average in decent times?

Mr. BAKER. In decent times, that 5 percent would be average. Our shopping centers have been impacted very slightly so far, because they are primarily strip shopping centers in smaller communities with very little competition where there is a need for the project as a place for people to shop. These areas have not been overbuilt and the 75, 80 percent of the tenancy is represented by two or three large stores leased to major national tenants under long-term leases.

The shopping center industry is not suffering, other than in isolated areas, as seriously as other commercial real estate, particularly office buildings. However, you still can't get any financing for them.

Mr. ROGERS. You have shopping centers in the New England area?

Mr. BAKER. In where?

Mr. ROGERS. In New England?

Mr. BAKER. In New England, yes.

Mr. ROGERS. Is that area worse off economically than any of the other areas you are in?

Mr. BAKER. I would suggest that New England is certainly suffering. However, the shopping center we have in Brattleboro, VT, where it is impossible to build any more space, not only has not lost value, it has increased in value.

Another shopping center in Northampton, MA, is tenanted by a large national tenant and has not felt much impact. There hasn't been an increase in sales, but there hasn't been more than a couple of percent in reduction in sales.

Mr. ROGERS. Mr. Rivera, I understand you have a train or a plane to catch fairly shortly. Perhaps we could ask you a couple of questions and then perhaps you may want to leave to catch your transportation.

What do you suggest, from your experience, would be something that the Congress ought to do, or the President could do, or the regulatory bodies could do to ease the problems that you are experiencing and your people?

Mr. RIVERA. My recommendation is that the Federal Government work hand in hand with the private sector to bring about the kind of program that will hopefully meet the needs of these low-income residents that we are talking about.

I believe that we would have the support of both the government and the private sector. Without that support, there is very little that can be accomplished. Affordable housing funds definitely will help to resolve, partially, the problem.

Mr. ROGERS. Well, I thank you very much. Mr. Vallone, in your written testimony you have put together a Bible of what we should do in great detail. And we appreciate your written testimony very much.

And Mr. Rivera, thank you for much for being with us, and I understand you need to travel.

Mr. RIVERA. Thank you.

Mr. ROGERS. Thank you very much for your nice testimony. Mr. Vallone, I know you summarized your testimony as you testified. But if you could, give me a very brief summary of what you think the Congress can and should do, and what the President could or should do, and/or what the regulatory agencies could or should do.

Mr. VALLONE. Well, I think it is an oversimplification to say that they have to make decisions that are going to encourage people to start investing in real estate again, and I think the passive loss rule changes, and depreciation changes, and changes like that are going to alleviate the credit crunch by bringing in new sources of capital.

Your question earlier, if I may, I wanted to make an extra comment on that because you were—I mean the Solomon's question here about how do we change the laws to encourage people to start investing again, but not in bad deals.

I think that whenever you make a change, like was made in 1986, where you suddenly take the playing field and the sets of rules and you radically alter them on the side of conservativeness and restrictiveness, you are getting in the way of the natural economic forces of equilibrium. It is a cyclical industry, and when there are excesses, there is wipeouts of the excesses and then it retrenches. There is a retrenchment and you find that equilibrium again, and then you know, depending upon which end of the curve you are on, demand either heats up first or supply heats up first. So whenever you make radical changes on the side of restrictiveness, you are getting in the way of that natural equilibrium process and you are interfering with the natural cycle of it.

So I would just say one thing Congress can do is be very careful when they consider changes, particularly change on the side of restrictiveness. The other comment I would like to make with your permission would be as to the RTC and how they can better off-load their assets without causing the taxpayers to take a bigger and bigger hit.

I think the No. 1 thing they could do to help is to provide financing. There is an old expression in real estate, I will give you your price if you give me my terms. If RTC wants to mark down to market value and provide financing, I think it is a pretty safe way to convert what is a liability right now on the books into an asset.

You push the ownership onto the private sector, you retain the financing for them, and now that mortgage on that property is an asset you have got. And I think it would make the books look a lot better, and I think it would allow the props to be sold at higher prices, and I think it would allow a much, much faster disposition of the asset base, because it would be one of the few places people would go to because there is financing.

You know, people pursue financing anywhere they can find it. If the word comes out that RTC wants to sell property, and they will consider financing right now, I think that would cause a little bit of a rush. And I think that what you would end up seeing is properties would be selling faster, you would be taking less of a hit, you would be converting liabilities to assets, and you would be really bringing people off the sidelines. Right now most real estate investors are just on the sidelines.

They just don't want to get into it, and if you pull them out, off the sidelines and onto the playing field, I think you would find that things at RTC would be a lot better.

Mr. ROGERS. Interesting proposition. I thank you very much.

Mr. Chairman, I yield back.

Mr. GUARINI. Thank you very much, Mr. Vallone and Mr. Baker for being with us, and helping us look into some of these problems from a local and regional viewpoint, and for giving us your perspectives. I want to thank you, and I appreciate your being here.

I would like to call next Steve Wechsler, who is president of the National Realty Committee, whose members include America's leading real estates owners, advisors, builders, investors, lenders and managers.

Also on the panel is James Rose, who is president of Interstate Coal. In addition to founding Interstate Coal, Mr. Rose is currently chairman and president of United Bank Corp. of Kentucky. It is one of the largest multi-bank holding companies in the State of Kentucky, and I understand also a very good friend of Hal Rogers, so I welcome both of you here.

Mr. Wechsler, would you like to begin?

Mr. WECHSLER. Thank you.

Mr. GUARINI. Your statement will be placed in the record. I know this is the last panel and you've sat through a long morning, and I thank you for your patience.

STATEMENT OF STEVEN A. WECHSLER, PRESIDENT, NATIONAL REALTY COMMITTEE

Mr. WECHSLER. It is nice to be here with both you and Mr. Rogers. Mr. Chairman, members of the Task Force, good afternoon.

As the Chairman mentioned, I am president of the National Realty Committee. My name is Steve Wechsler. NRC serves as real estate's Roundtable in Washington where it focuses full time on national policies effecting capital and credit, taxes, the environment and investment.

Our members are America's leading real estate owners, advisors, builders, investors, lenders and managers. Real estate's Roundtable appreciates the opportunity offered by this hearing. Every day our

lives are affected in one way or another by real estate. No other resource or industry touches so many of us in so many ways.

Our land, buildings and infrastructure provide the setting and context in which we live, work, play, communicate, travel, entertain, and grow. So pervasive and fundamental is real estate to the way we live that we often take this important national resource for granted. Yet real estate, valued at \$12 trillion, is America's greatest capital asset.

Real estate generates more than two-thirds of the taxes raised by local governments to support schools, hospitals, roads, and other essential services. The real estate industry, made up of relatively small businesses, produces about \$575 billion of goods and services while employing more than 8 million people.

America's real estate, whether it be our homes, farms, parks, factories, commercial or public buildings, is an asset directly or indirectly owned by a wide cross-section of Americans. When real estate suffers, so do people in businesses and all walks of life. And that is what is happening now.

Real estate is in trouble, as are the banks and other financial intermediaries, and the economy as a whole. And from our point of view, we have not yet hit bottom. Today's environment has serious consequences. Business failures soar, financial institutions weaken, quantities of the nation's wealth disappear as home values erode.

And state and local tax revenues, already strained from Federal cutbacks and the recession, dry up. How we arrived at this juncture is not a simple story, but I will try to capsulize it quickly. And then I will offer recommendations—first, for stabilizing the real estate and financial sectors; and second, for growing the national economy as we would all like to see happen.

In short, a combination of badly flawed national policies and poor business judgments are at the root of today's problem. The last decade started with significant inflation and resulted in a false belief by many, including national policymakers, that real estate could only go up in value and not down.

On the heels of this, Congress enacted the 1981 tax law containing excessive tax incentives for real estate, something vociferously opposed by the National Realty Committee back in 1981. Then, a flood of finance for real estate was unleashed by the deregulation of the thrift industry in 1982.

All this took place in the midst of the greatest boom in demand for real estate in decades, fueled by the baby boom generation coming of age, rapid technological developments, related new requirements in buildings, deterioration of obsolescence of older buildings, our older buildings stock and a shift from a manufacturing to a more service-oriented economy.

Then in 1986, we had the inevitable overreaction. The 1986 Tax Act went too far in the other direction, and its negative effects are being increasingly recognized as we have heard today.

And finally, in the past few years, we have seen bank regulatory policies that widely overreacted to weakened market conditions and questionable lending practices of past years. All this precipitated a liquidity crisis for real estate in the economy of mammoth proportions.

The net effect of all these developments is a much more pronounced real estate downturn than we would have otherwise seen. I say much more pronounced, because I do believe some sort of natural down cycle was inevitable as real estate has been a cyclical business. But today's business cycle is a depression for real estate, made worse by a perverse combination of national policies that are causing capital and credit flight from real estate today.

In this environment, financing for even healthy, existing real estate assets is virtually nonexistent. Values are in a free-fall and, as a result, the marketplace is highly unstable and largely dysfunctional.

And I want to emphasize that our main concern is not the shortage of credit or capital for speculative real estate development. Rightfully, its back has been broken and is unlikely to return. On the contrary, today's main problem is a severe liquidity crisis for existing real estate assets, and a reluctance of lenders to refinance even standing loans on well-performing properties.

How big is this problem? Based on data from the Federal Reserve, of the \$400 billion in commercial real estate mortgages on banks' books, about \$200 billion is maturing over the next 1½ to 2 years. Approximately 80 percent or \$160 billion of these loans are not likely to be resolved in a long-term fashion. That is, they are not likely to find permanent financing or to be rolled over for a significant period of time. And there is no replacement capital to take out the banks.

The insurance, thrift, pension, and foreign sectors are all trending down in terms of their credit and capital involvement with real estate. With no developed public market for commercial real estate debt and equity, which we don't have, the banks' holdings and the values free-fall and the state of the economy, together, become a national problem.

All this bodes ill for the banking system, which is likely to end up owning more property. It bodes ill for the Federal Government and the Federal budget, meaning the Federal Government is likely to end up in control of more failed banks and the Federal budget under more stress. And it bodes ill for taxpayers who will eventually foot the bill for cleaning it all up.

Clearly, something must be done to assure necessary liquidity levels for the nation's real estate markets and breathing room for the nation's banks. We need coordinated policy action and constructive national leadership, not band-aids or cosmetic surgery, and we need it now to stop the hemorrhaging.

The goal should be an orderly transition period during which the economy, the banking system, and real estate move to a new equilibrium characterized by disciplined lending, sensible borrowing, rational tax policy, and a healthy and sound marketplace.

To achieve a market that works for real estate owners, lenders and borrowers, and a healthier economy, we offer several recommendations outlined in our white paper, Addressing the Credit Crisis: National Policy Options, which we have provided to the Task Force.

Mr. GUARINI. We will place that into the record.

[The paper referred to above may be found at end of hearing.]

Mr. WECHSLER. Thank you, Mr. Chairman.

The first thing we need to do is to cultivate additional capital and credit sources to fill the void left by banks and to help banks to effectively reduce their real estate exposure over time. We suggest that Congress modify a number of tax laws that now impede prudent pension capital investment in real estate, much in common with what you heard earlier today from the private pension fund community. We are very much in support of their approach.

We also suggest changes to facilitate a stronger secondary market for commercial real estate debt and equity, which we think is an important step to get us out of this problem, but also to ensure we don't get in it again.

Second, we need regulatory balance in the lending environment. We suggest a delay in the implementation of the bank capital standards adopted in Basle, the modification of the risk-weighting formula now being implemented which results in credit allocation, nakedly favoring lending to the government over business loans for American taxpayers. And a revision of the "in substance" foreclosure rules as they apply to real estate loans.

Third, we very much need rational policies that tax real estate fairly and facilitate prudent investment in real estate assets. In this context, we suggest modifying the current passive loss rules so that real estate is taxed like all other businesses, as H.R. 1414 would do, sponsored by Mr. Andrews and Mr. Thomas in the House. We also recommend cutting the capital gains tax rate and modifying tax rules that unfairly penalize real estate debt restructurings or work-outs. In particular, two bills introduced by Representative Shaw should be enacted quickly, H.R. 3651 and H.R. 3652.

In conclusion, it is our view that despite tentative and well-meaning recent steps in the right direction by the Bush administration, today's credit crisis persists, and in some areas continues to grow worse. What we believe is needed is immediate, carefully coordinated action by the administration and Congress, as set forth in Representative Moran's amendment to the banking bill, which will be soon considered, to address the existing problems that confront the economy, as well as the real estate and financial sectors. Only by stabilizing markets today will we be in a reasonable position to expect growth tomorrow.

We would be happy to assist you, Mr. Chairman, and members of the task force in implementing initiatives along these lines. Please let us know how we can help.

Mr. GUARINI. I think the time has come, Mr. Wechsler, that we should all seriously start thinking of working together, the public and the private sector, or else a lot will be lost, and it will take us many years to recover. I agree with you.

Mr. Rose?

STATEMENT OF JAMES ROSE, PRESIDENT, INTERSTATE COAL

Mr. ROSE. Thank you, Mr. Chairman and members of the committee.

Thank you for the opportunity to share some of my observations and recommendations regarding the state of our economy. The views which I will express here today are nonpartisan, objective,

and are given for the sole purpose of making a contribution towards solving some of the problems faced by this great nation of ours in these economically difficult times.

These views are derivative from over 30 years' experience in the American marketplace. In those 30 years, I have held positions which range from \$1.50-an-hour day laborer to a CEO of multi-million dollar corporations.

I was forced by economic necessity to leave college and go to work during an economic recession in the coal industry in the late 1950s. In my career, I have operated heavy equipment and have performed practically every job that exists in the coal industry.

In 1978 I acquired my first bank which resulted in a multi-bank holding company which now controls six banks located in Kentucky. In addition to banking and coal, I have also been involved in oil, gas, real estate, railroading and one of the largest river-to-rail transloading facilities on the Ohio River.

I currently supervise approximately 2,000 employees, 95 percent of which are employed at a rate considerably over the minimum wage who are fully vested in retirement and health benefits. I have lived and worked through good times and bad.

It is my firm conviction that certain philosophies and policies must be consistent before we can have sustained and steady economic growth. Since this is a committee of the U.S. House of Representatives, I will try to direct my remarks to areas which are under the direct or indirect control of that body.

In my opinion, the economy of this country can best be served by the Government using its powers in the application of revenue direction rather than revenue collection and disbursement. To be more direct, very few things function when incentive is removed.

In sports, we would not see the competitiveness or the revenue generated, if it were not for the playoffs, the championships, the titles and personal recognition. All of these are incentives for investment in time, money and talent in the creation of a championship team or an individual effort.

This principle also applies in business. The incentive to build, to create, and advance the spirit of entrepreneurship and the recognition of the individual in corporate goals will not be achieved without the proper motivation to invest and reinvest in new and better equipment, products, buildings and similar ventures.

This can be achieved by having significant capital to pursue these ambitions together with an adequate return on investment, which can be reinvested in future projects. If the capital is not available, and the return on that capital is not adequate, there will be neither the means nor the incentive to expand existing businesses or develop new initiatives.

Do we use the taxing power of the Federal, State or local governments to implement initiatives to direct investment monies into specific areas of the economy and foster a better return on investment, or do we use the tax laws to collect monies from those investments already made and distributed, those various and sundry programs, created and directed by individual government entities.

The latter choice just will not work. Very simply, no incentive for investment opportunities which exist in this country today. The depreciation tables which were greatly lengthened in the 1986 tax

act, this offered little incentive to a 50-year-old man who, at the peak of his earning power, who may be a doctor or lawyer or other professional person that would like, for example, to invest in an apartment building or housing for the elderly or for the poor, but cannot complete his depreciation on that building until he reaches 80 years of age.

In other words, the current depreciation and passive income rules have helped to eliminate much initiative to purchase Resolution Trust properties as investments and may help cost the American taxpayer a considerable amount of money in the sale of these assets. Equally illogical, in light of the current condition, is the failure to enact a capital gains tax which would encourage more investment.

The fact is, under the current tax rates, one can achieve almost equal yield by placing surplus investments, investment capital in security investments, other than put those dollars at risk. Unfortunately, this will continue until tax incentive to provide the initiative for risk capital. This can be implemented by revenue direction in providing the tax incentive to channel capital into those areas that are suffering the most.

Revenue collection does nothing to enhance this. In fact, it stifles initiative and investment. Further, more capital is lost on the revenue collection by the governmental administration costs of collection and distribution of these funds. It further serves no purpose by indulging in political rhetoric such as soaking the rich.

Most of the people I know that achieved some degree of financial independence in their lives did so through hard work, perseverance, great risk, reinvestments and the will to contribute and initiate new ideas and new concepts in their chosen field. They were not privileged, but rather brought themselves up by the bootstraps through much adversity, achieving financial independence by ingenuity and hard work.

This is the American dream which should be available to every individual regardless of their social standing. I know this is possible, because I have been a part of this American dream. But I regret to say that I see the dream fading in a maze of taxation and regulation.

Congress has the power to set the agenda. This country has nothing to gain by political panegyric. This country was built on a singular proposition of class mobility using the tools which I just named—hard work and ingenuity.

Finally another area where growth and economic development can be stagnated is here in regulation. The excesses of the S&L failures are not to be condoned. We must constantly guard against irresponsible financial behavior and the hazards of greed to which some people are bound to succumb.

We must seek and maintain a fine-line balance between regulatory responsibility and regulatory repression, and a natural result thereof, economic recession. Regulators cannot solve the problems of this nation's banking and real estate crisis by assuming broader administrative and operational power over banks. It must continue to regulate to avert solvency problems in banks.

However, we should not mandate administrative responsibility on banks to regulators. It is difficult enough for industries to sur-

vive in good times; it is next to impossible to survive in bad times, especially when saddled with the heavy burdens imposed by layer after layer of regulation.

The majority of the regulations I refer to are often enforced by competing regulatory agencies, each with their own agenda and unfortunately their own interpretations of the rules and regulations. It seems to me at times that these agencies view their mandate, not to support the banks and the industry, but to seek to criticize, even if such criticism goes far beyond the realm of reasonable business standards, if there were any wonder why this array is this in the industry, even when the regulators cannot be consistent.

Whatever I have achieved in my life has not come easily. I have made enormous sacrifices and have received a lot of help from people I have worked for and with. It has also been acquired financial help, the kind that banking systems provides to every family and small businessman in this country.

Without the help from ~~some~~ very good banks who provided capital for acquisition and expansion, the companies I am associated with would not have been able to place billions of dollars in the local economy and continue to be a source of employment for many deserving Americans.

Again, Mr. Chairman and panel, I thank you for your time and your consideration.

[The prepared statement of Mr. Rose may be found at end of hearing.]

Mr. GUARINI. Thank you very much, Mr. Rose.

I understand that you are an example of a true American success story; that you worked your way up from the bottom to be one of the most successful businessmen in Kentucky. I congratulate you for that. I understand that the rural areas have the same problem as urban areas; there is no difference as far as the credit crunch is concerned; is that correct?

Mr. ROSE. That is correct.

Mr. GUARINI. If you had to put your hand on the single, most important problem, would it be bank regulators, or would it be the tax code that would be more disturbing to you?

Mr. ROSE. It is the current tax code, and under the 1986 Tax Act.

Mr. GUARINI. And the bank regulations are just that much more added to the problem?

Mr. ROSE. They are added to it, and it also has an effect in the way you administer your banks. In other words, the regulators nowadays are trying to come in and make evaluations after the fact, which is easy to do.

Mr. GUARINI. It is interesting that in the 1930's, when the stock market was at its low point, real estate was still holding up, and it eventually became depressed some years later. Real estate did not crash with the stock market in the 1930's.

Part of the reason for this is that regulations were very lax. You could buy stock at a minimal margin, and those laxities led to the crash in 1929.

Now it seems to be the other way around. In 1981 we had some very generous real estate tax laws, and then in 1986 we took everything away. In the 1986 Tax Reform code, real estate took the biggest hit. And now real estate is depressed, and because people have

no place else to put their money they invest in the stock market, which is forcing stock market prices up artificially. So you have inflation in stock equity values, and you have depression in real estate values.

This seems to be just the opposite of what had happened some 50 or 60 years ago. In your opinion, Mr. Wechsler, what caused the over-building of all these shopping centers and see-through office buildings? Was it the overgenerosity of the tax policies of our country?

Mr. WECHSLER. I think we have excess supply in many markets today due to a combination of factors. And I think the most critical factor was, there was a substantial increase in demand during the 1980s for real estate, whether it was for homes or offices or retail space, whatever.

At the same time that this demand appeared in the marketplace, we instituted in 1981 some very excessive tax incentives. The combination of those two forces, the dynamic effect of those two forces together with the inflation mentality of the late 1970s, early 1980s, where people believed they couldn't lose money investing in real estate, led to a lot of building.

Mr. GUARINI. So what started out as a boom to real estate ended up killing it?

Mr. WECHSLER. Right; that is why the National Realty Committee opposed the tax incentives and testified so before Congress.

Mr. GUARINI. Mr. Seidman testified this morning that interest deductions are too generous, that we have a debt-driven society leading to huge private debt, consumer debt, and public debt. By being driven by debt, we have created the situation we are in.

We actually allow very generous deductions of interest from our taxes, whether it be corporate or individual. Could you comment on this? Did that help to cause the predicament we are in, and are we on the wrong track in encouraging it?

Mr. WECHSLER. In many cases, real estate, as well as other assets, were highly leveraged during the 1980s with a large amount of debt. But I believe as Chairman Seidman pointed out, the flaw in tax policy is not necessarily the deductability of interest, but the non-deductability of dividends paid.

As I recall, he suggested that the whole policy be looked at in terms of that imbalance.

Mr. GUARINI. And do you agree on that?

Mr. WECHSLER. Congressman, as you know, the Ways and Means Committee has asked Treasury to come up with a study along those lines, which they have not released, as I recall.

Mr. GUARINI. You represent the largest builders and developers in America. You certainly have the most significant group of people in your association who are very, very much involved in real estate development. How they go, so goes the real estate market, as I understand.

Do you get much help from pension funds, and should that be a source that should be looked at to relieve the money shortage?

Mr. WECHSLER. Mr. Chairman, we believe that there are several disincentives in the system today which artificially reduce the level of pension capital investment in real estate. It keeps capital away

arbitrarily, and we believe those obstacles should be reviewed, and several of the suggestions we are making go to those areas.

Mr. GUARINI. Do you think that the \$3 trillion in pension funds should have more than 5 percent invested in real estate?

Mr. WECHSLER. Given the relationship of the value of real estate to the value of assets in this country, I think yes, it is not an unreasonable approach. Consistent with the prudent investment standards of ERISA, I don't see anything wrong with it. If we have a level playing field, which is what we are suggesting is needed in that area—And pension capital of \$3 trillion is one of our largest, if not our largest capital source, so real estate has to have a level playing field for it.

Mr. GUARINI. Is it that money supply growth has slowed up even as we lower interest rates, hoping that this is going to increase the money supply? Is the M2 problem that we have today, where there is a money slowdown, a money shortage, is that contributing to our present predicament?

Mr. WECHSLER. I believe it is one of our contributing factors at present. The Fed has worked to lower interest rates, and as Chairman Seidman pointed out, they have effectively lowered short term rates but not long term rates.

At the same time, M2 is not growing within the targeted levels. I think one of the reasons for that essentially is that as interest rates are lessened and banks have capital or credit to provide, it is going back into Treasury securities and the national debt. That is one of the problems with the risk-weighting system, because Treasury securities are zero.

Mr. GUARINI. Instead of banks lending, they are putting money in treasury securities and adding to their capital?

Mr. WECHSLER. Correct. That is one of the reasons we are not seeing this growth in money supply and credit to private businesses that the country needs.

Mr. GUARINI. Does your association believe that if the Federal Reserve Bank keeps lowering interest rates that this will eventually work, that there will be more money out there for real estate?

Mr. WECHSLER. Lower interest rates will be helpful, particularly so for workouts in the real estate context, but it is not the sole answer. There is no silver bullet to this problem. A number of initiatives need to be undertaken.

Mr. GUARINI. Both in banking regulations as well as tax policy reform?

Mr. WECHSLER. Banking regulation, tax policy, and we believe in terms of encouraging a secondary market for real estate debt and equity.

Mr. GUARINI. Do you think long-term interest rates will come down after we consistently keep push short-term interest rates down? Will long-term rates eventually follow?

Mr. WECHSLER. I think if there is a consistent belief that inflation will not raise its head, we are more likely to see those longer term rates go down, but no one is buying that yet.

Mr. GUARINI. That is our real concern. We can always work our problem out with inflation by decreasing the money supply, but then we end up in the eternal spiral.

Mr. WECHSLER. Running a \$350 billion Federal budget deficit, a lot of people have that concern.

Mr. GUARINI. I thank you very much. Your remarks are very well-taken.

Mr. WECHSLER. Mr. Chairman, I wanted to respond to one of the questions Mr. Rogers raised with an earlier panel, because I think I can clarify it. It respects the passive loss rules, and whether modifying or reinstating prior law in that area would lead to excesses once again.

And the point I would like to make is that in 1986, over 30 provisions were modified or amended that were directly or indirectly aimed at real estate, at reducing the attractiveness of investing in real estate. Only one of those provisions was the passive loss rules.

At the same time depreciation was stretched out to 31.5 or 27.5 years, and for the minimum tax, 40 years. Tax exempt bond financing was changed, capitalization of construction interest was instituted, capital gains was eliminated, a range of other things took place.

Modifying the passive loss rules, in and of themselves, will not bring back tax shelters so long as you leave unchanged the bulk of the other things done in 1986.

Mr. GUARINI. We should lower the depreciation scale, bring it back more to where it was previously, pre-1981?

Mr. WECHSLER. Pre-1981 depreciation is probably the best case in my judgment. What happened between 1981 and 1986 was aberrational and led to many of our problems. Pre-1981, where an apartment building that clearly had a useful life of 15 years or 20 years was being depreciated over such a period, and a different kind of building that had a 40-year life was being depreciated over that period, made sense. Today everything is treated the same across-the-board. That is one of the problems with depreciation in real estate today.

Another problem that is adding to the credit crunch problems we face today concerns or leasehold improvements and depreciation. If someone owns an office building and needs to put in improvements for that building for a tenant over a 5-year lease, the owner now can only depreciate that, because of the 1986 Tax Act, over 31.5 years, even though after 5 years it is going to have to be torn out.

That is a serious problem in the tax code today, and plays into a lot of the problems that banks and owners and the RTC will have in terms of addressing this real estate crisis.

Mr. GUARINI. When it comes to capital gains, do you believe in a targeted capital gains tax or going back to the Kennedy days when the capital gains tax was the same on every appreciated item? Are we talking about just capital gains for new capital ventures, or are we talking about across-the-board traditional capital gains?

Mr. WECHSLER. My judgment is across-the-board capital gains is preferable, so long as it is done—I think as Chairman Seidman pointed out—to encourage long-term investment.

And I think that when you start trying to target it to one asset class or another, you run into concerns about trying to manage the economy in a micro fashion that may have unintended results in the end that no one is comfortable with.

Mr. GUARINI. Not only that, but the men and women with green shades who stay up until 2 or 3 in the morning will still find many ways of getting around the code in the first instance. So, therefore, you really have a hard time trying to draw a fine line, and you leave the code open to other kinds of exploitation.

Let me ask you, a suggestion was made by Donald Trump that he didn't mind how high the marginal tax rates were, as long as you got rid of passive gains and losses, because you still would have to pay the alternative minimum tax, so that you will never have what happened years ago, where you could zero out, that is, end up paying no taxes at all. There would still be a 24 percent minimum floor tax that everybody would have to pay no matter how much money they made.

So his thesis is, as I understand it, raise the marginal tax rate, raise it to 50 percent, 60 percent, if you will, but then allow write-offs to encourage people to put money back into industry and real estate development, thereby expanding our economy. Don't have any passive and active gain problem.

Let people write down their marginal taxes because they will never get a rate lower than the alternative minimum tax anyway. What do you think about raising marginal rates?

Mr. WECHSLER. I believe that raising tax rates is no panacea to encouraging investment; that the real issue before us is how do we have a rational and sound tax policy?

Today, real estate, in terms of tax policy, is on the short end of the stick, principally because of these passive loss rules, not because of higher or lower rates.

Mr. GUARINI. But it would encourage people to buy less Treasury bonds because they would look for writeoffs. So if you give them writeoffs, and if they see that they have a large amount of cash, by encouraging writeoffs, you give people an incentive to invest in real estate and other business ventures, and they would then ratchet down their tax liability.

And a person's tax liability would never go down to zero, like before, because we would have the alternative minimum tax, so that everybody will be responsible.

At least this way, according to Mr. Trump, you would encourage people not to leave their money dormant, but to make it active. Therefore, it would benefit the economy. Can you comment on that?

Mr. WECHSLER. You would encourage people to do a lot of things, including investing in tax free bonds, the higher the tax rate. So it would induce a lot of different kinds of behavior, and—

Mr. GUARINI. But tax free bonds would argue for a lower income tax rate, because you don't pay any tax at all on a tax free bond. I am just wondering where our incentives are to get people to invest and make their money move, to increase the velocity of money and get a mix of investment out there?

Mr. WECHSLER. I think if people believe they could invest in real estate and if they lost money, the Tax Code would account for it fairly, they would invest in real estate. Today, if they invest in real estate, the Tax Code does not account for it fairly, and therefore there is a real burden and barrier to making that investment.

And I think that is a primary—one of the primary reasons we face these problems today. An incentive isn't necessarily needed, but rational policy with fair taxation is needed.

Mr. GUARINI. Mr. Hal Rogers.

Mr. ROGERS. Thank you, Mr. Chairman. I am wondering if Mr. Rose might respond to the Chairman's last question or comment, that, in effect, Donald Trump was saying that at the same time we reinstate the passive loss provision of the 1986 Act, that he would suggest that we raise the marginal tax rates on income brackets to make up the difference to lost revenues, under the theory that only when you have higher tax rates does it encourage people to invest in order to claim the passive losses on real estate and the like.

What is your thought about that?

Mr. ROSE. My response to that would be that to a certain extent, he could be right, but certainly not to the limits he was possibly willing to talk about during the day. The limits he was talking about are far too high. I think other things are involved in it too, because if you are going to have those type of potential capital depreciations, you are also going to have to have capital gains deductions to provide additional incentive in there, too. So I don't necessarily agree with that.

I think it would spur some investment, but not to that extent, because there are too many other areas that should be invested in.

Mr. ROGERS. Let me ask you, Mr. Rose—and Mr. Wechsler gave us a nice history of how we got where we are a moment ago, on how we came to the—we had the excessive incentives in the 1981 Act; we had enormous credit available during the 1983 period with huge demand; in 1986 we overreacted, he says, and went too far in the other direction. Among other things, taking away the passive loss.

We had bank regulatory policies during that period of time which—and then that is a rough summary of the history of where we are.

Let me ask you, Mr. Rose, as a businessman, as a banker, do you have faith and confidence in the Government as you make business decisions these days, about what we are going to do to you?

Mr. ROSE. Well, I think that the Government today has an enormous credibility problem. The 1986 Tax Act is a prime example of that.

We went out and people went out and made millions of dollars of investments and signed their name to millions of dollars for property, up until 1986. I have firsthand knowledge of that because I am a partner in a \$50 million project with two other fellows.

Mr. ROGERS. Tell us about that. You have told me but it is interesting for some of us to hear it.

Mr. ROSE. We went in to build a 30 story office complex and we went in and like any business person, you make decisions, so in 1985 we went in to take and evaluate the potential for putting this particular project in, and we put it in, we signed our name to a \$50 million group of notes, and you go in and you put it into operation, and you find out the next day, as millions of people found out, that once your name is signed, you have got the project built, that you no longer can have the tax incentives and everything has gone away.

The Government, in effect, left millions of people high and dry, just walked away from them, and that is what, in my opinion, as has been expressed earlier today, has caused a lot to do with the S&L crisis.

People all over the country went out and signed their name and went into debt to build incredible projects, I am talking about really incredible projects, and then they just moved the tax act out in 1986, and you find out these projects are right down the tube. That is what is wrong to a great extent with the S&L crisis.

Mr. ROGERS. That particular project, which now is the Signatory Building on the Lexington, Kentucky landscape, that bank building and office building which you and your partners put together in 1985, borrowed the money, made your loans, programmed out your expenditures and the payment stream you would have to make through the years to pay off the loan, based upon the tax laws that existed at the time, the passive loss provision was in the law, I understand you had immediate or fairly immediate good occupancy.

Mr. ROSE. Ninety-five percent, sir. It was a great project.

Mr. ROGERS. It was a great investment for you and the tenants and all the people who worked to build the building and all the people who worked in the building when it was finished. So it created a lot of new jobs and economic activity in that area.

And then the next year, the Government comes along and takes away that passive loss provision, which all of a sudden does what to your investment deal?

Mr. ROSE. Well, in our particular case, we had investment income coming in from the passive sources that offset that, so our particular project, it didn't get hit with this because we had other sources of revenue coming in to take care of it, and the building has always been around 95 percent occupied.

But what I want to emphasize is where you have an isolated instance of that, you had millions and millions of people that were not fortunate enough to have the other sources of income coming in to offset, and the passive income rules bankrupted about almost all of our builders and the entrepreneurs in this country.

And I think our Government has really got an apology to do. I think they have got to go back and reinstate and do away with the passive rules. And those people—there is a matter of morality here.

Mr. ROGERS. Morality because all those people relied upon what the Government said—

Mr. ROSE. Yes. The retroactive rules, yes. Really you had an implied situation or almost like an implied contract that these are what the rules are going to be. You go out and you invest and you put this kind of money into a project, these are what the rules are going to be, and in the very next year they change the rules.

So there is a morality problem, and it bankrupted a lot of people throughout this country. That is what is wrong with the RTC—I mean, the S&Ls. It is caused the RTC problem.

Mr. ROGERS. You are also a very large co-operator, the largest in Kentucky and Tennessee too, is that right?

Mr. ROSE. Yes, sir.

Mr. ROGERS. How many employees do you have?

Mr. ROSE. In the mining operations, about 1,600.

Mr. ROGERS. Now, that is a heavily capitalized business. It takes lots of money, heavy machinery, and large expenditures, and I know you are one of the most progressive operators in the country, because you heavily invested and kept reinvesting in those operations. What is your intent now to—as far as investing in the future, in that business?

Mr. ROSE. Coal mining is a capital intensive business. You use an awful lot of equipment and machinery. It is rough in nature, and so I had been spending anywhere from \$20 million in a low year to \$40 million a year in new capital expansion.

And so recently, for example, I can give you an example of the credibility of Government again right now, as an entrepreneur in the marketplace and the rules changing. Recently I had looked at—having had on the drawing boards a mining complex that is going to have a \$30 or \$40 million capital investment that is scheduled to go this year.

Instead of doing that, I put in my budget, in my 3-year plan \$8 million, with not one dollar—not one dollar of it going to new capital expansion.

Mr. ROGERS. Why is that?

Mr. ROSE. \$40 million right down the tube, and the \$8 million I did put in was to replace our engines and rebuild older equipment. Why did I do that?

Why did I not have a dollar in when ordinarily over a 3-year period I would have had \$100 million? It was because I was reading last year about how we were having hearings about the possibility of United Mine Workers' Pension Fund, for all practical purposes, is bankrupt. That is what everyone knows.

So we have a Senator now going to introduce a bill on the floor that says something to the effect that they are going to charge all companies, all coal companies in this nation 75-cents-a-ton on all coal mining processed.

I greatly resented that because our profit margin in these operations was estimated to be like \$2.25 or \$2.50 or something like that. And then if I had gone in and put that project in, and then you wake up next day and you find out the Government then has imposed a 75-cents-a-ton tax, that project would be right down the tubes.

It is a carbon copy of exactly what would have happened with the 1986 Tax Act. You would have had \$40 million out there invested and you wake up the next day, and we had a law on the books that says you are going to pay 75-cents-a-ton into the United Mine Workers' Fund. I greatly resented that because I have been in the business 30 years.

