Richard Sch - 1/4/73 - for TROIKA Mtg. 1/4/73

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## Required Reserves and The Hunt Commission Report

Hunt Commission Proposals

-- establish, after a transition period, equal reserve requirements on demand deposits for all institutions (member banks, nonmember banks, savings and loan associations, mutual savings banks)

-- abblish legally required deposit reserves on time and savings deposits, share accounts, and certificates of deposit

Major Arguments for equalizing reserve requirements

1. Unequal reserve requirements provide nonmember banks with a competitive advantage over member banks.

2. Since demand deposits of nonmember banks are included in the money supply, unequal reserve requirements make control of the money supply more difficult: with a given reserve base, the higher the level of demand deposits held in nonmember banks, the less stable the relationship between reserves and the money supply.

Major Arguments against equalizing reserve requirements

1. Imposing reserves on nonmember banks moves in the wrong direction. Required reserves ought to be eliminated.

2. If nonmember banks are required to hold reserves, the major distinction between national and state banking systems would be eliminated. The dual banking system would decline as banks shifted their charters from state to national charters. (Others contend that other differences in regulation and supervision would maintain the dual system.)

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January 10, 1973

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The savings and loan systems of the Americas are a monument to the spirit of international cooperation that created them and to the ideas of thrift and home ownership that have encouraged their growth.

Each year since 1962, delegates representing the savings and loan movement throughout our Hemisphere have met to review the progress and discuss the problems of this vital and dynamic industry. This year it is my special pleasure to welcome you to the United States for your Eleventh Inter-American Savings and Loan Conference.

The decisions made and the useful information exchanged at past conferences have resulted in the building of homes and brighter futures for thousands of families throughout our Hemisphere. I am confident that your deliberations in the next few days will add to the success you have already realized, and that you and your associates will play an ever-expanding role in advancing the human values of the societies you represent.

/s/ Richard Nixon

To be sent to AID when signed. Call Miss Green: 632-8424

RN:Hasek:nm.
cc: R. M. Woods/J. Warren/M. White/J. Davis, NSC(FYI)/E. Hasek/CF
Event: Jan 13, 1973
Requested by Dr. John Hannah
Approved by Ray Price

sent

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OFFICE OF THE SECRETARY OF THE TREASURY

WASHINGTON, D.C. 20220

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MEMORANDUM FOR: DR. BURNS
MR. SIMON
MR. GARRETT
MR. STEIN
MR. SCHMULTS
MR. FLANIGAN
MR. BROOKS
MR. KAUPER
MR. SCOTT

FROM: James H. Lorie JHL

SUBJECT: Preliminary Draft of Statement on Public Policy on American Capital Markets.

Attached is a draft of a preliminary statement on Public Policy on American Capital Markets. The document is still very much a working document and does not represent the official views of the Treasury Department. As such, its distribution should be limited.

The document represents a substantial revision of the prior draft which you reviewed. I have attempted to make the present draft more issue oriented. The document contains an initial discussion of the various objectives of public policy and subsequent sections dealing with particular issues under the following headings:

(1) The Structure and Rules of the Central Market.

(2) The Governance of the Central Market.

(3) The Role and Impact of Institutional Investors.

(4) Taxes

(5) International Capital Flows

The sections dealing with the banking industry and taxes are still being worked on and will be forwarded for your review as soon as they are completed.

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We would appreciate receiving your substantive and editorial comments on the draft before the close of business on Friday, January 18. They should be submitted to Ursula Farrell, Executive Assistant to Secretary Shultz.

I wish to thank you for your very helpful comments on my prior draft. Some of your comments are reflected in this draft. Others may not be. Please feel free to repeat your previous comments if you believe they have not been sufficiently responded to and deserve further consideration.

Attachment

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Public Policy for American Capital Markets

I. Introduction

II. Objectives of Public Policy

A. Efficiency in Determining Prices of Securities

B. Efficiency in Transferring Ownership of Securities

C. Efficiency in Executing Orders

D. Public Confidence in Capital Markets

E. Equity and Reasonableness in the Regulation of Financial Institutions

F. Taxes Which Do Not Unnecessarily Impede the Achievement of Other Objectives

G. An Adequate Dispersion of Economic Power

III. The Issues

A. The Structure and Rules of the Central Market

1. Structure

a. The Communications System

b. Access to the System

2. Rules

a. Competitive Rates

b. Trading Rules

c. Use of Private Information

d. Conflicts of Interest

B. Governance of the Central Market

C. The Role and Impact of Institutional Investors

1. Some General Remarks

2. The Special Problem of the Banks

D. Taxes

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1. Taxes Affecting Saving and Investment in Corporate Securities

2. Taxes to Increase the Financial Strength of Brokerage and Investment Banking Firms

E. International Capital Flows

IV. Summary and Conclusions

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To: Secretary Shultz and Deputy Secretary Simon

From: James H. Lorie

Subject: Public Policy for American Capital Markets

## INTRODUCTION

American capital markets are of great importance to the vitality of the American economy. Efficient and equitable markets encourage the flow of individual and institutional savings to American corporations, thereby reducing their cost of capital and providing profitable opportunities for investors. Some informed observers feel that the relative vitality of the American economy throughout its history has been fostered to an important degree by our system of capital markets.

All evidence suggests that the proportion of American investing directly in common stocks and other corporate securities is much greater than the proportion of any other country. The New York Stock Exchange is by far the largest organized capital market in the world, and the other American exchanges and the over-the-counter market are relatively large and active by comparison with most foreign markets. For approximately 50 years, New York has also been the leading center of international finance.

The characteristics of the American capital markets which have produced these results are numerous, but perhaps the most important are the fact that investors feel that they can buy at the lowest available price and sell at the highest available and the fact that the generation and flow of relevant information is relatively rapid, accurate, and complete.

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Recently, according to many observers, including prominent members of both houses of Congress, American capital markets have been in disarray. Public confidence has been shaken, as evidenced by the first decline in many years in the number of Americans investing directly in common stock, the failure of many brokerage firms, and a decline in the historic dominance of the New York Stock Exchange with a consequent ~~undesirable~~ fragmentation of the "central market."

One important cause of difficulty in domestic markets has been the increased importance of institutional investors and the failure of the New York Stock Exchange and other exchanges to make appropriate adjustments in their rules and procedures with sufficient rapidity. The rise of the institutional investor has revealed some short-comings in the specialist system as it now operates and has emphasized the economic ~~absurdity~~ arbitrariness of the present structure of brokerage fees. Other causes of domestic difficulty have been the rapid increase in trading volume which has placed an occasionally intolerable strain on an inefficient and outmoded system of clearing and settling transactions, a change in the structure of costs of brokerage firms with a consequent increase in the volume of trading necessary to avoid losses, the inadequate capitalization of many brokerage firms, and needlessly complex and overlapping systems of regulation.

Any discussion of public policy for American capital markets should include a discussion of the effects of policy on the rate of savings and investment in business enterprise. Our tradition has been to leave decisions regarding saving and investment to individuals,

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to business managements, and other creators and managers of investible funds. Nevertheless, intentionally or not, public policy concerning taxes and other things have a great influence on such decisions. We should assess these influences to see whether they are consistent with broad, national economic policy or not. This is especially important at this time when there is a general and proper concern about the level of personal savings and investment, viewed in the context of a competitive world economy in which many industrialized countries have much higher levels of savings and investment.

New York has lost ground, primarily to London, as an international financial center. The deterioration in New York's position has been caused in part by the interest equalization tax, in part by the capital controls program, in part by the impact of the withholding tax on interest and dividend income of foreign investors, and in part by the estate tax on foreign holdings of American securities. The interest equalization tax, the controls, the withholding tax on foreign investment, and the estate tax, may have been justified at the time they were instituted, but they should be reconsidered now that circumstances have changed and some adverse side effects have appeared.

Most of the discussion of public policy about American capital markets has focused on the market for stocks rather than on the markets for short and long term debt instruments. The overwhelming reason for this preoccupation with stock markets is dissatisfaction with their operation. The money markets and bond markets seem to work well. Fixed commission rates, inadequacies of the specialist system, various restraints of trade, the fragmentation of the central market and

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other real or alledged ills pertain to the stock market rather than the money market or debt market. Further, concerns about the increased dominance of institutions and concentrations of economic power pertain to the stock market and not to the debt market. Since the reasons for the general preoccupation with the stock market seem valid, this memorandum will focus on the stock markets with only an occasional reference to the other capital markets.

Changes impose threats and create opportunities. Some people are more impressed by the former; some, by the latter. Recently, there was a series of informal meetings at the Treasury Department with over sixty leaders from all segments of the financial community -- brokerage firms, investment banking firms, and institutional customers -- from New York and from many other cities. No point of view or policy recommended here is without important support from brokers, investment bankers, and managers of financial assets. Also, almost no point of view or policy is without significant opposition. Probably, this situation is unavoidable when important changes in any industry are being considered. When changes affecting an industry are changes in technology or in the general economic environment, the industry has little choice but to adapt. When the changes are in the rules of the game as imposed by self-regulatory bodies or the government, it is understandable that there will be controversy about these more manageable influences.

Opponents of some of the changes recommended here base their opposition either on specific ills which might ensue or on general principles of conservatism regarding major changes in the rules for an important, complex industry which has served this country.

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better for many years than its counterparts in foreign countries. This memorandum considers these possible ills to see whether they are likely to result and whether they would be offset by benefits.

There is merit in the conservative position that important changes in a complicated industry should be imposed cautiously and slowly since the ultimate ramifications can never be foreseen accurately or with confidence. But, excessive caution leads to paralysis, and this is no time for paralysis. For the last several years the securities industry has worked less well than throughout much of its history. Widespread failures among brokerage firms, loss of public confidence in the market, fragmentation of the "central market", and numerous inefficiencies indicate that important changes may be necessary. The last time the industry was in serious trouble was in the 1930's. The important changes in public policy which were instituted then have served the industry and the public well. This is also a time when important changes deserve serious consideration.

Public policy regarding American capital markets is much discussed these days. The usual procedure is to discuss the obvious, important issues individually. An alternative -- which is employed here -- is first to consider the desirable characteristics of these markets to help determine what resolution of current issues is most likely to create these characteristics.

The next main section discusses the objectives of public policy. The following section discusses the issues under five headings: (1) the structure and rules of the central market, (2) the governance of the central market, (3) the role and impact of institutional

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investors, (4) the effect of taxes on the process of saving and investment, and (5) international capital flows.

## OBJECTIVES OF PUBLIC POLICY

### Efficiency in Determing Prices of Securities

One desirable characteristic of capital markets is efficiency in determing the prices of securities. "Efficiency" in this context means the ability of capital markets to function so that prices of securities react rapidly to new information. Such efficiency will produce prices that are "appropriate" in terms of current knowledge, and investors will be less likely to make unwise investments. A corollary is that investors will also be less likely to discover great bargains and thereby earn extraordinarily high rates of return. Efficiency makes it difficult to be either a fool or a genius in selecting securities, although some investors may enjoy very high rates of return through luck, ~~or~~ daring and others may suffer greatly through a variety of mistakes or from assuming great risks.

Although efficiency eliminates much of the opportunity for extraordinary enrichment and may therefore seem undesirable, efficiency does insure that individual investors are not at a significant disadvantage compared to institutional investors in selecting securities and does increase the likelihood that savings will be channelled into investments in accordance with the risks and the promise of profit of the corporations whose securities are bought.

Numerous studies of the American capital markets have indicated that they deserve high marks for efficiency both absolutely and relative to foreign markets. This efficiency has been promoted by the very large number of investors, the very large number of

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security analysts, the system of communication which provides for the rapid and widespread dissemination of information, the system of regulation, and the market mechanism itself which makes prices quickly responsive to the changes in views which are caused by new information.

Efficiency seems to war with other characteristics which are often believed to be desirable. Efficient markets cause prices to change rapidly and, occasionally, dramatically in response to new information. Such changes are sometimes considered to constitute excessive volatility, something with which public policy should deal. When price changes are in response to new information, public policy should facilitate rather than impede them.

Further, efficient markets are made possible by the ardent, competitive quest for new information regarding investments. Those who secure new information first sometimes derive large profits from their knowledge. This sometimes creates a feeling that those who profit have an unfair competitive advantage. Principles of equity must be kept in mind in pursuing the goal of efficiency in determining prices of securities.

## Efficiency in Transferring Ownership of Securities

It is desirable that the costs of transacting be low. The liquidity of capital markets and their ability to cause prices to react promptly to new information are greater when buying and selling securities are not costly. Transaction costs have three main components. One is the cost of brokerage; a second, the cost of using the capital and bearing the risks which are necessary

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when market makers maintain inventories; a third, the cost of physically doing what is necessary to effect transfers of ownership. This last cost is large -- unnecessarily large.[21] Although there have been some improvements in the machinery for making such transfers, none would contend that the current system is close to optimum or even close to what existing technology and existing plans for its use would make possible.

Efforts have been made by the New York Stock Exchange, the regional exchanges, and the National Association of Security Dealers to develop new systems for clearing and settling transactions, but the efforts have been incomplete and have stopped far short of achievable goals.

Although there are short-term economies from having a single, national system for clearing, settling, and holding securities, the monoply power of such a system, if artificially sustained by law, would create the usual dangers from monopoly of lethargy and lack of innovation. The benefits of competition could be preserved, in the form of greater innovations and lower costs in the long run, if competing systems were permitted subject only to the requirement that they interface.

## Efficiency in Executing Orders

Also contributing to a reduction in the costs of transacting is a policy which would reduce the costs of executing orders. Such costs have two components. The first is the cost of brokerage which is the cost of doing the communicating, keeping the records, and doing the other things which a broker does in his role as financial agent for

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an investor. The second cost is the cost of maintaining inventory and bearing risks, costs which are incurred by dealers, including specialists on the organized exchanges.

In order for these costs to be low, it is essential that there be no artificial impediments preventing adjustment of the prices of services to the costs of performing them. Such impediments inevitably create inefficiencies. Obviously, the issue of fixed versus competitive rates for brokerage services is relevant in pursuing the goal of efficiency in executing orders.

Competition among brokers and among dealers also fosters efficiency. In this area, as in others, public policy should minimize restraints of trade and other obstacles to full and effective competition unless it can be shown that such competition is contrary to the public interest.

Equity in the Relationships Between Investors and Their Financial Agents

Participation in the capital markets is encouraged by equitable relationships between investors and their financial agents. Equity has four dimensions: (1) prices of services, (2) provision of information, (3) execution of orders, and (4) the absence of conflicts of interest.

Equity requires that the prices of providing services be approximately proportional to the costs of providing them. Such equity presumably exists whenever there is effective competition.

Investors also need to feel that they are not discriminated against by brokers or other financial firms from whom they receive the information upon which their judgments about investments are

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based. "Discrimination" is hard to define in this context. Different investors desire different kinds of information. Equity does not require that all clients of a given firm receive identical infomation. The service provided by the firm may differ according to the desires of clients, and prices for different services can differ. Equity does require, however, that prices for identical services be identical.

Equitable treatment of investors in executing orders requires that orders be executed in the order of receipt, taking account of prices which investors are willing to pay or accept. The problem arises in a particularly difficult form when large blocks are sold. The Securities and Exchange Commission has ruled that the small investor be allowed to participate in block transactions when it would be to their advantage. On the exchanges, the specialists book of limit orders makes this possible. It is more difficult in the third and fourth markets, but existing technology is adequate to solve this problem.

Perhaps the most serious problem in achieving equity has to do with conflicts of interest. American capital markets suffer far less than most foreign markets from such conflicts, and this condition has fostered wide-spread participation by the American public in the American markets. Although not all conflicts can ever be ~~eliminated~~ eliminated, public policy should have as an objective the elimination of conflicts.

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Public Confidence in Capital Markets

Public participation in American capital markets, especially stock markets, is fostered by confidence that returns will be reasonably related to risks, by confidence in the financial integrity of the institutions through which they deal, and by confidence that the individual investor is not at a serious disadvantage compared with the institutional investor. To an astonishing degree the American public has had confidence in our stock markets and, as a consequence, direct participation in our stock markets by American investors has been greater than participation by the public of any other country.

A recent survey, conducted on behalf of the New York Stock Exchange, 3/ suggests that public confidence in American stock markets has recently been shaken. Probably as a consequence, the number of individuals investing directly in common stocks declined for the first time in about 40 years. The survey indicated that the primary causes of the loss of confidence were the following: (1) disappointment because rates of return on common stock for the past five years have been low, (2) a feeling that individuals are at a disadvantage compared to institutional investors because the latter receive preferential treatment from brokers and have the power to manipulate prices, and (3) the relatively high incidence of failure in the brokerage community.

Public policy concerning American capital markets cannot deal effectively with some of the causes of reduced public confidence. Rates of return on common stocks have been low for the last several

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years because of the state of the general economy rather than because of the conditions in the capital markets themselves. The nominal cost of debt capital has risen as a consequence of inflationary expectations. For the same reason the cost of equity capital has risen with the result that price-earnings ratios have declined and the stock market has proved disappointing to many who were accustomed to the high rates of return that existed for most of the period since World War II.

Public policy must strive to create conditions which result in the equitable treatment of invididual investors as compared with institutional investors. The most important conditi is strenuous competition, but other conditions can help.

The failure of brokerage firms would have been less if their capital had been greater. Public policy can facilitate the accumulation or creation of capital by brokerage firms. When failure does occur, public policy can soften the effects on the customers of these firms. The Securities Investor Protection Corporation (SIPC) serves this function. (An alternative or perhaps a supplement would be to require security firms to have commercial insurance on behalf of their customers to protect them against failure of the firm.)

Equity and Reasonableness in the Regulations of Financial Institutions

The best regulator and protector of the public interest is competition. Competition must be made more effective, but governmental and self-regulation will continue to be necessary. Our present system of self-regulation by the exchanges and other organized markets, with governmental oversight, has worked reasonably well. An improve-

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ment will come through eliminating excessive regulations, eliminating overlapping regulatory juridiction, and avoiding unequal regulations of competitors. Perhaps even more improvement will come from eliminating present impediments to effective competition.

Taxes Which Do Not Impede Investments in Domestic Business Enterprise and Which Do Not Place American Financial Firms at a Disadvantage in Their Competition with Foreign Firms

A variety of taxes can affect the volume of saving and investment and international capital flows. Obviously, ordinary income taxes and capital gain taxes have their effect. Less obviously, taxes on the income of partnerships and brokerage firms have affected their ability to accumulate capital and to compete with other kinds of financial institutions both here and abroad. The Interest Equalization Tax has ~~almost~~ undoubtedly diminished New York as a center of international finance and diminished opportunties for investment by Americans in foreign enterprise. The withholding taxes on the interest and dividend income of foreign investors has likewise discouraged foreign investment in the United States.

These taxes produce revenues and may serve other purposes. ~~The fact that they impose costs on those who pay them does not mean that they are not justified, but~~ However, the indirect effects of these taxes may warrant their modification in order to further the achievement of acknowledged objectives of public policy.

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An Adequate Dispersion of Economic Power

For at least twenty-five years, institutions have increased the proportions of stock and bonds and other financial assets which they manage for their own account and on behalf of others. The relative importance of institutions as traders has increased even more rapidly than their relative importance as owners and managers of funds. There is an understandable concern that the increasing institutionalization of our capital markets has created undesirable concentrations of economic power over both the markets themselves and the assets which are managed and traded. Our political traditions has always included strong elements of distrust of great concentrations of economic power, and this distrust is based on sound political philosophical principles. But, we have also held that bigness per se is not bad; its badness depends on its consequences and must be demonstrated in a factual context.

## THE ISSUES

### The Structure and Rules of the Central Market

Almost all -- perhaps all -- informed commentators on the evolution of our system of capital markets have agreed that we should move toward a single, central market. The term, "central market" is ambiguous, however, and many of those who advocate it are advocating different things.

The Securities and Exchange Commission has issued two excellent statements regarding the structure of the new central market. [5/] In these statements the Securities and Exchange Commission defines

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the central market as a system of communications by which the various elements of the market place are tied together for the purpose of exchanging information about bids and offers as well as the prices at which securities are bought and sold. Implicit in the existence of a complicated system of communications is a set of rules governing participants in their activities on the system and a means of ensuring compliance. The Securities and Exchange Commission's concept of the central market is the one which is used in this memorandum.

The Securities and Exchange Commission's policy statement seems, with only unimportant exceptions, admirably designed to achieve the objectives of public policy specified above. This memorandum will not deal in detail with the structure and rules of the central market, since detailed treatment of these subjects are available in the two Securities and Exchange Commission's documents. Rather, this document will indicate the most important characteristics of the new system, indicating occasional disagreement with the Securities and Exchange Commission's position.

## Structure

### The Communications System

The communications system will have three main components. The first is a consolidated tape which will report the prices and volume of securities which are bought and sold. It will be similar to the present tape of the New York Stock Exchange but will include

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all transactions in securities in the system whether transactions in them take place on the New York Stock Exchange, on regional exchanges, or on over-the-counter market. At the outset, at least, transactions in the fourth market would be excluded both because of relatively small volume of trading in the fourth market and because of the difficulty of regulating the activities of institutional investors transacting without the use of broker-dealers who are members of the central market system. Should the volume of trading in the fourth market increase dramatically, the difficulty referred to should be overcome so that the fourth market transactions also would be reported on the tape.

Decisions must be made as to the securities to be included. The main criteria for inclusion should be the degree of public interest as measured by the dollar volume of trading. Actual decisions about stocks to be included would be made by the governing body of the central market.

The Securities and Exchange Commission has already adopted a rule requiring the creation of a tape which would report transactions in all listed securities.[6] This rule conforms in all essential respects to the recommendations contained here.

The second main component on the communications system is the combined quotation service. This service would display conveniently and in one place all the bids and offers for included securities. Such a system would enhance the competitiveness of capital markets and would eliminate the undesirable fragmentation of these markets which has been taking place in recent years. Since such a quotation service would do more than almost anything else to enhance the

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competitiveness of the system, the Securities and Exchange Commission should push vigorously for its creation. Once such a system is in place, some of the detailed regulation of American capital markets would no longer be necessary, since increased competition among brokers and dealers would protect the public interest.

The third component of the communications system would deal with clearing and settling transactions and the associated system of securities depositories. The first step in the creation of a new system would be either: (1) The creation of a single national system, based on the principles of continuous net settlement which would clear and settle and hold in depositories all securities whether traded in the new central market for listed securities or in the over-the-counter market, or (2) A system of regional clearing organizations or depositories based on the same principles and with satisfactory electronic interfacing.

¶ Much of what progress has been made in recent years has come from regional exchanges and the over-the-counter market. Competition among markets has been a constructive force. Such competition and the innovation which might result should not be forbidden by law, although any competing systems should be required to interface electronically to achieve all possible economies. ¶ Progress in this area has been slow. Recently, the New York Stock Exchange, the regional exchange, and the National Association of Security Dealers have agreed to work cooperatively for the creation of a new system. The Securities and Exchange Commission should vigorously push the creation of such a system and should request the necessary power to impose such a system if satisfactory progress is not made.

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Access to the System

The Securities and Exchange Commission has wisely recommended that all qualified broker-dealers be permitted access to the new communications systems which constitute the new central market. Qualifications would be based upon financial strength, competence, a demonstration of integrity by principals, and a willingness to support financially the governing bodies of the system and to abide by their rules. It is not necessary that there be a single governing body. With the new system, as with the existing system, there is much to be said for the preservation of regional exchanges and over-the-counter firms which make markets and act as brokers for listed securities. Although all participants in the system would be subject to the same general rules, as devised by the self-regulatory bodies with Securities and Exchange Commission approval, the various exchanges and the National Association of Security Dealers could chose to operate differently within the same general constraints.

The major question concerns the desirability of membership of firms wh execute orders on their own account or on the behalf of funds which they manage for others. On January 16, 1973, the Securities and Exchange Commission promulgated rule 19b-2, a complicated rule whose complexities and nuances will not be discussed here. Its essential provision is that membership on existing exchanges or new exchanges be limited to firms doing at least 80 percent of their volume of securities transactions on behalf of non-affiliated persons or institutions.

For three reasons, it is recommended that access to the central market system of the future be limited to firms doing 100.

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percent of their securities business on behalf of non-affiliated persons. The first reason is that only by such a restriction can conflicts of interest between the firm and its public customers be avoided.

The second reason is that likely changes in public policy regarding American capital markets will cause some disruption and financial distress to some broker-dealers. Although many persons compellingly argue that broker-dealers can thrive under the new environment -- perhaps better than at present -- prudence suggests that broker-dealers be protected from threats which ~~do not serve an~~ can be minimized without harming any important public interest. The requirement that only firms doing 100 percent of business with the public be allowed access to the new central market will serve to strengthen the broker-dealer community and avoid conflicts of interest, while jeopardizing no important objective of public policy. This will be true only when fully competitive rates for brokerage services exist.

A third reason for limiting access to firms doing 100 percent business with the public rather than on their own behalf is the feeling which many hold -- with considerable plausibility -- that institutions which trade on their ~~on~~ own behalf and have direct access to the central market could have some advantage as compared with the general public in buying and selling securities. The advantage would derive from the superior knowledge and the speed of reaction which are possible for direct participants as compared with those who must deal through others.