I have paid and our company has paid its medical benefits for all our employees every single month. Our company has every single month paid its retirement funds. Every single month.

Now we find out that our company, a non-union company, may, in fact, be charged with 75 cents a ton, for all companies of America to pay into that. There isn't any way I can make a capital investment, because if that happens, we just aren't going to do it. So did I not have one dollar in capital expansion.

Mr. ROGERS. The point that is being made here is because of Government changing the rules of the game, all the while it is causing

business people to withdraw their monies from the capital field, and stash it away?

Mr. ROSE. Passing laws and rules and making them retroactive is what my complaint is about. I do not have a complaint about real estate for someone, for example, that went in and invested in 1988, 1989, 1990. They very well knew what the rules were.

Where I am having the complaint, and a lot of the people I know are complaining, it is going in and changing the rules on pre-1986 properties that causes all the problem. That is the reason, having been burned once in the rules and regulations, we can no longer invest and no longer have the credibility and trust in the Congress to go in as an entrepreneur and not have the rug just jerked right out from under you.

Mr. ROGERS. Your banks, six of them, in small cities in Kentucky, what is the loan demand now compared to, say, a year ago or two?

Mr. ROSE. Well, the loan demand right now, like I have heard some earlier testimony today, the banks are very liquid because there isn't anyone out there wanting to borrow the money.

Mr. ROGERS. So the assets, instead of going out in loans because there is no demand for loans, is instead going to what, treasuries?

Mr. ROSE. Treasuries and building up capital reserves, exactly what has been said here earlier. A treasury doesn't count anything against your capital requirements. You put that in, but I want to hasten to emphasize, if the demand was out there, I think that the banks would—are more than willing to loan the money.

They were looking for really good loans, but the loan demand isn't out there because we have a crisis of confidence because of some of the reasons we talked about.

Mr. ROGERS. So the problem in the communities you are serving with your banks is not a shortage of money to borrow at the banks, banks have more money than they can lend, right?

Mr. ROSE. Yes. To, a great extent, most banks have a considerable amount of liquidity. I think that is what Mr. Seidman testified.

Mr. ROGERS. And the reason for the fact that they have a lot of money that is not loaned out is that there is not the business activity in the community to demand the loans; is that right?

Mr. ROSE. That is correct, and banks have regulatory pressures and have had applied to them such stringent lending standards that for a loan, it is hard to meet a lot of the standards that regulators are imposing.

Mr. ROGERS. Have you noticed a lessening of the regulatory pressures since the President announced the policy changes some weeks ago?

Mr. ROSE. That has been so recent, I would not have had the opportunity to do that. However, I have noticed that regulators and enforcement have been tougher and actually more unreasonable in the last year.

Mr. ROGERS. Do you know of applications at your banks that were what you would consider under normal circumstances a good loan, that you have had to decline because of excessive regulatory pressure?

Mr. ROSE. I know of loans that were classified at a recent examination that would boggle your mind as to why they were classified. A loan that was made in 1989, for example, for a fast food restaurant, is \$565,000. This gentleman that paid down on it to \$485,000, he paid about 27 straight payments every month, never been late, not one day, of \$882 a month. The loan was down to \$485,000 at the time of exam, appraisals were \$540,000. He had \$2 million net worth with no debt and \$195,000 tax income, and that loan was classified 17.

Mr. ROGERS. Why?

Mr. ROSE. Because they said the business itself was not generating a great amount of revenue for the cash flow, and, in fact, it had generated—and they also said equipment in that fast food restaurant was 2 years old. It is kind of tough.

It is mind-boggling, some of the things that are going on out there right now. That is one reason the banks are very hesitant to make commercial loans.

You say, what does a substandard classification mean? A substandard classification on that loan means—in this case it was a \$100 million bank, you have got to take \$49,000 roughly and put it into reserve. If you had \$100 million bank and it turned one percent on assets, that is a million dollars a year in earning.

So what you did there, you took the out 4.9 percent of your year's earnings and put it into reserve for a loan that should have never been there to start with, in a substandard situation. That is destroying the earnings of the bank in a situation like that. And it makes it very tough for a bank officer to—I don't know how you get a better loan it. Makes it tough for them to loan anyone else any more money.

Mr. ROGERS. Mr. Wechsler, let me compliment you and your organization for this compilation of answers to the questions we have been asking today. It is thorough and probably more thorough than we can digest very quickly here, but thank you very much for a lot of hard work that went into that.

Do you think based upon your assessment, that we are—have we reached the bottom of this downturn, recession, whatever you call it?

Mr. WECHSLER. I don't believe so. I mean, certainly from everything I hear, read and see, no.

Mr. ROGERS. Do you have a feel for when we will reach the bottom?

Mr. WECHSLER. I think it will go into 1992, well into 1992. That is my sense.

Mr. ROGERS. I wonder what the association generally predicts. Is there sort of a consensus in the industry?

Mr. WECHSLER. We don't have an official, organizational position or consensus on this. But my experience in talking to people throughout the country, is that the expectation is that things will get worse.

Mr. ROGERS. What will lead us out of it? In the past we have said this recession was cured by a consumer-led recovery, or maybe a real-estate-led recovery. What do you think will lead us out of this one?

Mr. WECHSLER. I think one of the things we need to lead us out of it is a strong leadership in Washington, both from the Administration and Congress. That is something that we would very strongly advocate.

Mr. ROGERS. The President is saying now, or his advisors are saying that he intends to address the matter in his State of the Union address sometime in late January or so. Is that an adequate response, do you think?

Mr. WECHSLER. We would certainly advocate it be sooner rather than later, that time is critical right now, and we understand that it takes time to devise such a plan, however, time is of the essence in these matters.

Mr. ROGERS. You are saying it needs to be done before then, something needs to be done before then?

Mr. WECHSLER. We would advocate strong action be taken immediately.

Mr. ROGERS. Including congressional action?

Mr. WECHSLER. Including congressional action.

Mr. ROGERS. Would it be wise for the Congress to adjourn and leave town here next Tuesday or so until January?

Mr. WECHSLER. I think it would be wise for Congress to consider these problems and take action as soon as practicable.

Mr. ROGERS. I don't think we can do it before Tuesday. I thank you very much, both of you.

And Mr. Chairman, let me commend the testimony of both these gentlemen, particularly Mr. Rose, who is a long time friend of mine, and a very polished businessman, and a very successful businessman who has come from a day's labor, and who is one of the most successful business people in the country.

Mr. GUARINI. We are very pleased to have you here, Mr. Rose and Mr. Wechsler. We talked today about job opportunities and economic growth for our people, so that we may have a better standard of living, and not go backward. I think if there is one thing that has come out of our hearing, it is that our country is in serious trouble unless business and Government get together, put all the politics behind us, develop a political will to do something about our tax policy, about our banking regulations, about our budget deficit, which is pulling us down and taking away a great sum of money that could be put out into the public and private sector in developing the expansion of industry, and developing a better economic base. And it is just unfortunate that we are missing some very prime opportunities.

One thing about our country is that when we do have crises, we respond to it. Well, we have a crisis now, and we still have time to act. But we shouldn't miss this last opportunity because, I agree with many of you, it has been said here today from the very first witness, Mr. Seidman, that we are all in deep, deep trouble unless we get our act together. And this takes a lot of political will and pulling together.

I want to also say that Robert Dugger of the American Bankers Association, the chief economist for the ABA, which is an association that includes both the large and small banks, with combined assets of 95 percent of the total commercial banking assets in America, has submitted for the record a statement, and it will be

placed into the record. Mr. Dugger was unable to stay, as the hearings have become rather protracted.

[The prepared statement of Mr. Dugger may be found at end of hearing.]

Mr. GUARINI. I know you gentlemen certainly have gone long past your lunch, and I want to thank you both for being here, for your testimony, for your statements. They have been very, very clear. Thank you for the message you have given us. I think your insights are very profound, and we are very grateful to you.

Mr. Rose, I wish you a safe trip back to Kentucky. My thanks to both of you gentlemen for being here.

We will conclude the Urgent Fiscal Issues Task Force hearing on the credit crisis. Thank you very much.

[Additional material submitted for the record follows:]

STATEMENT
of
GEORGE VALLONE
before the
U.S. HOUSE OF REPRESENTATIVES
HOUSE BUDGET COMMITTEE'S
TASK FORCE ON URGENT FISCAL ISSUES

INTRODUCTION

Mr. Chairman and members of the Task Force, my name is George Vallone, and I am a builder from Hoboken, New Jersey. My company is the West Bank Construction Corporation. I appreciate having this opportunity to testify on the credit crunch, and to provide to the Task Force several legislative and regulatory suggestions for alleviating this crisis.

Mr. Chairman, as the Task Force knows, the existence of a serious credit crunch in housing production lending is well documented and has been recognized at the highest levels of government. The Administration is now finally giving the issue the attention it deserves, urging bank regulators to make sure that bank examiners do not "chill" the flow of loans that could lift this country out of the recession. In addition, Treasury Secretary Brady, Federal Reserve Chairman Greenspan and key members of Congress have all recently expressed concern that the country will continue to be mired in recession if credit is not relaxed.

The Administration's concerns are well-founded: while the rate of growth in the overall credit market activity has declined slightly since 1988, the rate of growth for depository institutions' credit has plummeted (Chart [1]). In fact, since early 1990, credit at depository institutions has contracted. Chart [2] shows the precipitous drop in thrift lending activity. The decline in bank credit is more modest, but is nevertheless the industry's lowest rate of credit growth in the past 15 years. This chart is more telling: it shows no increase in the rate of bank lending to compensate for the negative growth in thrift credit activities.

The Administration and the federal banking regulators recognize that much of the reason for the failure of the banking industry to make up the decline in thrift acquisition, development and construction lending lies in regulatory and supervisory barriers that discourage banks and thrifts from extending that credit, such as capital requirement and examination policies on real estate valuation. Many bankers indicate a fear that they will be "punished" by the regulators through the examinations process if they make any kind of real estate production loan, no matter what the circumstances. Consequently, as Federal Reserve and FDIC surveys show, bankers have undertaken a prolonged and cumulative tightening of their credit standards for construction loans.

FEDERAL EFFORTS TO ADDRESS THE REGULATORY CREDIT CRUNCH

Throughout 1991, the Administration and the four federal banking agencies (Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Office of the Thrift Supervision, and Federal Reserve Board) have pursued policy measures intended to encourage examiners to take a balanced, common sense approach and to persuade banks that it is all right to lend to creditworthy customers.

Several attempts have been made to resolve the issues related to supervisory and examination practices involving real estate loans. On March 1, 1991, the federal banking regulators, under the auspices of Treasury, issued a package of supervisory policy clarifications aimed equally at banks and examinations personnel. The key elements this package were reiterated by the OCC on July 30.

On October 8, 1991, the White House announced a comprehensive package of initiatives entitled "Easing the Credit Crunch to Promote Economic Growth." The announcement encouraged both bank management and bank supervisors to maintain a constructive atmosphere for working through troubled loans and/or continuing to provide credit for sound borrowers in troubled industries, particularly the residential real estate industry. The package also included changes in capital rules to make it easier for banks to raise capital and make new loans; an enhanced examination appeals process; and discussion of reasonable real estate valuation policies.

On November 7, 1991, as a follow up to the October 8 announcement, a joint policy statement on the review and classification of commercial real estate loans was issued by the four federal banking regulators. Among other things, the joint statement provided comprehensive guidance on loan portfolio review procedures, indicators of troubled loans, analysis of loans and collateral values, and the review of institutions' loss allowances. In addition, a random audit program was unveiled to ensure that the policies are carried out at the examination level. A meeting of all agencies' senior examinations staff will be held in December to review implementation of the guidelines.

FINE-TUNING THE CAPITAL RULES

The credit crunch, of course, stems from more than just regulatory actions. Another inhibiting element is the capital rules that force institutions to reduce lending and pare assets to meet new standards. Also, there continues to be concern about ways in which specific regulations for banks' risk-based capital ratios serve to reduce arbitrarily the attractiveness of residential production lending. The National Association of Home Builders, of which I am a member, has been working to address these issues. NAHB has called for a delay in the scheduled implementation of the fully phased-in capital ratio of 8% of risk-adjusted assets, currently due to take effect at the end of 1992. In view of the significant increase in capital already entailed in meeting the current level of 7.2%, NAHB believes the established phase-in schedule may be needlessly burdensome on financial institutions and the capital markets.

NAHB also has urged federal regulators to reconsider the regulations that they have issued under the Basle guidelines, which assign a 50% risk weight to loans "for residential purposes," that are "fully secured by a mortgage on residential property which is rented or is (or is intended to be) occupied by the borrower," and which is made "in accordance with strict prudential criteria." NAHB believes that, in interpreting the applicability of the 50% risk category, OCC and the other federal banking regulators have left out two types of residential loans that meet the criteria set forth in the Basle guidelines. These are: (1) construction loans for homes that have been pre-sold to buyers who have been pre-approved by lenders for permanent mortgage financing upon completion of the home; and (2) multifamily mortgages that meet maximum loan-to-value and minimum occupancy requirements.

REGULATORY AND LEGISLATIVE ACTIONS THAT WOULD PROVIDE RELIEF FOR THE CREDIT CRUNCH

Mr. Chairman, I would now like to take this opportunity to enumerate a number of specific regulatory and legislative changes which would go a long way toward remedying the ongoing credit crunch – particularly as it affects real estate. While, clearly, the Congress cannot be expected to effect all these changes by itself, I am confident the Task Force would agree that regulatory policies as well as legislative policies should reflect the need to alleviate the credit crunch. Moreover, several of the regulatory issues I will mention below are also now under consideration by the House Banking, Finance and Urban Affairs Committee as it marks up funding legislation for the Resolution Trust Corporation.

I. Capital Requirements for Banks and Thrifts

- a. Amend the definition of "residential loans" that receive a 50% weight under the risk-based capital rules to include qualifying residential construction loans for pre-sold homes to buyers approved for permanent financing. Construction loans to individuals for the building of their own homes are included in the Basle definition under OCC and OTS rules. A construction loan to a builder for the construction of a house in accordance with a prudently structured sales contract is functionally similar to a construction loan made directly to the homebuyer.

- b. Amend the definition of "residential loans" that receive a 80% weight under the risk-based capital rules to include qualifying multifamily mortgages. Currently, no multifamily loans are included in that definition in bank regulations, while only very limited loans are included in the thrift rules. Qualifying multifamily mortgages that meet certain minimum occupancy requirements and are prudently underwritten should be eligible for the 80% risk weight, and the Basic Agreement would not need to be changed to do so.
 - c. Require lenders to calculate capital on mortgage loans sold with recourse only relative to the actual amount of recourse. At this time, lenders must maintain capital relative to the entire amount of loans sold with recourse, even if the recourse exposure is only a fraction of that amount.
 - d. Extend the phase-in period for risk-based capital for banks and thrifts by at least one year. As of December 31, 1990, banks and thrifts must have risk-based capital ratios of at least 7.2%. This ratio is due to increase to 8% on December 31, 1992. Under an extended phase-in, this ratio would not go into effect until at least December 31, 1993.
 - e. Consider lowering the minimum leverage ratio requirements to no more than 3% of total assets for all banks and thrifts. Currently, banks and thrifts must have a ratio of Tier 1 capital to total assets of at least 3%, regardless of the level of capital required under the risk-based capital rules. The 3% level, however, applies only for those institutions with the very highest soundness rating. In effect, most institutions must maintain a capital ratio of 4% of assets, and some may have to maintain as much as 5% of total assets in Tier 1 capital. The result is that, as the leverage ratio increases, the system of risk-based capital is negated. The amount of Tier 1 capital needed is no longer related to the risk profile of a bank's portfolio and may significantly exceed the amount necessary under the risk-based calculation. Institutions that cannot meet the higher leverage ratio would be subject to supervisory sanctions even though they do meet the risk-based requirements.
2. Performing Real Estate Loans
- a. Amend FIRREA in order to limit FDIC's and RTC's powers to repudiate performing loan commitments and outstanding loans. Essentially, FIRREA gives these agencies broad powers to cancel most types of contracts, including funding commitments and outstanding loans, with little cause and very little liability for damages. Indiscriminate exercise of this authority often results in good loans going into default. Related to this, FDIC or RTC and their asset managers and contractors should be prohibited from calling performing loans following takeover of an institution.

- b. When institutions are taken over by FDIC or RTC, require them to review or extend performing loans where private-sector refinancing is not reasonably available.
- c. Amend accounting practices so that current and performing loans cannot be placed on nonaccrual status. When a loan is put on nonaccrual status, the lender must put up more reserves. In order to avoid this, the lender often demands more equity or accelerated payments from the borrower.
- d. Require examiners to get an independent appraisal of a property when they are considering writing down the loan because of changes in market conditions rather than because of any change in the borrower's performance. There have been complaints that examiners have been reducing loan values without getting a qualified reappraisal.
- e. Require the banking regulators to establish different examination and valuation guidelines for commercial real estate and residential real estate. The current practice is to value residential loans based on income and market projections that are applicable only to commercial properties.

3. Workouts of Temporarily Troubled Loans

- a. Amend accounting and regulatory rules in order to make foreclosures the more costly alternative over temporary workouts for the lender in terms of capital charge-offs. Under existing accounting rules, a lender has an incentive to foreclose on a recoverable loan rather than to modify the loan terms. This is due in large part to the fact that accounting rules for loan restructurings are designed to deal with permanently impaired loans and are inappropriate for dealing with temporary problems.
- b. Implement an accounting rule that recognizes a temporary impairment of an asset and allows for temporary workout arrangements rather than imposing the more burdensome and costly conditions of an FAS 15 formal loan restructuring in such situations. Although this was attempted in the proposal for informal loan restructuring (the so-called "loan-splitting"), the proposal was not responsive to the temporary nature of the problems it was intended to resolve.
- c. Amend the compensation system for FDIC and RTC asset management contractors to encourage them to work out temporarily troubled loans rather than to foreclose on and sell the property quickly. The contracts often tie compensation to the time in which an asset is disposed rather than to the amount recovered on the asset.

4. Loan Limits for Housing Production Loans

- a. Promote thrift use of FIRREA's exception allowing a 30% loans-to-one-borrower (LTOB) limit for housing production loans by rescinding OTS' Regulatory Bulletin 24 and substituting a notification process for the approval procedure for thrifts

that meet the eligibility requirements prescribed by FIRREA. Regulatory Bulletin 24 sets forth an extensive, often subjective, approval process that goes way beyond the criteria set forth in FIRREA, and requires an eligible institution to repeat this process annually.

- b. Establish an LTOB exception for banks to allow them the higher 30% limit for housing production loans if they are eligible by virtue of meeting their fully phased-in capital requirements. Currently, banks do not have any exceptions to the standard 15% LTOB limit.

5. Federal Home Loan Bank System

- a. Expand the types of credit products and credit enhancements that the Federal Home Loan Banks can offer to provide liquidity for their member institutions' housing production lending.
- b. Eliminate unequal treatment of nonthrift members of the Banks in terms of stock purchases and access to advances. The disadvantages imposed on nonthrift members have hampered efforts to attract new members to offset the decline in thrift membership.
- c. Allow state and local housing finance agencies and mortgage banking companies to join the FHLB System.

6. Appraisals

- a. Delay full implementation of FIRREA reforms to July 1, 1992 so that states can have time to assure a smooth transition to full implementation. Some states may not be fully prepared by the current deadline of January 1, 1992.
- b. Require only licensing, rather than certification, for all single-family (1-4) appraisals. As of now, appraisals for single-family homes that are valued in excess of \$1 million, or that are valued at more than \$250,000 and considered "complex," must be performed by a certified appraiser. This requirement will increase the cost of appraisals and limit the pool of appraisers who can do the work.
- c. Raise the de minimis amount for which an appraisal is required to \$100,000 for all FFIEC-member regulators in order to reduce unnecessary fees and avoid costly delays in obtaining appraisals. Currently, the Federal Reserve has a threshold of \$100,000 while the other agencies have a \$50,000 de minimis level. OCC, FDIC and RTC have announced proposed rules that would raise the level to \$100,000.
- d. Make agency appraisals (FHA, VA, Fannie Mae, Freddie Mac and FmHA) acceptable to all FFIEC-member regulators. Federal regulators have adopted standards for what constitutes an acceptable appraisal. These standards go beyond the kind of appraisal required by the federal housing agencies and the

GSEs. (OTS has carved out an exception for FMA and VA.) Some builders are reporting that problems are arising because of inconsistent requirements between appraisals that meet agency requirements but not regulator requirements.

7. Economic Recovery

- a. Repeal the passive loss restrictions for real estate investors in order to allow investors in rental real estate to deduct losses without limitation and thereby encourage investment in multifamily housing.
- b. Enact a legislative package that, in addition to repealing the passive loss restrictions, would stimulate housing and economic recovery by: (1) creating a tax credit for moderate-income first-time homebuyers; (2) allowing penalty-free withdrawals from retirement plans for downpayments on homes; (3) extend the low-income housing tax credit and mortgage revenue bond programs; and reinstate a capital gains rate differential for real estate and other assets.

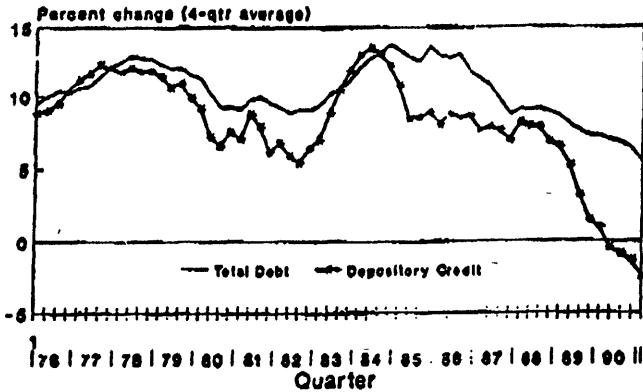
8. Pending Issues that Could Aggravate the Credit Crunch

- a. Delay or end consideration of OTS' proposed interest-rate risk component of capital (and similar action by banking regulators), which could needlessly add to the cost of mortgage credit and reduce the availability of more desirable fixed-rate mortgages.
- b. End consideration of specifying loan-to-value ratios for real estate loans in statute or regulation. Such restrictions would preclude the underwriting flexibility necessary for residential production loans and render sound projects economically unfeasible.
- c. Halt efforts by FFIEC and the banking regulators to label certain types of mortgage-related securities structures as unsuitable investments for financial institutions lest such actions inadvertently damage the secondary markets and raise the cost of mortgage credit for homebuyers.

Mr. Chairman, thank you for this opportunity to share these suggestions with you. I would be happy to answer any questions.

Chart #1

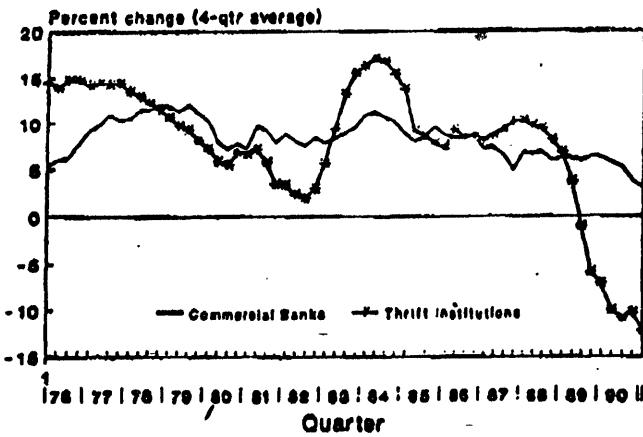
TOTAL CREDIT MARKET ACTIVITY AND DEPOSITORY INSTITUTIONS



Source: Flow of Funds Accounts (Z.1)

Chart #2

DEPOSITORY CREDIT BY SOURCE



Source: Flow of Funds Accounts (Z.1)

PREPARED STATEMENT OF ELIU RIVERA

GOOD MORNING, CHAIRMAN GUARINI AND DISTINGUISHED MEMBERS OF CONGRESS. MY NAME IS ELIU RIVERA AND I AM THE EXECUTIVE DIRECTOR FOR PUERTORRIQUEÑOS ASOCIADOS FOR COMMUNITY ACTION, BETTER KNOWN AS PACO. OUR ORGANIZATION, WHICH HAS BEEN IN EXISTENCE FOR OVER 20 YEARS, WORKS WITH THE HISPANIC COMMUNITY IN DOWNTOWN JERSEY CITY. MOST OF THE MEMBERS OF OUR COMMUNITY ARE LOW AND MIDDLE INCOME RESIDENTS. MEMBERS OF THE COMMUNITY RUN AND WORK AT PACO. SINCE OUR INCEPTION AND FIRST DAYS IN A COLDWATER FLAT IN JERSEY CITY, WE HAVE STRIVED TO IMPROVE THE QUALITY OF LIFE FOR HISPANICS AND ALL RESIDENTS OF DOWNTOWN JERSEY CITY.

IN ADDITION TO MANY SOCIAL SERVICE PROGRAMS WE HAVE PUT TOGETHER, ONE OF THE MOST PRESSING NEEDS THAT PACO TRIES TO HELP WITH IS HOUSING. WE HAVE WORKED WITH OTHER COMMUNITY GROUPS AND GOVERNMENT PROGRAMS TO BUILD AFFORDABLE HOUSING UNITS. WE OFFER ASSISTANCE FOR THOSE LOOKING TO SECURE AFFORDABLE HOUSING, OR THOSE WITH HOUSING PROBLEMS.

FINDING AFFORDABLE HOUSING AND GETTING FINANCING FOR HOUSING HAS NEVER BEEN PARTICULARLY EASY IN OUR COMMUNITY. WE HAVE MANY LOW-INCOME RESIDENTS. ADDED TO THIS HAS BEEN THE LANGUAGE AND CULTURAL BARRIERS THAT CONFRONT HISPANICS.

DURING THE PAST YEAR, AS THE RECESSION HAS TAKEN A HEAVY TOLL ON OUR AREA, THE PROBLEMS IN GETTING HOUSING AND FINANCING HAVE INCREASED GREATLY. WE LIVE IN A COUNTY THAT HAS AN UNEMPLOYMENT RATE OF OVER 9 PERCENT. THERE HAVE BEEN RECORD NUMBERS OF FORECLOSURES. BANKS ARE NOT DOING WELL IN OUR AREA. SO THEY MAKE IT TOUGHER FOR OUR RESIDENTS TO GET THE FINANCING THEY NEED TO EITHER BUY A HOME, REFINANCE A MORTGAGE OR IMPROVE THEIR PROPERTIES.

SOME OF THE REASONS FOR THE NEW TOUGHNESS ON THE PART OF THE BANKS IS BECAUSE THEY ARE TIGHTENING THE REQUIREMENTS AND TAKING LESS RISKS. THIS IS TO BE EXPECTED. SOMEONE WHO HAS DEFECTED ON LOANS OR SHOT THEIR CREDIT RATING CANNOT EXPECT TO HAVE A BANK THROW MONEY TO THEM.

BUT IN MANY INSTANCES, WE ARE SEEING RESIDENTS REJECTED FOR LOANS FOR NITPICKING REASONS. ONE LATE PAYMENT ON A PREVIOUS LOAN IS SOMETIMES ENOUGH TO REJECT A MORTGAGE REQUEST.

WHILE WE CAN'T EXPECT THE BANKS TO TAKE RISKS THAT DON'T MAKE SENSE, THEY ALSO SHOULDN'T BE SO RISK ADVERSE THAT IT MAKES IT IMPOSSIBLE FOR PEOPLE TO GET THE FINANCING THEY NEED.

AND SOME OF THE REASONS THAT BANKS ARE TIGHTENING ARE BEYOND THE CONTROL OF THE AVERAGE RESIDENT LIKE MYSELF. PROPERTY VALUES SKYROCKETED IN OUR COMMUNITY IN THE LATE 1980S. WITH THE RECESSION, THEY HAVE FALLEN. COMBINED WITH HIGHER TAXES DUE TO THE OVERVALUING OF THE PROPERTY AND LOWERED INCOMES BECAUSE OF THE RECESSION, MANY PROPERTY OWNERS HAVE DEFAULTED ON THEIR MORTGAGES. AS MORE PEOPLE DEFAULT AND THE BANK GETS STUCK WITH MORE PROPERTIES, THE BANKS ARE SO AFRAID OF MORE DEFAULTS THAT THEY MAKE IT TOUGHER FOR THOSE OF US WHO ARE NOT BAD RISKS.

EVERY DAY AT PACO, I SEE PEOPLE WHO NEED FINANCING. BUT THEIR ATTITUDE NOW IS TO NOT EVEN TRY GOING TO A BANK FOR A CONVENTIONAL MORTGAGE. THEY FIGURE THEY DON'T HAVE A CHANCE.

SO THEY TURN TO US AND ASK FOR HELP IN FINDING AFFORDABLE HOUSING THROUGH GOVERNMENT PROGRAMS. THIS PUTS A STRAIN ON THE LIMITED SUBSIDIZED HOUSING THAT IS AVAILABLE. GOVERNMENT FUNDING FOR NEW PROJECTS IS SHRINKING. WE IN PACO HAVE HAD SOME SUCCESS IN BUILDING AFFORDABLE HOUSING PROJECTS. BUT THERE IS NOT NEARLY ENOUGH HOUSING FOR THOSE WHO CAN'T AFFORD A CONVENTIONAL MORTGAGE. IN THE END, THE GOVERNMENT AND THE TAXPAYERS END UP PAYING, BECAUSE THE BANKS ARE SO RELUCTANT TO LEND.

THIS RELUCTANCE TO LEND ALSO AFFECTS THE OVERALL VALUE OF PROPERTIES IN OUR COMMUNITY. PEOPLE CAN'T GET THE MONEY TO IMPROVE THEIR HOMES OR BUSINESSES. THIS MEANS THAT THE COMMUNITY SLIDES, BUSINESSES LEAVE AND MONEY GOES OUT OF THE AREA. THIS LEADS TO MORE FORECLOSURES, WHICH LEADS TO THE BANKS BECOMING EVEN MORE RELUCTANT TO LEND MONEY IN OUR COMMUNITY. IT IS A VICIOUS CIRCLE AND THE AVERAGE WORKING PEOPLE ARE THE ONES GETTING HURT.

THE BANKS CANNOT TAKE STUPID RISKS. BUT THEY HAVE TO LOOK TO ENCOURAGE HOMEOWNERSHIP AND IMPROVEMENT WITHIN THE COMMUNITY. AND GOVERNMENT HAS TO WORK WITH THE BANKS TO DEVELOP PROGRAMS THAT HELP PEOPLE OBTAIN CONVENTIONAL MORTGAGES. IF NOT, GOVERNMENT WILL HAVE TO SPEND EVEN MORE MONEY ON PROVIDING HOUSING AND SOCIAL SERVICES FOR OUR RESIDENTS.

THANK YOU.

PREPARED STATEMENT OF L. WILLIAM SEIDMAN

Good morning Mr. Chairman and members of the Committee. I appreciate the opportunity to address the committee on the topic of credit availability.

It is clear that the amount of credit outstanding in large commercial banks has declined from \$300 (plus) billion in January, 1991 to approximately \$295 billion in November.

I have been asked to address this decline, sometimes called the credit crunch, with respect to the following issues.

1. The extent to which increased supervision by regulatory agencies may have contributed to the credit crunch.
2. The effect of the recession on the demand for credit.¹
3. If tax policies should be changed to encourage investment in real estate.

With regard to the question of whether increased supervision contributed to the credit crunch, I would suggest that many factors have contributed to the lack of available credit. Overly zealous bank examiners may have discouraged some bankers from making certain marginal loans -- loans they might have approved just a few years back.

But I believe this is a small factor when compared to the larger and more fundamental causes of the credit crunch.

Many areas in the United States are substantially over-built, at least in terms of commercial real estate. Bankers are certainly aware of this fact and are understandably cautious when presented with loan applications for new construction.

In terms of mortgage applications and extensions of past credit, bankers principally base their decisions on current market prices and potential loss exposure. In many areas real estate markets, and particularly commercial real estate markets, have declined in value. If bankers are more circumspect in their attitude toward real estate related lending, I would first congratulate them, and second, suggest that their circumspection is due more to the economic realities of the marketplace than to a fear of bank examiners.

Having said that, I would agree that bank examiners may have discouraged bankers from making prudent and profitable loans in certain cases. But since this happens on an individual, case by case basis, it is difficult to generalize a solution to the problem, except to suggest that each situation be addressed on its merits. In this regard, I believe the new Interagency Statement by the FDIC, OCC, OTS and the Federal Reserve could be helpful.

But it certainly will not "cure" the credit crunch.

This brings me to the second issue which you have asked me to address and that is the effect of the recession on the demand for credit.

First, most profitable banks (and nearly 90 percent were profitable during the last quarter) want to make good loans. That's how banks make money. Where there is a demand for loans backed by solid collateral with the expectation of repayment, then there will be banks to extend the credit. However, this credit worthy demand is always reduced in a recession.

In the current market there is evidence that the demand has slackened -- particularly in the areas of commercial real estate construction and development. This is no surprise considering the overdevelopment and the vacancy rates in certain regions of the country. In many regions it will be several years before the demand for commercial real estate catches up with the supply.

Nevertheless, the banks are making commercial loans in increasing amounts today -- not because they want to, but because their business judgement is that they have to make them. The reason is that the short term "mini-perm" construction and development loans are coming due (perhaps \$150-\$200 billion worth over the next two years).

The banks have been rolling these loans over from construction loans to real estate loans since there is no other source of funding. Thus banks' portfolios of real estate loans continue to increase during the so-called credit crunch. In addition, loans not "rolled over" are called and become REO (real estate owned) so that the bank involvement in the real estate market is further increased through ownership.

Overall, while banks are not making many new borrower commercial real estate loans for the reasons cited, they are actively adding to their real estate portfolios -- which is unfortunate.

Industries that are dependent upon real estate construction and development are naturally effected by the sluggish market as well. They too will recover as the markets improve.

This brings me to the third topic which is whether I believe tax policies should be changed to stimulate real estate investment. In this regard, I believe a capital gains tax reduction incentive could be helpful, as well as some changes in the passive loss rules for real estate investment.

But encouraging real estate investment without addressing the fundamental problems causing the sluggishness in our economic recovery will not solve the problem.

It should be said that federal budgetary deficits have an important effect on credit, and an even more important effect on equity availability to the private economy. Both credit and equity must be available in increased amounts to get our economy up and going again.

Your Committee's work in this area, under its able leadership, is of utmost importance to the economic recovery.

Addressing the Credit Crisis: National Policy Options

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National Realty Committee serves as Real Estate's Roundtable for national policy issues. NRC members are America's leading real estate owners, advisors, builders, investors, lenders and managers.

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EXECUTIVE SUMMARY

A credit crisis grips the economy, particularly real estate. The crisis shows no sign of improvement as business failures soar, financial institutions weaken, quantities of the nation's wealth literally disappear and state and local property tax bases erode.

Recent steps announced by President Bush will be helpful. The White House recognized the necessity of encouraging: (1) prudent loan renewals; (2) the utilization of realistic real estate appraisal techniques; and (3) an expanded time frame for banks to reduce real estate loan exposure.

Still, as the Administration itself acknowledges and as Congress is increasingly aware, more can and should be done to alleviate the credit crisis, stabilize the real estate and financial sectors, and stimulate economic growth. Immediate, coordinated action is critical.

1. Additional sources of credit and capital must be cultivated.

Pension funds, with their long-term liabilities, are a logical source of capital for real estate investment. Policymakers should:

- modernize the tax rules that apply to pension investment in debt-financed real estate;
- simplify the rules applying to partnerships between pensions and taxable partners;
- treat a domestic pension fund the same as a foreign fund is treated when investing in real estate through a real estate investment trust; and
- enact a moratorium on the application of the dealer rules to pension fund investments in residential development activities.

Strengthening the secondary market for commercial real estate mortgages would provide significant liquidity. Policymakers should:

- clarify the amount and allocation of capital required of holders of senior and subordinated interests to eliminate overreserving;
- allow subordinated interests to be traded; and
- encourage uniformity in commercial real estate loan and securities documents.