The Rules

Using history as a reliable guide -- and in this instance it almost certainly is -- the rules governing the new central market will be expressed in thousands of pages. Comment here is limited to the most important rules.

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Competitive Rates

Perhaps the most important rule is that there be no collusion with respect of the establishment of prices for any financial services. The issue of fixed versus competitive rates for brokage services has been adequately discussed in both houses of Congress, before the Securities and Exchange Commission, in informal meetings at the Treasury Department, and in many other places. The Securities and Exchange Commission's current policy of requiring fully competitive rates after April 30, 1975, is admirable. 2/ There will continue to be strenuous efforts by opponents of this policy to have it reversed. Undoubtedly, it will be pointed out that the time is not ideal in the spring of 1975, because the time will never be ideal for making such an important change. Nevertheless, competitive rates are the only rival to the new systems of communications in their promise of benefits both to the financial community and to the general public.

At the present time, fixed rates bear no sensible relationship to costs. The result is great inefficiency which imposes costs on the investor with no corresponding benefit to the financial community which serves that public.

The three main arguments which are still seriously advanced in favor of fixed rates are the following: (1) Competitive rates will confe great advantages on large firms, thereby causing the failure of many smaller, regional firms and, consequently, a reduction in the ability of the broker-dealer network to raise capital for small, new enterprises. (2) With competitive rates and in the absence of the requirement that all listed securities be traded on an exchange rather than on the over-the-counter market , incentives for membership on exchanges would

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be substantially eliminated with the consequent demise of the auction market. (3) Rates for small transactions would rise and thereby further discourage individual participation in the equities market.

There is no compelling evidence to support the position that competitive rates will confer great advantage on the largest firms. The most competent study of the economics of the brokerage industry show that there are no overwhelming economies of scale in that industry and that the regional firms have been among the most prosperous. 8/

With respect to the second main argument in favor of fixed rates, the evidence is less clear. It is possible that competitive rates combined with the new central market system, which permits trading in listed securities in the over-the-counter market, will decrease and conceivably destroy the importance of trading floors and specialists who operate on them. Even though this outcome is unlikely, the changes being proposed are sufficiently important and their ramifications are sufficiently complex and uncertain to require that one take seriously the possibility that trading floors and specialists will lose their importance.

This issue has recently been the subject of an informative public controversy between the New York Stock Exchange and the Securities and Exchange Commission. 9/ The New York Stock Exchange argues that fixed commissions are the only important incentive to exchange membership in a system which permits non-member broker-dealers to trade in listed securities. Since the New York Stock Exchange feels that the demise of the exchanges would damage the public interest, they urge that after April 30, 1975, when fully competitive rates presumably

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will exist, trading in securities listed on exchanges be limited by law to those exchanges.. The damage to the public interest which the New York Stock Exchange seeks to avoid is the destruction of the auction process for buying and selling securities and the debasement of standards which would result from the elimination of the exchanges as self-regulators. The Securities and Exchange Commission does not accept the New York Stock Exchange's argument. In particular, the Securities and Exchange Commission believes that the exchanges would continue as viable, effective organizations and that the auction-agency system would flourish in the new market environment even if the exchanges became much less important. The Securities and Exchange Commission's case is the more convincing.

The New York Stock Exchange's argument contains an anomaly which has not yet evoked public comment. It is alledged that the auction system as it now exists on the New York Stock Exchange and other American exchanges is a more efficient system than any other because it permits the crossing of public orders without the necessity of a dealer's spread. As a result the cost of transacting is reduced. The anomaly in the New York Stock Exchange's argument is that this efficiency and this benefit to their customers is not regarded as an important incentive to exchange membership. To the extent that the efficiency and benefit are important, the incentive to membership should be important. Even the largest brokerage firm executes only a small percentage of the public business, so that the opportunity to cross orders "in house" is small by comparison with the opportunity available on the floors of the exchanges.

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Normally in a competitive environment, business flows to those firms with the greatest efficiency or best service. The New York Stock Exchange has not yet demonstrated why the normal result would not be evident in the brokerage business. Those who fear ~~that~~ the demise of the specialists and even of exchanges themselves in an era of competitive rates and a third market should strive to create competitive advantages for exchange members and their customers. The primary incentive for exchange membership should be superior ability to serve customers rather than the opportunity to profit from collusively determined rates. Many people, including the (New York Stock Exchange), believe that exchanges do have particular advantages which will insure their survival. The market should determine whether these opinions are valid.

Of course, there may be costs associated with exchanges membership which offset or more than offset the advantage just described. The cost which the New York Stock Exchange emphasizes is the cost of maintaining high standards and of ensuring compliance with them. To the extent that different standards exist and to the extent that surveillance and enforcement procedures differ in effectiveness among markets, there is an opportunity for constructive governmental remedy.

No one contends that public regulation should bear unequally on competing firms. Equal safeguards should be provided by the government to the public investor whether he chooses to trade through an exchange or in the third market. The same standards should exist with respect to financial strength, disclosure of transactions, priority for public orders, and other things. The Securities and Exchange Commission is the appropriate agency for devising, imposing, and enforcing those

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standards, ~~through~~ through self-regulation subject to SEC oversight should continue. The ~~NASD~~ National Association of Securities Dealers and the exchanges should be free to impose additional rules, but the public interest does not require that these rules be uniform among markets.

The ~~NYSE~~ New York Stock Exchange has not made a convincing case that current or prospective standards for it are higher, more onerous, or more strictly enforced than standards of other exchanges or of the over-the-counter market. Rules differ.[10/] Rules 113 and 394 of the New York Stock Exchange,[11/] for example, have no counterparts on the regional exchanges, but the necessity of these rules has not yet been demonstrated to the SEC. And, the possibility of such demonstration seems remote.

In an appendix to its report on "Incentives to Exchange Membership in a Central Market System",[12/] the ~~NYSE~~ New York Stock Exchange presents an estimate by a member firm of the differences in costs of transacting through the ~~NYSE~~ New York Stock Exchange as compared with the third market. The estimates are not represented as being precise, but they certainly do not sustain the argument that exchange membership imposes significant additional costs because of differing standards or burdens of compliance. It is estimated that the "compliance/regulatory reporting" expense for the NYSE is $.15 per $100 of gross commission revenue. The estimate for the third market is zero, assuredly a serious underestimate as any member of the ~~NASD~~ National Association of Securities Dealers will sadly testify. The differential expense, thus, is almost certainly less than one-tenth of one percent of revenue from brokerages.

It seems easier to argue that fixed rates have been largely responsible for the growth of the third and fourth markets than to argue that competitive rates will enhance the relative importance of these markets.

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It is dubious that the essentials of the auction process would be jeopardized in the new national market system, even if the exchanges became less important. With the new system, market makers, whether specialists on the floor, block positioners, or third market firms will compete so that would-be buyers and sellers can easily know all bids and offers in the market at any time. The new system will contain the essence of the auction process. This essence will not be destroyed if specialists are not part of the system. At the present, only a small fraction of trading on the floor of the New York Stock Exchange consists of the crossing of market orders from the public. By far, the larger fraction consists in transactions involving a dealer on one side of the trade. The virtues of the auction process as it now exists are exaggerated by some who fear for its survival. At the same time, the fact that the new system contains the essence of the auction and process is ignored or denied.

In summary, the Securities Exchange Commission's case and the additional arguments presented here do not lead to accepting the New York Stock Exchange's conclusions regarding the harmful consequences to the public of permitting off-board trading of listed securities after April 30, 1975. Should the adverse consequences appear, there will be time to impose effective remedies -- perhaps through the prohibition which the New York Stock Exchange seeks.

The third reason for opposing competitive rates is that they would increase costs of brokerage on small orders and would therefore further discourage investments in equities by individual investors. Almost certainly, the costs of brokerage itself would decline. There has been abundant testimony to this effect before Congressional Committees and the Securities and Exchange Commission. It is quite

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possible that the charge for bundles of service now provided would rise for the small investor, but the variety of bundles of service would increase. Individual investors would have a much greater choice of services, and brokerage firms would offer different bundles of services on terms which would make their sale profitable. At the present time many firms feel that it is not profitable to serve small accounts, whereas banks and others find arrangements which provide profit to the institution and reduced costs to small investors. In the market system of the future, there is no reason why brokerage firms should not have the same opportunities and freedoms which the banks and other institutions now enjoy in serving the small investor. The brokerage rates for "bare bones" brokerage would almost certainly decline.

Trading Rules. The main trading rules which are recommended here are those set forth in the Securities and Exchange Commission policy statement on the Structure of a Central Market System. The first trading rule specified by the Securities and Exchange Commission is the "Auction Trading Rule". The purpose of this rule is to insure that all public orders would be protected against the execution of any transaction in the system at an inferior price. That is, the system would prevent any sale at a higher price than was offered by a public investor or a purchase at a lower price than was bid by a public customer. No one disagrees that such a characteristic of the system is desirable. This characteristic would be present in the new central market and is not present in the current, fragmented system of markets.

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The second main trading rule, called the "Public Preference Rule", would prevent any broker-dealer from participating as principal in any transaction unless his bid was higher or his offer lower than any public bid or offer on record in the system. This rule, which would grant priority to public orders, would strengthen the agency system.

The SEC does not comment on the trading rules with respect to short-sales, but these rules should be changed. The change should be made whether or not the central market emerges in the recommended form or any other. At the present time, the up-tick rule [14] and the treatment of gains from short-sales as ordinary income [15] make short-selling relatively difficult and costly. Short-selling is no more dangerous or evil than ordinary selling or buying. If short-selling were easier and less costly, there would be more of it with a consequent increase in the liquidity of the market and in its efficiency. At the present time, much research which indicates that securities are over-valued is wasted because of the costs and difficulty of short-selling. As a consequence, prices adjust less certainly and rapidly in response to research with negative implications.

Use of Private Information. At the present time, companies are required to place promptly in the public domain all information material to investors in judging the value of securities. Insiders are prohibited from profiting by trading in securities on the basis of priviledged information. These policies are sound and should be vigorously enforced.

Current policy is silent or at least ambiguous with respect to the permissible limits of private exploitation of private information. Over 12,000 professional analysts and thousands of amateurs are engaged

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in a continuous quest for private information which will enable them to make superior judgments regarding the value of securities. The information which they seek is not material by any reasonable legal definition of the term. Rather, they seek small clues which, when analyzed perceptively and promptly, indicate the future of corporations more completely than merely public information can. Both the quest for private information and the use of private information in investing are to be encouraged, because the quest and the use are an important source of the efficiency of the American security markets. The continuous search for under- and over-valued securities causes prices to hover closely around intrinsic values. This result is beneficial to all investors, since it prevents important mistakes in selecting assets.

Sometimes the quest leads to discoveries of great importance, and the discoverer makes large profits either by direct investment or by selling advice. On these occasions, some people feel that the important private discovery should be placed in the public domain prior to its use by its discoverer so that the discoverer would not have an advantage over other investors. Public policy should not in general prohibit the private exploitation of private information, since such prohibition would diminish the quest for private information and the efficiency of American capital markets.

Nevertheless, there may be kinds of private information which should be placed in the public domain. A reasonable policy would be to require that indications of illegal actions by a corporation should be disclosed to the proper authorities -- typically the SEC in cases involving securities -- before the discoverer of the information

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is allowed to act upon it. A reasonable interval should intervene between the notification to the authorities and the action by the informer.

Before leaving the subject, it is desirable to comment on the nature of information. Some recent public discussion suggests that information is readily recognizable and that its implications can be accurately and almost automatically discerned. In fact, valid information frequently cannot be distinquished from false rumor or merely plausible conjecture. Further, the implications of the information or the rumor are always uncertain.

A reasonable rule would be to require the reporting of all "information" about illegal activities which seemed valid enough to its discoverer to warrant reaction by buying or selling securities or advising others to do so. Difficulties remain, including the difficulty that many who seek useful private information are not fully informed of the intricacies of securities law.

Conflicts of Interest--Public confidence is fostered by an absence of conflicts of interest. It is impossible to eliminate all conflicts, but there are some which are so important that they should be dealt with through public policy.

One conflict is that between the broker-dealer in his role as broker dealer and in his role as money manager. In a strenuously competitive environment, the long run interest of broker-dealers will prevent their generating unnecessary brokerage fees in accounts over which they have discretion. This competitive constraint would seem to be adequate for dealing with personal accounts over which the broker dealer is given full discretion by the investor. On the other hand, some further legal

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constraint seem desirable for broker-dealers in their role as managers of investment companies. Since it has been recommended that institutional investors not be permitted direct access to the central market, it seems equitable to prohibit the execution of orders by broker-dealers on behalf of investment companies which they advise and manage.