2. Regulatory balance must be restored.

Policymakers should:

- stretch-out the phase-in of the bank capital standards;
- adjust the risk-based capital standards for commercial, multi-family and single-family real estate;
- revise the "insubstance foreclosure" rules;
- end mark-to-market, liquidation-based, appraisals;
- strongly encourage loan renewals; and
- communicate policy more effectively to bank examiners and bankers in the field.

3. Tax changes are necessary.

Policymakers should:

- modify the passive loss rules;
- reduce the capital gains tax; and
- ease tax penalties associated with loan restructurings.

**ADDRESSING THE CREDIT CRISIS:
NATIONAL POLICY OPTIONS**

During the past year and a half a credit crisis of national proportions has taken hold of the economy and grown increasingly severe, particularly for real estate. To date the credit crisis has shown no sign of improvement. Its effects are being felt broadly throughout the nation as business failures soar, financial institutions weaken, quantities of the nation's wealth disappear and state and local property tax bases further erode. Immediate, carefully coordinated action by Federal policymakers is critically needed to arrest this crisis. President Bush recently outlined a set of proposals to address this problem. These recently announced steps should be helpful, but additional initiatives must now be developed and implemented to restore the availability of credit and capital and stem the downward pressure on real estate values. As a critical first step, liquidity must be provided to ensure a healthy and efficient marketplace that works for owners, lenders and investors. National Realty Committee believes the following policy options, addressing capital and credit availability, the regulatory environment and tax policy can play a meaningful role in resolving the current crisis.

I. Capital and Credit Availability -- Additional sources of capital and credit are needed for America's real estate industry and financial institutions to recover from the current crisis and regain their health. With a substantial portion of banks' \$400 billion of commercial real estate loans maturing over the next two years, it is essential that new sources of capital and credit be developed immediately, particularly given the pressure on banks to reduce the existing percentage of real estate credits in their portfolios. Absent new sources of capital and credit the value of real estate investments -- even those conservatively leveraged and operated in a sound manner -- will continue to plummet. New capital and credit sources can most effectively be developed through two means: additional prudent investment in real estate by pension capital and a strengthened secondary market for real estate debt and equity.

A. Pension capital. Pension funds, with their long-term liabilities, are a logical source of capital and credit for long-term real estate investment. That is why many pension fund managers recommend a five to 15 percent allocation of the investment portfolio to real estate. However, several current tax and regulatory policies create undesirable and unnecessary obstacles to such investment. Without undermining the very significant and substantive protections against undue risk already in place, several rule changes should be made to allow for prudent pension investment strategies in real estate.

1. Today, domestic pension funds are treated less favorably than are foreign funds under investment rules applying to REITs. A "look-through" rule, similar to that applied to foreign pension funds, should be applied to domestic pension funds investing in real estate assets through REITs. To qualify as a Real Estate Investment Trust, no more than 50 percent of a REIT's stock may be owned by five or fewer individuals. This rule was designed to keep individuals from acting in concert to derive tax advantages through personal holding companies. Domestic pension funds are, through a quirk in the law, considered one individual, while foreign pension funds are "looked-through" and treated as if each pension fund beneficiary is an investor. Due to the relatively small size of most REITs, it is very difficult for domestic pension funds to make economically feasible investments without violating this ownership restriction. A "look-through" rule, similar to that applied to foreign pensions plans, could be applied to domestic pension plans. This would encourage additional investment by pension funds in real estate yet preserve the original purposes of the REIT ownership rules.
2. Rules unduly restricting pension fund investment in debt-financed real estate should be revised. Pension funds must comply with certain restrictions to ensure that income from debt-financed real estate is tax-exempt. These restrictions, enacted to stop pension funds from "trading" on their tax exemption by paying an inflated price or charging a below-market rent, generally deny tax-exempt status to pension investments in real estate that involve a contingent purchase price, sale-leaseback, participating mortgage or seller financing.

Significant changes in the tax law have occurred since these rules were enacted. Given these changes, the rigidity of these rules makes little sense from a tax policy standpoint today and they impose penalties which are not proportionate to the problem. Modest changes should be made that would not create tax abuse yet would encourage more open pension fund investment in real estate, provide liquidity to financial institutions and benefit individual investors. Current restrictions in need of revision follow.

- a. Modify the fixed purchase price requirement. Currently, income earned by a pension fund from debt-financed real estate is not tax-exempt unless the price of the real estate is fixed with certainty on the date of acquisition. This rule should be changed to allow standard post-closing purchase price adjustments, such as completion guarantees, lease-up of property, etc.
- b. Modify the treatment of "cash-flow" or "participating" loans. Currently, income earned by a pension fund from debt-financed real estate is not tax-exempt if the terms of the property's debt are dependent upon revenue, income, or profits of the real property. These "cash-flow" or "participating" loans are standard in today's real estate environment, and the tax rules should be changed to allow pension funds to use them.

- c. Modify the treatment of sale-leasebacks. Currently, income earned by a pension fund from debt-financed real estate is not tax-exempt if any of the real estate is leased back to the seller of the property. This rule should be changed to allow modest sale-leaseback activity, e.g., a leaseback of five or 10 percent of the real estate should be allowed.
 - d. Modify the treatment of seller-financing. Currently, income earned by a pension fund from debt-financed real estate is not tax-exempt if there is any seller financing. An exception should be provided for non-abusive transactions involving seller-financing terms that are commercially reasonable.
3. The rules controlling partnerships between pension funds and taxable investors should be clarified. A pension fund seeking to invest in real estate through a partnership must comply with the so-called "fractions rule" which dictates the allocation of income and expenses among the partners. This rule was originally enacted to combat the perception that partnerships between pensions and taxable entities were being designed to allocate income to the pension and deductions to the taxable partners. The rules are exceedingly complex and have been subject to frequent change (the rules were added in 1984, and modified in 1986, 1987, and 1988). These frequent rule changes, together with their lack of clarity, have made it exceedingly difficult to structure partnerships with pension funds. Additionally, the perceived abuse targeted by the rules no longer exists in light of the current economic state of the real estate industry and changes in the tax law in 1986, such as the passive activity rules and lengthening of depreciation lives.

Although the Internal Revenue Service recently issued limited clarifications and guidance in IRS Notice 90-41, many unanswered questions remain that cause pensions to avoid real estate partnership investments. At a minimum, IRS Notice 90-41 should be revised and made consistent with the rules applicable to non-pension partnerships which require all allocations to have substantial economic effect as defined in the tax laws.

4. To ease the credit shortage for needed housing development, a moratorium should be enacted on the application of the dealer rules to pension fund investments in residential land development activities. Presently, if a pension fund holds property for investment purposes and then disposes of it, the gain on the sale is tax-exempt. However, if a pension fund purchases land for resale to homebuilders, or to build houses for resale, then the pension is considered to be a "dealer" and the gain on such sales is fully taxed. These two policy objectives -- the immediate need for capital in the housing sector and the longer-term desire to limit competition from tax-exempt pension funds -- could be met if the dealer rules were suspended for five years and not applied to pension investments in residential land development activities.

B. Secondary market for real estate securities. Strengthening the secondary market for commercial real estate securities would infuse significant capital and liquidity into the banking and real estate sectors of the economy. Although a small securitization market now exists for commercial mortgages, there are a number of steps the Federal government should take to greatly bolster this market. These include:

1. Clarify the amount and allocation of capital required of holders of senior and subordinated interests to eliminate overreserving. The most effective credit enhancement short of a Federal guarantee is subordination. Subordination generally involves dividing a loan or pool of loans into two classes of ownership interests -- a subordinated or junior class bearing the first risk of loss and a senior class benefiting from having losses first allocated to the subordinated class.

Current risk-based capital rules require a bank to maintain eight percent capital against the entirety of a commercial loan -- even if the bank has sold a senior interest in the loan and retained a junior portion. Technically, this is because the bank is not treated as having disposed of any portion of the loan for capital purposes. While a higher than normal capital requirement for subordinated interests may be justified as corresponding to a higher probability of loss, the current capital requirement is excessive. In addition, if a bank holds the senior interest -- which presumably entails a smaller likelihood of loss -- it too is required to maintain eight percent capital against 100 percent of the senior interest. In such a situation, the aggregate capital requirement is in excess of eight percent.

More appropriate guidelines governing the allocation of risk among senior and subordinated interests in commercial mortgage loan pools should be issued to prevent overreserving. More appropriate guidelines would remove the current arbitrary obstacle to private credit enhancement and strengthen the secondary market for commercial real estate loans.

2. Permit freely tradeable subordinated interests in investment trusts. IRS rulings restrict the tax pass-through benefits of "trust" status to cases where the subordinated interest is permanently retained by the issuer and is neither transferred nor traded. This limits the liquidity and reduces the value of subordinated interests. For example, a bank currently holding a subordinated trust interest and seeking to increase its risk-based capital ratio might wish to sell the interest -- perhaps to an unregulated entity or investor. Such a transfer would be forbidden by the current IRS rules and would cause the trust to be taxed as a corporation. There does not appear to be any basis in law or policy for this restrictive interpretation. An announcement should be made stating that the transfer or transferability of a subordinated interest in a fixed investment trust would not affect the classification of the trust.
3. Extend benefits enjoyed by SMMEA securities to comparable commercial mortgage securities. The Secondary Mortgage Market Enhancement Act of 1984 (SMMEA) removed a number of legal impediments to the development of a private mortgage backed

securities market for residential mortgage pools. These include pre-emption of state blue-sky laws, preferential capital treatment, favorable margin rules and eligibility for "shelf" registration. Congress should extend SMMEA to commercial mortgage securities.

4. **Clarify availability of the Real Estate Mortgage Investment Conduit for commercial mortgage transactions.** The tax companion to SMMEA was the REMIC provision of the 1986 Tax Reform Act. REMIC created an improved tax vehicle for the issuance of multiple-class pass-through securities. Although available for commercial mortgages, there are a number of ambiguities and uncertainties in the law that make it difficult to utilize. IRS should issue regulations to clarify that prepayment penalties, contingent interest and other forms of interest typical in commercial mortgages may be passed through to holders of the security.
5. **Promote greater uniformity of loan and securities documentation.** Commercial mortgage loans tend to be much less homogeneous than residential mortgage loans. Securitization would be enhanced if there were a movement towards more uniformity in loan documentation. The government should take a lead role in developing and promoting model commercial loan documents or model securities documentation. For example, simplified regulatory review of loans involving uniform documents might be an appropriate incentive.

II. Regulatory Balance -- President Bush recently announced a series of proposals directed towards achieving greater balance in the bank supervision and examination process. In particular, the call for a revised appeals process to reduce the misapplication of regulatory standards, the stated desire to end the liquidation approach to valuation and the directive instructing bankers to work constructively with borrowers experiencing temporary difficulties, are encouraging and will be helpful. Consideration should also be given to taking steps in the following specific regulatory policy areas.

- **Delay full implementation of the new bank capital standards.** Consideration should be given to extending the full implementation of the Bank for International Settlements (BIS) capital requirements beyond December 31, 1992. Although the transition period through 1992 seemed appropriate when agreed to in 1988, it is now apparent that the current pressure on U.S. banks to meet these standards encourages banks to shrink their balance sheets by not renewing real estate and other credits, to the overall detriment of the economy.
- **Adjustment of the risk-based capital standards.** Current risk-based capital standards require banks to reserve 100 percent against all commercial and multi-family real estate loans while other credits enjoy much lower capital reserving. This discourages banks from making or holding such loans. These rules should be revisited and criteria should be established to ease this disincentive now affecting all commercial and multi-family real estate credits -- perhaps reducing the 100 percent standard for loans demonstrating a history of solid repayment performance.

- **Revision of the "insubstance foreclosure" rules as they apply to real estate.** Current rules classify all loans in which the borrower has no equity -- based on unrealistic appraisals made in today's dysfunctional marketplace -- as "insubstance foreclosure". This rule was never intended to apply to real estate and its use in evaluating real estate credits now unnecessarily distorts the true risk associated with a lender's portfolio and should be revised.
- **Encouragement of prudent loan renewals.** Policies and regulations must be adopted urging that banks renew or extend loans backed by existing income-producing real estate in accordance with current underwriting standards. These initiatives must include a revision of supervisory agreements (i.e., letters of commitment, memoranda of understanding, cease and desist orders) between bank directors and regulatory agencies that effectively mandate banks to rapidly reduce real estate loan concentrations.

III. Rational Tax Policy -- The stability of real estate has suffered during the past decade first from tax rules that in 1981 stimulated excessive investment in real estate, and then in 1986 when rules were adopted that discourage capital investment in real estate, artificially eroding real estate values. A long-term, rational tax agenda for real estate should at a minimum include:

- **Modifications to the passive loss tax rules.** The current passive loss rules exacerbate the deterioration of real estate values by misstating the true economics of owning and operating real estate. The rules single-out losses from rental real estate and prohibit their current deduction, even against real estate income. This tax on "gross" income makes holding or acquiring troubled real estate much more difficult and increases the pressure on financial institutions. Modification of the passive loss rules should be made to ensure that they are applied to those in the real estate industry the same way that they are applied to other businesses.
- **A reduction in the capital gains tax.** A lower capital gains tax would be an important step in reducing U.S. capital costs and promoting investment. Importantly for real estate, it would lessen the need for debt financing, help attract needed capital, ameliorate the taxation of inflationary gains that exists currently and help stabilize real estate property values.
- **Tax rules that do not unnecessarily penalize real estate debt restructurings or workouts.** Today debt restructuring is a common occurrence, as are foreclosures or deeds in lieu of foreclosure. The tax consequences associated with these transactions can lead to significant tax liability, many times forcing borrowers to liquidate properties they otherwise would not sell. The option to reduce the tax basis in retained depreciable property as an alternative to debt forgiveness income, which was repealed in 1986, should be reinstated. In addition, financing provided by lending institutions on real estate owned by them should be treated the same under the at-risk rules as financing provided by a third-party lender.

Appendix A

A Closer Look at the Pension Capital Options

A CLOSER LOOK AT THE PENSION CAPITAL OPTIONS

INTRODUCTION

Many legislators and other national policymakers have expressed an interest in examining the role that pension funds could play in mitigating the credit crisis affecting the U.S. economy today. As a result, several real estate organizations asked Price Waterhouse, working with numerous real estate and pension fund professionals, to prepare the following analysis and review. The paper discusses the credit crisis affecting the real estate industry, parallels with a comparable situation in the United Kingdom in the 1970s, ways in which pension funds could help solve the current problems in this country, and policy options to mobilize pension capital and thereby reduce the crisis.

OVERVIEW

The U.S. real estate industry is in the midst of a deep recession, if not a depression. In many parts of the country, property values are declining, sales and rentals of existing properties are slow, and new construction has virtually stopped. This is true not only for commercial real estate but for housing as well.

While overbuilding certainly played a fundamental role in the problems real estate faces today, the so-called "credit crunch" is also at the heart of the crisis. Because real estate credit from traditional sources like banks, savings and loans, and insurance companies has largely vanished, there is a severe shortage of liquidity in the real estate markets. The results are that economically viable development is arrested, refinancing is extremely difficult if not impossible, partially completed projects go unfinished, and the normal functioning of the market is greatly retarded.

At the same time, the nation's financial institutions -- savings and loan associations, commercial banks, and insurance companies -- are also experiencing significant problems. The problems of the real estate industry and the nation's financial institutions are closely related and intertwined.

In the 1970s, pension funds played a major role in helping to resolve a similar situation in the United Kingdom. For U.S. pension funds to play a similar role in this country, several barriers that tend to limit pension fund investment in real estate could be lowered or removed. Of particular importance are many federal income tax provisions that do not appear well-structured for the present economic environment. These provisions, along with some options for possible change, are discussed in more detail below.

THE CREDIT CRUNCH IN THE REAL ESTATE INDUSTRY**The 1980s**

During most of the 1980s, the economy was strong and the demand for real estate was high. Capital for real estate investment was plentiful, both for buyers of existing property and developers of new property.

Debt and equity capital came from a number of sources during the 1980s. The deregulation of savings and loan associations turned these institutions into major real estate investors. Commercial banks became increasingly involved in real estate lending as other investment opportunities diminished. Institutional investors, such as insurance companies and pension funds, played an active role. The Economic Recovery Tax Act of 1981, which provided 15-year depreciation for commercial property, spurred a massive influx of capital. Finally, foreign investors were a major source of capital in the 1980s.

The 1990s

The Credit Crunch. In marked contrast to the 1980s, the 1990s have been characterized by recession and a severe shortage of liquidity and capital in the real estate industry. As widely reported, normal transactions cannot take place because buyers cannot get financing, refinancing is extremely difficult if not impossible, and developers of economically viable properties are unable to obtain credit, even to finish projects already underway. The S&L industry is greatly contracted and is no longer a viable source of commercial real estate financing. Insurance companies, in response to developing problems in their industry, are cutting back on real estate lending. Tax law changes subsequent to 1981, particularly the Tax Reform Act of 1986, have diminished the supply of capital to real estate from other sources by sharply cutting after-tax returns. The influx of foreign capital has slowed markedly, the result of changes both here and abroad.

Role of Commercial Banks. Commercial banks were the biggest provider of credit for multifamily and commercial real estate going into the 1990s, and, they now hold about \$400 billion of loans for such property. But banks are cutting back on new real estate lending and are seeking to reduce the total amount of real estate loans in their portfolios. For example, a Federal Reserve survey indicates that 80 percent of banks' construction and mini-perm loans (on multifamily and commercial real estate) maturing within the next 12 months have no take-out or refunding commitments. National Realty Committee estimates that that 80 percent represents about \$66 billion. These developments in the banking sector are especially significant because there is a limit to the capacity and willingness of other financial intermediaries to provide the needed replacement capital.

The reduction in bank real estate lending is, in large part, a response to pressure from bank regulators fearing a repeat of the S&L situation. As a result of this pressure, banks are making fewer new real estate loans, even for sound real estate projects. Real estate assets are being written down, using conservative valuation techniques, forcing increases in loan-loss reserves and reducing the funds available for new lending. Other funds that would normally be available are tied up in what were meant to be short-term loans. Banks are increasingly being forced to foreclose on loans and put properties on the market at deflated values, adding to the downward pressure on real estate prices.

Thus, the banking and real estate industries are caught up in very difficult circumstances, in which continued problems in one sector will lead to continued problems in the other.

Collateral Effects. The effects of the credit crisis extend beyond the real estate industry and financial institutions. The credit crisis limits the ability of banks to lend in the non-real estate sectors. The effects of the problems in real estate and banking are being felt throughout the economy, hindering recovery from the overall economic recession.

These problems also affect the federal government and state and local governments. At the Federal level, the Administration projects that Federal costs relating to deposit insurance losses in the coming fiscal year will be \$115 billion. Further declines in real estate values will not only add to the Federal costs of deposit insurance, but will exacerbate the developing problems in the banking and insurance industries. At the local level, declining property values result in lower property tax receipts.

THE U.K. EXPERIENCE

The Problem. Similar problems faced the real estate and financial markets in the United Kingdom during the 1970s. In the early 1970s, there was a boom in commercial real estate development. The Bank of England, wanting to keep credit available for anticipated industrial uses, discouraged banks from making real estate loans. The demand for funds in the real estate sector was filled by so-called "fringe banks", deposit-taking institutions not subject to the full oversight of the Bank of England.

Beginning in 1973, certain fringe banks were unable to rollover their deposits and faced possible collapse. This problem threatened to develop into a crisis of confidence that might have affected the entire U.K. banking system.

At the same time, an increase in interest rates and other factors led, beginning in 1974, to a drop in property values. This drop in property values was reflected in the stock prices of property companies, which fell precipitously.

The "Lifeboat". Against this background, the Bank of England, together with the English and Scottish clearing banks, established the lifeboat program to rescue the fringe banks and restore confidence in the U.K. banking system. U.K. pension funds played a major role in this effort by providing liquidity to property companies needing to sell their investments.

U.S. PENSION FUNDS

U.S. pension funds, with assets of over \$1.8 trillion¹ could play a role in this country similar to that played by U.K. pension funds in that country in the 1970s. There are a number of approaches that could be taken by pension funds in helping to solve the credit crunch. For example, pension funds could recapitalize banks and other financial institutions through direct investments. However, a more effective way of solving the problems in both the real estate and financial sectors may be for pension funds to provide liquidity and credit to owners of real estate assets.

In particular, there are two areas in which pension funds could help resolve the crises now facing the real estate industry and financial institutions:

1. Liquidity for existing investments. As a result of the credit crunch, owners of existing real estate assets (i.e., real property and real estate loans) are having extreme difficulty selling or refinancing such assets. This is particularly a problem for those under strong pressure to sell real estate assets, such as financial institutions and the Resolution Trust Corporation (RTC).
2. Credit for new housing. The lack of availability of affordable housing is a major problem in many parts of the country. As a result of the credit crunch, however, developers of single family and multi-family housing cannot obtain sufficient financing from traditional sources.

Currently, only a relatively small amount of pension fund assets (approximately \$88 billion, or five percent²) are invested in real estate. The current status of pension fund investment in real estate, ways in which pension funds could provide additional capital and liquidity to the real estate industry, specific barriers to additional pension fund investment in real estate, and policy options to overcome these barriers, are discussed below.

PENSION FUND INVESTMENT IN REAL ESTATE

Investment Trends

Real estate first became a major investment for U.S. pension funds with the passage of the Employee Retirement Income Security Act of 1974, or ERISA. ERISA imposes standards on pension plan fiduciaries, including a requirement that the fiduciary diversify the investments of the plan to minimize the risk of large losses. As a result of ERISA, many pension plans began investing in real estate to increase the asset-class diversification of their investment portfolios.

The trend toward increased real estate investment was furthered by research suggesting that real estate had a number of desirable investment characteristics, particularly when viewed as part of an overall investment portfolio. These desirable characteristics included high historical returns, low variability, a strong correlation with inflation, and a low correlation with the returns on stocks and bonds (reducing portfolio risk). As a result of these and other factors, pension fund investment in real estate grew well into the 1980s.

Recent research based on the Russell-NCREIF Property Index suggests that the long-term returns on institutional-grade property compare favorably with those on equities and bonds, particularly when measured on a risk-adjusted basis. In addition, in the long run, real estate has been shown to be less volatile than stocks or bonds, and effective both as an inflation hedge and as a portfolio risk-management tool³.

Nonetheless, beginning in the late 1980s, many pension funds scaled back their real estate investment plans. This has been primarily due to the drop in returns and asset values being experienced in the current depressed environment.

Methods of Investing

Pension funds invest in real estate in a number of ways. Some pension funds invest directly in real estate. Others invest through commingled funds (managed by outside managers, such as insurance companies) or real estate investment trusts (REITs). Pension funds also provide long-term debt financing to real property owners. Historically, asset allocation models, used by pension fund managers to determine the amount invested in different asset classes, generally recommended a roughly 10 percent allocation to real estate, with a range between five and 15 percent (at the extreme, some allocations are over 20 percent). Actual allocations to real estate, however, often fell well below these targets.

POTENTIAL ROLE OF PENSION FUNDS

Despite the current problems in the real estate industry, many believe that pension funds stand ready to make additional investments. Even where target allocations have been reduced, there is still a great deal of allocated but uninvested capital available for investment in real estate. Thus, pension funds represent a substantial potential source of investment capital to help alleviate the real estate credit crunch.

In particular:

- Pension funds could provide liquidity to owners of real estate assets, including financial institutions, that want to divest such assets. For example, pension funds could purchase real estate from banks and the RTC.
- Pension funds could help alleviate the housing credit crunch by investing in multi-family rental housing, and land development and homebuilding.

TAX LAW BARRIERS AND POLICY OPTIONS

There are a number of barriers that may hinder pension funds from making additional investments in real estate. For example, certain aspects of the financial accounting rules and the bankruptcy laws may serve to discourage pension funds from making real estate investments.

Furthermore, significant barriers are found in the Federal income tax law. One way to encourage additional pension fund investment in real estate would be through targeted changes in the tax rules that affect pension funds. These tax barriers, and policy options for lowering them, are outlined below.

Real Estate Investment Trusts

Background. A real estate investment trust is an entity that has transferable shares, is owned by at least 100 persons, is not closely held, is engaged primarily in passive real estate investment, and distributes most of its income to its shareholders.

An entity will generally not qualify as a REIT if more than 50 percent of the value of its shares is owned by five or fewer individuals. For this purpose, the rules count a U.S. pension fund as one "individual", rather than counting the many beneficiaries of the fund as many individuals. Thus, if five or fewer U.S. pension funds own more than 50 percent of the share value of an entity, the entity will not qualify as a REIT. Due to the relatively small size of most REITs, it is not possible in many cases to structure a REIT in which pension funds can make economic investments without violating this rule.

Policy Option. The REIT rules could be modified to make it easier for large pension funds to make REIT investments without violating the five-or-fewer shareholder rule. For example, a rule that looks through the pension fund to its beneficiaries -- similar to the rule that applies to foreign pension plans -- could be applied to domestic pension plans.

Debt-Financed Property

Background. An unrelated business income tax (UBIT) applies to certain otherwise tax-exempt organizations, including pension trusts. The general scheme of the UBIT is to tax the net income earned by a pension trust from activities that are regularly carried on and not substantially related to the trust's exempt purpose.

Congress specifically excluded certain types of investment income from UBIT because such income is "passive in character", "not likely to result in serious competition for taxable businesses", and has "long been recognized as a proper source of revenue for educational and charitable organizations and trusts."⁶⁴

In general, the rules which exempt from UBIT certain rents from real property and gains from the sale of investment property do not apply to the extent that the rents and gains are derived from debt-financed property.

However, this restriction was modified in legislation enacted in 1980, so that rents and gains from debt-financed real property owned by "qualified organizations" (including pension trusts) are generally not subject to tax. In enacting this provision, Congress stated that it was inappropriate to continue the restrictions "to the extent that they discourage prudent debt-financed real estate investments."⁶⁵

Nevertheless, conditions were imposed on this exception for qualified organizations to discourage the type of abusive transactions at which the debt-financed income rules were targeted. Unfortunately, these conditions also serve to prevent pension funds from entering into non-abusive transactions, arms-length transactions, or transactions involving third parties.

Policy Options. There are a number of modifications that would encourage pension funds to invest in real estate while still preserving safeguards against abusive transactions.

Contingent Price Sales. Under present law, the exception from the debt-financed property rule for qualified organizations is unavailable in cases in which the price of acquiring or improving a property is not fixed. The legislative history indicates some leeway for price adjustments due to customary closing adjustments.⁶

Consistent with that philosophy, common post-closing sales price adjustments (such as completion guarantees) could be allowed as not constituting a contingent sales price. This could possibly be accomplished through regulations, without new legislation.

Participating Loans. At present, the exception from the debt-financed property rule for qualified organizations does not apply where the amount of the loan, or any payments under the loan, are contingent on the revenue from the property.

These restrictions could be modified to permit "equity kickers" in the case of third-party financing.

Sale-Leasebacks. Under present law, the exception from the debt-financed property rule is unavailable to a pension trust that leases property back to the seller or to a person related to the seller. Thus, a pension trust entering into a sale-leaseback does not qualify for the exception, even if the transaction is conducted at arms-length and at fair market value terms.

Both as a conceptual and practical matter, this rule against sale-leasebacks could benefit from a de minimis allowance that would permit pension funds to purchase property, without incurring tax, from sellers who will utilize only a small amount of the space in the property.

Seller-Financed Property. At present, the exception from the debt-financed property rule does not apply to seller-financed property.

This provision could be restructured so that it does not affect non-abusive transactions. Factors used to distinguish a non-abusive transaction could include a minimum equity investment by the pension fund, or seller-financing terms that are commercially reasonable.

Partnerships. Under present law, the exception from the debt-financed property rule is unavailable when a partnership involves an entity that is not a qualified organization, unless the partnership meets certain standards relating to the partnership's allocations of income and loss. The underlying policy concern is that the income might otherwise be allocated to the qualified organizations and the deductions allocated to taxable partners.

The rules relating to allocations have been changed many times and are exceedingly complex. Particularly troublesome is the "fractions rule" (which limits income allocations to qualified organizations) and its interaction with the requirement that each allocation must have substantial economic effect within the meaning of section 704(b) of the Internal Revenue Code. The IRS has issued only limited guidance in this area and left many unanswered questions. As a result, some pension trusts have been reluctant to enter into partnerships that would be subject to these rules.

At a minimum, this area would benefit from modification to clarify the interaction of the fractions rule with the substantial economic effect requirements of section 704(b). For example, the rules could be modified to provide that an allocation that has substantial economic effect also meets the requirements of the fractions rule.

General Commentary on Policy Options for Debt-Financed Property. Intervening changes in the tax law have reduced the impetus for the type of abusive transaction that was contemplated in structuring the 1980 legislation. Thus, it is possible that the restrictions relating to contingent price sales, participating loans, sale-leasebacks, and seller-financing could be eliminated without causing an increase in abusive transactions.

Similarly, intervening changes in the tax law have significantly reduced the ability of taxable partners to take advantage of the tax shelter opportunities once afforded by partnerships with tax-exempt organizations. Accordingly, the continued need for narrow and complex restrictions on partnership allocations may also be questioned.

Services to Tenants

Background. Rents from real property are normally not subject to UBIT. However, rents from real property are subject to UBIT if services (other than services customarily provided in connection with the rental of real estate) are provided for the convenience of tenants. This regulation subjects to tax income earned, for example, from owning and operating a hotel.

If services are provided to tenants, it is not clear under the tax regulations whether all or only a portion of the rents are subject to tax.

Policy Option. Under a more functional approach, a determination of whether services are rendered in connection with the rental of real property would depend on what is customary for the type of property. This approach is used in the REIT area and would permit pension funds, for example, to invest in hotel properties.

The regulations could also be modified to clarify the amount of income that is subject to tax in the event services are provided to tenants. This could be done through a de minimis rule or by clarifying that only a ratable portion of rental income is subject to tax if services are provided.

Land Development and Homebuilding

Background. Present law provides an exclusion from UBIT for gains from the sale of investment property, but not for the sale of property that is inventory or dealer property. Thus, if a pension trust holds property to generate rental income and then disposes of it, the gain on the sale is not subject to UBIT. However, if a pension trust were to purchase land for resale to homebuilders, or build houses for resale, it would be considered a "dealer" and the gain on such sales subjected to tax.

Policy Option. An amendment could provide, for a temporary period, that gain from land development and homebuilding activities is excluded from unrelated business taxable income. The temporary duration of the amendment would balance two policy objectives -- the immediate need to respond to the credit crunch in the

housing sector, and the UBIT rationale of taxing tax-exempt organizations on income earned from the active conduct of a trade or business.

Other Changes

Options. At present, gains on the lapse or termination of options written to buy or sell securities (but not real estate) are not subject to UBIT. This exclusion could be extended to real estate as well.

Depreciation. If a tax-exempt entity is a partner in a partnership with a for-profit entity, an amount equal to the tax-exempt's proportionate share of the property is treated as "tax-exempt use property" unless the partnership allocations meet certain requirements. Buildings which are tax-exempt use property must be depreciated over a longer period (40 years) than other buildings (27.5 or 31.5 years). These tax-exempt use leasing rules could be amended to make partnerships between tax-exempt and taxable entities more attractive.

SOURCES

- ¹ Greenwich Associates, Going Global, Good Going (1991).
- ² Greenwich Associates, id.
- ³ AEW Research, Why Real Estate? (April 1991).
- ⁴ Senate Report No. 2375, 1950-2 C.B. 483.
- ⁵ Senate Report 96-1036, 1980-2 C.B. 723.
- ⁶ Senate Report, id.

Appendix B

A Closer Look at the Secondary Market Options

A CLOSER LOOK AT THE SECONDARY MARKET OPTIONS

INTRODUCTION: THE CREDIT/LIQUIDITY CRUNCH

Many observers of the financial and credit markets believe that there is a problem of crisis proportions affecting the availability of commercial mortgage loans, and the liquidity of institutions that hold such instruments in their portfolios. Treasury Department Under Secretary Robert R. Glauber was quoted recently as acknowledging the existence of "a serious credit crunch in this country", explaining that, "we have banks unable, unwilling, for whatever the reason, to make loans to worthy clients."¹ The unavailability of credit, even for economically sound business plans and projects, may help to drag out the recovery from the nation's current recession. Moreover, serious lender liquidity problems for institutions holding existing commercial mortgage loans may aggravate the already heavy burdens on the Federal Deposit Insurance Corporation, RTC, and the Federal Reserve Board.

Comparable problems of liquidity and funding shortages characterized the residential mortgage markets during portions of the 1970s and early 1980s. The development of an active secondary market for residential mortgage loans, including the development of new forms of residential mortgage-backed securities, was a timely solution to what otherwise could have been a serious capital shortage for housing, as well as liquidity problems for financial institutions holding residential real estate mortgages.

The specific problems faced by the commercial real estate markets of the 1990s are different from the problems that faced the residential mortgage markets in the 1970s and 1980s. The problems in the residential mortgage markets were primarily related to interest rate and prepayment risks, not to credit risks and related regulatory concerns. However, the generic problems that resulted are comparable. Accordingly, any measures that would further the development of a secondary market in commercial mortgages and commercial mortgage-backed securities would help to address current shortages of funding and liquidity in the commercial mortgage markets.

Although the challenges of commercial mortgage securitization are different, and perhaps more daunting, than the problems that were faced by the residential mortgage markets, there are a number of steps the Federal government could take to enhance the development of a more active secondary market in commercial mortgages and commercial mortgage-backed securities.

FACILITATING PRIVATE CREDIT ENHANCEMENT

Importance Of Private Credit Enhancement

Unlike the residential mortgage markets, the commercial mortgage markets generally benefit from no direct or implicit Federal credit enhancement. There is no VA, FHA or FmHA for commercial mortgages, and no GNMA, FNMA, or FHLMC to guarantee securities backed by loans for office buildings, industrial parks, or retail complexes. To the extent credit enhancement is needed to facilitate secondary trading and securitization of commercial mortgages, it must be provided from entirely private sources. While guarantees, letters of credit, and pool insurance policies can be obtained in some cases, they can be extremely costly.

In the residential mortgage market a similar need was faced in the market for conventional, non-conforming (i.e. "jumbo") residential loans that were ineligible for direct or implicit Federal credit enhancement through guarantees provided by GNMA, FNMA, or FHLMC. During the late 1980s a form of "internal" credit enhancement known as subordination proved to be the key to a thriving secondary market for "private label" mortgage-backed securities.

Subordination generally involves the division of a loan (or pool of loans) into two classes of ownership interests. One class, the subordinated or junior class, is the first to bear the risk of any losses arising from defaults or delinquencies. The other class, the senior class, benefits from having credit losses allocated first to the subordinated class. As long as total losses do not exceed the principal balance of the subordinated class no losses will be suffered by the senior class.²

Adverse Regulatory and Capital Treatment Of Subordination

The continued usefulness of subordination has been hampered by a restrictive regulatory approach to the treatment of holders of subordinated interests, as well as unduly restrictive capital requirements for senior interests.

Under current risk-based capital rules (once they are fully phased-in) a bank holding commercial loans in the amount of \$100 million would be required to maintain \$8 million of capital. If the bank sold a \$90 million (90 percent) senior interest in the loans and retained a \$10 million (10 percent) subordinated interest, it would still be required to maintain capital in the amount of \$8 million, even though it only retained a \$10 million investment. Technically, this is because the bank is not treated as having disposed of any portion of the loan for these purposes. In effect, however, this is tantamount to imposing an 80 percent capital requirement on the subordinated interest, as compared to the eight percent fully phased-in requirement normally applied to undivided commercial loans.

While a higher than normal capital requirement for subordinated interests can be justified as corresponding to a higher probability of loss, the current capital requirement appears excessive. The regulatory guidelines do not appear to reflect any comprehensive assessment of the risks involved in senior/subordinated arrangements. For example, even if the subordinated interest represents less than eight percent of the pool, the effective capital requirement applicable to a commercial bank would remain at eight percent of the entire pool balance, and thus

could actually exceed 100 percent of the potential risk exposure associated with the retention of the subordinated interest.³ In addition, the holder of a senior interest -- which presumably entails a smaller likelihood of loss corresponding to the greater likelihood of loss on the subordinated interests -- is required to maintain full capital against 100 percent of the balance of that interest. To illustrate, in the 90/10 case described above any bank holding the \$10 million subordinated interest would be required to maintain \$8 million of capital, while any bank holding the \$90 million senior interest would be required to maintain \$7.2 million of capital (eight percent times \$90 million) for a total of \$15.2 million on a total loan balance of \$100 million. The aggregate capital requirement is thus almost doubled from eight percent to 15.2 percent -- even though the aggregate risk of loss has remained the same.

Adverse Tax Treatment Of Subordination

Subordination arrangements have also recently been the subject of inappropriately harsh treatment by the Internal Revenue Service. In 1985, the IRS issued final regulations denying the benefits of trust status for entities that issued trusts with multiple classes of ownership interests. Although the final regulations exempted trusts involving senior/subordinated arrangements, the IRS has issued a number of private letter rulings restricting the availability of this regulatory exemption to cases where the subordinated interest is permanently retained by the issuer and is neither transferred nor traded. There does not appear to be any basis in law or policy for this restrictive interpretation.

Restricting the transferability of subordinated interests obviously limits their liquidity, and accordingly reduces their value. It also prevents institutions from adapting to changing economic or regulatory conditions. For example, a bank currently holding a subordinated trust interest and seeking to increase its risk-based capital ratio might wish to sell the interest -- perhaps to an unregulated entity or investor. Such a transfer would effectively be forbidden under the IRS' rules.

Even if an isolated "one-shot" transfer were to be allowed in such circumstances (as the IRS has allowed in the case of a receiver liquidating the assets of an insolvent institution) the price that could be obtained for the subordinated interest is reduced because it is an essentially illiquid investment that must be held by the purchaser until maturity. The inability to create freely transferrable subordinated trust interests also has the effect of preventing multiple levels of subordination (e.g., a security comprised of a five percent fully subordinated interest, a 10 percent, "mezzanine" interest, and an 85 percent senior interest). Such arrangements can be useful in creating securities with different levels of credit enhancement and different credit risks.

Fully tradeable subordinated interests and multiple levels of subordination are permissible in structures for which a REMIC election is made. Although the REMIC provisions are available for mortgages principally secured by commercial real estate, there can be obstacles to the effective utilization of REMICs for some commercial transactions. Accordingly, the option to utilize a non-REMIC trust should also be available.

POSSIBLE SOLUTIONS**Adopt Rules Allocating Risk-Based Capital Requirements For Commercial Mortgage Pools Among Senior and Subordinated Interest Holders**

The Office of the Controller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision could issue new guidelines governing the allocation of risk, for risk-based capital purposes, among senior and subordinated interests in a commercial mortgage loan or loan pool. Such guidelines could be issued by the appropriate agencies, and would not require any legislation.

There are a number of approaches that might be followed. One approach might start with a determination of the appropriate capital required for the senior securities and proceed to determine the amount of capital required for holders of subordinated interests by subtracting the senior interest holder's required capital from the amount of capital that would be required for an undivided loan or loan pool.

For example, senior interests in commercial mortgage pools that meet certain standards (e.g., loan-to-value ratios lower than 80 percent) might be given treatment comparable to similar residential mortgage securities and accorded a 50 percent risk-weighting. In the case of a \$90 million (90 percent) senior security, the required capital would be 50 percent times eight percent times \$90 million, or \$3.6 million. Since the amount of capital required in the case of an undivided pool would be \$8 million, the proper amount of capital required to be held by the \$10 million (10 percent) subordinated interest holder under this approach would be \$4.4 million -- an effective capital requirement of 44 percent.⁴

Alternatively, the regulators might wish to focus on an analysis of the risks inherent in the subordinated interest, and make an independent assessment of the factors that would support any particular level of capital requirement. The capital required for the holder of a senior interest might then be determined by subtraction from the overall capital required for an undivided pool, or by an independent analysis of the risks of holding a senior interest. Guidelines might be established involving such factors as appraisals, loan-to-value ratios or geographic diversification.

Still another approach might seek to establish private sector mechanisms to limit and assess the risk associated with credit enhancement provided through subordination. Certainly, at a minimum, the OCC, Fed, and FDIC should expeditiously adopt the OTS rule that capital will not be required in excess of 100 percent of the maximum exposure associated with the retention of a subordinated interest.

Undoubtedly, this is an area that the regulators could spend much time studying in search of an optimal approach. However, an interim step would certainly be desirable pending further review. Certain interim measures might even be designed to be applicable only to refinancings or extensions of existing loans.

Permit Freely Tradeable Subordinated Interests In Investment Trusts

The Internal Revenue Service could issue a revenue ruling, or the Treasury Department could issue an announcement, stating that the transfer or transferability of a subordinated interest in a fixed investment trust would not affect the classification of the trust. Such an announcement could also clarify the allowability of multiple levels of subordination in a fixed investment trust.

**REDUCING OTHER LEGAL IMPEDIMENTS TO
COMMERCIAL MORTGAGE SECURITIZATION**

In the residential mortgage market of the early 1980s, a number of legal impediments existed to the development of a private (i.e., non-agency backed) mortgage backed securities market. The Secondary Mortgage Market Enhancement Act of 1984 (SMMEA), and the REMIC provisions of the 1986 Tax Reform Act were enacted to address these impediments. SMMEA established a new category of securities known as mortgage-related securities. This category of highly rated, investment grade, residential mortgage-backed securities qualified for certain benefits under the SMMEA legislation, and have subsequently been accorded a variety of benefits under various regulatory regimes ranging from the OTS' risk-based capital regulations to the SEC's rules for borrowing on margin. The benefits now accorded to SMMEA-eligible mortgage-related securities include:

1. pre-emption of state blue-sky and legal investment laws, subject to each state's ability (within a limited window period) to override the Federal pre-emption;
2. preferential capital treatment (e.g., 20 percent risk weighting);
3. removal of investment restrictions applicable to various federally chartered financial institutions;
4. favorable margin rules, and related rules, for loans from broker-dealers secured by mortgage-backed securities; and,
5. eligibility for "shelf" registration procedures under the securities laws -- simplifying the process and reducing the costs of issuing multiple issues of a series of mortgage backed securities.

Some or all of these benefits would be valuable in helping to reduce the transaction costs associated with commercial mortgage securitization, or helping to enhance the market for such securities.

The companion legislation to SMMEA were the REMIC provisions of the 1986 Tax Reform Act. The REMIC provisions created an improved tax vehicle for the issuance of multiple-class pass-through securities. Since 1986, REMICs have become the vehicle of choice for most residential securitization transactions. Although REMIC is available for commercial mortgages, there are a number of ambiguities and uncertainties in the law that can make it difficult to utilize.

POSSIBLE SOLUTIONS**Extend Benefits Enjoyed By SMMEA Securities
To Comparable Commercial Mortgage Securities**

Congress could extend the provisions of the Secondary Mortgage Market Enhancement Act ("SMMEA"), currently applicable only to residential mortgage securities, to comparable commercial mortgage securities. The principal benefits that would flow from such legislation would be a pre-emption (subject to possible state override) of state blue-sky and legal investment restrictions.

As an interim measure, some or all of the Federal regulatory benefits accorded to SMMEA securities could be accorded to highly rated commercial mortgage securities by regulation or executive order. These Federal regulatory benefits would include (i) preferential capital treatment (e.g., 20 percent risk weighting), (ii) removal of investment restrictions applicable to federally chartered financial institutions, (iii) favorable margin rules and related rules for loans from broker-dealers and (iv) eligibility for "shelf" registration procedures under the securities laws.

Clarify Availability Of REMIC For Commercial Mortgage Transactions

REMIC is available for loans that are "principally secured" by real estate, regardless of whether the real estate is residential or commercial. Questions can arise in some commercial mortgage transactions as to whether a loan to a business secured by a mortgage on real property used in the business is "principally secured" by the real estate, or whether the loan is secured by the expected revenues of the business. The IRS could issue regulations clarifying that a commercial real estate loan will be considered "principally secured" by the real estate, if it is secured by real estate whose value in the borrower's business is at least equal to a specified fraction (e.g., 80 percent) of the loan balance at the time of origination. In addition, the definition of "real estate" for REMIC purposes could be interpreted to include any property that is considered real property either for tax purposes or for local law purposes.

The IRS has recently issued proposed regulations that would permit the pass-through to certain investors (i.e., REMIC "regular" interest holders) of customary commercial mortgage prepayment penalties. This is a welcome development. However, prepayment penalties may not be created by the REMIC or modified by the REMIC. In addition, the proposed regulations do not address the pass-through of other forms of contingent interest payments (e.g., equity kickers). There are also uncertainties regarding the extent to which similar interest rights can be separated from mortgage loans under the coupon stripping rules. Favorable rulings on these and related points could be helpful in facilitating the securitization of commercial mortgages.

Promote Greater Uniformity Of Loan and Securities Documentation

Commercial mortgage loans tend to be much less homogeneous than residential mortgage loans. This reflects the much greater variety of business needs that must be satisfied in commercial lending transactions. While it would not be desirable to eliminate the ability of lenders to meet the particular needs of their business customers, securitization might be enhanced if there were some movement towards more uniformity in loan documentation.

The government could take a role in developing and promoting model commercial loan documents, or model securities documentation, that might help promote greater uniformity in this area. In the residential markets, uniformity followed from the desire of mortgage sellers and servicers to participate in the Federally subsidized and government sponsored agency securitization programs. Subsequently, the standards developed in these programs began to be a model for structures and documents in some non-agency programs. Standardization also resulted from the leadership of wholly private traders and investment bankers that used law firms to develop documents and began to trade mortgages and securities based on those documents.

One approach the government or some agencies might follow would be to develop standardized documents as models. In addition, agencies might create modest incentives for the utilization of such documents. Simplified, streamlined, or modestly liberalized regulatory review of loans involving such documents might be an appropriate incentive.

CONCLUSIONS

Securitization and the development of active secondary markets are not panaceas. Nor are any of the proposals outlined herein "magic bullets" that can cure fundamental economic or financial problems. However, the ability to securitize and trade loans in a secondary market creates liquidity, by definition. Loans and securities that are more liquid are more valuable. Moreover, the more liquid the assets held by a financial system, the more stable, secure, and flexible that system will be.

Indeed, it is noteworthy that despite the nation's current economic and financial problems, the one financial problem we are not experiencing is a shortage of residential mortgage financing at market interest rates. To a large extent this is attributable to the advances made in the secondary trading and securitization of residential mortgage loans.

There are significant differences between commercial and residential mortgage loans. Most particularly, commercial loans are far less homogeneous. In addition, commercial loans generally do not benefit from government sponsored credit enhancement. Nevertheless, commercial mortgage securitization and secondary trading exists today, and could be promoted by the modest actions recommended in this paper.

The recommendations in this paper represent a reasonable first step to eliminate obstacles that stand in the way of the development of a more active secondary market for loans having a reasonable degree of credit quality. Other, more ambitious approaches could also be considered that might focus on the problems posed by various categories of non-performing loans, including loans that might otherwise be candidates to be acquired by the government in connection with potential insolvencies of insured depository institutions. If the government is likely to be bearing the ultimate credit risk with respect to such loans, it may be prudent to consider steps that would address credit problems before the loans become the property of the government.

SOURCES

¹ American Banker, September 6, 1991, page 2.

² For example, a typical senior/subordinated structure might involve a \$100 million pool of loans with a \$90 million senior class and a \$10 million subordinated class. As long as losses on this pool do not exceed \$10 million, the \$90 million senior class will be fully paid. This structure allows investment rating agencies to assign a high rating to senior classes in certain pools, despite the absence of any external guarantees against loss. The precise level of subordination required (e.g., 90:10, 85:15, 80:20, etc.) to provide adequate protection to the senior class would depend on an evaluation of all the facts and circumstances pertaining to a particular loan or loan pool, including such factors as appraisals and loan to value ratios. In the case of rated transaction, the investment rating agency would determine the minimum level of subordination required as a condition of any particular rating.

³ Although the OTS capital regulations provide that the seller of a loan with recourse will not be required to maintain capital in excess of 100 percent of the maximum loss exposure, no similar rule has been adopted by the OCC, Federal Reserve Board, or FDIC.

⁴ Under this approach it should not matter whether both interests are actually held by regulated financial institutions. The objective is not just to avoid "double counting" of aggregate capital requirements within any single regulatory regime. The objective is to avoid requiring inappropriate amounts of capital, in relation to risk, for any single institution. Nevertheless, because assessing risk is not an exact science, and subordination does not increase the probability of losses, limitations on the extent of any single institution's ability to hold large concentrations of subordinated interests in their portfolio might be appropriate.

**PREPARED STATEMENT OF HON. JIMMY HAYES, A REPRESENTATIVE IN
CONGRESS FROM THE STATE OF LOUISIANA**

I would like to thank my colleague, Mr. Guarini, for inviting me to sit on the Task Force with him today. I appreciate the opportunity to share my views on the "credit crunch" issue.

As we are all aware, the credit crisis in this country has reached disastrous proportions. Bowing to the lack of liquidity in the economy, this nation's small businessmen and women, farmers, ranchers, and rural business owners, are unable to obtain the credit necessary to begin building businesses, and consequently, reconstructing this economy.

The decline in interest rates has not had enough of an effect on the economy to pull it out of this recession, due to the fact that there is limited credit availability. We can place blame for this credit shortage on many factors, be it the Savings and Loan crisis or foreign competition, but what is far more important at this point is to assure the future economic health of the nation, and look ahead to viable solutions.

The lack of liquidity lies at the core of this nation's inability to recover from the recession. Despite all of the positive measures that have been taken to overcome this economic breakdown, economic recovery still remains stymied by this persistent lack of liquidity.

A Resolution that I recently introduced, H.J.Res. 369, along with my colleagues Mr. McCollum, Mr. Chandler and Mr. Bryant, expresses the sense of the Congress that the policy of the United States to foster improved financial stability of the nation's banking and thrift institutions "shall be consistent with the preservation of the availability of credit, under safe and sound lending practices, for commercially prudent business purposes in order to create jobs and promote a speedy and robust economic recovery."

This Resolution speaks for the hundreds of thousands of individuals who are trapped in the middle of this credit crunch, and are screaming for a way out. Friday's 120-point stock market decline, and this week's continued fall, is an indication that this economy is not yet firmly on its way to economic recovery.

The Credit Crunch Resolution, which my colleagues and I have introduced, positions the importance of financial institutions' need to re-examine their credit policies with a view toward the role that these institutions play in fueling economic recovery. Regulators must be sensitive to the dangers that overly restrictive credit policies pose to the health of the economy.

Furthermore, economic strength will minimize the effects of the bank failures that these regulators are charged with resolving. The sooner the economy recovers, the less likely it will be that more taxpayer funding will be needed. Regulators must be vigilant in criticizing both unduly lenient and unduly restrictive bank lending practices if we are to begin our journey toward economic recovery.

As the economy did not reach the breaking point that it is at today in one month, neither will it reach full economic recovery overnight. H.J.Res. 369 is a tool that can help begin our journey of economic recuperation.

Again, I thank my colleague, Mr. Guarini, for inviting me to be here today.

RESULTS OF THE SURVEY OF MONTANA'S BANKERS**(Conducted by Hon. Ron Marlenee)**

I. Number of surveys sent.....135
Number returned to date.....44 or 32.59%

II. Replies

1. What organization (F.D.I.C., Federal Reserve, Comptroller of the Currency, etc.) is your primary bank examiner?

- a. F.D.I.C. 19 or 43.18%
- b. O.C.C. 17 or 38.63%
- c. Fed. Reserve 6 or 13.63%
- d. O.T.S. 2 or 4.54%

2. Are you being confronted with overzealous examiners that refuse to listen to all facts presented to them?

- a. yes 20 or 45.45%
 - b. no 15 or 34.09%
 - c. sometimes 9 or 20.45%
- 66 %

3. Do many of the examiners lack the necessary expertise to evaluate agricultural and/or commercial credits?

- a. yes 25 or 56.81%
 - b. no 14 or 31.81%
 - c. sometimes 5 or 11.36%
- 68%

4. Do you feel as if bank regulators are more concerned with protecting themselves than with insuring the safety and soundness of your bank?

- a. yes 22 or 52.38%
 - b. no 14 or 33.33%
 - c. sometimes 6 or 14.28%
- 66 %

5. Have you adjusted your bank's lending criteria as a direct or indirect result of the activity of bank examiners? If so, please explain.

- a. yes 26 or 60.46%
- b. no 17 or 39.53%

6. Do you feel as if bank examiners have an unresponsive, combative or defensive attitude if their findings are challenged?
- | | |
|--------------|--------------|
| a. yes | 21 or 50% |
| b. no | 19 or 45.23% |
| c. sometimes | 2 or 4.76% |
7. How would you assess the level of training of recent bank examiners that you have dealt with?
- | | |
|----------------|--------------|
| very good | 3 or 6.81% |
| satisfactory | 22 or 50 % |
| unsatisfactory | 19 or 43.18% |
8. During your last examination, how would you describe the overall communication between the bank examiners and your bank staff?
- These replies are highly specific ranging from very good to very bad. The majority, however, are negative.
9. Do you find that bank examiners are consistent in their interpretation of compliance regulations?
- | | |
|--------|--------------|
| a. yes | 22 or 51.16% |
| b. no | 21 or 48.83% |
10. Do you find that the examiners' report does not reflect what the examiners said during the review? If so, please explain.
- | | |
|--------|--------------|
| a. yes | 18 or 40.90% |
| b. no | 26 or 59.09% |
11. Do you find that the examiners are classifying loans that they have never or rarely classified in the past, such as S.B.A. loans?
- | | |
|--------|--------------|
| a. yes | 19 or 43.18% |
| b. no | 25 or 56.81% |

12. Have you been advised that extension of a loan, for any reason, is an indication of financial weakness and will cause the credit to be classified?

a. yes 20 or 45.45%
b. no 24 or 54.54%

13. Add any additional comments that you may have which are relevant to this survey.

These replies are also highly specific.

**STATEMENT
of
ROBERT H. DUGGER
on behalf of the
AMERICAN BANKERS ASSOCIATION**

Mr. Chairman and members of the Task Force, I am Robert Dugger, Chief Economist and Director of Policy Development for the American Bankers Association. The member organizations of the American Bankers Association range in size from the smallest to the largest banks, with 85 percent of our members having assets of less than \$100 million. The combined assets of our members comprise about 95 percent of the total assets of the commercial banking industry.

It is no exaggeration to say that this Task Force is dealing with the most critical questions facing our economy and the banking industry. The question of bank credit availability determines, to a considerable degree, the availability of credit from all sources. We commend you for holding these hearings and appreciate this opportunity to present a banking industry perspective on the credit availability issue.

Demand and Supply Side Issues

Credit is made available in the United States via a system of highly-regulated bank and less-regulated non-bank lenders. The banking industry through direct lending is responsible directly for about 25 to 30 percent of U.S. private credit to businesses and households. Through letters of credit and lines of credit backing non-bank lending activities, the banking industry is indirectly responsible for an additional 40 to 50 percent of U.S. private credit. See Tables I and II.

Credit availability is a function of demand and supply factors. With the current uncertain economic outlook, many credit worthy borrowers are sharply reducing their demands for credit. Similarly, perceiving risks to be greater, many lenders are being more cautious in advancing credit.

This testimony focuses on the banking industry's ability to supply credit and will attempt to explain the institutional factors that are causing bankers to be far more cautious in their posture toward risk-taking.

Supply Side

Most bankers and economists understood that the credit growth rates of the 1970s and 1980s would be moderated in the 1990s and viewed this as constructive. Furthermore, most experts expected that recoveries from recessions in the early 1990s would be less vigorous than in previous years because the kinds of credit surges that powered us out of slumps in the past would not likely recur. Some economists speculated that credit growth rates in the 1990s would be closer to the levels of the 1950s and 1960s than the high growth years of the 1970s and 1980s. The reasons given were various and included the mid-1980's tax changes, population aging, implementation of the Basle Accord bank capital standards, and reduced capital flows from foreign sources.

It is widely recognized that bank credit growth is a lagging indicator of recovery. However, as Table III shows, bank credit growth rates in the current recession are lower than in the 1970s and 1980s, and significantly lower than the rates of the 1960s. Two questions arise: First, we understand why bank credit growth rates are lower than the 1970s and 1980s, but why are they so much lower than those in the 1960s? And second, do current credit trends reflect a sound and constructive moderation in the credit trends of the 1980s -- a moderation that in conjunction with a "soft landing" monetary policy will put in place the foundations for low-inflation, stable growth in the 1990s? Or do they reflect a constructive moderation and the effects of contractionary policy over-reactions that are slowing the flow of credit more than is appropriate?

In our judgment the answer to both questions is "yes" and rests in a host of institutional factors that were not present in the earlier decade.

Understanding current bank credit availability trends involves understanding four fundamental forces in banking -- information technology, "too-big-to-fail," macroeconomics, and government policy. The cumulative effect of these forces is a bank credit slowdown that reflects much more than a healthy moderation in earlier credit trends.

Information Technology. As financial and information technology progressed, larger, well-capitalized companies became able to directly access capital markets for credit. As more and more of them did, the customer base of the banking industry shrank and came to consist of ever smaller companies and households. Year after year, as the more credit-worthy customers left, the bank customer base also became steadily riskier. Because advances in information technology are likely to continue, possibly even at an increasing rate, the upward trend in customer base risk can be expected to continue and perhaps intensify.

Importantly, because larger banks generally served the companies that were the first to leave the bank customer base, these banks were affected earliest and most significantly by information technology advances. This, in part, explains the general increase in the problems of larger institutions over the past two decades. The impact of

information technology, however, is affecting more than just money center and regional institutions. It is reaching into every banking market no matter how small or remote, and it is affecting the operations of every bank.

Of all the factors affecting banking, information technology advances have been the most significant in my judgment. The ability of the banking industry to adapt to these advances is constrained by banking laws that have remained essentially unchanged for half a century. For the banking industry to adapt, financial modernization is essential.

Too-Big-To-Fail. As its customer base narrowed and banking industry risk rose, larger institutions began to fail with greater frequency. Public and private policy-makers, unwilling to take the political heat for failing to prepare for such events, chose to fully protect all depositors, particularly in larger institutions. The result came to be a clear expectation that bank deposit liabilities are perfectly safe. Unfortunately, bank assets are not.

Protecting bank liabilities but not their assets resulted in a powerful imbalance within bank balance sheets -- bank liabilities, perceived by the public as riskless, became a magnet for funds at the same time bank assets, the loans to a shrinking customer base, were becoming riskier. The end result was more money flowing into the banking industry than could be profitably re-lent.

Seen from this perspective, an overriding reason for getting rid of the too-big-to-fail policy is to bring an end to the risk imbalance between bank liabilities and assets that has resulted in an overfunding of the banking industry. Of all the elements of deposit insurance reform, ending the too-big-to-fail policy is the most crucial. However, if it is not ended in a clear structured manner over a period of a few years, the costs of consolidation could be far higher than they need to be and the risk of outright crisis unacceptably high.

Macroeconomics. A well-run bank is a mirror of the economy that it serves. If its customers are doing well, its assets (loans to them) will be sound, and the bank will be sound overall. Simply said, a bank is only as strong as its customers. If the economy is weak, the bank will be vulnerable.

As we know only too well, the post-World War II boom that sustained our economy for more than three decades is over. The growth that occurred during the 1980s was not financed by our own productivity. It was financed by borrowing -- from Asian and European countries, and our grandchildren.

Our economy has a number of structural weaknesses -- over-reliance on borrowed (especially foreign) capital, low productivity, and an over-emphasis on consumption at the expense of saving. Our saving, investing, and spending priorities are out of balance. As a consequence, we are in an extended period of slow growth, at best, and reduced economic competitiveness, and the banking industry reflects this with mirror-like accuracy. Some regions of the country have suffered more than others from the present recession. Here, loan losses have eroded bank capital, forcing banks to curtail loan growth. If banks are required to keep at least a six percent capital-to-assets reserve

then default on a \$100 loan can mean that a bank must restrict new loans by \$1,667. Table IV shows that, as expected, loan growth since the recession began in July 1990 has been the slowest in the Northeast (especially) and Southwest.

Government Policies. The banking industry is possibly the most highly regulated and supervised of all U.S. industries. Even small changes in agency policy can have profound effects on profitability and lending. The most evident recent example has been a sharp decrease in commercial real estate credit availability following a sharp tightening of examination standards. 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 that are affecting the flow of credit.

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. As a result of unduly lenient bankruptcy rulings, the likelihood of greater loan losses is having a chilling effect on lending in general, and particularly bank lending. 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.

Appraisal Costs -- As a result of recently enacted legislation, the cost of obtaining residential and commercial real estate loan appraisals is rising sharply. In addition, there is a sound basis for concern that an insufficient number of licensed and certified appraisers will be available when the new law becomes effective on January 1, 1992. The result is very likely to be a sharp increase in appraisal costs, as well as lengthy delays in the lending process.

Regulatory Costs -- The volumes of government regulations and reports with which banks, and banks alone, must comply and file increase bank operating costs, reduce credit availability and increase the cost of the credit that is available. The steady growth of bank regulatory and reporting requirements has made regulatory compliance the number one cost concern in banking. In the last four years, there has been ten major new consumer-related laws, each adding significantly to bank paperwork burdens. As these costs mount, lending becomes less and less profitable. In addition, the rapid increase in the time that a bank must spend in observing regulations and filing reports cuts into the time the bank has to conduct business, including making loans.

Officer and Director Liability -- The most important aspect of any business is its management. 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 S&L crime law enacted last year greatly increased the liability of officers and directors, and pending legislation could further increase this burden. As an example, on August 9, 1989, bank officers and directors were exposed to civil money penalties of up to \$1,000 per day for serious offenses. One day later, on August 10, 1991 when FIRREA was signed into law, bank officers and directors became vulnerable for fines up to \$5,000 per day for "unintentional" violations, up to \$25,000 per day for violations "likely to result in more than minimal losses," and up to \$1 million per day for serious offenses that the day before warranted \$1,000 per day fines.

Because of these changes, bank lawyers are increasingly advising officers and directors that prudence and vigilance in overseeing a bank's affairs may no longer protect them from devastating personal liabilities. There are two results -- first, bank officers and directors are trying to protect themselves by making their banks safer than safe. They do this by instituting more restrictive loan standards that inhibit prudent risk-taking vital to our economy. Second, many valuable directors are simply resigning from even the best run and strongest banks.

Deposit Insurance Premiums -- Deposit insurance premiums have increased from 8.3 cents per \$100 of deposits to 23 cents -- almost 300 percent -- in less than 24 months. Deposit insurance premiums are a cost of doing business. As that cost increases, the return from the business of banking, taking deposits and making loans, declines. Credit availability decreases -- especially in institutions with little or no earnings.

Institutions with at or near regulatory capital minimums and with low earnings cannot pay the premium without further depleting retained earnings and reducing capital. The only option these institutions have is to decrease lending and, in some instances, to actually shrink by selling assets. As is shown in Table V, not surprisingly and unfortunately, the reductions in credit availability are greatest in those regions already experiencing economic difficulties where bank earnings and capital positions are already under great pressure.

Interest on Reserves -- The banking industry is subject to a large hidden tax in the form of non-interest-bearing reserves held at the Federal Reserve. Since 1981 alone, this hidden tax has cumulated 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.

Product and Services Restrictions -- In our increasingly complex economic world, businesses and consumers need more services from their bank. But banks have not been allowed to offer the insurance and securities services to suit their customers' needs. With the profitable and risk-diversifying income from these business lines, banks could better afford to expand lending and withstand credit risk.

Credit Crunch, Credit Caution, and Credit Availability. Banking, like virtually all of finance, is a business of optimizing the relationship between risk and return. As banking's return on equity declined, some bankers attempted to increase return by taking on greater risk. For many of them, this was a regrettable undertaking. In hindsight it is clear that there was really no way to tactically take on greater risk and win. These

bankers were trying to swim upstream against an inexorably narrowing customer base, a weakening economy, a generally overfunded banking industry, and increasingly restrictive government policies.

Virtually all bankers now understand their situation very well. They know that increasing risk to increase return is simply not possible, and that they really have only one alternative -- reduce risk to bring risk and return into an acceptable alignment. Across the country bankers are now scaling back lending and attempting to reduce overall risk. For less credit-worthy borrowers there is a tangible decrease in credit availability. The semantics of "credit caution" versus "credit crunch" are lost on them. If you have just been turned down for a loan, it is a "credit crunch." For a banker concerned about his or her future, it is a "credit caution." Credit crunch or credit caution, it adds up to credit contraction.

When bank credit availability decreases are mentioned, there is always someone who will suggest that other nonbank lenders will step in and fill the gap. Unfortunately the gap cannot be filled quickly or completely. It takes time, measured in years, for new lenders to step in, and they cannot fill the entire gap. Because nonbank lenders are not supervised or insured, the marketplace requires that they hold more capital than banks. Today, a dollar of bank capital supports about \$15 of loans. A dollar of nonbank lender capital can support at most only about \$11 dollars of loans. Thus, even if a nonbank lender does step in a year or so later and begins lending in a region where banks are capital-strapped, the nonbank lender will be able to replace, at most, seventy percent of the bank loans.

Table I

BANK AND NONBANK SOURCES OF CREDIT FOR BUSINESSES
Billions of Dollars at the End of 1990

	Nonfinancial business	Farm	Non-farm
Total borrowing	\$4,815	\$159	\$4,656
Borrowed from banks	\$1,156	\$51	\$1,106
Percent from banks	24%	32%	24%
Mortgage loans	\$1,059	\$84	\$975
From banks	\$457	\$17	\$439
Percent from banks	43%	21%	45%
Total nonmortgage loans	\$2,533	\$75	\$2,458
From banks	\$594	\$33	\$561
Percent from banks	23%	44%	23%
Bonds & commercial paper	\$1,223		\$1,223
Held by banks	\$105		\$105
Percent from banks	23%		23%

Data from Board of Governors of the Federal Reserve System,
 "Flow of Funds Accounts, First Quarter 1991" and "Call Reports"
 submitted by banks to the Federal Deposit Insurance Corporation

Table II

SOURCES OF CREDIT FOR HOUSEHOLDS

Billions of Dollars in March 1991

	From Banks	Not From Banks
Mortgages	\$465	\$2,235
Consumer credit	\$371	\$541
Security credit	\$15	\$39
Total	\$896	\$2,814

This table was derived from the table on "Households, Personal Trust, and Nonprofit Organizations" in the Board of Governors of the Federal Reserve System, *Flow of Funds Accounts, First Quarter 1991*. To adjust for the non-household accounts, the figures for "other mortgages" (i.e., personal commercial mortgages), tax-exempt debt, "bank loans n.e.c." (personal business loans), and trade credit were omitted.

Table III

GROWTH OF BANK CREDIT DURING RECESSIONS

Annualized Percent Growth Rate of Loans and Leases from Commercial Banks After the Onset of Recessions Since 1960

<u>Start of Recession</u>	Growth of Credit from Start of Recession Through		
	Three Quarters	One Year	Five Quarters
April 1960	9.0%	4.6%	5.6%
December 1969	4.2%	4.5%	4.6%
November 1973	16.7%	14.3%	11.3%
January 1980	4.0%	7.7%	6.1%
July 1981	4.8%	6.3%	6.6%
July 1990	2.6%	2.0%	0.8%

The recessions were dated by the National Bureau of Economic Research. Data on commercial bank credit came from the Board of Governors, *Banking and Monetary Statistics, 1941-70* and *Annual Statistical Digest* (several issues) and *Federal Reserve Statistical Release G.7* (407).

Table IV**Regional Annualized Growth Rates
Of Bank Credit Since July 1990**

	Northeast	Southwest	Central	West	Southeast	Midwest
3 qtrs	-4.7%	0.1%	1.0%	2.8%	3.3%	7.5%
1 year	-2.8%	0.4%	2.3%	2.5%	3.0%	6.1%

Based on quarterly figures for regional aggregate commercial bank assets found in the FDIC's *Quarterly Banking Profile*

Table V
**REGIONAL COMPARISON OF PROJECTED LOAN GROWTH
 RATES UNDER SELECTED DEPOSIT INSURANCE PREMIUMS**

Actual 1985-1990 Growth Rates Compared to
 Projected 1990-1995 Growth Rates, Annualized

<u>Region</u>	<u>Actual 1985-1990 Growth Rate</u>	<u>Projected 1990-1995 Growth Rate</u>		
		<u>Premium Rate in Cents per \$100 of Domestic Deposits</u>		
		<u>23</u>	<u>30</u>	<u>40</u>
Northeast	7.1%	-1.6%	-1.7%	-1.8%
Southeast	7.7%	-1.4%	-1.6%	-1.8%
Central	4.9%	0.9%	0.8%	0.6%
Midwest	3.7%	2.0%	1.9%	1.6%
Southwest*	0.1%	0.4%	0.2%	-0.2%
West	6.1%	2.8%	2.7%	2.6%
Nation	5.3%	0.0%	-0.1%	-0.3%

Regions

<i>Northeast</i>	Connecticut, Delaware, District of Columbia, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Puerto Rico, Rhode Island, Vermont
<i>Southeast</i>	Alabama, Florida, Georgia, Mississippi, North Carolina, South Carolina, Tennessee, Virginia, West Virginia
<i>Central</i>	Illinois, Indiana, Kentucky, Michigan, Ohio, Wisconsin
<i>Midwest</i>	Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota, South Dakota
<i>Southwest</i>	Arkansas, Louisiana, New Mexico, Oklahoma, Texas
<i>West</i>	Alaska, Arizona, California, Colorado, Hawaii, Idaho, Montana, Nevada, Oregon, Utah, Washington, Wyoming

In the data presented in this table, each bank's performance is projected to remain the same over the next five years as over the last three with the following exemptions: (1) Higher deposit insurance premiums are projected to reduce earnings (which finance future bank growth). (2) Banks are projected to pass one quarter of the increase in premiums on to customers in the form of higher interest rates on loans, lower interest rates on deposits, and higher fees. (3) Banks are projected to reduce the growth of their assets to maintain their capital-to-asset ratios. Loans are aggregated by region, and annualized growth rates of the aggregates from the end of 1990 to the projected end of 1995 are presented in this table.

- Economic problems in the Southwest during the last five years depressed loan demand and caused many bank failures. As a result, bank loans grew only 0.1 percent per year, the lowest of any region during this period. With a recovering economy, the surviving banks are projected to provide a somewhat stronger rate of credit growth even at a premium rate of 30 cents per \$100 of deposits. Three factors explain this anomaly: First, as compared to the last five years, the Southwest's banking industry appears to be stronger now and better able to provide credit growth in the next five years. Second, the reduction of credit in banks that failed in the last five years, and no longer exist, does not enter into the projection. And, third, past losses are projected to yield tax credits which can help restore bank earnings and growth.

PREPARED STATEMENT OF ROBERT C. BAKER

Mr. Chairman and Members of the Committee:

It is an understatement to say that banks are reluctant to extend credit for commercial real estate ventures. In actuality, they are refusing to make any new real estate loans or extend old real estate loans. Banks no longer recognize real estate as collateral. Banks wish to be in the business of making loans fully collateralized with liquid assets. In other words, banks want to be in the business of lending you back your own money. This problem affects not only the large real estate entity with blanket or personal borrowings in excess of the bank's evaluation of the value of the underlying assets, or the owner of an office building with large vacancies and not enough income to carry the outstanding mortgage. This problem impacts on sound real estate which has no problems other than the current credit crunch.

My company, National Realty & Development Corp., has developed and owns 70 shopping centers located in 15 eastern States. There are no blanket mortgages on these properties. They are not cross-collateralized and there are no personal guarantees on the mortgages. The mortgages average less than half of the present value of the real estate, yet we are unable to obtain funding to meet the present needs of these properties.