Extremely important conflicts of interest exist in many developed countries where banks act as money managers on behalf of others, as brokers and as investors in equities for their own accounts. Fortunately the Glass-Steagall Act prohibits these conflicts, and these prohibitions should be continued.

Some feel that there are important conflicts between the trust departments of banks and their commercial lending activities. That is, lending officers may be influenced by holdings in the trust department, and investment officers may be influenced by the decisions of lending officers. Public policy now prohibits communications between the commercial side and the trust department for the purpose of influencing either investment or lending decisions. In the absence of more persuasive evidence than has been presented so far regarding the harmful effects of present arrangements there is no reason to change public policy in this area.

Governance of the Central Market System

The present system of self-regulation by the exchanges and by the National Association of Security Dealers with oversight by the Securities and Exchange Commission should be continued. The power of the Securities and Exchange Commission over the exchanges should be increased so that it is equivalent of its power over the National Association of Security Dealers. That is, the Securities & Exchange Commission should have the authority to impose new rules or disapprove changes suggested by the exchange themselves.

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In the new central market system, the various exchanges, should they continue to exist, and over-the-counter firms would be linked together through the new communications system. Representatives of the governing boards of the various exchanges and of the National Association of Security Dealers should be represented on the governing boards of ~~these~~ this communications system.. The Securities and Exchange Commission should have the power to specify the proportions of the new governing board which should come from the constituent organizations and from the general public. The Securities and Exchange Commission should have the same authority over the new governing board as is recommended with respect to the various exchanges and the National Association of Security Dealers.

When the central market comes into being with the increased competitiveness which its communications system will create, the self-regulatory bodies and the Securities and Exchange Commission should undertake a systematic study of the complex and voluminous body of rules to see which are necessary to protect the public interest. For example, present rules and new rules which have been suggested require that market makers have a responsibility to maintain orderly markets. With the new system of more effective competition, such a rule would probably be unnecessary. The system would make known the highest bids and the lowest offers, and that would be sufficient to protect the public interest. The desired degree of liquidity and orderliness would emerge. There are many other rules which seem promising candidates for elimination. It is impossible to guess how the new system will operate, and it is impossible to forecast which of the rules now required in the public interest would no longer be necessary.

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All institutions which participate in any aspects of the process of buying and selling securities and effecting transfers of ownership should be subject to the authority of the Securities and Exchange Commission. Whether the institutions be broker-dealers, banks, depositories, non-bank transfer agents, or others, the Securities and Exchange Commission should have the authority to impose their rules, ascertain their degree of compliance, and impose appropriate sanctions. In the future, as at the present, much of the tasks of rule making, surveillance, discipline, and enforcement will be delegated by the Securities and Exchange Commission to self-regulatory bodies or perhaps to other governmental agencies (e.g., the Comptroller of the Currency). It would be ~~S.E.C.'s~~ Securities and Exchange Commission's responsibility and purpose to insure that the rules of the various self-regulatory bodies provide equivalent protection for the investing public and that standards of surveillance and enforcement are equivalent.

## The Role and Impact of Institutional Investors

### Some General Remarks

For the past twenty-five years, institutions have rather steadily increased the volume and proportions of financial assets which they own directly or manage on behalf of others and the proportion of the volume of trading of financial assets for which they account. Many people now blame institutional investors for a variety of ills which are believed to afflict our capital markets. As a consequence, various proposals have been made to diminish the importance or to restrain the freedom of institutional investors. Before mentioning these ~~proposed regulations~~ proposals to regulate of institutional investing, it seems sensible to consider the validity of the allegations regarding the

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harmful consequences of such investing.

It is alledged that institutions have diminished the liquidity of our stock markets. The liquidity of an asset is measured by the degree to which large quantities of it can be sold quickly without much impact on its price. Because institutions typically hold relatively large amounts of individual assets and because they have become increasingly important as owners, managers, and traders of financial assets, trades involving relatively large volumes of individual securities have become much more frequent. Although such trades may have a larger impact on the price of an asset than smaller trades, there is no evidence that large trades now have a larger impact than they did formerly when institutions were of less importance. The market has not become less liquid; the demands upon the liquidity of the market have become greater.

In fact, it could be argued that liquidity has been increasing at the same time that institutionalization has been increasing. The dollar volume of trading has been rising dramatically. The dollar volume on the New York Stock Exchange in 1972 was over four times as great as the volume ten years earlier. It seems hard, though logically possible, to argue that liquidity has been declining when the dollar value of stocks changing hands has been rising so dramatically.

When security prices change because of a temporary imbalance between orders to buy and orders to sell, the main sufferer is the investor responsible for that imbalance. The investor who places a large block of stock on the market and depresses its price bears the main costs. Other investors, recognizing the causes of the

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decline in price, would purchase the security at an advantageous price and thereby cause the price to return to its equilibrium level. The self-interest of institutional investors will cause them to be cautious in placing unreasonable demands on the liquidity of the market. No issue of public policy is involved.

Some complain that institutions can cause sudden dramatic changes in the price of securities when the cause of the change lies in a change in the value of the corporation of the securities that is being traded. Those who have such concern feel that the public interest would be served by legally restraining such price changes to create the illusion that the change in value had not taken place. Such an illusion would be costly to the public and contrary to an important objective of public policy -- namely, efficiency in setting the price of securities. It is in the public interest for the prices of securities to adjust very rapidly to changes in their inherent value. If institutions promote and facilitate such adjustments, they are to be encouraged and commended rather than the reverse.

There is complaint that the institutions concentrate their holdings in relatively few securities causing their price-earnings ratios to be "too high" relative to securities which do not enjoy institutional favor. International Business Machines is perhaps the most favored institutional holding. Incidentally, International Business Machines is the stock on the New York Stock Exchange which has provided the greatest total returns during the past fifty years. This return is derived from the extraordinary success of the company rather than any artificial inflation of its price relative to its earnings. People who believe that institutions buy and sell in

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concert are particularly upset about the rising importance of institutional investing. The Securities and Exchange Commission's Institutional Investor Study of 1971 indicates that parallel trading by institutions is not more common than such trading by individuals.[17] The notion that the news that a particular institution is buying or selling would cause other institutions to adopt similar courses of action seems invalid in view of the fact that institutions deal with each other in much greater volume than with individuals. The news that Institution "A" is selling a security is more often than not offset by the news of that Institution "B" is simultaneously buying that security. The success of a communications system such as Instinet or Autex which permits institutions to transact directly with each other, is some evidence that institutions do not blindly play the game of "follow the leader", but buy and sell to and from each other.

As stated above, when institutions or individuals simultaneously react to new information about a security which changes preceptions of its value, their behavior should cause the price to change rapidly and even dramatically when the change in value is large.

Some believe that the increased relative importance of institutional trading has increased the volatility of the stock market. It is curious that the volatility of the institutional favorites has typically and, also on the average, been less than that of other stocks. It is also curious that the volatility of the American Stock Exchange, where institutional investing and trading are relatively unimportant, has been greater than that of the New York Stock Exchange were most of the institutional interest is focused.

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Others complain about institutional investing because some institutions have come to manage very large volumes of assets. Some feel that there is an undersirable degree of concentration of economic power in the hands of the large institutional investors. This power is of two sorts. The first is power over the companies whose securities are controlled; the second is the power over the prices of the securities themselves. Before considering each of these kinds of power, it is worthwhile to consider the degree of concentration which exists. The largest institutional investor manages approximately twenty-six billion dollars of assets. About twenty billion dollars are invested in common stock. This represents about two percent of the value of all common stocks, although the proportions of the stocks of some companies are obviously much greater. By the time one gets down to the tenth largest institutional investor, the volume of holdings is less than ten billion dollars. The ten largest institutional investors combined manage less than fifteen percent of the value of all common stock. This degree of concentration does not automatically seem alarming. Those who feel alarm have yet to demonstrate the harmful consequences which alarm them. It would be alarming if the largest investors colluded or followed identical policies without collusion. There is no evidence of either type of behavior.

From 1958 to 1968 the market was generally rising, trading volume was rising, the brokerage industry was prosperous, the relative importance of institutions as owners, managers, and traders of stocks, was increasing rapidly, and there were few complaints about

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institutional investing. Since 1968, stock prices have generally been declining, trading volume has been highly erratic, and there have been wide-spread losses and failures in the brokerage industry. Institutional investors have received much of the blame. No one has satisfactorily explained why the rapid rise in the importance of institutional investing prior to 1968 had such an apparently benign effect while the effects became harmful only after 1968.

There are more plausible explanation of the difficulties that have been blamed on institutional investors. Much of the general, substantial decline in the prices of common stock since 1968 can be explained on the basis of normal economic relationships. As the rate of inflation increased, the expected rate of inflation increased with a consequent increase in nominal interest rates. And predictably and naturally, as the nominal cost of debt capital rose, the cost of equity capital rose. The increased cost of equity capital is reflected in a decling price-earnings ratio.

Although some stocks have much higher price-earnings ratio than others, this has always been true. Institutional investing is not plausible as an explantion of a phenomenon which existed before institutional investing became so important.

Financial distress in the brokerage industry has been caused in part by declining stock prices, in part by widely fluctating volume, and in part by other causes. It is true that the rise of institutional investing has probably caused the New York Stock Exchange to lose ground relative to the third market, regional exchanges and the fourth market. But, some of the competitive advantages of the New York Stock Exchange's competitors seem to have

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their source in rules of the New York Stock Exchange which the New York Stock Exchange itself could change.

The ~~preceding paragraph~~ foregoing suggests the conclusion that institutional trading does not seem to have caused the difficulties which are sometimes attributed to it. As a consequence, some of the prescribed remedies seem unnecessary, and, also contrary to the public interest.

What are some of these remedies and what would be their effects? One remedy would be to limit the percentage by which a stock price could change in a given day. This remedy is designed to diminish short-term volatility which is often attributed to institutional trading. Limitation of price changes is contrary to the public interest. When prices change as a consequence of changed preceptions regarding the value of a company, market efficiency requires that the changes take place rapidly. If investors are unwilling to pay more than $45 per share for a stock, no loss is avoided and no weath is preserved by stopping all transactions when the price declines to $48. If the highest bid is $45, the stock is worth $45 by the only test which one can imagine imposing. Preventing transactions from taking place at $45 imposes costs on those who wish to transact at that price and confers no offsetting benefit on anyone else.

It has also been suggested that the volume of a security which any investor can buy and sell in a given time period be limited. The purpose of this restriction also is to diminish short-term price volatility. Limiting price changes directly is a relatively efficient way to achieve an undesirable objective. Limiting the

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volume of sales or purchases by a single investor is merely an inefficient means to achieve the same undesirable objective.

Some have suggested that the volume of assets managed by a single insitution be limited to some maximum. Before imposing new regulations, it would seem desirable to establish some evidence of the evils or dangers which would be eliminated. That case has not been made. It is possible that the volume of assets managed by some institutions will ultimately become so large that the case can be made for imposing a maximum, but recent trends do not suggest that that condition will soon exist.

It has been suggested that the proportion of a company's stock which can be controlled by a single institution be limited. Ten percent has been suggested as an appropriate maximum. There is one reason for this suggested maximum. It is to limit the amount of control which an institutional investor can exert over a company whose stock is owned or managed. In this connection, it is moderately amusing to recall that during the 1930's and 1940's there was wide-spread concern regarding the disenfranchisement of the individual investor which was the result of the wide dispersion in the ownership of stocks of individual companies. Such wide-spread ownership, it was alleged, effectively disenfranchised the owners and gave management unchecked reign. Now that ownership has become somewhat more concentrated because of the rise of the institutional investor, there is concern that the shareholders will use their franchise and exert an influence over management. Before a maximum is set on the proportion of a company's stocks which an institution can own

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or manage, there must be a better demonstration than has been made so far of the harmful consequences of enfranchising the investor.

It has been suggested that institutions make periodic disclosures of their holdings. Some have even suggested that institutions disclose not only their trades but their intention to trade. ← Although little harm and possibly some good could come from periodic -- say, quarterly -- disclosure of holdings, harm to those whose assets are managed by institutions would certainly result from disclosure of intentions to trade. Unless one can demonstrate that placing institutional investors at a disadvantage relative to others is in the public interest, it is hard to imagine any benefit from such required disclosure which would not be more than offset by the harm to those investors who use institutions to manage their funds.

In summary, institutions cannot reasonably be blamed for the ills which are sometimes attributed to them. Therefore the regulations which have been proposed for institutional investors to remedy the ills discussed above seem unnecessary and in some instances to have adverse effects.