Funding is needed in connection with four types of improvements. Firstly, capital improvements must be made either in connection with maintaining a property such as roof and parking lot repairs or replacement. Secondly, there is often a need to modernize the shopping center by rebuilding the exterior of the buildings. Thirdly, it is often necessary to make tenant improvements for new tenants interested in occupying vacant space. Lastly, it may be necessary to tear down an existing building and replace it with a new building to meet the requirements of a new tenant, thereby upgrading the shopping center. It is impossible to obtain additional mortgage proceeds from the holder of the existing mortgage or to refinance the existing mortgage. These needed improvements which provide jobs and fuel the economy through the expenditure of money must either be postponed or must be funded out of our own capital.

An expenditure of \$750,000 was recently required in connection with making repairs, tenant improvements and modernizing the exterior of a shopping center located in New Jersey. Since no bank financing is available, it will be necessary for us to fund the improvements from our own capital. As a result of the new leases and improvements, the value of the shopping center will be increased by \$1,500,000, twice the expenditure of capital, however, since real estate is no longer viewed by banks as an asset, they will look only at our company's liquid asset position and we will be asked "how did you loose \$750,000 this period?" Many of our shopping centers are located in relatively small towns where they are the primary shopping facility. If vacant stores cannot be replaced, if needed improvements cannot be made and if real estate taxes cannot be paid, the economy of the area will suffer. Our company has had the financial strength to fund our needs internally since the credit crunch began, but we are the exception, not the rule, in our industry. In addition, we must weigh every new expenditure against our needs for the future and our estimate of how long it will be before we can expect the banks to resume lending on real estate.

There are no construction loan funds available from banks at the present time for shopping centers or other commercial projects. This is desirable in case of a proposal to build an office building

or hotel in an overbuilt market but cannot be desirable in all instances. We recently requested our lead bank with whom we had a long and impeccable relationship to fund the construction of a new 93,000 square-foot Wal-Mart store. The store was to be built at an Upstate New York shopping center owned by us. It was to replace a twenty year-old building previously tenanted by another tenant who had gone bankrupt and vacated the premises. The new Wal-Mart would rejuvenate a twenty year-old shopping center which would be completely rebuilt, it would provide construction jobs as well as permanent jobs, pump money into the local economy, provide new tax dollars and be a desirable shopping facility for the town and surrounding areas. Certainly, the type of project to be encouraged for the social good.

We advised our bank that we had a twenty-year lease with Wal-Mart, a permanent mortgage commitment from an insurance company and requested them to fund the construction loan. This was the type of loan they had made to us many times before in past years. We were advised by the lending officer, an important executive of the bank that the real estate department was under a mandate to reduce the amount of outstanding loans. He advised us that there was not one dollar available for new construction loans, regardless of the past relationship with prospective borrowers, regardless of the financial strength of the borrower and regardless of the quality of the loan. We received a similar response from other banks. The project was salvaged by selling a portion of the shopping center to Wal-Mart who built their own building using their own corporate funds. This type of solution is available only in special situations.

I would like to relate one last example of present bank lending practice. Over the past nine years, we repaid 65 million dollars in construction loans to one of our banks. There remained one last loan with a \$600,000 balance due November 3rd of this year. We were advised to repay the loan by wiring the money to the bank on that date. When we requested the bank to extend the loan for one year, they refused notwithstanding the fact that they acknowledged that the 50% guarantee of the principal would be just as good after expiration of the one year, that the guarantee of interest payments for the year was good, and that they had not even appraised the real estate mortgaged to see if it was adequate security for the loan. They merely advised us that they were under a mandate to reduce the amount of money they had in real estate loans by many billions of dollars. They could not get paid on the bad loans so they were refusing to extend a good loan. The lending officer and possibly his bank's chairman were not aware of the FDIC memo directing examiners not to criticize every bank renewal of maturing real estate loans.¹

What can Congress do to support the value of good real estate? This is important because permitting good real estate to become bad real estate will only add to the present problem created by the abundant supply of weak real estate already on the market, whether in private hands, held by banks, or in the portfolio of the RTC. The Chairman of the Federal Reserve, Alan Greenspan, the Comptroller of the Currency, Robert Clarke, and the past Chairman of the Federal Deposit Insurance Corporation, William Seidman, have told the banks to fund safe projects. The banks have been advised that there would be a clarification of examination standards, a loosening of banking restrictions, a more flexible policy toward writing down troubled loans and more lenient reserve requirements. Real estate could be valued based on its ability to generate cash rather than on the price it would bring in a depressed market. However, the rating on bank bonds are down, bank stocks are

¹ See "FDIC Memo Might Ease the Renewals of Some Commercial Real Estate Loans". The Wall Street Journal, June 24, 1991.

depressed and the bankers rightfully blame their portfolio of bad real estate loans. Congress and the Federal regulatory agencies are telling the banks that past bad loans should not prevent them from making new good loans needed by the economy, but the message is not being heard. Congress must make sure that the message is transmitted from the Chairmen and Presidents of the banks to the officers making the loans. The banks should be rewarded for good loans as well as penalized for bad loans. The banks must be made to realize the value of making and keeping good loans. All real estate loans should not be viewed as a detriment to the stability of a bank. Good real estate loans produce needed income. The present policy being followed by the banks will force banks to reduce their real estate portfolio by calling the good loans which can be paid, refusing to make new good loans and leaving banks with even weaker real estate portfolios which will cause greater problems in the future.

Have interest rate reductions helped and should further reductions be made? Yes. The housing industry has been helped and carrying charges on some existing real estate loans indexed to prime or Libors have been reduced. Lower interest rates probably imply lower equity capitalizing rates and higher real estate values. Lower interest rates will facilitate the refinancing of the close to 100 billion dollars of life insurance company loans maturing in the next ten years. Lower interest rates will also stimulate the economy which will help alleviate many existing problems of the real estate industry. But interest rates have been lowered for a banking industry that refuses to loan.

The real estate industry was severely damaged by the 1986 Tax Reform Act but the Act is not the only culprit. Even without the passage of the Act, the excesses of the 80's would have produced most of the problems we face today. However, the real estate industry can be helped by undoing some of the provisions of the 1986 Tax Reform Act, particularly the provision regarding passive losses. Reworking the passive loss provisions will broaden the demand for owning equity in real estate. This will help attract needed capital into the real estate market to supplement bank lending. As in the case of reductions in interest rates, the reworking of the passive loss provisions will permit real estate to sell for lower equity capitalization rates, creating higher market values, and resulting in better loan-to-value ratios for the mortgages presently held by the banks. The higher real estate values and broader base of interest in equity ownership will help to solve the problem presently faced by the RTC in liquidating its real estate.

PREPARED STATEMENT OF JAMES L. ROSE

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE, THANK YOU FOR THE OPPORTUNITY TO SHARE SOME OF MY OBSERVATIONS AND RECOMMENDATIONS REGARDING THE STATE OF OUR ECONOMY.

THE VIEWS WHICH I WILL EXPRESS HERE TODAY ARE NON-PARTISAN, OBJECTIVE, AND ARE GIVEN FOR THE SOLE PURPOSE OF MAKING A CONTRIBUTION TOWARDS SOLVING SOME OF THE PROBLEMS FACED BY THIS GREAT NATION OF OURS IN THESE ECONOMICALLY DIFFICULT TIMES.

THESE VIEWS ARE DERIVATIVE FROM OVER 30 YEARS' EXPERIENCE IN THE AMERICAN MARKET PLACE. IN THOSE 30 YEARS, I HAVE HELD POSITIONS WHICH RANGE FROM A \$1.50 AN HOUR DAY LABORER TO CEO OF MULTI-MILLION DOLLAR CORPORATIONS.

I WAS FORCED BY ECONOMIC NECESSITY TO LEAVE COLLEGE AND GO TO WORK DURING AN ECONOMIC RECESSION IN THE COAL INDUSTRY IN THE LATE 50'S.

IN MY CAREER, I HAVE OPERATED HEAVY EQUIPMENT; AND PERFORMED PRACTICALLY EVERY JOB THAT EXISTS IN THE COAL INDUSTRY.

IN 1978, I ACQUIRED MY FIRST BANK WHICH RESULTED IN A MULTI-BANK HOLDING COMPANY WHICH NOW CONTROLS 6 BANKS LOCATED IN KENTUCKY.

IN ADDITION TO BANKING AND COAL, I HAVE ALSO BEEN INVOLVED IN OIL, GAS, REAL ESTATE, RAILROADING AND ONE OF THE LARGEST RIVER TO RAIL TRANS-LOADING FACILITY ON THE OHIO RIVER.

I CURRENTLY SUPERVISE APPROXIMATELY 2,000 EMPLOYEES, 95 PERCENT OF WHICH ARE EMPLOYED AT A RATE CONSIDERABLY OVER THE MINIMUM WAGE WITH FULL VESTED RETIREMENT AND HEALTH BENEFITS.

I HAVE LIVED AND WORKED THROUGH GOOD TIMES AND BAD.

IT IS MY FIRM CONVICTION THAT CERTAIN PHILOSOPHIES AND POLICIES MUST BE CONSISTENT BEFORE WE CAN HAVE SUSTAINED AND STEADY ECONOMIC GROWTH.

SINCE THIS IS A COMMITTEE OF THE UNITED STATES HOUSE OF REPRESENTATIVES, I WILL TRY TO DIRECT MY REMARKS TO AREAS WHICH ARE UNDER THE DIRECT OR INDIRECT CONTROL OF THAT BODY.

IN MY OPINION THE ECONOMY OF THIS COUNTRY CAN BE BEST SERVED BY THE GOVERNMENT USING ITS POWERS IN THE APPLICATION OF REVENUE DIRECTION RATHER THAN REVENUE COLLECTION AND DISBURSEMENT.

TO BE MORE DIRECT, VERY FEW THINGS FUNCTION WHEN INCENTIVE IS REMOVED. IN SPORTS, WE WOULD NOT SEE THE COMPETITIVENESS OR THE REVENUE GENERATED, IF IT WERE NOT FOR THE PLAY-OFFS, CHAMPIONSHIPS, TITLES AND PERSONAL RECOGNITION. THESE ALL PROVIDE INCENTIVES FOR THE INVESTMENT OF TIME, MONEY, AND TALENT IN THE CREATION OF A CHAMPIONSHIP TEAM OR AN INDIVIDUAL EFFORT. THIS PRINCIPAL ALSO APPLIES IN BUSINESS.

THE INCENTIVE TO BUILD, CREATE AND ADVANCE THE SPIRIT OF ENTREPRENEURSHIP AND THE RECOGNITION OF THE INDIVIDUAL IN CORPORATE GOALS WILL NOT BE ACHIEVED WITHOUT THE PROPER MOTIVATION TO INVEST

AND REINVEST IN NEW AND BETTER EQUIPMENT, PRODUCTS, BUILDINGS, AND SIMILAR VENTURES.

THIS CAN BE ACHIEVED BY HAVING SUFFICIENT CAPITAL TO PURSUE THESE AMBITIONS TOGETHER WITH AN ADEQUATE RETURN ON INVESTMENT, WHICH CAN BE REINVESTED IN FUTURE PROJECTS.

IF THE CAPITAL IS NOT AVAILABLE AND THE RETURN ON THAT CAPITAL IS NOT ADEQUATE, THERE WILL BE NEITHER THE MEANS NOR THE INCENTIVE TO EXPAND EXISTING BUSINESS OR DEVELOP NEW INITIATIVES.

DO WE USE THE TAXING POWER OF THE FEDERAL, STATE OR LOCAL GOVERNMENTS TO IMPLEMENT TAX INITIATIVES TO DIRECT INVESTMENT MONIES INTO SPECIFIC AREAS OF THE ECONOMY AND FOSTER A BETTER RETURN OF INVESTMENT, OR DO WE USE THE TAX LAWS TO COLLECT MONIES FROM THOSE INVESTMENTS ALREADY MADE AND MAKE DISTRIBUTION THROUGH VARIOUS AND SUNDRY PROGRAMS, CREATED AND DIRECTED BY INDIVIDUAL GOVERNMENT ENTITIES. THE LATTER CHOICE DOES NOT WORK.

THERE IS SIMPLY NO INCENTIVE FOR INVESTMENT OPPORTUNITIES WHICH EXIST IN THE COUNTRY TODAY. THE DEPRECIATION TABLES WERE GREATLY LENGTHENED IN THE 1986 TAX ACT. THIS OFFERS LITTLE INCENTIVE TO A 50 YEAR OLD MAN WHO AT THE PEAK OF HIS EARNING POWER WISHES TO INVEST IN FOR EXAMPLE AN APARTMENT BUILDING BUT WHO CANNOT COMPLETE DEPRECIATION ON THAT BUILDING UNTIL HE REACHES THE AGE OF 80 YEARS.

IN OTHER WORDS, THE CURRENT DEPRECIATION SCHEDULES HAVE HELPED TO ELIMINATE MUCH OF THE INITIATIVE TO PURCHASE RESOLUTION TRUST

PROPERTIES AS INVESTMENTS AND MAY HAVE CAUSED THE AMERICAN TAX PAYER A CONSIDERABLE AMOUNT OF MONEY IN THE SALE OF THESE ASSETS. EQUALLY ILLLOGICAL, IN LIGHT OF THE CURRENT CONDITIONS, IS THE FAILURE TO ENACT THE CAPITAL GAINS TAX WHICH WOULD ENCOURAGE MORE INVESTMENT. THE FACT IS, UNDER THE CURRENT TAX RATES, ONE CAN ACHIEVE ALMOST EQUAL YIELD BY PLACING SURPLUS INVESTMENT CAPITAL IN SECURE INVESTMENTS RATHER THAN RISK ADVENTURES.

UNFORTUNATELY, THIS WILL CONTINUE UNTIL THERE IS SOME TAX INCENTIVE TO PROVIDE THE INITIATIVE FOR RISK CAPITAL. THIS CAN BE IMPLEMENTED BY REVENUE DIRECTION IN PROVIDING THE PROPER TAX INCENTIVE TO CHANNEL CAPITAL INTO THOSE AREAS THAT ARE SUFFERING MOST.

REVENUE COLLECTION DOES NOTHING TO ENHANCE THIS. IN FACT, IT STIPLES INITIATIVE AND INVESTMENT. WHEN REVENUE IS COLLECTED, NO ONE KNOWS IN WHAT AREA IT WILL BE REDISTRIBUTED.

FURTHER, MORE CAPITAL IS LOST UNDER REVENUE COLLECTION BY THE ADMINISTRATIVE COSTS OF COLLECTION AND DISTRIBUTION OF THESE FUNDS.

IT FURTHER SERVES NO PURPOSE BY INDULGING IN POLITICAL RHETORIC SUCH AS "SOAKING THE RICH".

MOST OF THE PEOPLE I KNOW THAT HAVE ACHIEVED SOME DEGREE OF FINANCIAL INDEPENDENCE IN THEIR LIVES DID SO THROUGH HARD WORK, PERSEVERANCE, GREAT RISK, REINVESTMENTS, AND THE WILL TO CONTRIBUTE AND INITIATE NEW IDEAS AND NEW CONCEPTS IN THEIR CHOSEN FIELD.

THEY WERE NOT PRIVILEGED, BUT RATHER BROUGHT THEMSELVES UP BY THE BOOT STRAPS THROUGH MUCH ADVERSITY, ACHIEVING FINANCIAL INDEPENDENCE BY INGENUITY AND HARD WORK.

THIS IS THE AMERICAN DREAM WHICH SHOULD BE AVAILABLE TO EVERY INDIVIDUAL REGARDLESS OF SOCIAL STANDING. I KNOW THIS IS POSSIBLE. I HAVE BEEN A PART OF THIS AMERICAN DREAM, BUT I REGRET TO SAY, I SEE THE DREAM FADING IN A MAZE OF TAXATION AND REGULATION.

CONGRESS, HAS THE POWER TO SET THE AGENDA. THIS COUNTRY HAS NOTHING TO GAIN BY POLITICAL PANDERING TO CLASS DIVISIONS.

THIS COUNTRY WAS BUILT ON THE SINGULAR PROPOSITION OF CLASS MOBILITY UTILIZING THE TOOLS WHICH I HAVE JUST NAMED, HARD WORK AND INGENUITY.

FINALLY, ANOTHER AREA WHICH GROWTH IN ECONOMIC DEVELOPMENT CAN BE STAGNATED, IS THE AREA OF REGULATION. THE EXCESSES OF THE 8 & L FAILURES ARE NOT TO BE CONDONED. WE MUST CONSTANTLY GUARD AGAINST IRRESPONSIBLE FINANCIAL BEHAVIOR AND THE HAZARDS OF GREED TO WHICH SOME PEOPLE ARE BOUND TO SUCCUMB.

WE MUST SEEK AND MAINTAIN A FINE LINE BALANCE BETWEEN REGULATORY RESPONSIBILITY AND REGULATORY REPRESSION AND THE NATURAL RESULT THEREOF, ECONOMIC RECESSION. THE PROBLEM IS NOT NECESSARILY BAD BANKERS, IT IS BAD CIRCUMSTANCES, BAD ECONOMICS, AND, THEREFORE, BAD LOANS.

REGULATORS CANNOT SOLVE THE PROBLEMS OF THIS NATION'S BANKING AND REAL ESTATE CRISIS BY ASSUMING BROADER ADMINISTRATIVE

(OPERATIONS) POWER OVER BANKS. IT MUST CONTINUE TO REGULATE TO AVOID SOLVENCY PROBLEMS IN BANKS. HOWEVER, WE SHOULD NOT MANDATE ADMINISTRATIVE RESPONSIBILITIES IN BANKS TO REGULATORS.

IT IS DIFFICULT ENOUGH FOR INDUSTRIES TO SURVIVE IN GOOD TIMES; NEARLY IMPOSSIBLE IN THE BAD TIMES, ESPECIALLY WHEN SADDLED WITH THE HEAVY BURDENS IMPOSED BY LAYER AFTER LAYER OF REGULATIONS THAT ARE CREATED NOT TO FURTHER GROWTH THROUGH INCENTIVE, BUT TO ENFORCE SOCIAL AND ECONOMIC PROGRAMS TOTALLY UNRELATED TO THE INDUSTRY.

THE MAJORITY OF THE REGULATIONS I REFERRED TO ARE OFTEN ENFORCED BY COMPETING REGULATORY AGENCIES, EACH WITH THEIR OWN AGENDA AND, UNFORTUNATELY, THEIR OWN INTERPRETATIONS.

IT SEEMS TO ME AT TIMES THAT THESE AGENCIES VIEW THEIR MANDATE NOT TO SUPPORT THE BANKS, BUT TO SEEK TO CRITICIZE IN EVERY WAY IMAGINABLE, EVEN IF SUCH CRITICISM GOES FAR BEYOND THE REALM OF REASONABLE BUSINESS STANDARDS.

IS THERE ANY WONDER WHY DISARRAY EXISTS IN THE INDUSTRY WHEN EVEN THE REGULATORS CANNOT BE CONSISTENT?

A DISTINCTION MUST BE DRAWN BETWEEN THE REGULATORS OVERSEEING THE MAINTENANCE OF A SAFE, SOLVENT BANK, AND THEIR INVOLVEMENT IN THE DAY-TO-DAY OPERATIONS OF THAT BANK.

WHATEVER I HAVE ACHIEVED IN MY LIFE HAS NOT COME EASILY. I HAVE MADE ENORMOUS SACRIFICES AND HAVE RECEIVED A LOT OF HELP FROM

THE PEOPLE I HAVE WORKED FOR AND WITH. IT HAS ALSO REQUIRED FINANCIAL HELP, THE KIND THAT A BANKING SYSTEM PROVIDES TO EVERY FAMILY AND SMALL BUSINESSMAN IN THIS COUNTRY. WITHOUT HELP FROM SOME VERY GOOD BANKS WHO PROVIDED CAPITAL FOR ACQUISITION AND EXPANSION, THE COMPANIES I AM ASSOCIATED WITH WOULD NOT HAVE BEEN ABLE TO PLACE BILLIONS OF DOLLARS IN THE LOCAL ECONOMY AND CONTINUE TO BE A SOURCE OF EMPLOYMENT FOR MANY DESERVING AMERICANS.

AGAIN, THANK YOU FOR YOUR TIME AND CONSIDERATION.

PREPARED STATEMENT OF DAVID M. WALKER

Good morning, my name is David Walker. I am National Director of the Compensation and Benefits Practice of Arthur Andersen & Co. Prior to my current position, I served as Assistant Secretary of Labor for Pension and Welfare Benefit Programs for the Department of Labor. I am also Chairman of the Association of Private Pension and Welfare Plans' Investment and Accounting Issues Committee. The APPWP's over 400 members sponsor or provide services to employee benefit plans providing pension and health care benefits to over 100 million participants.

I am pleased to be here to discuss the shortage of credit which is the focus of these hearings. Recently, I was struck by a fact reported in USA today that the McDonald Douglas company was seeking to sell a 40% share of the company to a foreign investor for \$2 billion. The sale would represent the first major inroad by a foreign competitor into the aircraft business, one of the few where the U.S. retains unparalleled leadership. The article quoted one business analyst who noted that "We're once again going to be giving away technology and helping out a competitor...And its all coming because of a lack of capital."

Why would an Association which represents pension plan sponsors be testifying at a hearing concerning the current credit shortage? In answer, we hope our appearance here will advance Congressional appreciation of the critical role pension funds play in providing capital to fuel economic growth, provide jobs, and enhance our competitive posture. We also come to express our concern that certain tax policies put in place during the 1980's may seriously erode America's future capital needs. Finally, I am here to express APPWP's strong support for the basic fiduciary standards under the Employee Retirement Income Security Act (ERISA), which serve to protect these plans.

Much of what is discussed herein is found in a recent APPWP publication, Return on Investment: Pensions Are How America Saves, written by Professor John Shoven, former Chairman of the Stanford Economics Department and Charles Schwab Professor of Economics, which discusses the role of pension savings in the national economy. We are submitting a copy of this study for the record along with this testimony.

The Growth in Pension Assets

The role of the private and public pension system in providing meaningful retirement income to a sizable portion of the American workforce is well understood. What is less appreciated by those

outside the benefits community is the critical role pensions play in the American economy.

The place to start is with the sheer size of the employer sponsored pension system. In 1950, the system contained around \$17 billion dollars and accounted for 2% of national wealth; today it has been estimated to contain around \$3.0 trillion and constitutes 17% of national wealth. Of this sum, approximately three quarters are held by private employer plans with the remaining one-quarter being held by public sector employers, excluding the federal government. This sum is larger than the total GNP of Japan! Moreover, during the 1980's while Japanese pension system was accumulating around \$5,000 in pension assets per plan participant, the American system put aside \$12,000 per participant.

Part of this growth in pension assets was stimulated by enlightened legislative policies. In 1974, ERISA required employers to set aside specific assets to help assure that promised pensions would be paid. Equally important, ERISA forbade employers sponsoring defined benefit plans, the primary form of retirement plan, from holding more than a modest amount employer securities, in effect requiring that employers invest the substantial majority of pension assets elsewhere. At the same time, individuals who were responsible for the management and administration of plans and the investment of plan assets became subject to a number of stringent fiduciary standards.

As a result, in 1987 pensions owned more than 24% of all equities and 39% of total outstanding corporate bonds. In 1986, about 35% of all non-bank investment capital came from pensions. Moreover, by 1990, pension fund assets exceeded the value of directly-held equity and mutual fund shares by approximately \$600 billion.

Pensions Are Now America Saves

The growth in pension assets coincided with what was otherwise a general collapse in savings. While aggregate net savings as a fraction of GNP was remarkably constant between 1950 and 1980, ranging from approximately seven to eight percent, the 1980's tell a different story. Net national savings were a little over three percent of GNP during the first half of the decade and exactly two percent of GNP in the second half. About two percentage points of the five percent drop was caused by increased government deficits. Responsibility for the remaining three percentage point fall is split between households and business.

The collapse of savings in the 1980's has dramatic consequences on domestic capital per worker as measured by real net wealth per worker. After steadily increasing from 1950 to 1980 this measure

of capital intensity of production fell sharply during the 1980's. By 1990, real net worth per worker was almost precisely where it had been in 1976. This is illustrated in the attached Figure 1.

The one bright spot in this otherwise dismal picture has been the growth in pension assets. To quote from Return on Investment,

"The result is that for the decade of the 1980's the real value of pension assets went up by more than did the real value of national wealth! At least in this sense, the growth in pension assets provided for all of national saving. We are not talking about 'a large fraction of' or "most", but all. This is one of the most amazing and unappreciated facts about the performance of the United States economy."

This fact is illustrated in Figure 2.

Besides its enormous size and its role in national savings, pensions also represent the most egalitarian form of capital formation. Another APPWP publication, Benefits Bargain: Why We Should Not Tax Employee Benefits, demonstrated that the tax incentives associated with pension savings are distributed primarily to those earning between \$20,000 and \$50,000 dollars. There is no other form of savings that so broadly attaches to the middle class.

Pension Legislation in the 1980's: Eating Our Seed Corn

Despite this remarkable record of capital formation, the future presents a less than rosy picture. While the rest of the economy was being de-regulated during the 1980's, the budget reconciliation process of the last few years has resulted in unreasonably curtailing appropriate funding of pension plans. While the ultimate outcome of this activity has been the reduction in pension security for retirement promises made to active employees, there has also been a profound effect on the level of national savings (and hence, capital formation) that could be achieved through the pension system.

Specifically, these reductions in the 1980's occurred in three separate areas:

1. Reduction of maximum pensions. Commencing in 1982 and in succeeding pieces of legislation, Congress rolled back the maximum benefit and contribution limits applicable to tax-qualified pension and profit sharing plans. In addition, freezes on the maximum dollar amounts which could be paid from tax qualified plans were imposed on defined benefit plans and defined contribution plans.

A freeze on the maximum limit is still in effect on defined contribution plans.

While ostensibly an "attack" on unreasonable benefits for highly compensated individuals, the unfortunate aspect of these rollbacks is that it impacts a company's ability to set aside funds for current workers necessary for their retirement. Thus, employers may not make contributions on behalf of middle income workers whose projected pensions would exceed the current limitations.

2. Reduction in Full-Funding Limitations. In 1987, Congress reduced the maximum amount that could be contributed to pensions from one which permitted employers to set aside funds to pay for projected benefit obligations to one which imposed a limitation equal to 150 percent of current liabilities.

3. Additional Tax Rules. Over the decade of the 1980's, Congress and the Treasury Department added an additional 80 pages of Internal Revenue Code provisions and over 600 pages of regulations. The area has become so complicated that the sheer complexity and administrative expense associated with maintaining a pension plan has become a significant barrier to those who wish to start and/or keep a pension plan. According to a Hay-Huggins study done for the PBGC, the administrative costs associated with maintaining a defined benefit plan, rose during the 1980's on average between 9 and 10 percent per year.

By 1989, for every defined benefit retirement plan that was being created three were terminated. While terminations increased by 37%, net plan formation fell by 67%. The picture for 1990 was even worse: for every defined benefit plan which was created, more than eight were terminated. And in 1990, more defined contribution plans, the other major form of retirement plan, were terminated than created.

To be sure the 1980's were also characterized by a shift from manufacturing industries which are most often associated with defined benefit pension plans to service-based industries, which are not. However, most observers believe that the legislative changes noted above had a major deleterious effect on plan formation.

It is not surprising that contributions to pensions and profit sharing plans began to decline during the 1980's. See Figure 3. While some of this decline was due to extraneous factors such as the maturation of pension obligations and favorable pension earnings, most point to reductions in permitted funding of pension obligations and the lack of growth in new plans as the reason for the decline in pension contributions.

Many of these additional limitations which withdrew funding incentives associated with pensions were based on flawed analyses. For example, the method of revenue analysis used by the Congress to calculate the cost of today's system, ignores the present value of tax revenues which will ultimately be recovered by the federal government--some \$750 billion. Thus revenue numbers which are used by Congress, mislead decision-makers into believing that pension incentives actually cost a great deal more than they do. Moreover, they ignore the investment value of what is perhaps the largest single pool of capital in the world.

Additionally, it should be noted that employers during the 1980's maintained total employee benefit costs as a percent of payroll at a relatively constant level. This occurred despite the fact that medical costs as a percent of payroll rose substantially, while pension costs, in part for the reasons described above, declined. As health care costs continue to expand, and assuming that employers will not increase the percentage of compensation that employers are willing to devote to benefits, it is likely that we will see pensions--and increased capital formation--crowded out by increased medical costs.

It is unfortunate that today we see not only domestic capital formation eroded by forces that may be beyond our control, but that we ourselves have, in the name of deficit reduction, robbed future capital formation through pensions to pay for current consumption.

Pension Fund Investments

As noted, the employer-sponsored pension system today holds a sizable portion of both equities and securities. Although we have no data for public plans, of private-trusteed funds in 1989, nearly 53% of such funds were held in equities; 26% were held in bonds; 12% were held in cash; and, close to 9% were held in "other assets."

Under current law, briefly described above, employers are subject to three principle standards imposed by ERISA, which govern the investment of pension funds. First, plan fiduciaries are obligated to establish and maintain retirement plans for the exclusive benefit of employees and their beneficiaries. Second, fiduciaries must act with the same care that a "prudent man" familiar with such matters, would use if acting in a similar capacity in a similar enterprise having a similar purpose. Third, fiduciaries must diversify plan investments so as to minimize the risk of large losses, unless, under the circumstances, it is clearly not prudent to do so. An exception to this requirement exists for certain defined contribution plans where investments are directed by participants and in Employee Stock Ownership Plans (ESOPS), which are designed to invest in employer securities.

Together, these rules have been interpreted to mean that plan fiduciaries, acting on behalf of plan participants, must maximize returns to the plan so long as it is done prudently and must diversify plan investments to increase the security associated with such plans. Over the years these standards have been challenged by those who wish to see greater pension investment in, for example, low interest mortgages, corporate enterprises, or even in real estate. Most recently, a number of states and cities have sought (and in some cases succeeded) to borrow from state and municipal pension funds which are not subject to ERISA's standards in order to help lessen budget deficits.

APPWP members strongly support the standards espoused in ERISA and would vigorously oppose any effort to dilute these standards to permit what has recently occurred in the public sector. As representatives of current and future retirees, plan fiduciaries have an obligation to see that sufficient funds are retained in the plans to pay promised benefits. A lessening of standards to promote one form of investment over another, or even worse, to attempt to bail out a weakened industry, means that lesser returns are acceptable. Given the realities of the investment world, even under the current standards, there is always the risk, borne by the plan sponsor, that there will be insufficient funds to pay benefits because retirement plans were forced to accept a lesser rate of return. Moreover, the Pension Benefit Guaranty Corporation, already in financial difficulty, would be subject to greater exposure from potential plan insolvencies as a result of reduced returns.

At the same time, plan fiduciaries, acting in the best interests of plan participants are in a better position to judge the types of investments which are appropriate for the covered population. For example, a plan covering younger workers and relatively few retirees could accept longer time horizons and lower liquidity often associated with such investments as real estate. On the other hand, a plan with larger numbers of retirees has shorter investment horizons and greater needs for liquidity. It would be imprudent to substitute Congressional judgement for that of professional fiduciaries and investment managers to promote some other perceived need which may exist today, but not tomorrow.

The wisdom of the ERISA standards is self-evident. According to statistics published by the Department of Labor, between 1977 and 1986, the average gross rate of return for large defined benefit plans was 11.6%; during the same period, the average gross rate of return for stocks was 9.5% and 8.3% for bonds. In 1987, when on a single day in October the New York stock exchange lost over a quarter of its value, pension funds lost around 10% of their value. Importantly, while the market merely managed to break even for the year, pension funds managed to finish the year with a 6.6% gain.

To do away with, or limit, ERISA standards and direct alternative forms of investment which some have suggested, risks the future security of retirees and borders on insanity. Moreover, to do it for one industry now, invites other industries to seek similar relief which might be politically popular, but in the end, financially disastrous.

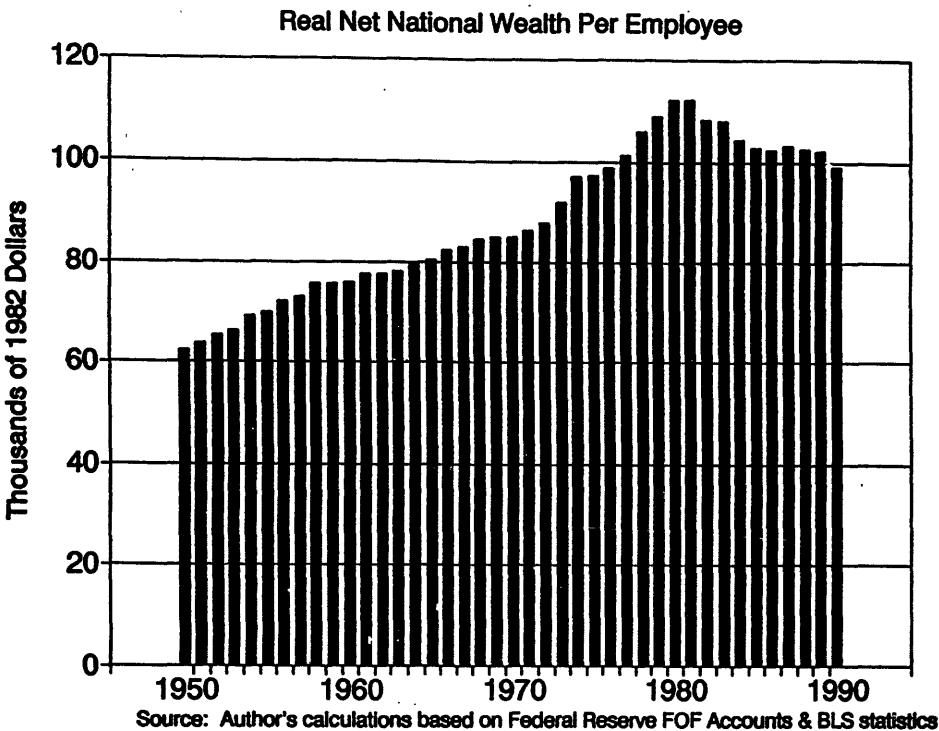
Conclusion

Future economic growth in America depends on readily available capital for expansion. Moreover, to the extent we seek to finance our capital needs with assets from abroad, we sell our children's birthright to future profits from today's investments. Our most important ally in increasing our capital pool are pension funds. By restoring incentives to establish a pension fund and permitting reasonable funding of obligations, we not only increase the retirement security of millions of Americans, we increase the economic well-being of the nation. It is time we commit ourselves to expanding incentives associated with retirement savings in this country.

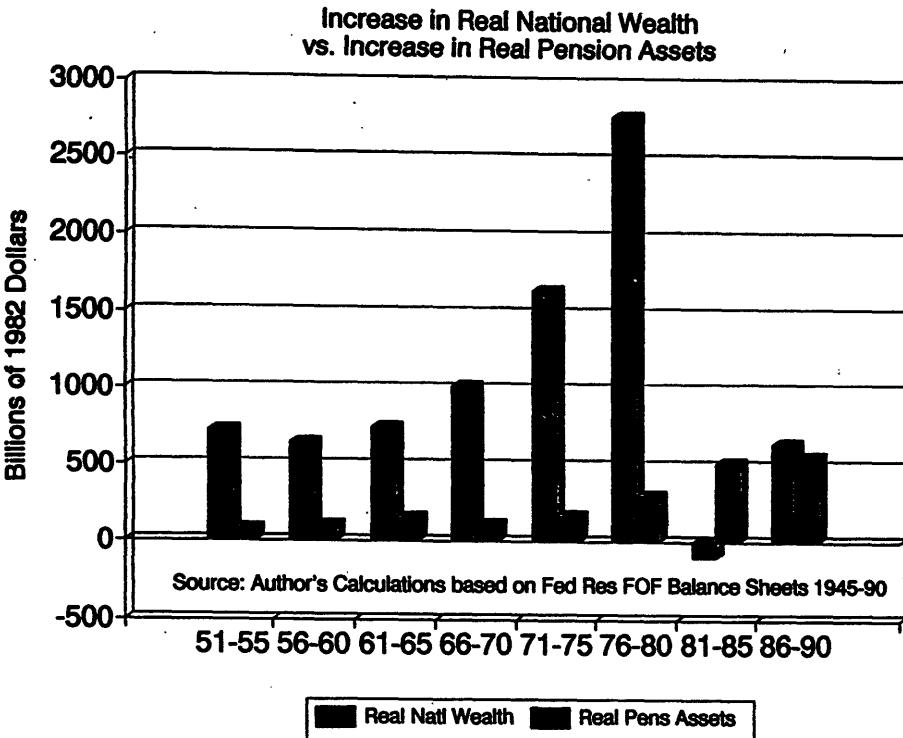
But while we need to encourage greater pension savings, suggested attempts to loosen investment standards to favor one ailing industry or another, supplants Congressional judgement as to which industry has greater promise for that of professionals who currently make that judgment in the best interests of plan participants. Any attempt to do so would put at risk not only the economic future of America, but also the retirement income security of millions of workers and retirees.

(FIGURE 1)

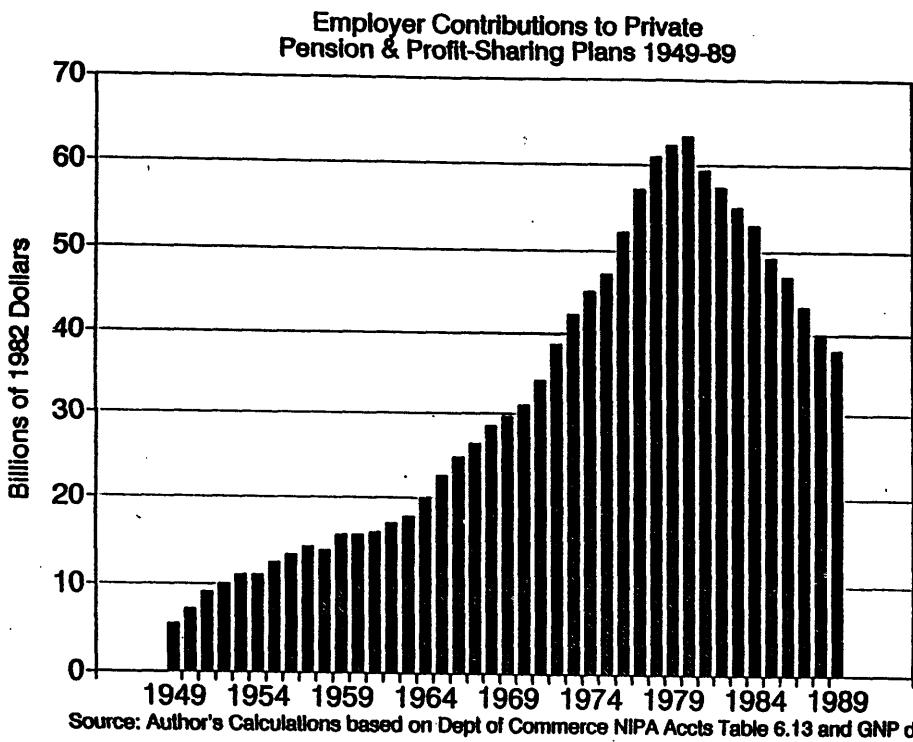
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(FIGURE 2)



(FIGURE 3)



**RETURN ON INVESTMENT:
PENSIONS ARE HOW AMERICA SAVES**

By John B. Shoven

Director, Center for Economic Policy Research, Stanford University

FOREWORD

The Association of Private Pension and Welfare Plans has long made the case that the employer-sponsored retirement system is central to the well-being of all Americans. While acknowledging the role of the employer-sponsored system in providing retirement security for millions of Americans, we have heretofore ignored the role of retirement funds in creating wealth for the U.S. economy. This paper fills that gap in our understanding of the role of employer-sponsored retirement plans.

Just as the APPWP has been forthright in extolling the virtues of the voluntary retirement system, we have also been outspoken in decrying much of the misguided legislation of the 1980's which cut back incentives and created gobs of administrative red tape for those who want to establish and maintain a retirement plan. We have lamented the resulting stagnation in coverage because it means that in the future retirees will have less than those of today. We have also lamented the artificial limitations placed on an employer's ability to set aside funds to provide for its future retirees. These changes are not only undermining the future of prospective retirees, but, as this paper demonstrates, America's economic future as well.

The employer-sponsored system provides a return on investment that would stagger any money manager. In a prior paper, Benefits Bargain: Why we Should Not Tax Employee Benefits, we demonstrated that for every dollar of federal revenue expenditure, the employer-sponsored pension system returned approximately five dollars in benefits. In this paper we find that pensions are how America saves. In short, the employer-sponsored retirement system has proven its worth. We urge those who read this paper to do what they can to restore its former lustre and get America saving for retirement again.

This paper was written at our behest by Dr. John Shoven of the Stanford University Economics Department. Dr. Shoven is a widely recognized scholar who has written extensively on savings. In preparing this paper, the Association stayed out of the author's way so that he could tell the story as he saw fit. While we agree wholeheartedly with his results, it is his independent view of these issues which adds to the weight of its conclusions.

The APPWP is proud that so many of our members, acknowledged herein, chose to support the preparation of this paper. An Association is only as strong as its membership and if the backing of this paper is any indication, the APPWP will be around for a good while.

Howard C. Weizmann
Executive Director
APPWP

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Executive Summary

The most fundamental problem of the American economy today is the collapse of national saving, which is producing dire consequences for our Nation's future. This paper makes clear that while pensions are how America saves, public policy has unwisely acted to curtail the private pension system.

Almost all types of saving in the 1980's were weak -- household saving, business saving, and government saving, and real national wealth per employee actually fell. Our collective saving behavior also looks disastrous from an international perspective. In the 1980's the U.S. saving rate was the lowest of any major industrialized country in the world. Our net saving rate was less than one-fifth the rate in Japan and at least 60 percent lower than Canada and most European countries. For a nation determined to regain its international competitive edge, while rebuilding needed domestic programs, this is not encouraging news.

Pension fund accumulations, which are included as a part of household saving, have been the only bright spot in the nation's savings picture, especially during the high-consumption binge of the 1980's. Americans' accrual of significant wealth in their pension plans resulted in an astounding fact -- the total increase in real (inflation-adjusted) pension assets in the 1980's exceeded the total real increase in the country's wealth, i.e. these assets provided for all of national savings. That is, if one measures savings as the real increase in wealth, pension accumulations accounted for more than 100 percent of all savings in the 1980's,

while other activity has diminished savings. Since the 1950's, when pensions represented only 2 percent of national wealth, pensions have increased more than eight-fold so that by 1990, more than 17 percent of all wealth was held by pension funds.

Yet, despite these remarkable achievements, short-sighted public policy in this country has actually contributed to our national savings drought. As the paper shows, despite its central role in national savings, the 1980's saw enlightened policy incentives, designed to maintain tax qualified pensions, severely reduced. And during that decade, aggregate net national saving as a fraction of the GNP fell to one-third of the level of the 1950's, 60's, and 70's.

With eyes only on the short-term, yet illusive, goal of shaving the deficit, new limits on retirement benefit levels that qualify for preferential tax treatment, and tightened limitations on the funding of retirement plans were imposed. Pension sponsors were faced with increasing, rapidly changing, and costly-to-comply-with regulations. These regulations substantially increased the cost of establishing and maintaining a pension plan, particularly for small firms. The result has been dramatic: In FY 1990, for example, there were seven times as many defined benefit plan terminations as new plans established. Pension saving maintained its central role in the total saving picture only because of the high returns earned on pension assets.

Public policy in the 1980's not only helped drive the decline in pension plans established, but also weakened funding as well.

Total real pension contributions were ratcheted back to their pre-ERISA 1972 level. A pension system that is not expanding by bringing in younger workers also results in reduced contributions by employers. A decline in contributions occurred at a time when there were huge increases in the size of the work force, the absolute number of pension participants covered by the employer-sponsored retirement system grew, and the aging of the population began in earnest. Just when we should be providing more for the future, we are providing less.

Unless we reverse our savings drought, current and future generations of Americans will be hurt. Without robust saving, our economy cannot create the wealth that will be needed to address fundamental domestic needs, such as education, public infrastructures, and fighting poverty. Workers in America, whose inflation-adjusted average hourly wage in 1990 was no higher than 25 years earlier, will continue to suffer. The next generation of workers will have an enormous foreign debt to service as well as a greatly enlarged elderly population to help support. Without increased saving, we can anticipate a stagnant economy with more pressing problems than resources to devote to them.

However, because of a misperception of the true cost of pension incentives during the decade of the 1980's, Congress consistently reduced the amount of savings that could be contributed to retirement plans during the period. Nothing reflects the government's concentration on its near term budgetary situation at the expense of the long term health of the economy more than the official measure of the revenue expenditure of the

tax preference towards pensions. This tax expenditure is estimated to be the largest of all those listed by the Joint Committee on Taxation. However, the number grossly exaggerates the cost of current policy. Completely ignored is the roughly \$750 billion present value of tax receipts which will eventually be collected from the \$3 trillion currently in public and private pension funds in the country.

If one looks at the actual return on investment from the pension system, it becomes clear that the federal government is getting a good deal. In fact, the government's investment in the future will earn a rate of return comparable to that earned by the pension plan participant. This profit will be realized as the number of retired people with taxable income grows substantially over the next few decades. Unfortunately, official accounts ignore the asset created by this investment. A more accurate approach to calculating pension costs would be to measure the enormous benefits to the economy pensions provide, rather than mismeasure their cost to this year's budget deficit.

Just how high are the stakes in raising national saving? If we return to the saving behavior of the 1950-80 period rather than continue the consumption binge of the 1980's, real wages would be roughly 15 percent higher by 2020. Working households would have approximately 15 percent higher incomes just when the burden of the retiring baby-boom generation begins to mount. For a country which has been experiencing declining real wages, the possibility of a 15 percent increase seems worth the cost of withdrawing from current consumption behavior.

The failure to enact policies to encourage saving of all forms must be reversed. Improving government saving (i.e. decreasing the deficits) by curtailing private saving makes no sense. More saving is the most reliable recipe for faster growth and greater domestically-financed investment. The government has to pay attention to the future and encourage the private sector to do likewise. The importance of employer-provided pensions to total national saving is hard to overstate. Imperative to getting America saving again is the restoration of the workhorse of retirement saving to its central role. We must simplify and stabilize the regulation of pensions and provide sufficient incentives rather than tighten down on benefit and funding limitations.

We need to return to the "good old days" of saving in 1950-80. We need to go "back to the future" to make life better for the next generation of Americans. We need to appreciate that pensions are how America saves.

SECTION I
INTRODUCTION

Economic analysts and public policy makers have been looking for the better part of a decade now for the adverse consequences of the enormous U.S. federal government deficits that have been with us since 1982. People have predicted or feared runaway inflation, a collapse of the stock market, a severe recession or depression, and yet nothing of the kind has occurred, with the possible exception of the 1987 stock market crash. Even that unprecedented market drop proved to be relatively temporary. So, what is going on? Are the deficits as damaging as many say? If so, what is the nature of the damage and what steps can be taken to protect the economy from the negative consequences? Can we design tax policy in such a way as to mitigate the problem? Are all ways of lowering the deficit of equal social value or are some ways pernicious and counterproductive? Are the deficits the true fundamental problem in the first place? If not, what is? These are some of the questions that this essay attempts to address.

The first question -- are the federal government deficits all that harmful? -- has the usual answer of economists -- "It depends." Deficits in and of themselves need not be particularly damaging. The impact of the deficits on things that we care about depends on other aspects of the economic environment in which they occur. However, the circumstances of the U.S. economy since roughly 1980 are just those for which large federal deficits are

most harmful. Further, and most importantly, the U.S. economy is and has been suffering from a very serious economic malady and the deficits have greatly contributed to the problem.

The fundamental economic problem of the country is not the deficits per se, but the lack of national saving and thus our collective failure to provide adequately for the future. To claim that this is the fundamental problem is pretty sweeping. However, I take that position after considerable research and thought. The anemic saving rate in the U.S. is a much greater problem than the savings and loan fiasco, for instance. For if Americans were saving today as they did in the 1950's, 1960's and 1970's, then the total saving available to the economy would be higher by at least \$250 billion annually. The saving rate may even be more important than our environmental concerns in that if we don't save, we won't be able to afford to tackle such crucial problems as nuclear waste disposal. The same can be said about the state of disrepair of our national infrastructure. Clearly, that is a problem of the first magnitude. However, if we don't solve the saving problem, it is unlikely that we will be able to make progress on many of the pressing social needs. Almost all of our social concerns -- from the decay of our cities to the state of our public schools, to our ability to help the countries of Eastern Europe -- require massive economic resources. The only way that we will have the ability to address these problems is if we first secure our economic future by increasing current saving.

The primary problem of the economy is the lack of national saving. The federal government deficits are a problem in the context of weak national saving. But, they are only part of the problem. Household saving is also extremely weak in the U.S., and business saving has been declining. Only saving in the form of accumulating pension assets (which is counted as part of household saving) has been strong in this country, and even in this area public policy initiatives have curtailed the growth of the pension system. All components of national saving will have to increase if we are to have the ability to solve other pressing national problems. Imperative to getting Americans saving again is the restoration of retirement saving to its central role. Even the position of the United States as the world's greatest political and military power will be undermined unless we take steps to increase economic growth. The most reliable recipe for a faster rate of growth is more saving which would be translated into additional domestically-financed investment.

Section II of this document, entitled "The National Saving Rate", reviews the definition of national saving and documents the saving rate for the U.S. since 1950. American saving behavior is compared with that in other advanced economies. The recent reliance on foreign capital by the U.S. is seen to be a direct consequence of the low level of national saving.

Section III entitled "The Consequences of the Low National Saving Rate", explores further this serious problem. It is argued that most Americans judge the performance of the U.S. economy by

the purchasing power of their weekly paycheck. The facts are that the U.S. economy has been performing extraordinarily poorly in this regard. Both weekly and hourly earnings of non-supervisory employees have been declining steadily since 1973 and have reached levels last seen 25 to 30 years ago. This paper links this depressing fact to inadequate national saving.

Section IV, entitled "Pensions Are How We Save", turns to the question of how and why people save. The accumulation of pension assets is examined with particular scrutiny, since pension saving appears to be the most important and vibrant form of saving in the United States. It is shown that pension saving has contributed a staggering fraction of all saving since 1980. There are, however, some disturbing trends buffeting even this most robust form of saving.

Section V of the paper, entitled "Why Do We Save So Little?", addresses the question of why Americans save so little, although all explanations must be considered reasonable speculation. It is extraordinarily difficult to look behind what people do and determine motives. Certainly, it is next to impossible to prove why people behave as they do. Further, it is difficult to be certain how people's behavior would change under a different set of government policies. Some responses can be ruled out as impossible or improbable, while others may be considered logical and likely. Policy makers should consider the spectrum of possible responses to their actions and they should be extremely cautious about taking steps that risk our economic future. Since national saving should

be the country's highest priority, policies with the potential to affect national saving negatively should be carefully scrutinized.

The issue of the federal government deficit is returned to in Section VI, entitled "Public Policy Towards Pension Saving", via a discussion of the concept of and the figures for tax expenditures. It is argued that the pervasive tax expenditure concept used for evaluating the costs of providing certain incentives in the tax law, the largest of which is pensions, is very flawed for pro-saving policies such as the tax treatment of pensions. Policy makers could be seriously misled if they rely on the official tax expenditure figures as guides to alternative ways of lowering the federal deficit and thereby increasing national saving and economic growth.

Section VII, entitled "How Much Difference Would Additional Saving Make?", examines the question: How much better off would Americans be if they increased their saving? Would it be worth the effort? How sure can we be of our answers to this question? Surprisingly, it will be argued that we can be quite certain about the nature of the effects and even relatively precise about their magnitude. Paradoxically, it appears in some cases economists can predict the distant future with far more reliability than the near term outlook. The bottom line answer is that increased saving would have substantial beneficial effects -- effects that can be achieved in no other way.

Finally, Section VIII, entitled "How Can We Raise National Saving?" addresses reasonable policy goals and actions with respect

to the encouragement of additional national saving. The goal which is espoused is to return the net national saving rate to its average level in the 1950's, 60's, and 70's. While reducing government deficits is probably a necessary condition to accomplish the increased saving, this section stresses that not all ways of improving the deficit are of equal social value. One definitely wants to be certain that the improvement in public sector saving does not come at the expense of private sector saving. If it does, no progress is being made towards solving the fundamental saving problem.

The number one national priority should be a dramatic increase in the national saving rate; and an appreciation of the role played by pensions in achieving that goal should be understood. Sound policies and political leadership are urgently needed to get this country on course for a prosperous beginning to the 21st century.

SECTION II
THE NATIONAL SAVING RATE

If we assert that the low rate of national saving is the number one problem facing the United States, it is necessary to establish what is meant by national saving and then document that it is indeed low. Fortunately, national saving is a straightforward generalization of individual saving, a concept that, hopefully, almost everyone understands. Individual or household saving is simply the difference between after tax income and the amount of money spent on consumption. It is income not spent on consumption and is therefore the funds available for adding to wealth (i.e., investments). The money saved can be invested in the stock market, deposited in a bank or saving institution, or used to finance a real investment such as an addition to the family home.

On average, the real or inflation adjusted increase in a household's wealth will be equal to its saving. The actual increase in wealth of the household depends on both the household's saving and on the revaluation of the existing assets held by the family. However, the change in real value of existing assets (over and above the income that they generate) tends to be zero over the long run.

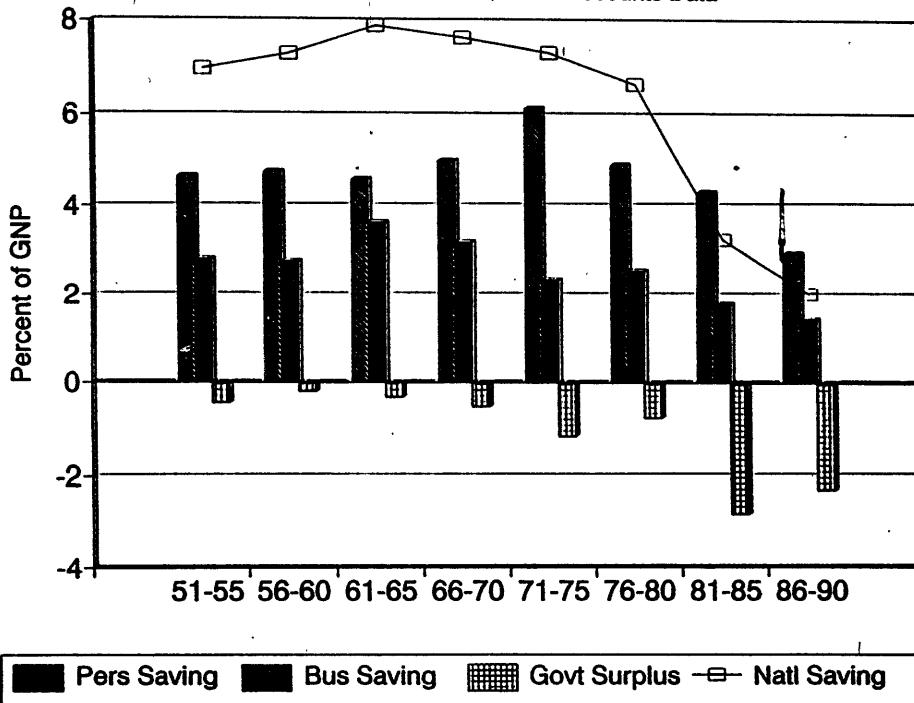
Most individuals know that their household can spend more than its income over relatively short time intervals, perhaps even for a year or two. However, they also know that if spending exceeds

income (i.e., saving is negative) then they must either sell off assets or borrow money or both. Further, they know that they cannot spend more than income over the long run. They would eventually run out of assets to sell and also lenders would become unwilling to advance them additional funds.

All of these characteristics of saving at the household level translate directly to national saving. National saving is simply national income which is not spent on consumption. It is the sum of all household saving plus all corporate saving (i.e., retained earnings) plus government saving (the sum of federal, state, and local government surpluses). Just as at the individual level, national saving generates the expected or average increase in real national wealth. Countries can spend (consume and invest) more than national income, but just as with households the necessary consequences of such behavior would be a sell-off of assets to foreigners or borrowing from abroad. Presumably, countries cannot sustain spending above income over the long run, as assets to sell and borrowing opportunities will eventually dry up.

With this basic understanding of national saving, let us now turn to the statistics regarding U.S. national saving. There are two primary sources for these statistics: the Department of Commerce's National Income and Product Accounts (NIPA), and the Federal Reserve's Flow of Funds (FOF) Accounts. Although the numbers don't always agree, the stories that they tell are remarkably similar. The NIPA numbers are shown in Figure 1. The three bars for each five year interval show the saving rate

Figure 1
U.S. Net National Saving, 1951-1990
Based on National Income Accounts Data



(relative to GNP) of the three components of national saving - personal saving, business saving, and government saving. The line in the graph shows total net national saving, i.e. the sum of the three components. The "net" aspect of these figures simply refers to the fact that this is saving after depreciation of existing assets due to wear, tear, and obsolescence. Net national saving is the difference between net national income and aggregate consumption.

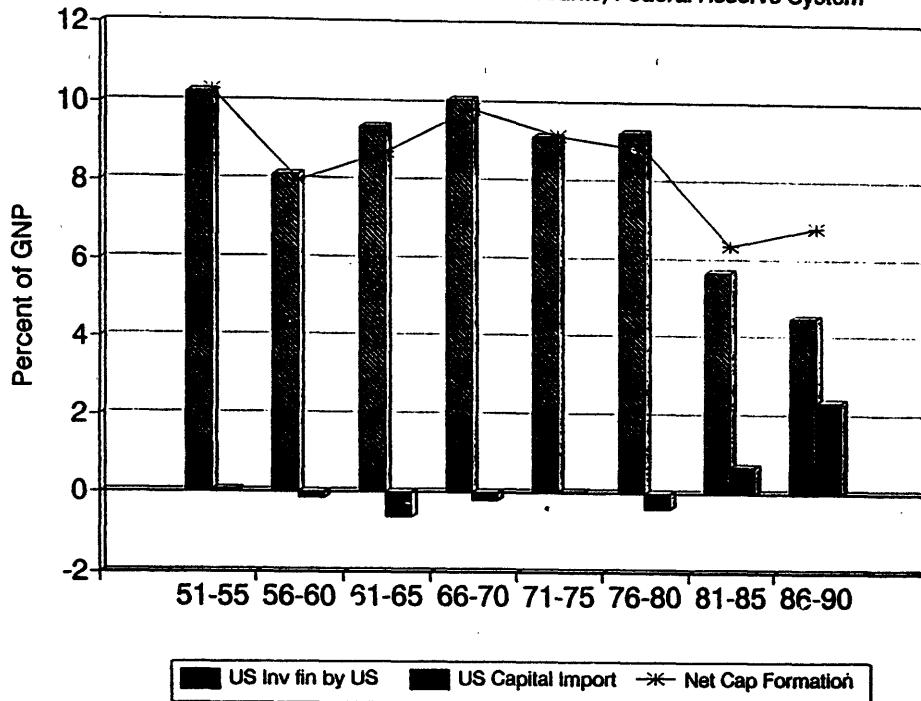
The story of Figure 1 is that aggregate net national saving as a fraction of GNP was remarkably constant between 1950 and 1980, ranging from approximately seven to eight percent. The 1980's were sharply different, with net national saving being a little over three percent of GNP in the first half of the decade and exactly two percent of GNP in the second half. All three components of national saving are seen to contribute to the massive decline in the aggregate. Personal saving, business saving, and government saving are all significantly lower in the 1980's than in the previous thirty years. Roughly two percentage points of the five percentage point drop in national saving by the latter half of the 1980's was caused by increased government deficits, while responsibility for the remaining three percentage point fall is split between households and business.

The fall in net national saving is quite dramatic in Figure 1, but even it understates how low the level of national saving has become in the United States. In the figure, net national saving is compared with GNP simply because GNP is a commonly used denominator

when analyzing economy-wide aggregates. However, since net national saving represents the expected increase in national wealth (it is the money that we can devote to domestically financed investments), a more natural denominator would be total national wealth. One constant that American economists learn early on in their study of the American economy is that the value of tangible assets in the U.S. (i.e., total national wealth) is about three times either annual national income or GNP. Two percent of GNP therefore translates to two-thirds of one percent of national wealth. This means that the saving rate of the last half of the 1980's was such as to permit real national wealth to grow on average at 0.67 percent per year. The labor force and population grow at least that fast. Thus, our saving performance is such that we can expect no growth in per capita wealth. This has obvious negative implications for the economy's growth rate of output and productivity, which we will explore further in this study.

What Figure 1 establishes is that at least according to the NIPA numbers, net national saving collapsed in the 1980's. Figure 2 shows somewhat comparable statistics from the other major source, the Federal Reserve's FOF numbers. What is shown in Figure 2 is the rate of net capital formation (i.e., investment) in the U.S. and the division between domestically financed and foreign financed investment. The bars showing U.S. investment financed by Americans are another estimate of the net national saving rate. The levels differ slightly from Figure 1. Here, the FOF statistics show that net saving ranged from eight to ten percent in the 1950 to 1980

Figure 2
U.S. Investment Flows, 1951-1990
Based on Flow of Funds Accounts, Federal Reserve System



period, but fell to 5.7 per cent in the first half of the 1980's and further to 4.5 per cent in the last half of the 1980's. The FOF numbers again show the same sharp slide in the net national saving rate with the fall from the 1950 to 1980 average to the level of the last half of the 1980's being about five percent of GNP. The main story is exactly the same as that told by the Department of Commerce's NIPA figures. At least part of the reason that the absolute level of the numbers differ is that the two concepts of saving are defined differently. For instance, the purchase of consumer durables such as furniture and stereos is treated as consumption in the NIPA accounts, but as investment in the FOF statistics. Nonetheless, the two sources are in agreement about the big story. U.S. net national saving collapsed in the 1980's.

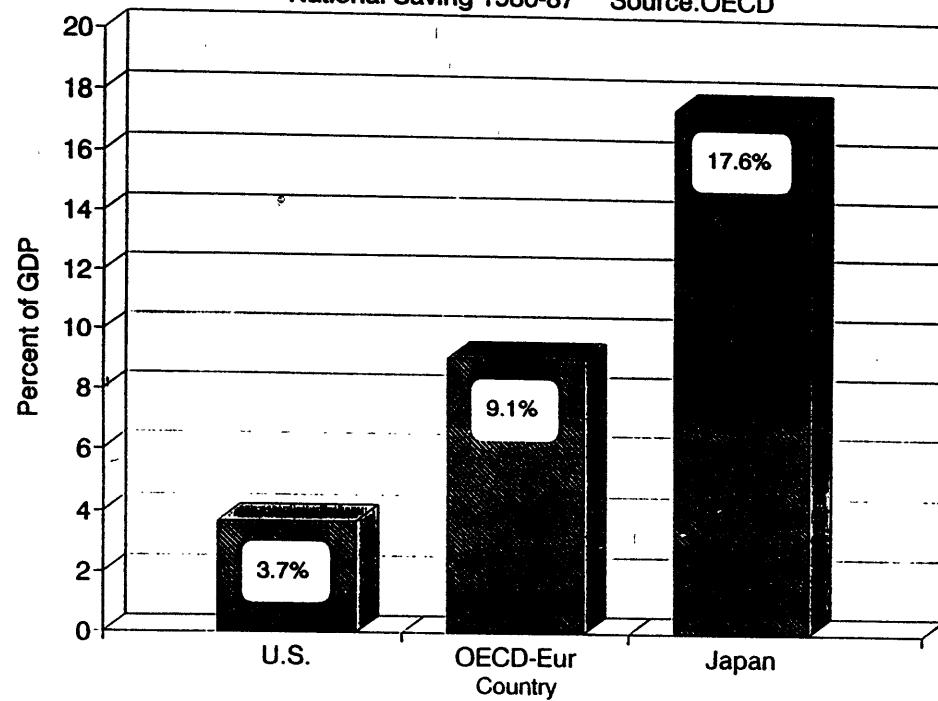
Figure 2 does make clear that our need to import capital (borrow from abroad and sell assets to foreigners) is a necessary consequence of our consumption, saving, and investment decisions. Remarkably, aggregate consumption plus investment exceeded national income in the last half of the 1980's by more than two percent of GNP. That is, as a country we spent more than 102 percent of our income. Such behavior is only possible if one turns to external sources to finance the excess spending. Figure 2 also indicates that the excess spending did not result from a boom in investment. It would have been nice if that had been true, but net investment in the U.S. was lower in the 1980's than in any of the three previous decades. The only conclusion that one can draw from the

official evidence is that the country went on a consumption binge at the expense of saving and the economic future.

Figure 3 compares the U.S. net national saving rate with the average of the European OECD members and Japan for the period 1980 to 1987. The figures were compiled by the OECD and were adjusted so that saving was defined in a comparable way across the countries. The story of this figure is no more pleasant than that of the earlier two. The U.S. net national saving rate over 1980-87 was well under half of the rate in Europe and roughly one-fifth the level in Japan. The rate of saving in the other high growth Asian economies such as South Korea and Taiwan was even higher than the rate in Japan.

The conclusion is obvious. The U.S. saving rate in the 1980's was low both by historical standards and by international standards. This figure also emphasizes that it is the national saving rate (and not the government deficits) which constitute the fundamental problem. In the 1980's, Japan experienced government deficits as large a fraction of GNP as those in the United States. However, with robust household and business saving, the Japanese had high overall saving and were able to purchase all of their government debt obligations, finance all of their domestic investment, and accumulate considerable foreign assets. It is my contention that government deficits are not particularly harmful in such an abundant saving environment. Unfortunately, the U.S. is a country with a shortage of private saving and therefore the dissaving of the government sector is particularly deleterious.

Figure 3
An International Comparison of Net
National Saving 1980-87 Source:OECD



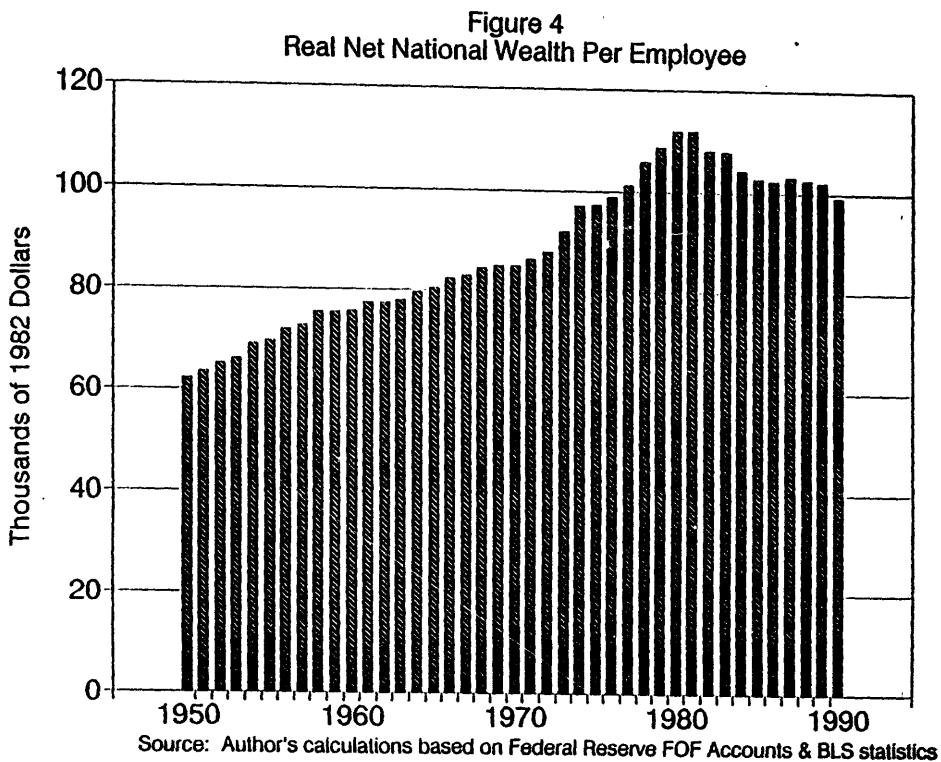
SECTION III

THE CONSEQUENCES OF THE LOW NATIONAL SAVING RATE

We have seen that the net national saving rate in the U.S. was extraordinarily low in the 1980's. One should ask the obvious question -- so what? Didn't we have the longest uninterrupted peacetime economic expansion in history from 1982 to 1990? Wasn't the stock market strong during most of the decade? Weren't both unemployment and inflation declining? What's so terrible about the low national saving rate?

A little deeper look at the statistics on the performance of the economy does show that the emphasis on consumption at the expense of saving did have some important negative consequences. Figure 4 shows a rather startling trend in real net wealth per worker, measured in constant 1982 dollars. Real net wealth per worker can be interpreted as domestically owned capital per worker or, more loosely, as "tools" per worker. After steadily increasing from 1950 to 1980, this measure of the capital intensity of American production has fallen sharply since 1980. Real wealth per worker in 1990 was almost precisely at the level it had been in 1976.

The emphasis on domestically owned capital or real wealth is appropriate because it is not obvious that Americans gain a great deal from foreign owned assets. The owners naturally expect to receive the bulk of the productivity of those assets as a return on their investment. Even if Americans finance their own physical

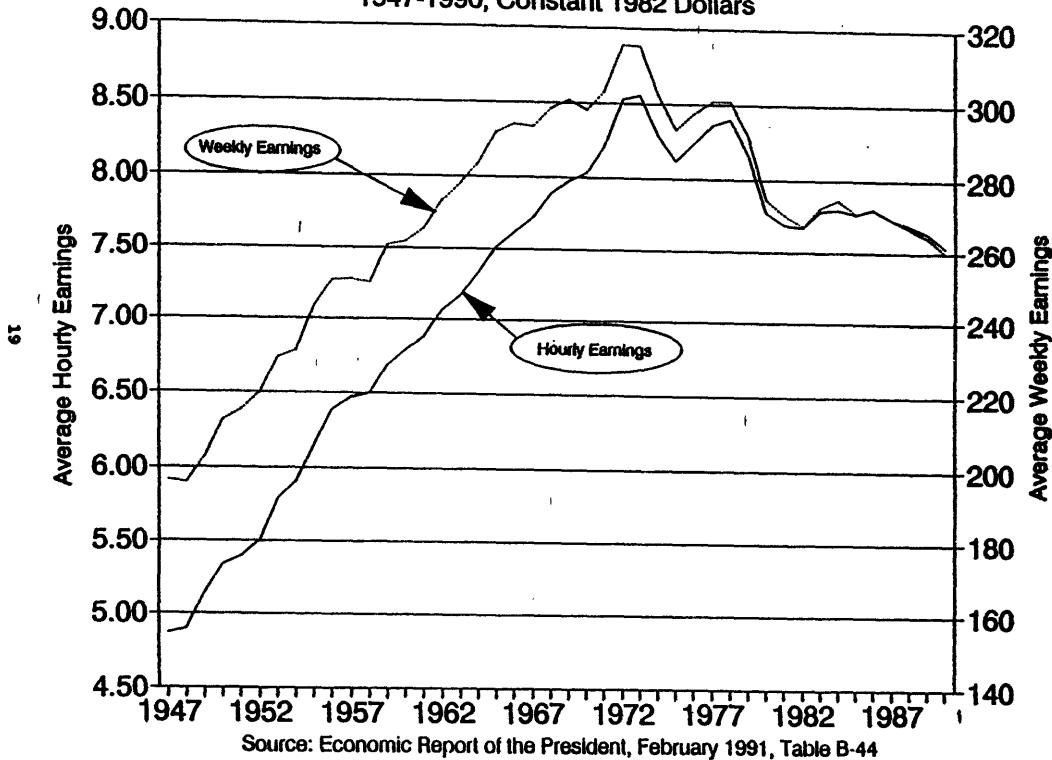


installations but rely on foreigners to finance our government deficits, it is not at all clear that U.S. workers and taxpayers will enjoy the full benefits of their investments. Much of the return on American owned assets will have to be transferred abroad (most likely through taxes) in order to service the foreign debt.