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International Capital Flows

With respect to the domestic economy, traditional national policy has been in favor of competition and free markets as protectors of the public interest. Unfortunately, public policy frequently departs from this tradition in order to favor one group or another, but by all international comparisons, our economy is remarkably competitive and does rely on free markets. We have also favored free international trade and free international flows of capital. We retreat from this policy from time to time. The Smoot-Hawley Tariff was an earlier departure, and, most recently, we have departed by imposing an Interest

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Equalization Tax (IET) and controls on direct foreign investments. The IET and the controls on direct foreign investments were imposed when our balance of payments was negative and deteriorating. It is unnecessary to argue here whether the remedy was desirable or not. In any case, the illness for which the remedy was prescribed no longer exists. Our balance of payments is positive. The dollar is strengthening. The prospects for the future are good. Therefore, the IET and the controls on direct foreign investment should be allowed to die in 1974.

The effect of eliminating the IET and the controls on direct foreign investment are hard to estimate. The direct and immediate effect will be to make it less costly and easier for Americans to invest abroad either in financial assets or directly in plant, equipment, and other productive resources. As a consequence, there should be an initial increased outflow of dollars. On the other hand, the elimination of these impediments to free international flows will symbolize America's confidence in its own economy and its belief in free trade and free international flows of capital. To some extent, manifestation of this confidence and this feeling will make the United States a more attractive place for foreign investment and will thus stimulate the flow of foreign capital to the United States.

This flow of foreign capital to the American economy would be re-enforced and stimulated by the elimination of the withholding tax on interest and dividend income accruing to foreign holders of American securities. The withholding rates differ from country to country according to the terms of tax treaties or the absence of a tax treaty, but the existance of the tax makes investment in American

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securities less attractive than it would otherwise be for many foreign investors. Domestic taxation in some foreign countries would make the elimination of the American withholding tax on American securities no more attractive than at present, but in some foreign countries, whose economies are large the elimination of the American withholding tax would undoubtedly stimulate a large flow of capital to the American economy.

The simultaneous, or nearly simultaneous, elimination of the IET, the controls on direct foreign investment, and the withholding tax would probably leave our balance of payments no worst off than with the continuation of the controls and the taxes. In addition, American firms and foreign firms would once again look to American capital markets as the primary source for their capital needs rather than rely so heavily on the Euro-bond market. The IET was enacted in 1964. In 1963, Euro-bond offer aggregated 164 million dollars. In 1964, the total was 719 million dollars. It rose rapidly thereafter reaching a total of more than six billion dollars in 1972. The figures for 1973 are not yet in, but the total will probably be the highest for any year except for 1972. With the elimination of IET, American capital markets will regain much of the ground which has been lost to the Euro-bond market.

One of the feared consequences of the elimination of the withholding tax on interest and dividend income accruing to foreign holdings of American securities is that American securities will become too attractive to foreigners. It is feared that foreigners will acquire control over increasing numbers of American enterprise and that this is contrary to the national interest. Although such foreign

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control of some industries which are critical for the national defense should be guarded against, the American stockholders, and the American public would all benefit from an increase in foreign investment in American securities. A consequence would be a reduction in the costs of capital to American firms which would benefit domestic consumers and enhance America's position in world markets. We should welcome rather than fear increased foreign investment in the American economy.

At the present time, foreign firms are not accepted as members of the New York Stock Exchange. Some of the regional exchanges do accept foreign members. The demand for such membership has been substantial, and there have been no serious problems of surveillance or of enforcement of American law. Foreign firms should have direct access to the new central market system.

Two arguments are sometimes advanced against foreign membership, apart from the argument concerning surveillance and enforcement. The first argument has to do with equity. Since American securities firms are denied membership on foreign exchanges, equity requires, so it is argued, that we deny foreign firms direct access to our markets. Since foreign access to our markets may beneficially stimulate foreign investment in American securities, the United States should take the lead in generating a freer climate for the international operation of securities firms. We should permit access by foreign firms to American markets and negotiate for reciprocal privileges for American securities firms in foreign markets.

The second argument against permitting foreign access is that foreign firms are not subject to the same restrictions as their American competitors. For example, as indicated above, foreign banks are permitted

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much greater latitude in the securities business than are American banks. Should, therefore, foreign banks or their subsidiaries be permitted direct access to American capital markets to compete directly with either American banks or American securities firms? Perhaps the wise course is to proceed cautiously by permitting foreign membership only for securities firms not associated with banks and not possessing substantial competitive advantages over American competitors because of their stricter regulatory climate.

## SUMMARY AND CONCLUSIONS

The recommended changes in public policy have as their goal the achievement of the objectives of public policy which were discussed earlier in this memorandum. An important proximate purpose of the changes has been strengthening competition in American capital markets. One way to strengthen competition is to eliminate certain restraints of trade such as fixed commissions on brokerage and arbitrary limitations on membership in or access to the organized exchanges. The other route to more effective competition is the creation of the communications system which is the heart of the new national securities market. The consolidated tape and the combined quotation service will reestablish the central market and make it stronger than it has been.

The changes in public policy toward American capital markets which are under discussion are not as revolutionary as they seem to some observers--perhaps particularly members of the New York Stock Exchange. They do not have seriously threatening consequences for a system which has worked well for many years. The recommended changes are an effort to build upon

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and strengthen the essential elements of the old system so that it is better adapted to current conditions in which institutional investors are important and in which modern technology permits the effective linking together of separate markets and market makers. What has made the American system superior will be preserved and strengthened. The auction process, in particular, will flourish in the new environment.

In recent years, the brokerage industry has not been very profitable. Fixed commissions do not, of course, automatically produce profits. In the brokerage industry, as in other industries, when direct competition is suppressed, competition of other sorts intensifies and erodes profit margins. Lack of a sensible relationship between fixed brokerage rates and the costs of providing brokerage services produced many inefficiencies and many forms of non-price competition. Although some feel that the era of fully competitive rates will jeopardize the financial strength of brokerage firms, there are good reasons to believe the contrary. Examples from the bond markets, from over-the-counter markets, from foreign securities firms, and from other industries suggest that competitive rates will not mean reduced profits. Rather, it seems more reasonable to expect a growing variety of financial services which will be profitable to both financial firms and their clients. Some feel that fixed rates helped create the third and fourth markets by driving institutions away from the exchanges and helped create bank-sponsored automatic investment plans because the rate structure made it unprofitable for many brokerage firms to solicit and handle small orders.

The financial strength of firms in the securities business is important. Five changes in the tax loss have been recommended to strengthen these firms. These changes are as follows: (1) a change in the legal definition of a personal holding company as applied to

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securities firms, (2) a change would enable securities corporations to avoid the corporate income tax by having the stock holders declare as personal income the pro-rata share of corporate income, (3) a change to liberalize the definition of "reasonable" accumulations of earnings, (4) a change which would treat redemption of subordinated loans of preferred stock as that of capital rather than as dividends and (5) a change which would permit the accumulation of tax-fr reserves against losses. The combined effect of these changes should be to increase substantially the financial strength of securities firms.

Changes have been suggested in the taxation of capital gains in order to stimulate personal investment in corporate securities. Increasing the rate of investment in American enterprise should strengthen it and enable the American economy to have more of the economic strength necessary to achieve its agreed objectives.

Institutional investors have increased greatly in relative importance. American capital markets and the securities business seem to benefit greatly from the growth of institutional investing prior to 1968. Since 1968, rates of return on common stock have been low and many securities firms have suffered financial distress. No one has made the case that the apparently beneficent effects of institutional investment prior to 1968 were turned into adverse affects after 1968. In some circles, the institutional investor are the new villain, but it seems easier to argue that the institutional investors have added liquidity and breadth to the capital markets than to argue the reverse. Further, although there has been some increase in the concentration of financial assets managed by the largest institutional

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investors, no specific ills resulting from this concentration have been demonstrated. As a consequence, no new regulations are recommended with respect to institutional investing.

The power of the SEC should be enlarged so that they can impose regulations on the exchanges just as they do on the over-the-counter market. Further, the SEC should have authority over all financial institutions in their role as participants in the process of buyers, sellers, affecting changes in ownership of other holding securities. The reach of the SEC should extend to banks, to non-banks transfer agencies, and to others who impinge on the operation of American capital markets. There has been talk of the need for a new super-agency which would formulate policy with respect to American capital markets. The SEC should be that super-agency; there is no need for another.

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FOOTNOTES

1/ In 1972 the number of stockholders in the United States declined for the first time since the New York Stock Exchange began counting in 1952. New York Stock Exchange, Census of Share Ownership for 1972, (March 1973).

2/ For example, the 386 member firms of the New York Stock Exchange reported that the clerical and administrative costs of effecting securities transactions during 1968 totaled $1.1 billion. Approximately $180 million of this cost was associated with the failure of brokers and customers to deliver stock on settlement day. This compares with their gross profit of approximately $300 million for the same year. The New York Stock Exchange Income and Expense Report for the year 1968, New York Stock Exchange, New York 1969. Report prepared for the American Stock Exchange, the National Association of Securities Dealers, and the New York Stock Exchange by Rand on Reducing the Costs of Stock Transactions: A Study of Alternative Trade Completion Systems, Vol. II, at 1 (1970).

3/ New York Stock Exchange, Marketing Securities to the Small Investor (June 28, 1973).

4/ The Securities Investor Protection Corporation (SIPC), created by the Securities Investor Protection Act of 1970, Pub. L. No. 91-598, 84 Stat. 1637, codified at 15 U.S.C. Sec. 78aaa, et seq., is a Federally chartered corporation whose membership includes all registered broker-dealers and members of national securities exchanges. SIPC will advance up to $50,000 per customer account

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in the case of any liquidation of a member broker-dealer firm. Protection for cash, however, is limited to $20,000 per customer account. 15 U.S.C. Sec. 78fff(f). The source of the funds for SIPC's insurance program is the industry itself, through assessments of SIPC members. In addition, SIPC is authorized to borrow up to $1 billion from the Treasury if the existing fund is insufficient for the purposes of the Act.

5/ Securities and Exchange Commission, Statement on the Structure of a Central Market, (Feb. 2, 1972) and Securities and Exchange Commission, Policy Statement on the Structure of a Central Market System, (March 29, 1973).

6/ Securities and Exchange Commission Rule 17a-15, 17 C.F.R. Sec. 240.17a-15 (1973).

7/ The Securities Exchange Commission recently ordered the end of fixed minimum brokerage commissions by April 30, 1975. SEC Securities Exchange Act Release No. 10383, September 11, 1973.

8/ Irwin Friend and Marshall Blume, Competitive Commissions on the New York Stock Exchange, Journal of Finance, Vol. XXVIII, No. 4, at 795-819 (Sept. 1973). See also, West and Tinic, The Economics of the Stock Market, at 121-139 (1971).

9/ New York Stock Exchange, Research Report on Incentives to Exchange Membership in a Central Market System (November 12, 1973). Letter of December 10, 1973 from Ray Garrett, Jr., Chairman of the Securities Exchange Commission, to Senator Harrison A. Williams, Jr., Chairman of the Subcommittee on Securities, Committee on

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Banking, Housing, and Urban Affairs, regarding the New York Stock Exchange's proposed amendment to S. 2519 requiring that all trading in securities listed on an exchange be consummated on an exchange. Public statement by James F. Needham, Chairman of the New York Stock Exchange, December 12, 1973.

10/ Rule 113 of the New York Stock Exchange prohibits specialists from accepting orders for the purchase or sale of any stock in which they are registered as specialists directly from the issuer, or any officer, director or 10 percent stockholder of the issuer, any pension or profit sharing fund, or any institution, such as a bank, trust company, insurance company, or investment company. This rule was adopted in order to prevent abuses by specialists in exercising their discretion in matching orders so as to favor their own customers over those whose orders were forwarded by another firm. Securities Exchange Commission, Policy Statement on the Structure of a Central Market System at 40-41 (March 29, 1973). Rule 113 has been said to place the New York Stock Exchange specialists at a competitive disadvantage as compared with third market makers, who are under no such prohibition against dealing directly with institutions.

11/ New York Stock Exchange Rule 394 generally prohibits Exchange members from executing transactions in listed securities off the Exchange unless a complex procedure, sufficiently onerous to discourage its use in most cases, is followed. This rule restricts

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the ability of Exchange members to obtain the best execution of orders for their customers by limiting their ability to execute the order in a market away from the Exchange.

12/ New York Stock Exchange, Research Report on Incentives to Exchange Membership in a Central Market System, Appendix I at 3 (November 12, 1973).

13/ Securities and Exchange Commission, Policy Statement on the Structure of a Central Market System (March 29, 1973).