Figure 4 illustrates an indirect measure of economic performance. Figure 5, however, shows measures of economic performance which are the vital to most American households. For most people, productivity is translated into real (inflation adjusted) wages or earnings. Statistics regarding economic growth don't mean too much unless they show up in the weekly paycheck. The message of Figure 5 is that real weekly and hourly earnings have fallen sharply since 1973. In the case of hourly earnings, by 1990 the figure had fallen to its 1965 level. For real weekly earnings the 1990 number is more than 15 percent less than the 1973 one and now is at the 1959 level. Such a great leap backwards hasn't been experienced in America except in the Back to the Future movies.

The statistics illustrated in Figure 5 refer to non-supervisory employees only. It is likely that supervisors and executives have done considerably better. Also, the weekly earnings figures are down more in percentage terms than the hourly ones because the average work week has been shortening, particularly in the rapidly expanding service sector. However, no matter how you interpret this figure, the main message is startling and discouraging. Real wages and earnings are now the same as they

Figure 5
Real Wages and Real Weekly Earnings
1947-1990, Constant 1982 Dollars



Source: Economic Report of the President, February 1991, Table B-44

were a generation ago, and substantially less than they were 15 to 18 years ago. The American dream that each generation would be substantially better off than its predecessor has become just that -- a dream. In fact, the only way the typical blue collar family in America has achieved even a modestly rising standard of living is by having more workers per family. As women's labor force participation rates approach those of men, it is obvious that this cannot remain the major source of real income growth for families.

Figure 5 should at least cause those who say that they haven't seen any negative consequences of our anemic saving and large budget deficits to pause and think. Something is obviously wrong in this economy. The primary culprit is our failure to force growth and provide for the future by saving. One problem with this explanation is timing. The official saving statistics don't show a collapse occurring until 1980, and yet the labor income measures start their slide in 1973.

How can the symptoms precede the disease? The reconciliation lies in the failure of the official statistics to capture the effect of the dramatic OPEC oil price shocks of 1973 and 1979 on the value of the American capital stock. Large amounts of capital were either made obsolete or at least sharply reduced in value by the increase in oil prices. You may remember what happened to the price of gas guzzler cars after these oil shocks. Their dramatic fall in price reflected their reduced economic value in an environment of high gasoline prices. However, their decline in value was only a small portion of the total losses suffered by the

economy from these events. The official saving statistics completely miss this loss of wealth (i.e., dissaving). What one would have hoped for after such an unexpected loss would be high saving to replace the now obsolete capital stock with more modern and efficient units. Unfortunately, just the opposite happened. The oil shocks of the 1970's were followed by the saving drought of the 1980's.

Certainly the terrible performance of real wages and weekly earnings are not due only to the saving and investment declines that we have experienced. The composition of the work force has changed considerably, union power has diminished substantially, and there has been a relative decline of manufacturing compared with the service sector. Further, saving and investment conceptually should include human capital as well as physical capital. Workers can be made more productive (and therefore enjoy higher wages) by either providing them additional and more modern tools or by giving them the extra knowledge and capabilities that come with better education. Unfortunately, the performance of the U.S. education system has also deteriorated over the past 20 to 30 years. One objective measure of this deterioration is offered by the average SAT scores of college bound high school seniors. The 1967 average verbal score was 466; by 1988 the average had fallen to 428. The story about the math SAT scores is similar with the 1967 average of 492 falling to 476 by 1988 (College Examination Board, 1990). Unfortunately, our failure to provide abundant physical capital has not been offset by a large accumulation of human capital.

SECTION IV
PENSIONS ARE HOW WE SAVE

The now conventional economics model of household consumption and saving behavior is the so-called lifecycle model associated with Modigliani and Brumberg (1954). This model assumes that people plan their desired consumption path over their entire lifetime taking into account their current wealth and expectations regarding future income, prices, and rates of return. The basic problem for such a farsighted household is that their desired consumption pattern may differ markedly from the pattern of the receipt of income which they anticipate. The period where anticipated income and desired expenditures may differ the most is retirement. By the definition of retirement, labor income is insignificant during this phase of life, but desired expenditures may be quite high due to health expenses or leisure plans. Many households can anticipate at least one person living in retirement for twenty years or longer. The difference between income and consumption is saving. If one anticipates a long period in retirement where consumption will exceed income (i.e., a period of dissaving), one must prepare for this by accumulating a great deal of wealth during the work years. Most economists think that saving for retirement is the largest motivation for saving, although they recognize that other major purchases such as college educations for children, a house, or a car provide additional reasons to save.

A common image of a saver is someone who periodically makes

deposits in a saving institution, building up a considerable stock of funds. While there undoubtedly are many people who save in this way, much of their saving is offset from the entire economy's point of view by people who take out consumption loans by such practices as accumulating credit card debt. In the aggregate, there are several ways to save which are quantitatively more important than the traditional deposit route. One important form of household saving is done quite automatically and systematically by those who have a mortgage on their home. The mortgage payments include an amount for the reduction of the principal, and that clearly is private saving and household wealth accumulation. In fact, due to the lack of inflation indexation of mortgages, a homeowner's equity usually increases much faster than the principal payments. Many households own their own house free and clear by the time they reach retirement and the house represents one of their most valuable assets. One should note, however, that if an existing house is being purchased by one household from another, while the acquiring household is accumulating an asset, society is not getting wealthier. What is going on is simply a transfer of ownership of one of the society's assets. Only newly constructed homes (or additions to existing homes) represent saving and investment from an economy-wide perspective.

Another way that many people save is through an employer provided or sponsored pension plan. There are several types of plans, but they all involve the gradual accumulation of the right to a retirement benefit. Participation in the majority of plans is

automatic and mandatory, although many plans provide for the possibility of supplementary contributions. This mandatory and automatic participation may be desirable because of the "Christmas Club" effect. Many people seemingly don't trust themselves to have the discipline to accumulate a substantial amount of money. They are afraid that they might be tempted to squander it along the way. They actually prefer to enter a contractual arrangement which will force them to stay in a long run accumulation plan.

There is a third important way in which households provide for their retirement, namely the earning of Social Security benefits. Social Security provides people with inflation-indexed life annuities of enormous value. The present value of future Social Security payments is often the largest single asset that a person has at retirement. A married couple where both spouses are age 65 might have a present value of Social Security retirement payments of perhaps \$300,000. The exact present value depends on their earnings history. In addition, Social Security provides Medicare coverage for people over 65. This coverage can easily have a present insurance value of more than \$150,000. The number for the average present value of Medicare benefits may turn out to be considerably higher than this if health care costs continue to escalate at roughly twice the rate of inflation. These figures loom very large relative to other asset values and even amount to a significant percentage of all the resources needed to finance a modest, but long retirement.

The problem with Social Security is that for the most part the

system is not accumulating assets to match the apparent accumulation of wealth of its participants. For most of its history, Social Security has strictly been a pay-as-you-go system whereby benefits are paid out of the current contributions or taxes of workers. The right to a future annuity that workers are accumulating is not funded by stocks and bonds or other investments, but rather by taxes on future workers. The point is that while Social Security appears to create wealth for its participants, actually it is a transfer scheme between generations. Today's workers are supporting today's elderly. The next generation of workers will support this generation's workers in their retirement. This may be a good deal for today's workers, but only if the system is continued and the next generation of workers does indeed support them.

There is no social saving corresponding to the apparent private saving in the Social Security system. Without too great an exaggeration, we can refer to Social Security wealth as "phantom wealth." All of this discussion about the pay-as-you-go nature of the Social Security system has to be qualified somewhat in the present circumstances since the system adopted in 1983 a plan of partial pre-funding of the retirements of the baby-boom generation. The system is running a surplus now (around \$57 billion per year), although in effect that surplus is more than offset by the enormous deficits accumulating in other government accounts. It certainly is clear that the Social Security surpluses are not sufficient to dramatically improve national saving, since national saving remains

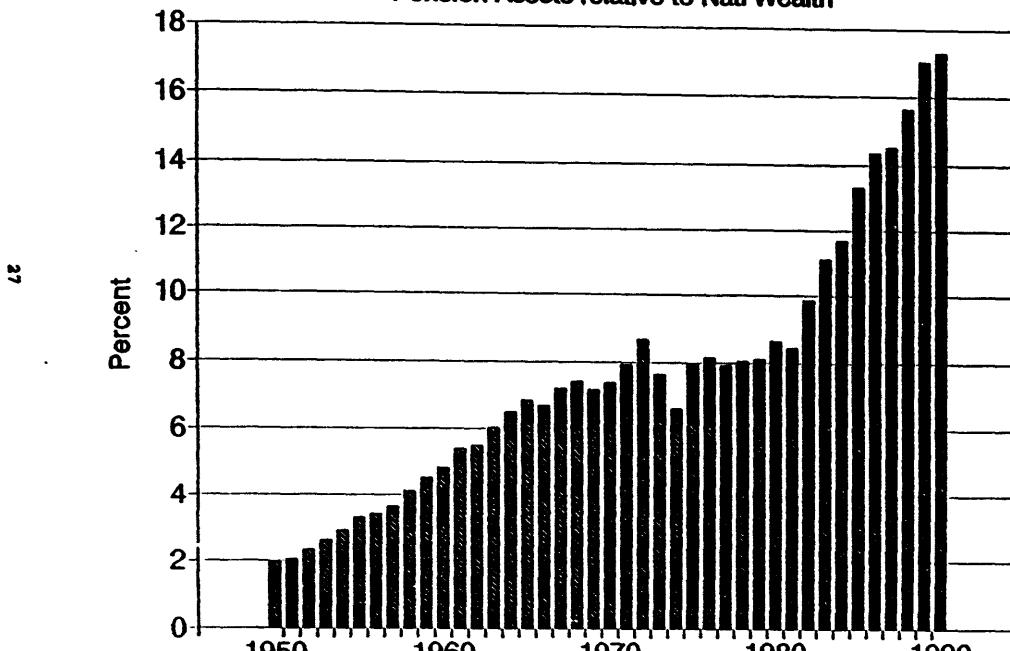
near its all time low.

The importance of employer provided pensions to total national saving is hard to overstate. Figure 6 provides one picture of the growing importance of pensions. It shows pension fund assets relative to national wealth, both as reported in the Flow of Funds statistics of the Federal Reserve System. The increase in pension assets relative to GNP since 1950 is extraordinary. Pension assets amounted to two percent of national wealth in 1950. The relative importance of pensions has increased more than eightfold since then. By 1990, slightly more than 17 percent of all wealth was held by pension funds.

Pension assets gained on all other forms of holding wealth. For instance, pension fund assets amounted to 44 percent of life insurance reserves on the aggregate household sector balance sheet in 1950. By 1990, pension fund assets were more than 7.5 times life insurance assets, a more than 15-fold relative increase. In 1950, households held far more wealth by directly owning equities or by owning mutual funds than they did in the form of pension assets. By 1990, pension fund assets exceeded the value of directly held equity and mutual fund shares by approximately \$600 billion. Clearly, pensions were the one form of wealth holding that proved immensely successful.

Figure 7 presents pretty much the same facts in a different and perhaps more revealing form. It shows the real or inflation-adjusted increase in pension wealth and in national wealth, again relying on the Federal Reserve statistics. In the period 1950 to

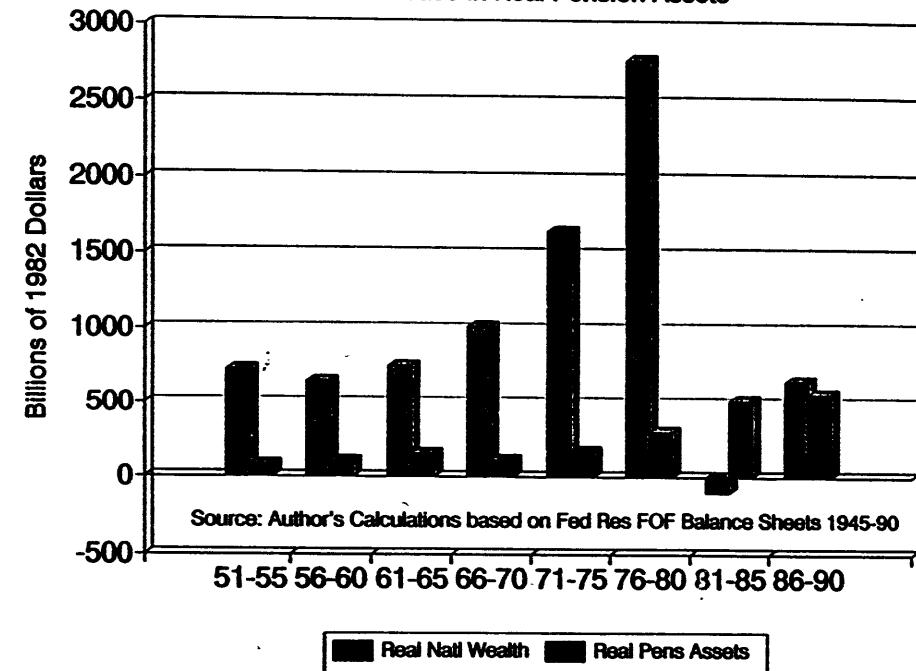
Figure 6
Pension Assets relative to Nat'l Wealth



Source: Author's Calculations based on Federal Reserve FOF Balance Sheets for the U.S. 1945-90

Figure 7

Increase in Real National Wealth
vs. Increase in Real Pension Assets



1980, the growth in the real value of pension assets amounted to between 15 and 20 percent of the increase in the real value of total national wealth. Things changed rather dramatically in the 1980's. While real pension assets grew at a somewhat faster rate than before (the real return on financial assets was quite high in the 1980's), the growth in real aggregate wealth completely ceased in the first half of the 1980's and was very low in the latter half. This is just another manifestation of the collapse in saving.

The result is that for the decade of the 1980's the real value of pension assets went up by more than did the real value of national wealth! At least in this sense, the growth in pension assets provided for all of national saving. We are not talking about "a large fraction of", or "most", but all. This is one of the most amazing and unappreciated facts about the performance of the United States economy.

The combined implication of Figures 6 and 7 is that pensions are an enormously important part of the U.S. capital stock and are a vital part of national saving. While it is not quite true that there wouldn't have been any national saving if it weren't for pensions (presumably other forms of saving would have materialized somewhat), it is true that pensions were and are the mainstay of saving in America.

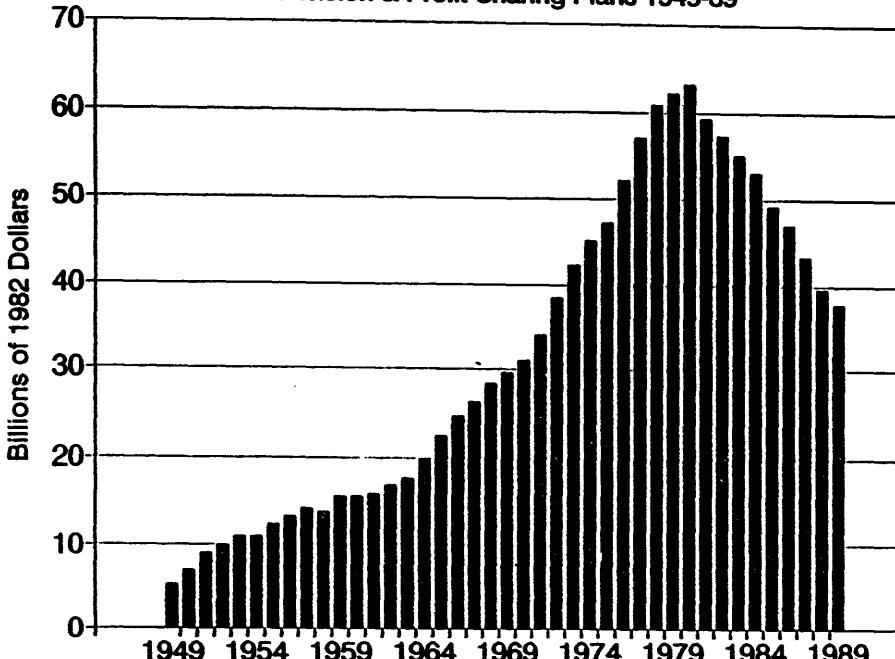
Even the saving picture regarding pensions is not all beautiful, however. If you look at the inflation adjusted value of

employer contributions to pension plans, the numbers are down as shown in Figure 8. In fact the contributions of 1990 are roughly equivalent after inflation adjustments to those in pre-ERISA 1972, and are down by at least one-third since 1980. This decline is even more dramatic when the circumstances of it are considered. The number of pension participants increased by more than 62 percent between 1970 and 1988 (U.S. Dept of Labor, 1991), and yet total real pension contributions were roughly unchanged over approximately the same interval. The average age of the work force has been increasing and with normal actuarial practice greater retirement benefits are thought to accrue to older workers. Despite these facts which would tend to cause pension contributions to grow considerably, the trend for the past 10 years has been for smaller aggregate contributions.

Why are pension contributions down when everything else about pension saving is so robust? There are at least two answers to the question. One reason that pension contributions are down is that pension assets have experienced such high rates of return. Retirement accumulation is the goal of both the employer and the employee, of course, regardless of the design of the pension plan (be it a defined contribution plan or a defined benefit one). When asset returns exceed all projections, as they did in the 1980's, a natural adjustment is to reduce contributions. The retirement income goal can be met with lower contributions. Government regulations have formalized this argument. Firms are restricted in the amounts that they can contribute to plans that have been

Figure 8

Employer Contributions to Private
Pension & Profit-Sharing Plans 1949-89



Source: Author's Calculations based on Dept of Commerce NIPA Accts Table 6.13 and GNP deflator

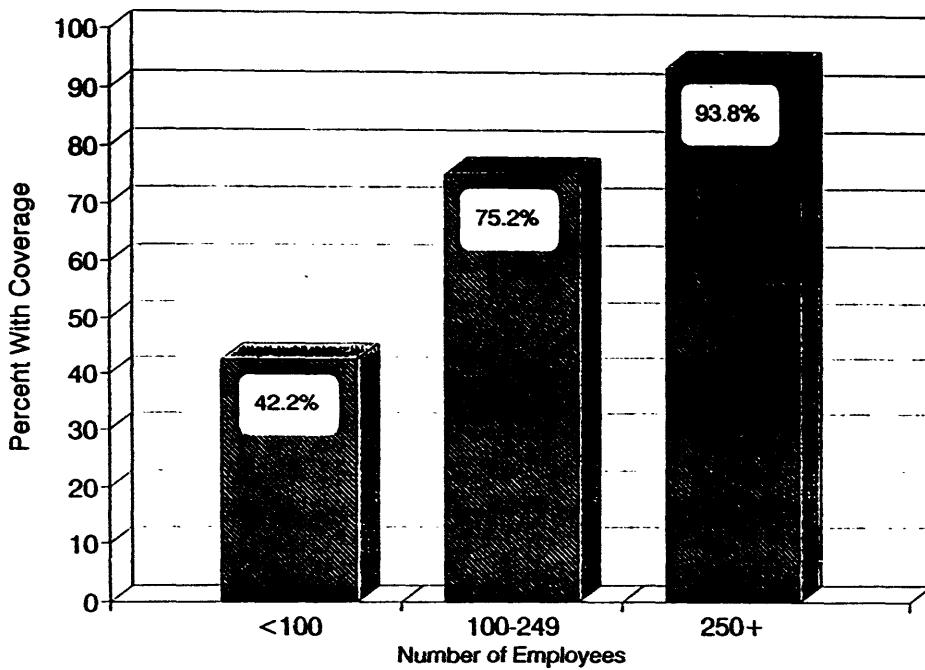
determined to be overfunded. These restrictions were tightened during the 1980's through a variety of legislative actions designed to reduce the size of current deductions for pension contributions. Further, a 15 percent excise tax is imposed on distributions in excess of certain limits.

A second reason that the growth in pension contributions stopped in 1980 was that the growth in pension coverage ceased. The fraction of all employees who participate in pension plans peaked in 1980 at 55.7 percent and declined noticeably by 1986 to 51.6 percent (APPWP, May 1989). What has happened can be inferred from Figure 9. Almost all "ERISA workers" associated with firms with more than 250 workers have an employer sponsored pension plan. ERISA workers are all workers between the ages of 21 and 64 who work at least half time and have been with their employer for more than one year. Pension plans are much less universal for smaller firms. Coverage is only 75 percent for medium sized firms (100 to 249 employees), and only 42.2 percent for firms with fewer than 100 workers. The pension coverage of the truly small firms with fewer than 25 workers is certainly well below 25 percent. This concentration of pensions among large employers contrasts with where job growth has been occurring in recent years -- in small, predominately service-sector firms.

Why don't more small firms offer their workers pension plans? Part of the answer is certainly cost - not just the cost of putting money aside for retirement purposes, but also the enormous administrative cost of establishing and maintaining a pension plan.

Figure 9

Percent of ERISA Work Force with
Pension Coverage by Size of Firm

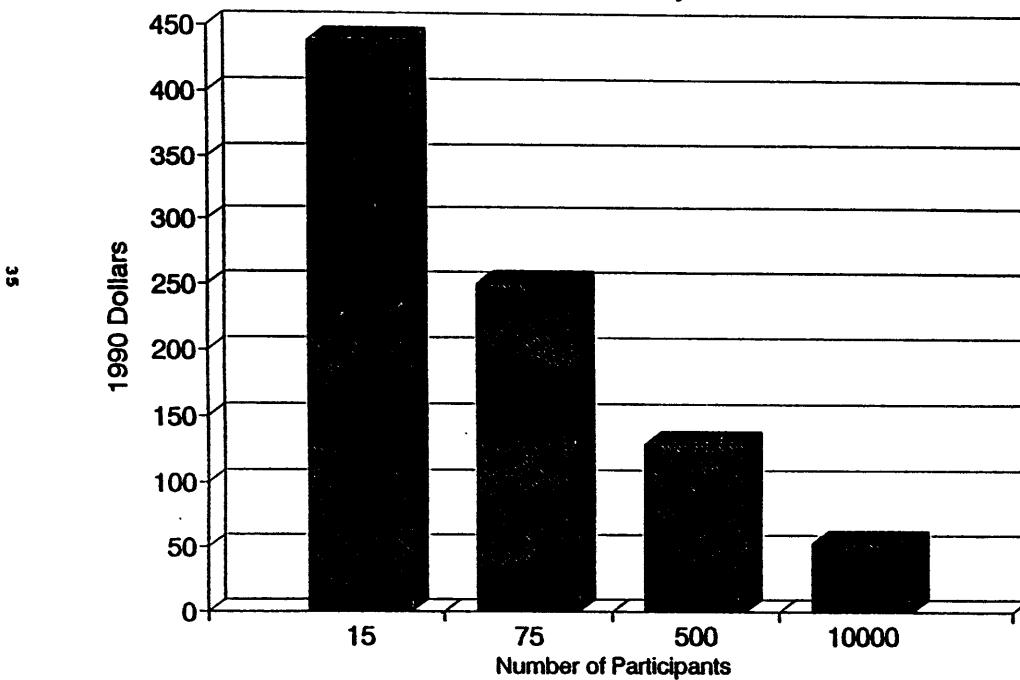


Source: Author's Calculations based on Table 4, APPWP's Benefits Bargain, 1990

These costs result from the multitude of forms that must be filed with the government and the increasingly complex nondiscrimination compliance tests that all retirement plans must meet. Extensive record keeping is required in order to compare the treatment of highly compensated employees relative to the less highly compensated, for example. Pension fund regulation is imposed by the Pension Benefit Guaranty Corporation (PBGC), the Internal Revenue Service, and the Labor Department. Some of the administrative costs associated with offering a pension recur every year, while other one-time costs are imposed by the rapidly changing rules imposed by new legislation and the steadily changing legal interpretations of existing legislation. In the 1980's there were changes in the maximum amount that could be contributed to plans, in the speed of amortization of unfunded liabilities, in the constraints on patterns of vesting, in the structure and levels of PBGC premiums, in the treatment of excess distributions, in the rules applying to plans which are integrated with Social Security, etc.

Both the ongoing costs and the one-time costs due to new regulations for defined benefit plans were estimated by the Hay/Huggins Company (1990) in a study commissioned by the PBGC. Figure 10 shows their results for the distribution of ongoing administrative costs as a function of plan size. The graph implies significant economies of scale in the administration of a defined benefit pension. The cost per employee goes from \$439 for plans with 15 participants to \$53 for plans with 10,000.

Figure 10
Ongoing Administrative Cost Per Worker
Defined Benefit Plans by Size 1990



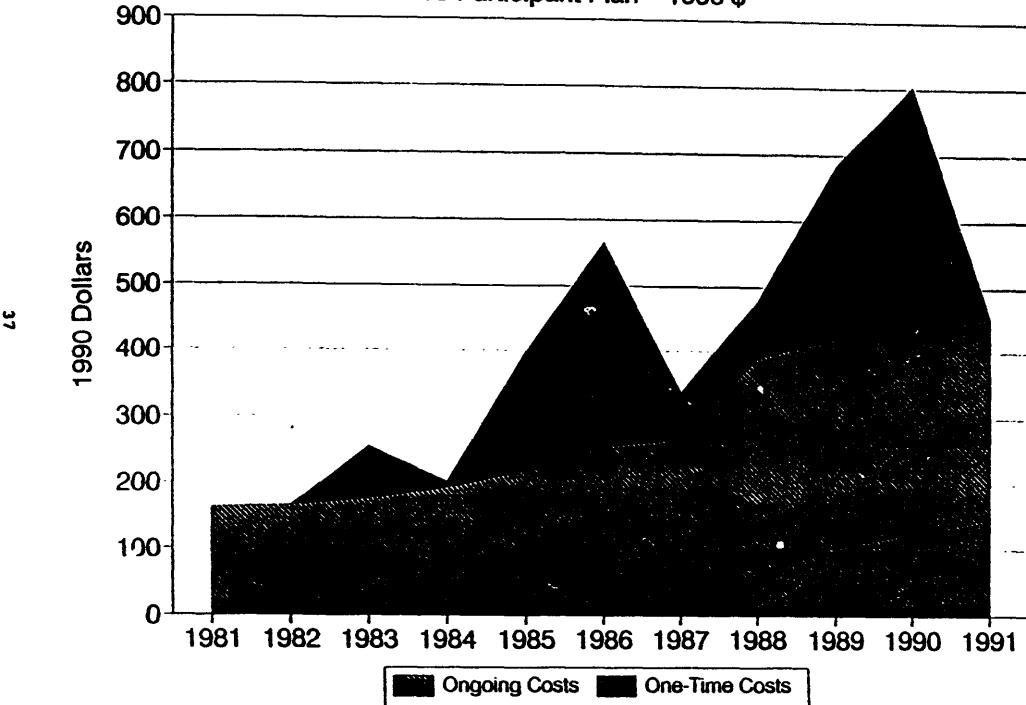
Source: Hay/Huggins Co., Pension Plan Expense Study for the PBGC, September 1990, Table 4

Figure 11 includes both the one-time costs to institute required changes in plan designs and administration and the ongoing expenses for small 15-participant plans between 1981 and 1991. In some years, the one-time costs rival the routine ones. The Hay/Huggins study finds that the total cost of administering a 15-participant plan in 1990 was over \$805 per worker. Given that the average pension contribution per worker in these small plans is about \$1400, the burden of administration is enormous. It would cost the average small employer \$2,200 in order to fund \$1,400 worth of retirement benefits for each employee. It is no wonder that in many cases the firms (and the workers) decide that this is not in their interest. These administrative burdens overwhelm even the considerable tax advantages of pension saving. It is true that defined contribution plans and 401(k) plans are somewhat cheaper to administer (and they have grown in importance relative to the defined benefit plans), but even the defined contribution plans place large administrative burdens on small employers.

The knowledge that pension participation is low for the employees of small firms and that the administrative costs are high causes one to support the initiatives to simplify the administration associated with pension plus -- especially for small firms. There has been a spate of proposals to do just that. Perhaps pension coverage can resume its growth with the adoption of some of these proposals.

The decline in pension contributions is far more than just a small-firm effect, however. The large firms have cut back their

Figure 11
Administrative Cost Per Plan Member
15 Participant Plan 1990 \$



Source: Hay/Huggins Co., Pension Plan Expense Study for the PBGC, September 1990, Table 3

contributions as well, largely because of government policy to limit the contributions that companies make on behalf of their employees' pensions. Both the full funding limitations and the IRS Section 415 limitations on the generosity of benefits have curtailed pension saving. These policies to restrict the size and funding of pension plans emanate from the concentration in Washington on this year's tax revenue rather than on the growth rate of the economy and the economic circumstances of the next generation of Americans.

It would be beneficial if there were a general effort to simplify pension administration and regulation. The frequency of legislative change should be reduced, redundant regulation eliminated, and limitations on contributions and payouts should be eased. These issues have been thoroughly addressed in the APPWP's September 1989 publication entitled, Gridlock: Pension Law in Crisis and The Road to Simplification. There it is documented that the complexity issue affects not only small firms, but big firms as well. It affects not only defined benefit plans, but defined contribution plans, 401(k) plans and all other pension structures.

SECTION V

WHY DO WE SAVE SO LITTLE?

The answer to the question of this section, why do we save so little, is undoubtedly complex and multifaceted. People have posited a wide array of explanations ranging from the fear of nuclear war to the amount of television advertising encouraging impulse buying. Surely, a major part of the story is the public provision of insurance, particularly long-life insurance through the institution of Social Security and Medicare. If, as posited earlier, the primary motivation to save is to provide adequate resources for retirement, then the existence of a universal government program providing an indexed life annuity and substantial lifetime health insurance for those over age 65 is likely to reduce the need for private accumulation.

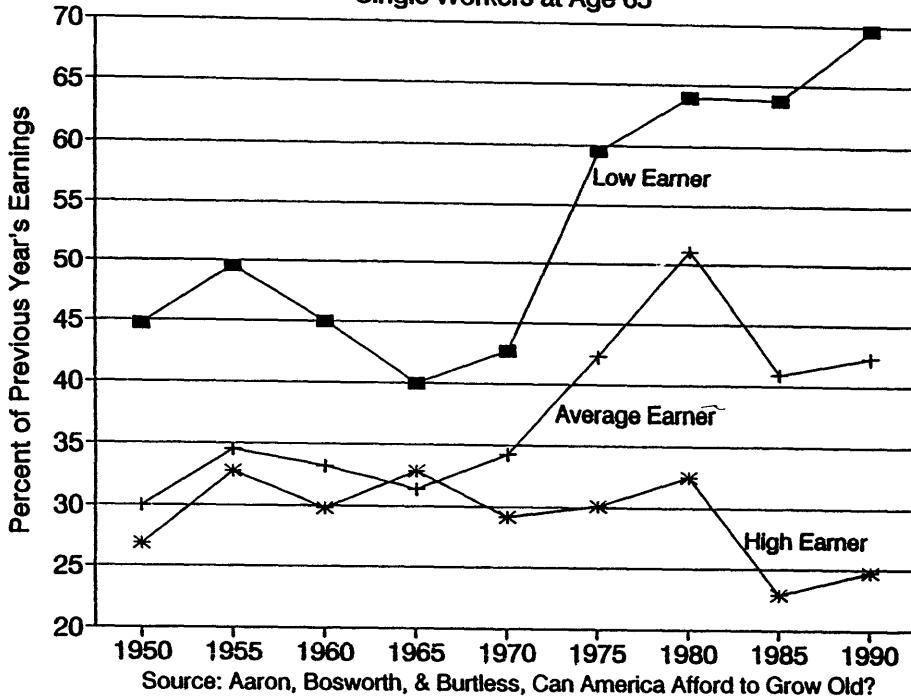
In his seminal paper, Feldstein (1974) finds that private saving was almost exactly halved due to the existence of Social Security. Despite an important flaw in his original work, later examinations using more recent data get qualitatively the same result. While researchers are not in full agreement, it is probably fair to say that most economists today feel that Social Security curtails private saving, although to scientifically prove the point is immensely difficult, if not impossible.

The Social Security system became significantly more generous in the 1970's, in large part due to a mistake in the way the system was originally adjusted for inflation. Inadvertently, benefits

were double-indexed for a period of about three years, resulting in a scaling up of benefits by amounts as much as 20 percent. The scale of Social Security benefits can be judged from Figure 12. The average earner is simply someone who earns the average annual earnings for each year of his or her career. The low earner is someone who earns approximately half of the average, while the high earner always earns at least as much as the maximum amount of taxable earnings. The statistics graphed in Figure 12 are the ratio of Social Security retirement benefits in the first year of retirement at age 65 to earnings in the last year of work. This ratio is commonly referred to as the "replacement rate." Note that the replacement rate for single average earners ranged from 30 to 35 percent between 1950 and 1970, but ranged from 41 to 51 percent in the 1980's. The replacement rates are much higher for low earners who are single. They approach 70 percent in 1990. Note also that all of the numbers illustrated in Figure 12 are for single individuals. One-earner couples get 150% of these amounts, so the number for the one low-earner couple would be approximately 100 percent in the 1980's.

The situation in this country is that those who own a home, and who have uninterrupted careers with a pension plan will be able to accumulate enough resources to maintain in retirement the lifestyle of their earlier years. In such circumstances there may be little incentive to save more than is implicit in the accrual of pension and Social Security rights and the equity in the family home. However, those whose careers are interrupted or who do not

Figure 12
Social Security Replacement Rates for
Single Workers at Age 65



Source: Aaron, Bosworth, & Burtless, Can America Afford to Grow Old?

have lengthy tenure in a job with a pension need to supplement the more or less automatic accumulations with private, discretionary saving. Failure to do so can and will lead to a lower living standard in retirement than in the working years.

The evidence is that many people are incapable or unwilling to plan for expenditures 20 or more years in the future. They do so when convenient plans are available or heavily marketed (as with the individual retirement accounts) or when voluntary plans are clearly subsidized by employers. The last point was documented in an unpublished survey compiled by The Wyatt Company which found that the participation rate in 401(k)-type plans was 57 percent if there was no employer match, but 72 percent if the match was 1 for 1 or better. Further, the amount deferred was almost double when such a generous match (relative to none) was offered, so the total saving from this source is quite responsive to the employer's matching terms.

There is also some evidence that people participate in various saving activities quite independently, indicating that they do not have an integrated plan of saving. If they took an integrated approach to saving, then those participating in a pension plan would have lower non-pension saving rates than those who are non-participants, particularly if their income levels were comparable. The facts as reported by the Bureau of Labor Statistics' Consumer Expenditure Survey from 1981 to 1988 do not support the hypothesis on integrated saving. The raw fact is that those within pension plans have higher, not lower, non-pension saving rates. This

observation of higher non-pension saving rates could be due to the fact the people with pension coverage have higher incomes than those without such coverage. However, an examination of the data suggests that non-pension saving is very comparable for people with and without pension participation within a given income range. So the evidence does not support the argument that pension saving displaces other forms of personal saving.

Even more compelling evidence on the segregation of saving into separate activities has been uncovered by Professor David Wise of the Kennedy School at Harvard. In work that has not yet been published, he has recently examined survey evidence on the saving of individual retirement account participants. As the rules changed in the 1980's regarding IRA accounts, the levels of their contributions varied. However, there is no evidence that increases in IRA contributions led to decreases in the non-IRA saving of IRA participants. Quite the contrary. Their non-IRA saving appears to have been substantially unaffected by their IRA contributions.

This substitution (or lack thereof) of different saving instruments is important in determining policy to encourage saving. For instance, it implies that when we curtail one saving vehicle (be it IRAs or employer-sponsored pension plans) we cannot expect that other means of saving will automatically offset the loss in saving. In order to institute a pro-growth national saving policy, we must encourage all forms of saving (household direct saving, pension saving, business saving, and government saving). This view suggests that one should be particularly cautious about public

policy with the potential to retard pension saving, given that it has been by far the most important source of saving in the economy.