14/ Rule X-10A-1, promulgated by the Securities and Exchange Commission under section 10(a) of the Securities Exchange Act of 1934, 15 U.S.C. Sec. 78j(a), prohibits any person from effecting on a national securities exchange a short sale of any security (1) below the last regular sale price of the security on such exchange, or (2) at such price unless such price is above the next preceding different price at which a regular way sale of the security was effected on such exchange. This so-called up-tick rule, in effect, prohibits short sales on a national securities exchange at or below the last sale price, except where the last sale price is higher than the last different price which preceded it, in which case the rule permits short sales at the last sale price.

15/ Section 1233(b) of the Internal Revenue Code provides that the capital gain on a short sale, which is closed with securities held by the taxpayer on the date of the short sale for not more than six months or with securities acquired by him after

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the date of the short sale but before the date of the closing of the short sale, shall be considered as short-term capital gain.

16/ Institutional Investor Study Report of the Securities and Exchange Commission, H.R. Doc. No. 92-64, 92d Cong., 1st Sess. (1971).

17/ Hans R. Stoll has analyzed the data of the Institutional Investor Study and found no evidence of systematic conscious or unconscious parallel trading on the part of institutional investors. Hans R. Stoll, Parallel Trading: The Facts and Implications in Proceedings of Seminar on the Analysis of Security Prices conducted by Center for Research in Security Prices, Graduate School of Business, University of Chicago (May 1973).

18/ Glass Steagall Act, 12 U.S.C. 377, 378.

19/ A study entitled The Impact of Possible Capital Gains Tax Changes on Investor Behavior (Study No. 1571, October 1973), prepared by Oliver Quayle and Co., indicates that reductions in capital gains rates would generate substantial additional tax revenue. Increasing the holding period, according to this study, would reduce tax revenue; reducing the holding period would increase it. Reducing tax rates in holding periods would cause large increases in trading volume.

20/ The New York Stock Exchange has issued a Research Report on Stabilization Reserves -- A Route to Easing Cyclical Problems in the Securities Industry (December 10, 1973), which supports the general position of this memorandum with quantitative estimates of the effects of some changes in the tax laws.

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21/ Interest Equalization Tax Act, Pub. L. No. 88-563, 78 Stat. 809 (1964) (codified in scattered sections of the Internal Revenue Code of 1954). The tax is imposed upon United States persons who acquire foreign stock or foreign debt obligations and is equal to a specified percentage of the value of the stock or obligation acquired. The imposition of this tax by the United States precluded foreign borrowers from exploiting the lower interest rates and substantial capital availability associated with United States markets and has encouraged multinational enterprises to turn to foreign borrowing, particularly the Euro-bond market, to meet growing capital requirements.

22/ Mandatory controls on foreign direct investment by United States corporations were imposed in 1968 by Executive Order No. 11,387, 3 C.F.R. 90 (Comp. 1968).

23/ The Administration intends to phase out the Interest Equalization Tax and the controls of the Office of Foreign Direct Investment no later than December 31, 1974. Statement on Foreign Economic Policy by Secretary of the Treasury George P. Shultz, dated February 12, 1973.

24/ Nonresident alien individuals and foreign corporations are subject to tax at the flat rate of 30 percent on interest and dividend income received from sources within the United States. Internal Revenue Code of 1954, Sections 871(a), 881(a), 26 U.S.C. Sections 871(a), 881(a).

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CIEP CORRESPONDENCE PROFILE

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DOC SOURCE/CLASS/DESCRIPTION

Incoming X
Outgoing ____
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From: JAMES H. LORIE
TO: Pres ____
PMF X
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Action X
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TS ____

SUBJECT: SENDS PMF PRELIMINARY DRAFT OF STATEMENT ON PUBLIC POLICY ON AMERICAN CAPITAL MARKETS FOR COMMENTS BY COB JANUARY 18, 1974

Originator's Ref. No. ____

Xeroxing Instructions ____

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|---|---|---|---|
| Executive Secretary | | X | |
| Deane Hinton | | | |
| Ray Sternfeld | | | |
| Robert Morris | | | |
| Jon Rose | | | |
| Gus Weiss | | | |
| Larry Brady | | | |
| John Niehuss | | | |
| Dick Erb | X | | |
| Bill Hawley | | X | |

ACTION REQUIRED

MEMO FOR PMF ( )
MEMO FOR PRES ( )
REPLY FOR ____ SIGNATURE ( )
( )
MEMO ____ TO ____ ( )
RECOMMENDATIONS ( )
( )
Refer to ____ ( )
ANY ACTION NECESSARY ( X )
CONCURRENCE ( )
DUE DATE: JANUARY 18, 1974
COMMENTS: (Including Special Instructions)

Submit Comments to Ursula FARRELL

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GPO: 1971 OL—426-

MEMORANDUM

COUNCIL ON INTERNATIONAL ECONOMIC POLICY

TRACER TRACER TRACER

JANUARY 26, 1974
(DATE)

MEMORANDUM FOR: MR. ERB

FROM: CIEP SECRETARIAT

SUBJECT: DISPOSITION ON CIEP CONTROLLED CORRESPONDENCE NUMBER 53241 ; REQUEST FOR

1. THE ABOVE MENTIONED CONTROLLED CORRESPONDENCE WAS SENT TO YOU FOR (ACTION) (ANY ACTION NECESSARY) ON 01-15-74 .

2. PLEASE ADVISE THIS OFFICE OF PRESENT STATUS.

ATTACHMENT (COPY OF CIEP CORRESPONDENCE PROFILE SHEET)

---

(DATE)

TO: SECRETARIAT

HANDLED By Phone
PER ERB

RECEIVED
FEB 8 1974
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(Signature of Professional Staff Member

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EXECUTIVE
FG 113
FI2

January 15, 1973

Dear Dick:

This will acknowledge and thank you for your January 8 letter to the President asking that consideration be given to appointing representatives of the Federal Land Banks and the Production Credit Associations to the Federal Farm Credit Board.

I will be pleased to present your suggestions for consideration at the time candidates for the FFCB are under consideration.

With warm regards,

Sincerely,

Dick

Richard K. Cook
Special Assistant

Honorable Dick Shoup
House of Representatives
Washington, D. C. 20515

bcc: w/incoming to Fred Malek for further action.

RKC:EF:VO:jlc

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EXECUTIVE
FG124
FI2
ST
ST28

January 25, 1973

Dear Senator:

I would like to acknowledge and thank you for your letter to the President in which you endorse the views of Commissioner Wendle H. Tarkington and Mr. W. Sale Lewis that closer cooperation should exist between the Federal and State authorities in the field of state-chartered savings and loan operations.

I will be pleased to call your letter to the President's attention at the earliest opportunity.

With warm regards.

Sincerely,

Tom

Tom C. Korologos
Special Assistant

Honorable Alan Bible
United States Senate
Washington, D. C. 20510

bcc w/inc to Peter Flanigan - for further appropriate handling

TCK:EF:jlc

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(6)

BB

MEMORANDUM OF INFORMATION FOR THE FILE

EXECUTIVE
JL3-2
CO39
FO4-3
FG11
FG88
FI2

DATE 2/16/73

LETTER, ~~MEMO, ETC.~~

TO: Secor Browne

FROM: Peter Flanigan

SUBJECT: Southern Airways

Hall, Graydon

Chase Manhattan Bank

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EDWARD J. PATTEN
15TH DISTRICT, NEW JERSEY

COMMITTEE:
APPROPRIATIONS

SUBCOMMITTEES:
MILITARY CONSTRUCTION
LABOR-HEW

# Congress of the United States
## House of Representatives
Washington, D.C. 20515

WASHINGTON OFFICE:
2332 RAYBURN HOUSE OFFICE BUILDING
202/225-6301

STEPHEN G. CALLAS
ADMINISTRATIVE ASSISTANT

OLGA JAMISON BROWN
EXECUTIVE SECRETARY

PERTH AMBOY OFFICE:
ROOM 313, NATIONAL BANK BUILDING
VALLEY 6-4610

FEB 26 1973

February 23, 1973

EXECUTIVE
FIR
FG120

Mr. Max Friedersdorf
Spec. Asst. to President Nixon
The White House
Washington, D.C.

Dear Mr. Friedersdorf:

The Allaire State Bank, of Wall Township, New Jersey, has applied for F.D.I.C. approval. One of the bank officials - the president of the bank - was informed about a week ago that approval action was imminent, but approval has not been made.

What makes IMMEDIATE approval so vital is that the bank is scheduled for its public opening on March 10th, which is very near. Announcements of the scheduled opening have been made in the newspapers and even the Governor has been invited to attend, as well as many other public officials. If the approval is not received in the next few days, it would be disastrous to the bank.

One of my aides called the F.D.I.C. (C 202, 393 - 8400) this afternoon and was told that action on the Allaire State Bank application is on the pending agenda, BUT THAT A MEETING MAY NOT BE HELD UNTIL ABOUT 10 DAYS FROM NOW. Meetings are called by the F.D.I.C. chairman and he MIGHT call a meeting within 10 days. Waiting until then would be awfully risky - and could be disastrous to the Allaire Bank officials.

I would deeply appreciate it if you would give serious consideration to contacting the chairman of the F.D.I.C. Board and obtain IMMEDIATE approval instead of waiting for a meeting that may not even take place 10 days from now. Will you please phone my administrative assistant, Steve Callas, on what you can do on this very important matter. I need your help now, Mr. Friedersdorf.

Sincerely,

Edward J. Patten

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meeting will be before March 10
= only 2 bd. members
= absolutely dead
= next Friday + Monday - advised Callas 2/27 - NK

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EX

EXECUTIVE
FI2
FG267
FG124

March 2, 1973

Dear Carl:

Many thanks for sending the summary of the regulations which apply to the different types of Savings and Loan institutions. It will be a great help in our Hunt Report work.

With best regards,

Sincerely,

Richard D. Erb
Staff Assistant
to the President

Mr. Carl O. Kamp, Jr.
Acting Chairman
Federal Home Loan Bank Board
101 Indiana Avenue, N.W.
Washington, D.C. 20552

CC: Howard Beasley

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SEP 11 1973
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EXECUTIVE
FO4
MAR 0 6 1973 FG131
FI2

Dear Arthur:

Thank you for informing me about the Board's current review of its policies regarding the regulation of foreign activities of U.S. banks and the regulatory framework of U.S. activities of foreign banks. I would like my deputy, Richard Erb, to remain in communication with the Steering Committee and to provide whatever assistance or liaison you deem appropriate. I look forward to learning of the progress of this effort.

With personal regards,

Sincerely yours,

PETE

Peter M. Flanigan
Assistant to the President
for International Economic Affairs

Honorable Arthur S. Burns
Chairman
Board of Governors
Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

PMF:Erb:ljs 3/2/73

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MAR 7 1973
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RDC

C.F.
FI2

March 6, 1973

ADMINISTRATIVELY CONFIDENTIAL

MEMORANDUM FOR

Honorable Walter Sorg
Acting Director
Office of Minority Business Enterprise
Department of Commerce

I understand that on January 30 the American Savings and Loan League submitted a proposal to OMBE for an $85,000 "add-on" to their existing contract. The purpose of this request is to operate a program to locate new sources of deposits for minority savings and loan institutions.

I am strongly interested in this proposed effort and would greatly appreciate being kept regularly apprised of the progress of this particular proposal.

Thank you for your consideration.

Stanley S. Scott
Special Assistant
to the President

ADMINISTRATIVELY CONFIDENTIAL

cc: Nate Bayer
Edward W. Huffcut

SSS:PAL:lmct

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BB

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**MEMORANDUM OF INFORMATION FOR THE FILE**

EXECUTIVE
FI2
HU2
FG21-17

DATE 3/6/73

LETTER, MEMO, ETC.

TO: Walter Sorg, OMBE

FROM: Stanley Scott

SUBJECT: American Savings and Loan League

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3/21

(1)

MEMORANDUM OF INFORMATION FOR THE FILE

DATE 3/8/73

EXECUTIVE
FI5-4
BE1
HU2
PU2-3
FI2

LETTER, MEMO, ETC.

TO: Hank Paulson

FROM: Stan Scott

Jarrett, ?

SUBJECT: Black Mortgage Companies
Chicago Tribune
Travis, Dempsey

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EX

EXECUTIVE
CO173
IT 19
FI2

March 9, 1973

Dear Bob:

Many thanks for the report on the Bank's relations with Arab countries.

I appreciate your prompt follow-up to our conversation; I'm sure the information will be very helpful.

Best personal regards.

Yours sincerely,

John D. Ehrlichman
Assistant to the President

Mr. Robert E. Wieczorowski
U. S. Executive Director
International Bank for Reconstruction
and Development
International Development Association
Washington, D. C. 20433

JDE:JLH:jlh

bcc: Charles DiBona (with copy of report)

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MAR 10 1973
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EXECUTIVE

FI8

FI2

THE WHITE HOUSE

WASHINGTON

March 28, 1973

Dear Mr. Chairman:

I am writing in response to your letter to the President of March 20, concerning interest rates.

As you know, in December 1971, the Cost of Living Council issued a determination under the Economic Stabilization Act, as amended, that regulations or orders providing for the stabilization of interest rates were not necessary to maintain interest rates at levels consonant with orderly economic growth. That determination remains in effect. On October 15, 1971, I established the Committee on Interest and Dividends to carry out a program for obtaining voluntary restraints on interest rates and dividends. This committee continues as part of Phase III of the Economic Stabilization Program.

As you point out, some interest rates have increased sharply in recent months. In particular, these are market rates on short-term business credits, and bank rates on loans to business firms, which generally move in parallel with market rates. These increases in interest charges are a direct outgrowth of the vigorous expansion in business activity that is taking place. Such increases cannot be avoided if we, the Administration, and the Federal Reserve System are to honor our responsibility to maintain a sound economic policy -- and healthy financial markets. I am determined to prevent the economic expansion from running away with itself and creating much more serious inflationary pressures, much higher interest rates, and a subsequent recession.

While some interest rates have expanded sharply, many others have remained close to or even below the levels that existed prior to August 15, 1971. This is especially true of rates on long-term borrowings, such as home mortgages, corporate bonds, and municipal bonds. It is also true of interest rates on consumer installment credit.

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The Committee on Interest and Dividends will take every action necessary to insure that interest charges do not move to levels that are inconsistent with our economic objectives. I will not permit excessively high interest rates or any other economic maladjustment to prevent the economy from returning to full prosperity and reasonable price stability.

Sincerely yours,

George P. Shultz

George P. Shultz
Assistant to the President

Honorable Wright Patman
Chairman
Joint Economic Committee
House of Representatives
Washington, D. C. 20515

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EXECUTIVE
FG 267
FI 2

April 4, 1973

MEMORANDUM FOR: PETER M. FLANIGAN

FROM: RICHARD D. ERB

Attached is the latest summary of legislative proposals stemming from the Hunt Commission. We hope to have a Troika meeting next week to obtain approval for these proposals. I heard indirectly that you were opposed to equity ownership by commercial banks. As the proposal now stands (see page 3, II 5), banks would be allowed only an indirect equity participation in connection with a loan -- e.g. an equity kicker in the form of a warrant. Once the warrant is converted to equity ownership, the equity must be sold within 18 months.

Do you want to discuss these proposals at some time?

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EXECUTIVE (2)

FI2
FI8
FG124

Dear Mr. Kamp:

Thank you for your letter of April 3 informing the President of recent developments in the savings and loan industry. Of special interest were your comments on recent mortgage interest rate increases.

With best regards,

Sincerely,

Kenneth W. Dam
Executive Director
Council on Economic Policy

Mr. Carl O. Kamp, Jr.
Acting Chairman
Federal Home Loan Bank Board
Washington, D.C. 20552

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APR 7 1973
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THE WHITE HOUSE
WASHINGTON

4-4-73

To: Dick Erb

From: Kenneth W. Dam

How has this kind of thing been handled in the past?

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THE WHITE HOUSE
WASHINGTON

4.3.73

TO: Ken Dam

For appropriate handling

Robert D. Linder

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7

FEDERAL HOME LOAN BANK BOARD

WASHINGTON, D. C. 20552

101 INDIANA AVENUE, N. W.

OFFICE OF
THE CHAIRMAN

FEDERAL HOME LOAN BANK SYSTEM
FEDERAL HOME LOAN MORTGAGE CORPORATION
FEDERAL SAVINGS & LOAN INSURANCE CORPORATION

April 3, 1973

RL

The President
The White House
Washington, D. C.

Dear Mr. President:

The Nation's savings and loan associations report February data reflecting two trends in home financing activity that should be noted with some concern. There has been a considerable slackening off in savings flow and the average effective interest rate on conventional home mortgages continues a slight upward trend that began last year.

For the month of February, net new savings (exclusive of interest credited) of insured institutions is estimated at only $1.6 billion compared to $2.7 billion in February 1972. This is the smallest inflow, on a seasonally adjusted basis, since the fall of 1970.

A Federal Home Loan Bank Board March report announced that the February average effective interest rate on new home loans was 7.69 percent, two basis points higher than in January. The average effective interest rate on existing homes for February was 7.61 percent, one basis point increase from the previous month. At last month's averages, effective rates for new and existing home loans were 18 and 19 basis points above the lows of last spring, but 15 points less than the most recent highs reached in the fall of 1971.

The Board believes that last month's small increase in the effective rate for home loans is a continuation of the slight upward trend that

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has persisted since last spring as a result of both rising market interest rates and a shift to lower downpayment loans.

The Board also took action last month to liberalize credit for member savings and loan associations in forty-four counties within six states. The basis for the Board's action was a White House national disaster declaration finding that properties in the areas concerned were severely damaged from natural causes. The Board recommended that Federal and State chartered institutions serving the designated areas be prepared to extend leniency and forbearance to borrowers whose abilities to meet contractual commitments have been impaired due to storm and flood damage. The Federal Home Loan Banks in the affected areas were authorized to modify existing limitations on credit to member institutions to help them meet the needs for repair, rehabilitation, or reconstruction of damaged properties.

Sincerely,

Carl O. Kamp, Jr.

Carl O. Kamp, Jr.
Acting Chairman

CEP #4-4

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(4

MEMORANDUM OF INFORMATION FOR THE FILE

EXECUTIVE
FG 124
PE 1
FG 17-5
FI 2

DATE 4/3/73

LETTER, MEMO, ETC.

TO: Kenneth Dam

FROM: Richard Erb

SUBJECT: Attempted extortion involving Federal Home Loan Bank Board employee

Fidelity Savings & Loan

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Special Files

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EXECUTIVE
FG120
FI2

4/7/73

Dear Mr. Wille:

The President has asked me to thank you for your summary of 1972 Federal Deposit Insurance Corporation activities. I admire your success in handling some difficult problems, including the Bank of Commonwealth situation. The continued progress of the FDIC is most encouraging and I appreciate your keeping us informed.

With best regards,

Sincerely,

Mr. Kenneth W. Dam
Executive Director
Council on Economic Policy

Mr. Frank Wille
Chairman
Federal Deposit Insurance
Corporation
Washington, D.C.

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EXECUTIVE

IV/1973/ST13(Champaign)
FI2

May 7, 1973

Dear Senator:

This is to acknowledge and thank you for your May 2 letter to the President endorsing the invitation extended to him to speak at the 50th anniversary of the Federal Intermediate Credit Bank and the 40th anniversary of the Production Credit Association on September 19 in Champaign, Illinois.

The President very much appreciated your letter of endorsement, but feels that he cannot make a commitment at this time for an event in September. Therefore, Mr. David Parker has written to Mr. T. R. McGuire in this regard and suggested that, if he would like to renew the invitation at a later date, it would receive every consideration.

With warm regards,

Sincerely,

Tom

Tom C. Korologos
Deputy Assistant
to the President

Honorable John L. McClellan
United States Senate
Washington, D.C. 20510

bcc w/incoming to Dave Parker - for appropriate handling

TCK:EF:jk

/0

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MAY 8 1973
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FSM/

(1)

EXECUTIVE
IV/1973/ST 13 (Changing
FI 2

May 9, 1973

Dear Senator:

Thank you for your letter of May 7 endorsing the invitation extended to the President from various officers and members of the Federal Intermediate Credit Banks of the Farm Credit System to speak at their 50th Anniversary meeting in Illinois on September 19, 1973.

I understand from the President's scheduling office that it is not possible for the President to commit his schedule for a date so far into the future and we have advised the members and officers to this effect. The President has asked that they resubmit their request again in July when his invitation schedule will be more committable. You may be sure, however, that I will bring your interest and endorsement to his attention.

With warm regards.

Sincerely,

Tom

Tom C. Korologos
Deputy Assistant to the President

Honorable Charles H. Percy
United States Senate
Washington, D.C. 20510

bcc: David Parker w/inc -- FYI only
cf

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EXECUTIVE
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May 10, 1973

MEMORANDUM FOR: ARTHUR BURNS

FROM: PETER M. FLANIGAN PMF

You will recall that we discussed in the past the adverse effect on US jobs and balance of payments from the massive move abroad by so many US financial institutions. The attached Wall Street Journal article restates the reasons and the effects most cogently.

I recognize that we are already working on some of the inhibitions to doing this banking business at home. You have clearly pointed out the dilema in making legal foreign branches of our domestic banks. However, given the fact that US banks are going to operate abroad in any event, in order to do their foreign business under less stringent requirements than the Fed imposes for the domestic business, I wonder if it is not in our interest to solve the dilema in such a way that the business can be done at home.

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EXECUTIVE
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July 19, 1973

Dear Chairman Bomar:

Thank you for your letter of July 2 with information regarding current trends in nationwide savings and loan associations. It is encouraging to note the increased volume of savings flows into thrift institutions as well as the activity in the mortgage lending area.

I appreciate your thoughtfulness in keeping us informed.

Sincerely,

/s/

Kenneth W. Dam
Executive Director
Council on Economic Policy

Honorable Thomas R. Bomar
Chairman
Federal Home Loan Bank Board
Washington, D.C. 20552

Dam:Erb:Ljs 7/19/73

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FEDERAL HOME LOAN BANK BOARD

WASHINGTON, D. C. 20552

101 INDIANA AVENUE, N. W.

FEDERAL HOME LOAN BANK SYSTEM
FEDERAL HOME LOAN MORTGAGE CORPORATION
FEDERAL SAVINGS & LOAN INSURANCE CORPORATION

THOMAS R. BOMAR
CHAIRMAN

July 2, 1973

The President
The White House
Washington, D. C. 20510

Dear Mr. President:

Last month's reports from the Nation's savings and loan associations reflect trends that indicate a continuing active residential mortgage market at near historical levels in the private sector of the country's housing industry.

Evidence of this activity is seen in the increased volume of savings flow into our member thrift institutions, mortgage lending at near record levels, and a sharp upward rebound of private housing starts.

These and other residential mortgage market trends from last month's data follow:

Savings Flow

The flow of savings into savings and loan associations improved substantially in May, after dropping to the smallest volume in two and one-half years in April. It appears this trend will continue at about the May pace into early June. The $1.7 billion of net new savings receipts at insured associations last month was 17 percent smaller than in May 1972. This modest falloff reflects high consumer spending and rising interest rates on marketable securities which are alternative investments for many savers.

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Mortgage Lending

Mortgage lending by associations continued in near record volume last month. It totaled $5.3 billion, 18 percent more than a year earlier. To achieve this lending volume, member associations continued to supplement funds supplied both by savers and from loan repayments, and borrowing from the Federal Home Loan Banks. Outstanding commitments for future mortgage lending increased less than seasonally last month because of the reduced savings flow, but were at a record $14.8 billion at the end of May.

Net Borrowing

Net borrowing by associations and other member institutions from the Federal Home Loan Banks totaled $0.7 billion in May, somewhat less than the record $1.0 billion volume in April. Federal Home Loan Bank credit increased nearly $0.4 billion further in the first two weeks of June, bringing the total to $10.5 billion, only slightly below the all-time high of December 1969.

Interest Rates

Effective interest rates on conventional mortgage loans closed rose from 1 to 9 basis points between early April and early May, following several months of relative stability when other long-term interest rates were rising. Private housing starts rebounded to a seasonally adjusted annual rate of 2.43 million units in May, from the relatively low 2.10 million units total in April. The Board believes that this does not appear to reflect a reversal of a basic downward trend.

There were several areas of significant regulatory activity announced by the Board last month. They were:

A Board announcement of intent to increase the amount of savings permitted to be held in the form of large Certificates of Deposit (over $100,000) from 3 to 5 percent of total savings.

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Withdrawal from consideration at this time of certain regulatory amendments relating to variable interest rate mortgage loans first proposed on July 8, 1972.

Discontinued from consideration of previously proposed amendments relating to authorizing Federal associations to collateralize public unit savings deposits.

Adoption of regulatory amendments to implement statutory amendments on Federal Savings and Loan Insurance Corporation insurance premiums and approval of conversions upon enactment of those amendments.

The Board has received and responded to numerous Congressional inquiries from the States of Illinois and West Virginia regarding the Board's action in permitting Federal savings associations to open branch offices on an "allegedly" more liberal basis than state-chartered associations in those two States. The Board has concluded that these two States allow de facto branching by competing financial institutions regardless of the liberal terms of State law and that the Board's branching policy for Federal associations in these States is necessary for competitive reasons and to meet the housing and saving needs of the residents of these States.