Even with all of this analysis, it must be admitted that the explanation for the collapse in saving in the 1980's is illusive. If Social Security depresses saving, it has been doing so for roughly 50 years. The phenomenon of the 1980's collapse is probably as much psychological as economic. It does appear that the consumption orientation of the 1980's (e.g., the Yuppies), so widely reported, was indeed an important social trend. It was sufficient in magnitude to upset the traditional relationship between consumption and income. Unfortunately, at least in this regard, the 1980's are not yet over. The extraordinarily low levels of national saving which characterized that decade continue without significant improvement to this very moment.

SECTION VI
PUBLIC POLICY TOWARDS PENSION SAVING

Employer-related private pensions have been encouraged by the federal income tax laws for as long as we have had an income tax (since 1913). However, the nature of that encouragement is not well understood, and for numerous reasons is not accurately captured by the tax expenditure figures computed annually by the Joint Committee on Taxation. The concept of a tax expenditure is well described in the 1990 APPWP publication, Benefits Bargain: Why We Should Not Tax Employee Benefits, written by Sylvester Schieber. Basically, revenue not collected because of a special feature of the tax code designed to encourage particular activities in the private sector is similar to collecting the full revenue (i.e. without the special treatment) and spending additional tax proceeds as a subsidy for the favored activity.

Accurately calculating tax expenditures is extremely difficult. If the favorable tax treatment of the activity was eliminated, at what level would it occur in the economy? How much extra revenue would be generated? How should you treat provisions which reduce tax collections today, but actually increase tax receipts in the future? The official Joint Committee projections, which are shown in Table 1 for the years 1992-96, are calculated as the current cost in revenues from the various provisions assuming no behavioral response in the economy.

TABLE 1

LARGEST FEDERAL TAX EXPENDITURE ESTIMATES
FOR FISCAL YEARS 1992-96

	1992	1993	1994	1995	1996	TOTAL 1992-96
Net Exclusion of Pension Contributions and Earnings	54.0	57.0	59.0	61.0	64.0	295.0
Deductibility of Mortgage Interest on Owner-Occupied Residences	38.8	42.2	45.9	50.0	54.4	231.2
Exclusion of Contributions by Employers and Self-Employed of Medical Ins Premiums and Medical Care	37.7	41.3	45.1	49.0	53.2	226.4
Exclusion of Untaxed Social Security & Railroad Retirement Benefits	25.6	27.0	28.4	29.9	31.4	142.3
Deduction of nonbusiness State and local income and personal property taxes	23.8	25.5	27.4	29.5	31.7	137.9
Depreciation on Equipment in Excess of Alternative Depreciation System	18.1	18.7	19.4	20.0	21.0	97.0
Deductibility of charitable contributions, other than for education and health	13.0	13.9	14.8	15.7	16.7	74.1
Deductibility of Property Tax on Owner-Occupied Homes	11.0	12.3	13.6	15.2	16.9	69.0
Exclusion of Interest on Public Purpose State and Local Government Debt	11.5	12.3	13.2	14.3	15.0	66.3
Deferral of Capital Gains on Sales of Principal Residences	11.5	12.1	12.7	13.6	15.5	65.3
Sum for 10 Tax Expenditures	245.0	262.3	279.5	298.2	319.8	1,404.5
Other Tax Expenditures	129.9	136.6	145.0	153.6	163.0	728.4
Total Fed Tax Expenditures	374.9	398.9	424.5	451.8	482.8	2,132.9

Source: Joint Committee on Taxation, March 11, 1991

The official figures show that the largest tax expenditure of them all results from the favorable tax treatment of pensions. The Joint Committee reports that pensions cost the Treasury 30 percent more than deductibility of mortgage interest on owner-occupied houses. They estimate that the current tax treatment of pensions will cost the IRS \$295 billion over the five-year period. However, as pointed out by Schieber, the official statistics of the Joint Committee grossly overstate the revenue cost of the treatment of pensions.

The tax expenditure methodology is most seriously flawed for pro-saving features of the tax code (such as the treatment of pensions) because of the failure to adequately credit these features with the extra revenue that will be produced by the wealthier society which will materialize in the future due to their existence. The way tax expenditure numbers are computed for pensions is that the tax that would be collected if pension contributions were taxed as ordinary income is added to the tax that would be collected if the earnings on pension assets were also subject to the income tax. From that total, the Joint Committee subtracts the taxes that are collected on current pension benefit payments, rather than the more relevant present value of the taxes that will be collected on the future benefits resulting from this year's contributions. With a rapidly growing pension system, an aging population, and tax rules that will be changing, the difference between taking a present value approach rather than a cash flow approach is enormous. The present value of the

government's revenue resulting from today's pension contributions greatly exceeds the amount that they are collecting on current pension receipts.

In fact, the current treatment of pensions may not reduce the present value of the government's tax collections at all. With the likelihood of rising marginal tax rates, the present value of the government's take from the future benefits attributable to current contributions at least matches the loss from not taxing current contributions. Related to this point, it should be noted that the government will ultimately capture at least 25 percent of the roughly \$3 trillion in public and private pension assets (with the conservative assumption that the average marginal tax rate of pension benefit recipients will be at least 25 percent). That is, the government has an asset worth at least \$750 billion due to the pension system, an asset which offsets the flows of "tax expenditures" which have been associated with the tax treatment of pensions.

The only present value revenue loss remaining due to the treatment of pensions is the failure to tax the earnings on pension assets (the "inside buildup"). Even here, there are reasons to doubt that the government ends up worse off financially. If, in the absence of the present treatment of pensions, households would have chosen to use the funds to finance consumption rather than saving, then there wouldn't be any inside buildup to tax. That is, to the extent the current tax treatment of pensions increases saving, it does so without costing the government resources. If

the money would have been saved anyway, then the government loses revenues since it doesn't collect on the earnings of the assets. It loses revenues, but only relative to a system (an income tax) which double-taxes saving. The current treatment of pensions is exactly proper relative to a consumption tax standard. The money is taxed once and only once -- when it is received and presumably used for consumption by the pension beneficiary.

We clearly should be concerned with the present value of tax collections and not solely current revenues. Provisions which lose revenues today but bring extra receipts in the future (like the treatment of pensions) should not be treated as the equivalent of the government spending the money on public goods or consumption items.

The government is basically funding a fraction of the pension plans for American workers, but at the same time it is accumulating a claim to get roughly the same fraction of the payouts of those pension plans. The result is that the government is making an investment and will earn a rate of return comparable to that earned by the pension plan participant. Given the shortage of capital in the United States, the investment will likely turn out to be profitable for the taxpayers as well as the plan participants. This profit will be realized as the number of retired people with taxable pension income grows substantially over the next few decades.

This discussion of the inappropriateness of the official tax expenditure numbers for pensions should also be related to the

earlier discussion of the deficit and national saving. If we focus on the real problem -- national saving -- then it should be immediately apparent that improving the federal government deficit by taxing pensions more heavily is a pretty crazy idea. In order to improve government saving (or, more accurately, to reduce government dissaving) one doesn't want to discourage the main source of private saving. And while we can't be certain of what would happen to pension saving and private saving if we worsened the tax law with respect to them, it is at least likely that this saving would weaken. That is a risk that is best not taken. When the problem of national saving is kept in mind, then any tax-related solution must involve raising taxes on consumption, not saving or even income.

SECTION VII

HOW MUCH DIFFERENCE WOULD ADDITIONAL SAVING MAKE?

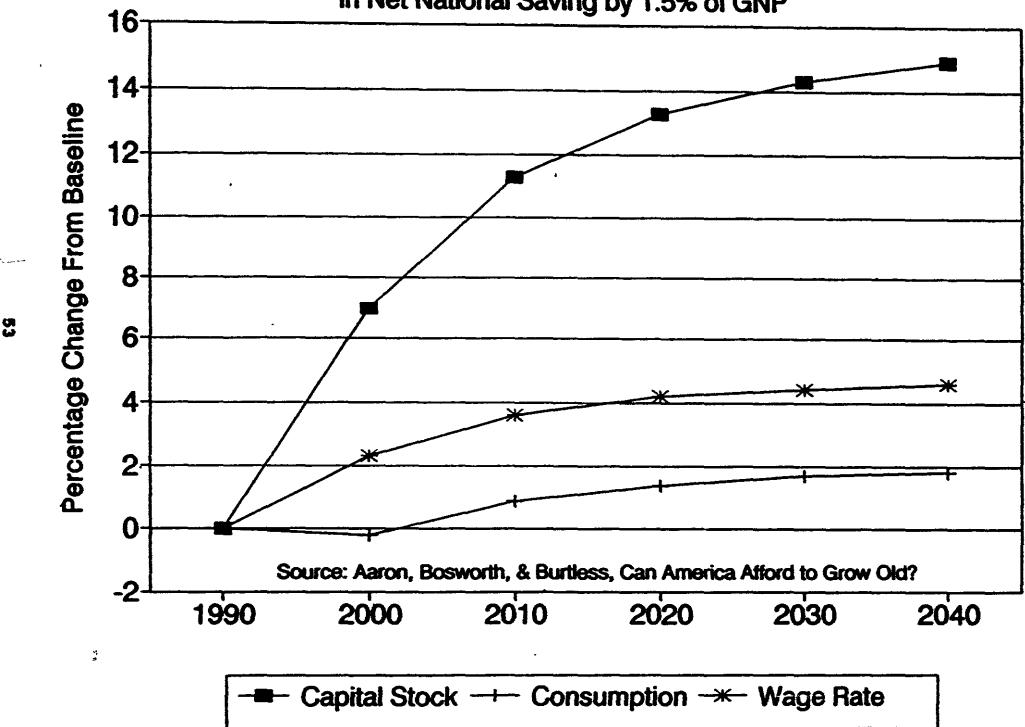
The appeal of additional saving is that it is the only reliable way of reversing the negative trends in real wages and weekly earnings. Additional savings, translated into more domestically owned capital, will ultimately raise capital per worker, worker productivity, and real wages. The impact would be much stronger, of course, if the additional accumulation of domestically owned tangible assets were accompanied by an improvement in the stock of human capital. If the talents of the workforce can be enhanced and workers can be provided with abundant and modern tools, the standard of living in the country is sure to rise. Only then will we be able to afford the many pressing needs that we are bound to face.

Just how much difference would the additional saving make? Surprisingly, economists can offer some answers to this question with a fair degree of certainty. The same people who have great difficulty in forecasting the direction of the economy over the next couple of quarters are much more reliable at determining the consequences of certain behavior over a much longer period of perhaps thirty years. How can this be so? Consider as an example of a situation where long run forecasting is much easier than short run forecasting the following scenario: two families look in many ways identical. They both have considerable wealth (\$150,000) which is invested in the stock market. They both have the same

income (\$60,000) and feature the same family structure and members of the same age. One family regularly saves 18 percent of income the other 3 percent. If asked which family will be richer in a couple of months, the best economist in the world will be right only about 50 percent of the time. It simply depends on which family is fortunate to have the better performing stock portfolio over this short interval of time. If you ask which family will be wealthier in 15 years, even an amateur economist will be right 99.9 percent of the time. The family which saves 18 percent will almost certainly be the richer one after 15 years. This situation is almost a perfect analogy with the case of the two economies of Japan and the United States. It is difficult to predict which of the two economies will perform better over short intervals like a quarter or a year. However, in the long run we can be quite certain that the country with the higher saving rate, in this case Japan, will enjoy the higher standard of living.

Figure 13 shows the predictions of a model developed by Henry Aaron, Barry Bosworth, and Gary Burtless (1989) of the Brookings Institution, of the long run effect of a relatively small increase in the net national saving rate of 1.5 percent of GNP. Their model forecasts that the extra saving would result in a capital stock which would be 13 percent higher than it otherwise would be by 2020. Real wages would be a little more than 4 percent higher. Consumption in 2020 would be 1.5 percent higher. By then, the sacrifice of less consumption in the present would be paying off as more consumption in the future.

Figure 13
The Impact of a Permanent Increase
in Net National Saving by 1.5% of GNP



Recall the admittedly arbitrary goal set earlier in this paper; to raise the net national saving rate by 5 percent of GNP. The numbers of Figure 13 suggest that real wages would be roughly 15 percent higher in that eventuality. For a country in which real wages were the same in 1990 as 25 years earlier, that seems like a major effect; one that would give the American Dream a little more claim to reality. The difference between returning to our saving behavior of 1950-80 and staying with the 1980's levels is enormous.

SECTION VIII

HOW CAN WE RAISE NATIONAL SAVING?

The goal for the U.S. should be a net national savings rate of eight percent of GNP. This is not impossible; after all, the saving rate was approximately that level throughout the 1950's, 60's, and 70's. A saving rate of eight percent would put the U.S. in the same league as Canada and most European countries.

One shouldn't minimize how difficult it will be to achieve this goal. Restoring the five percent fall in the saving rate which occurred in roughly 1980 means that we will have to curtail consumption by five percentage points relative to income. We might be able to achieve a 2.5 percent growth rate in GNP over a five year period. If we did so, we would need to have policies in place to hold the growth rate of aggregate consumption to 1.5 percent over the same five year interval. During the five year adjustment period, the per capita standard of living would have to be quite stagnant. That is the minimum that would be necessary in order for the country to withdraw from its consumption binge. After the adjustment period, consumption could resume its growth at 2.5 percent per year, or perhaps at a faster rate if the additional saving begins to pay off in a more rapid rate of growth for potential GNP.

What policies could likely improve saving to this degree? First, there are the government deficits. As was discussed earlier, even though the large deficits are not the problem per se,

they cannot be tolerated in a saving-starved economy such as the U.S. In order to increase saving to eight percent of GNP it will be necessary to eliminate the consolidated deficits of the federal, state, and local governments, or even create an aggregate surplus. However, as has already been emphasized, all methods of reducing the deficit are not equivalent. Since we are trying to increase net national saving, additional taxes and regulations on private saving should be ruled out. Pensions provide the prime example. Pensions are how the vast majority of people save. Lowering the deficits by taxing private saving is senseless public policy. Since what we are trying to do is restore the historical relationship between consumption and income, the obvious tax (if we need to raise taxes to balance budgets) is one on consumption. Increasing income taxes, while not as counterproductive as raising taxes on saving, is somewhat inappropriate as a means of stimulating national saving.

So, part of the answer is to balance the government's budget without placing additional taxes or restrictions on pensions or other forms of private saving. In fact, a policy of actively encouraging private saving (whether in the form of pensions, individual retirement accounts, or whatever) would be appropriate and desirable. Further, the corporation income tax still treats the return on debt far more favorably than the return on equity. This bias should be eliminated, thereby encouraging firms to retain and invest additional earnings.

I am somewhat optimistic that steps will be taken to improve saving in this country. Recognition that the shortage of saving is a fundamental national problem is a first step towards finding a solution. It is my sense that this recognition is becoming more widespread. What is needed now is considerable political leadership and a marketing of the idea that saving is socially desirable and respectable. We need to get the country focused on the future rather than almost solely on the present: and to recognize that pensions are how America saves.

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PREPARED STATEMENT ON BEHALF OF KENRICH PETROCHEMICALS INC.,
BAYONNE, NJ, SALVATORE J. MONTE, PRESIDENT

Kenrich makes inorganic titanate coupling agents some of which are used in the LOVA insensitive munitions program. Two Kenrich patents carry a secrecy order. The company's Ken-Reacts (titanates, zirconates and aluminates) are also used as additives in blow molding, tires, steel corrosion prevention, polymer films, chips, etc.

The company, which is 40 years old, has 26 patents, which are licensed and patented all over the world. Kenrich employees 66 people.

On October 1, 1990, Congresswoman Helen Delich Bentley gave a speech on the House floor telling the Kenrich story and the difficulties they encountered with a Japanese partner.

Two weeks later Kenrich signed a new agreement with their bank, Fidelcor Business Credit Corp. Two weeks (Nov. 14, 1990) later the bank was sold to CIT Financial Group, a jointly owned corporation of Dai-ichi Kangyo Bank (60 percent) and Manufacturers Hanover Trust (40 percent). Dai-ichi Kangyo has 4.9 percent of Manufacturer Hanover's stock.

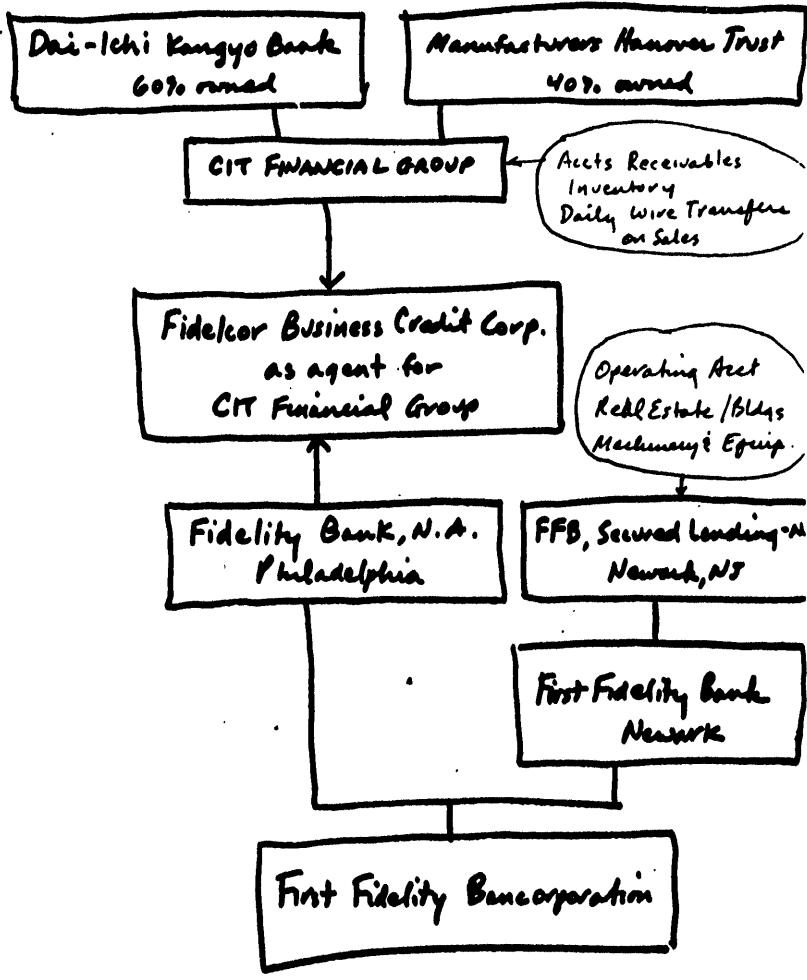
At that time Sal Monte was called and told to go Chapter 11 (bankrupt) or get a partner. The bank then took away his funds availability represented by foreign receivables which amounted to 15 percent of total sales and, reduced immediately available funds by \$250,000 which caused financial instability with Kenrich's vendors.

The bank also took possession of the Kenrich post office box. At that time Mr. Monte called Congresswoman Bentley's office asking for help and advice. An attorney from Washington then met with the bank and it resulted in a new agreement for Kenrich Petrochemicals.

The bank then proceeded to live legally within the agreement, but to do everything it could to make it difficult to stay in business. Special reserve accounts were set up to cover orders-taking cash away from the company's operating funds. The net result of these maneuvers was that Kenrich had to pay 18 percent for its money. Standby Letters of Credit were delayed and as time went on were actually turned down for \$125,000 GE order and \$30,000 U.S. Navy contract. These two turn downs are examples of others that occurred. Recently, Letters of Credit drawn on an American bank by large multinational foreign companies as collateral for accounts receivable financing were also rejected.

By October 31, 1991 the Foreign Credit Insurance Association (FCIA) coverage ended and was not renewed by FCIA despite a good record of payment. In 40 years of shipping Kenrich never had a claim on foreign insurance or problems of delay or payment with foreign shipments. The cancellation was based on questions raised by financial conditions of the company which the bank had created. Kenrich found out about the insurance cancellation one week after it actually occurred. FCIA is run through Ex-Im Bank.

Kenrich went to court to get a consent order to continue in business for another 60 days. By December 27th the company will be out of business and the bank will have the 26 patents, the Kenrich plant with machinery and real estate, plus the Monte's home.

BANKS DEALING WITH KENRICH

PREPARED STATEMENT OF KENNETH L. ROBINSON, PRESIDENT, NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS

Chairman Guarini and distinguished panel Members of the Urgent Fiscal Issues Task Force, my name is Ken Robinson and I am president of the National Association of Federal Credit Unions (NAFCU). Mr. Chairman, on behalf of NAFCU, I want to thank you and the Task Force for the opportunity to present this written testimony on the occasion of these important hearings. I would request its inclusion into the record of these proceedings. NAFCU is the only national organization which represents exclusively the interests of credit unions chartered by the federal government. Our member credit unions collectively hold over \$68 billion in assets while providing low-cost financial services to some 17 million American consumers. These totals represent more than half of federal credit unions assets.

Mr. Chairman, it is certainly no secret that today the U.S. economy is not in very good shape. The fact that the Federal Reserve has lowered interest rates five times over the past year while credit growth remains anemic suggests a serious lag between consumer confidence and the availability of credit. It is the bottom-up demand of credit union members which has most affected credit unions. We believe there is a palpable concern among consumers nationwide simply over job security. Additionally, due to the explosion of public and private debt throughout the 1980s, Americans are fearful of taking on more financial obligations especially in the current economic climate. Quite simply, there seems to be a pervasive lack of consumer confidence which cannot be solely or necessarily meaningfully addressed by lowering interest rates or issuing new regulatory guidelines.

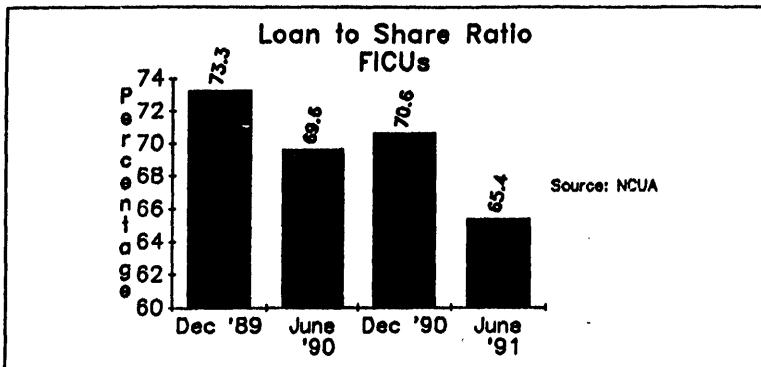
On the other side of the equation and what defines the term credit crunch is the lack of or unwillingness (by financial institutions) to extend credit. The continuing fall-out from the S&L crisis and ongoing recessionary woes have led to more stringent capital standards, higher deposit insurance premiums and much greater market discipline among commercial banks and thrifts. While credit unions, overall, remain a bright spot among financial service providers, they certainly have not escaped either Congressional or regulatory scrutiny. The National Credit Union Administration (NCUA) has recently promulgated final regulations on credit union investments and member business loans. Also, in light of the steady rise in real estate secured loans at credit unions and the risks involved in this type of lending, NCUA wrote to all federally insured credit unions (NCUA letter no. 124) in June detailing guidelines in this area. In Congress, the Senate Banking Committee has reported out comprehensive banking reform (S. 543, S. Rept. 102-167) which incorporates several credit union provisions drawn largely from a July 1991 General Accounting Office study of credit unions (Credit Unions: Reform for Ensuring Future Soundness, GAO/GGD-91-85). Provisions in S. 543 -- the "Comprehensive Deposit Insurance Reform and Taxpayer Protection Act" -- include increasing the National Credit Union Share Insurance Fund's (NCUSIF's) normal operating level; increasing credit unions' regular reserve target level; limiting loans-to-one borrower authority; and, enhancing NCUA's prohibition and removal authority. Mr. Chairman, these regulatory and legislative initiatives now being undertaken by Congress and NCUA reflect a number of dynamics. First, credit union operations and loan portfolios are becoming more diversified and complex. While credit unions' bread and butter remain consumer loans, real estate lending continues to expand among these financial cooperatives. As of June 1991, real estate loans comprised 35.1% of total loans, and 20.9% of assets for all federally insured credit unions. Significant losses to -- and in some cases the closing of -- a small number of credit unions in New England may be directly related to imprudent real estate lending and in some circumstances suspected fraud.

These initiatives are also aimed at ensuring and strengthening the safety and soundness of the credit union system which currently is faring extremely well. In light of our nation's current economic woes, which are reflected in the S&L debacle and bank fiasco, neither Congress nor NCUA nor credit unions themselves want to get burned. This is not to say that credit unions are in total agreement with all the proposals which have emerged from Congress or NCUA, but to suggest that credit unions operate in the same economic environment and accrue some of the same risks as banks and thrifts.

The "Credit Crunch" and Credit Unions

Mr. Chairman, as far as the credit crunch is concerned, we believe the term is a misnomer when applied to credit unions. While federal credit unions are occasionally at odds with our regulator, we do not believe the present NCUA supervisory policies or actions have been, in the

main, overly restrictive nor discouraged credit unions' willingness to extend credit to the nation's 62 million credit union members. A principal concern of credit union managers nationwide, and what should be the focus of any proposal aimed at stimulating the economy or attenuating a "credit crunch" is the woeful lack of consumer confidence. Declining consumer confidence translates into slack loan demand and a cutback in discretionary spending by consumers. The Federal Reserve has reported consumer credit falling \$1.55 billion in September and in the aggregate current consumer installment credit is some \$8 billion below last year's figure. According to NCUA, the loan to share (savings) ratio among federally insured credit unions declined from 70.6% in December 1990 to 65.4% as of June 1991. Compared to the year-end 1989, the loan to share ratio has declined a full 7.9%.



The declining loan to share ratio experienced by credit unions is directly attributable to strong share growth (10.7%) as compared to weak loan growth (2.5%) as reported by NCUA for the first half of the year. This pattern among credit unions fits historic consumer spending and saving habits during periods of economic slowdowns. Credit union members, like all consumers, tend to save more, spend less and payoff accumulated debt under these conditions. This trend is certainly exacerbated by the fact that consumers already carried significant debt into the recession. To reiterate, the chief culprit of slack loan demand for credit unions is a lack of consumer confidence.

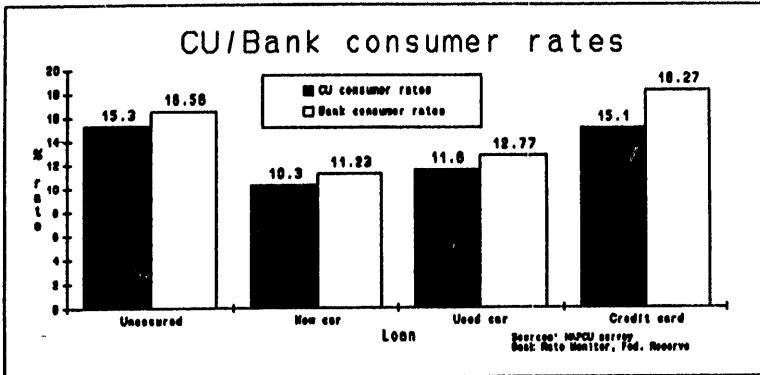
Mr. Chairman, the sharp differences both in credit union operations and overall health as compared to commercial banks and thrifts, further leaves credit unions out of the credit crunch loop. On November 7th, the four federal regulators of banks and thrifts -- Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Federal Reserve Board, and Office of Thrift Supervision -- issued joint guidelines regarding the review and classification of commercial real estate loans. The 18-page policy statement provides greater detail and further elaborates on the Administration's October 8th statement regarding "Easing the Credit Crunch to Promote Economic Growth." The conspicuous absence of NCUA as a co-author of this document reflects the fact the Federal Credit Union Act strictly limits commercial loan activity at federal credit unions. Recently promulgated regulations further clamp down on this activity. This type of lending comprises 1.2% of total loans for federal credit unions. To the extent that commercial lending is a principal focus of discussions on the credit crunch, credit unions do not enter into the conversation.

Mr. Chairman, it is obvious that commercial banks, especially money-center banks, are experiencing a profit squeeze. Given the record number of bank failures which has left the Bank Insurance Fund insolvent, commercial banks face higher capital requirements and soaring deposit insurance premium assessments. For banks, the recession has pushed up loan delinquencies and savaged commercial and residential real estate portfolios. This "squeeze" is clearly reflected by the fact that despite reduction in the cost of the funds for banks and steadily declining payout for

savings, the average rate charged for consumer installment credit, specifically credit cards, remains flat. Even when one factors in competition, operating costs, rising delinquencies and bankruptcy filings, credit cards remain a very profitable segment for banks. In the current economic climate banks will continue to maximize their profits in this area as long as the market will bear.

In sharp contrast to the present health of the bank industry and BIF, credit unions overall remain in robust health and the NCUSIF equity ratio stands at a bullish 1.23%. Credit union capital has reached an all-time high of 8.1% while delinquent loans remain steady at 1.6% and charge-offs register a mere 0.6%. The continued safe and sound condition of our nation's federally insured credit unions is inextricably linked to their philosophy. From their inception, credit unions, as non-profit democratic cooperatives, have pursued one course and that has been to provide low-cost financial services to their members. Credit unions by design are intended to improve the financial condition of their members by encouraging thrift in conjunction with offering financial services noted for their extremely reasonable rates, terms and conditions. The lifeblood of the credit union community and the bulk of its assets are in consumer loans. As of September, our nation's 14,000 credit unions held \$92.8 billion or 12.7% of the approximate \$730.5 billion outstanding consumer credit. Consumer loans are for all depository institutions the most risk adverse asset, especially compared to commercial real estate, leveraged buy outs and third world debt.

The differences between commercial banks and credit unions described above is clearly reflected in a comparison in loan rates charged for consumer loans. A recently completed NAFCU survey shows that across four consumer loan product categories, credit unions charged less in interest, on average, than do commercial banks. The sharpest comparison was registered for credit cards with credit unions charging 15.1% interest compared to 18.27% for banks.



Mr. Chairman, credit unions are not only absent from the credit crunch, but are on the opposite end of the credit spectrum. Credit unions as non-profit, member-owned financial cooperatives in good health, provide greater interest (dividends) on savings and charge less, on average, for consumer installment credit as compared to commercial banks. Given their current low loan to share ratio, credit unions are aggressively providing credit opportunities to their members. In essence credit unions are a recovery engine, albeit a very small one for the U.S. economy.

Solutions for a Flagging Economy

Mr. Chairman, as mentioned at the outset of this analysis, we believe it is certainly no secret that our economy is not in the best of shape. Whether we are in a recession, a period of slow growth or just stagnation does not materially change the fact that consumer confidence is at a low ebb. We would suggest in the current economic climate and existing high degree of public and private debt, both credit-worthy businesses and individuals are not predisposed to

accrue additional debt. A Federal Reserve summary commentary (the "beige book") on current economic conditions by the Federal Reserve District released October 23rd speaks for itself:

Sources contacted by the Federal Reserve banks generally described the economy in September and early October as weak or growing slowly. In most districts there has been little improvement in retail sales, a few reported some slowing. Auto sales have generally been weak. Expected crop yields vary, but agricultural prices remain low. Manufacturing output is still improving although at a slower pace in some areas. Several districts reported some increases in home sales, but residential construction is still at low levels. Loan demand has been weak for commercial, industrial, and consumer loans. Some districts noted a pickup in real estate loans, especially refinancings.

To the extent a credit crunch exists and in fact creates a continuing drag on our economy, the recent actions by the Administration should help to alleviate this condition. From our understanding, banks have complained bitterly that regulators have been forcing them to write down loans once the value of collateral fell. However, giving commercial depository institutions greater deference in the evaluation of real estate including factoring in the long-term income-producing capacity of properties as well as a borrower's willingness and capacity to repay, should: 1) increase lending opportunities; and, 2) lower the number of loans classified now and in the future as bad risks. Similar to banks and thrifts, credit unions have also complained about inconsistent examinations across regions, and in the banks' case across regulators. The fact that this policy guideline emerges collectively from all four bank and thrift regulators should, in part, address this concern. We would note, speaking from the credit unions' experience with NCUA, that until bank and thrift examiners actually implement these guidelines not much will change in the field.

Hopefully, in conjunction with lower interest rates, this policy guideline will stimulate lending. However, judging by the blitzkrieg of economic legislative proposals and concomitant highstakes political posturing, both the Administration and Congress feel a more comprehensive economic package needs to be put together. We would certainly agree with this assessment. Some of the proposals introduced under the rubric of a "jump-start" to the economy or in the name of "fairness," include: cutting the social security payroll tax, authorizing per child tax credit, reducing the capital gains tax, extending unemployment compensation and expanding Individual Retirement Accounts (IRAs).

One proposal which many credit unions feel deserves serious consideration, whether as a stand alone measure or in a large package, is expansion of IRAs. Before IRAs were significantly curtailed with the 1986 Tax Reform Act, they were immensely popular. In the year before the 1986 Act, some 16.2 million taxpayers stashed away \$38.2 billion into this type of account, nearly one third of the savings for 1985. Member savings dedicated in this area remains an important segment of credit unions' share accounts. Federally insured credit unions' share growth, as noted earlier, increased a robust 10.77% or \$19.3 billion over the first half of the year. Some \$1.66 billion or 8.6% of the growth went into members' IRA, Keogh or other retirement accounts. Whether the Bentsen-Roth super IRA, or the Gramm-Gingrich IRA plus or the Bush family saving account were implemented, significant benefits would accrue to the economy.

Another area of significant concern to credit unions, as well as to all depository institutions, is the rising tide of bankruptcies. Personal bankruptcy filings soared 16% to 718,107 claims in 1990. Bankruptcy filings have already jumped 18% this year to more than 800,000 filings. For the first half of the year, 58.4% of all federal credit unions (4,892 credit unions) reported some incidence of bankruptcy. Since credit unions, more so than of any type of financial institution, most directly passes earnings onto their members (customers), bankruptcy losses hit home particularly hard. Similar to a number of financial service providers and associations, the credit union community and NAFCU urges Congress to recognize the seriousness of this problem and enact bankruptcy reform legislation without delay. While it appears needed reforms will not be adopted before the end of this Session of Congress, we hope bankruptcy reform legislation will be a top agenda item for Congress during the Second Session. Progress in this area will importantly aid all financial institutions and the economy.

Summary Comments

Mr. Chairman, there is no precise science one may employ to determine the existence of a credit crunch. Much of the evidence brought to bear in this regard is anecdotal in nature and must be weighed as one strand in a complex web of economic variables which entangle the U.S. economy. To the extent that a credit crunch exists, credit unions are not participants. In fact credit unions find themselves on the other side of the spectrum not only in providing ample credit opportunities to their members but by providing by far the best rates among all financial institutions for consumer installment credit. One observation which is certain is that a lack of consumer confidence continues its negative drain on the U.S. economy. As the Federal Reserve noted, there is slack loan demand across the entire spectrum of the economy. The low loan to share ratio posted by federally insured credit unions closely fits this pattern. The continue fall in outstanding consumer installment credit also reinforces the Federal Reserve District's observations and credit unions' experience specifically. In response to our stagnant economy the Fed has lowered interest rates and the Administration has moved to implement new regulatory guidelines -- both of these initiatives are aimed at stimulating the economy. In our opinion more needs to be done to move the economy off the mark. Expanding IRAs and hitting hard on the question of bankruptcy reform are two areas which NAFCU and credit unions strongly advocate.

Mr. Chairman, there is no certain solution(s) to moving the economy out of its current doldrums. There is no question, however, that it will take important hearings such as these to flush out the necessary information in order to move forward.

Again, I want to thank you Mr. Chairman and your distinguished colleagues on the Urgent Fiscal Issues Task Force for the opportunity to submit written testimony for these important proceedings. If NAFCU may provide any additional information or assistance please call me or NAFCU's Vice President for Government Affairs, Bill Donovan, at (703) 522-4770.

[Whereupon, at 2:40 p.m., the Task Force adjourned.]