Last month the Board approved 61 savings and loan branch office applications. It also approved 13 merger applications.

In its continuing developmental projects with other Federal agencies affecting the Nation's housing industry, the Board last month participated in an important meeting at the Office of Management and Budget to formulate recommendations on the Report of the Hunt Commission. The Board has submitted an extensive and detailed report for Administration consideration.

The Board also continued to monitor progress of interest rate control regulation authority proposed by Congress. It developed a draft bill which would authorize issuance of stock charters to thrift institutions by the Board and authorize it to exercise specified Securities and Exchange Commission authority pursuant to Section 12(i) of the Securities and Exchange Act of 1934.

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Finally, last month, as in previous reports, the Board asked its Regional Banks to aid with liberal credit and forbearance on existing mortgage loans for all those families who had suffered damage to their homes from natural disasters proclaimed as such by Presidential announcement.

Sincerely,

Thomas R. Bomar

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EXECUTIVE
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FG 12
FI 2

THE SECRETARY OF THE TREASURY
WASHINGTON 20220

August 1, 1973

MEMORANDUM FOR THE PRESIDENT

Subject: Proposed Legislative Changes for Financial Institutions

In early 1970, following the credit crunch of 1969, you established a Presidential Commission to study the problems of the banking and savings and loan industries. The Commission, under the chairmanship of Reed O. Hunt, delivered its recommendations to you in December of 1971. For the past 18 months, an inter-agency task force under the leadership of Treasury has studied the recommendations and discussed them at length with industry and consumer groups.

This effort has resulted in the enclosed suggested policy decisions which have been unanimously agreed upon by the Troika.

It is hoped to be able to announce the decisions via a Presidential message in the very near future (perhaps Thursday, August 2) with the specific legislation to follow early in the Fall. Congressional consultations have already been held with the leaderships of the affected committees (Sparkman, Tower, Patman, Widnall, Mills, Long, Schneebeli, and Bennett).

The objectives of changing the powers of the financial system are to increase competition, improve the viability of the financial system, reduce the necessity for the federal government to bail out the industry in times of tight money, and to provide the consumer with better service and a fairer return on his savings.

The basic thrust of the legislation would be to broaden the lending powers of savings and loans (e.g., consumer loans and corporate bonds), to allow savings and loans to accept

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EXECUTIVE
FG6-11 Calhoun, John
FG6-11-1 SCOTT, STANLEY S.
FG6

AMERICAN SAVINGS AND LOAN LEAGUE, INC.
5505 FIFTH STREET, N.W. • WASHINGTON, D.C. 20011
(202) 723-8912

August 8, 1973

Mr. Stanley Scott
Special Assistant to the
President
White House
Washington, D. C. 20005

Dear Stan:

The American Savings and Loan League formally extends to you this invitation to serve as its luncheon speaker on Saturday, November 3, 1973 in Houston, Texas. The Conference-Convention will be housed in the Whitehall Hotel from November 1-4, 1973 and marks the twenty-fifth anniversary of the founding of the League. Your secretary was kind enough to promise via telephone to enter the date on your calendar, subject to your final confirmation.

Sixty-one minority savings and loan associations comprise the membership of the American Savings and Loan League - 44 Black, 14 Mexican-American, 2 Asian-American, and one Puerto Rican. It is our expectation that your audience will number 200 persons, with strong representation from the member associations, as well as other interest groups and guests.

A suggested topic for your speech is "The Administration's Program for the Growth of Minority Financial Institutions," with special attention to the savings and loan field. Of course you may adjust or adapt the presentation to your best interest and within your best judgement.

Transportation, hotel accommodations, and other expenses which you believe will be connected with the trip will be borne by the League for both you and your wife. We would be pleased to have you come in on Friday to be with us and Mrs. Scott would particularly enjoy the special ladies' tour of Houston and luncheon which has been planned. My wife Beth hopes that she will join her.

Among our Friday speakers are Councilman Judson Robinson, Jr. for the city of Houston, Congressman Charles B. Rangel, Norman Strunk (Executive Vice President of the United States Savings and Loan League), and Alex Armendaris (from whom we have a partial commitment). Workshops fill Friday afternoon; Friday night is "on the town", and the Saturday dinner features Julian Bond as the main speaker. We earnestly hope that you will consent to be the Saturday luncheon speaker.

Please let me know as soon as possible.

Sincerely,

French F. Stone
Executive Director

FFS:jc

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August 29, 1973

Colonel Jerry Asher, Republican State Central Committee, 403 Victoria, San Clemente - telephoned and left the following message for the President:

"I have been taking a sampling of Republican, middle class, and moderate public opinion in Southern California, Virginia and Kansas. It appears that it is to the best advantage of the President and his Administration (and the Republican Party) that he continue to highlight his statement of "no resignation" and continue to fight the bad publicity by exercising active leadership in the stype of Theodore Roosevelt - reaffirming such matters as a stronger defense, maintaining and improving the Panama Canal - considering the skepticism of the knowledgeable public toward Russia, Red China and other Communist nations who continue to seek destruction of the United States -- clearly showing that the President is active in the national interest in dealing with foreign powers.

As to the economy the unhappy public expects more vigorous antitrust action against national and international corporations in restraint of trade and lower taxes.

The majority of the voters are aware that the international bankers frequently do not act in accordance with the public interest. "

Your loyal campaigner,

/s Jerry Asher

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met w/ Erb. 9/5/73

THE FIRST BOSTON CORPORATION
MEMBER NEW YORK STOCK EXCHANGE, INC.

ROBERT M. BAYLIS
VICE PRESIDENT

20 EXCHANGE PLACE
NEW YORK, N.Y. 10005

CABLE: FIRSTCORP, N.Y.

August 29, 1973

Dr. Richard Erb
Room 217
Old Executive Office Building
Washington, D. C.

Dear Dr. Erb:

I am looking forward to visiting with you at 8:30 on September 5 and I will come to your office as you suggested.

As I mentioned, First Boston has been interested in financial institutions for some time and I am enclosing several materials which hopefully demonstrate this. The first is some thoughts of mine on bank capital written in 1969; the second is a description of Bancompare, which is a tool for the analysis of publicly owned bank stocks which we helped to develop; and the third is a report prepared recently by one of our analysts on mortgage flows.

I am looking forward to seeing you next week.

Sincerely yours,

Robert M. Baylis

Enclosures

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# Observations on Capital Planning for Commercial Banks

At First Boston Corporation, we make markets in bank stocks, and so we still consider commercial banking institutions as relatively free enterprises. The banking industry may be on the fringe of a whole new environment in which the entire fabric of the industry will change, but I believe that commercial banks will continue to be owned by private individuals rather than the government. The profit motive will be a large ingredient of this owner's objective, and earning a return on capital that compares favorably with at least some other businesses will be essential if a bank is to attract and retain outside capital. It is the task of management to insure that the most efficient use is made of the most appropriate type of capital.

## Capital Objectives

First, I must give my definition of the role of bank capital. Capital is the base on which the activities of the bank stand. Invested capital demonstrates the stockholders' underlying good faith in the management of the bank. It is required to face both customers and competitors in day-to-day business. Second, it provides the depositor some assurance beyond the FDIC that he is protected against reasonable swings in asset value. Third, the capital base gives the portfolio manager and loan officer the flexibility to take risk. Finally, to the bank's own stockholders, capital is an investment which is to earn the greatest possible return over a reasonable period of time.

The rate of return earned is a function not only of income but also of the size of the capital investment and the type of capital employed. Today, bankers are improving their ability to budget and control income levels so that the earnings figure produced at the end of any year is no longer supposed to be an accident or a surprise. The same degree of attention should be given to the capital accounts to result in the most effective balance of both internal and external sources.

## Capital versus Funds

In analyzing the capital accounts, it is important at the outset to distinguish between capital and invested funds. Capital in a commercial bank includes equity capital, long term debt and free reserves but does not include funds purchased on the money desk for day-to-day operations. Bank capital, therefore, is not nearly as large in relation to total assets as in nonfinancial industries.

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In manufacturing industries, equity and long term debt securities are required to support all long term earning assets, and, in principle, only working capital items of a current nature are financed with short term liabilities. In the banking business, deposits still provide by far the greatest source of invested funds. We know that most deposit liabilities have a degree of stability and we rely on this in investing in long term assets, but a bank's capital base takes on the risk of meeting these depositor's demands on the liability side of the balance sheet if they are greater than can be provided for on the asset side. Obviously, on a leveraged basis, capital can only cover a limited amount of demands, and hopefully you can avoid this risk entirely with a good portfolio defense.

The regulatory bodies that presently watch over bank balance sheets do so mostly from the point of view of depositor safety. The Federal Reserve and Comptroller of the Currency have some complex formulas to determine what amount of capital is required for any given bank. This capital, together with reserves, is often 10% of deposits or even less. To this extent, the capital funds obtain leverage and every dollar the stockholder has invested can support something like $10 of funds.

Invested funds are the raw materials used to build the total asset house and they must rest on a foundation of permanent capital. In maximizing the return on this total investment in the asset house, we do not necessarily maximize the return on the capital base. Although it is satisfying to earn more on assets than your competitor across the street, if you have twice as much capital, you may not be serving your stockholder as well.

Occasionally, a bank may be tempted to raise long term capital when the rate is equal to that for short term investable funds. However, if you are netting 1% on assets and 10% on capital, the stockholder's rate of return will be diluted unless any new capital dollar can earn 10% net after taxes and all expenses. Since an asset dollar need only be invested at 1%, most capital dollars are brought in with the idea of obtaining full deposit leverage. If nine dollars of deposits are obtained based on the dollar of capital, it will again only be necessary to earn a 1% net return on the new investment. The point I am making here is that it is not appropriate to raise long term capital funds merely because the market looks attractive but it must be done in the context of a present or future capital requirement.

Risk

If the basic operating function of the capital base is to take on a risk, the potential investor will evaluate these risks in order to determine what return is required in compensation. Therefore, his weighing of this risk-reward relationship is closely linked to the cost

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of new capital. This investor is examining not only the risk of loss of his capital but the risk of having it immobilized at unsatisfactory returns for long periods of time. There are at least two types of risk: first, a long term risk or business risk, that is to say possible loan losses or losses in the securities portfolio and, second, an interest rate risk. It is this latter risk which figures into the liquidity requirement so prominently discussed today and which is further complicated by fiscal and monetary policy.

Meeting liquidity requirements today involves liability management as well as asset management. Banks are learning not only to have funds available to cover volatile deposits but also to compete in the markets for various types of funds. Efficient liability management allows a bank to make use of all types of sources of funds from demand deposits to commercial paper.

As rates have risen in recent years, it has been increasingly tempting to take an interest rate risk and lengthen the portfolio and perhaps even lower the quality of municipal holdings. Although in the long run the returns earned on these investments may turn out to be attractive, at the present time such aggressive policies have put pressure on capital. At the end of 1968, we did a study of the securities depreciation among 35 major banks. At that time, total depreciation was equal to 10.5% of capital and it is undoubtedly higher today. We know one large bank not included in this study in which depreciation was very nearly equal to capital. To some extent a bank's liquidity position can be measured in terms of its ability to take losses. In the case of the latter bank, they must hold the majority of their securities until maturity, and liquidity is scarce or nonexistent.

In recent years asset management has referred to the problem of dealing with continually increasing demand for loans and in many cases it has simply meant a loan control policy. However, this may be changing. We now see a new philosophy developing involving a broader choice of asset alternatives. Those banks that are concentrating on maximizing the stockholders' return rather than loan volume have even found themselves deciding to buy a few municipal bonds. In the future some banking institutions may allocate an increasing volume of investable funds to areas such as equipment leasing and small business investment. These vehicles for capital gains are more difficult to evaluate and to compare with fixed income alternatives, but, in many cases, they may offer higher returns in spite of higher risk. Planning for adequate capital here is an extremely delicate task, just as in the previous case of substantial security depreciation. When these kinds of risks are incurred, the possible effect on capital must be considered.

## Capital Adequacy

It is impossible to generalize as to what constitutes adequate capital for an "average bank". To give you some perspective on my point of view on capital adequacy, I find that most banks who talk about raising additional capital are generally over-capitalized in spite of all the

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loan, deposit and capital ratios we work out. It is a mistake to build the capital base, or the foundation for an asset house, without studying resources available and asset opportunities to build the rest of the house. Capital ratios of commercial banks in the United States are considerably higher than those in other countries. It is true that in many of these other countries the banking systems are structured differently and banks are even government-owned; but it might also be said that the Federal Reserve System is making some operating decisions for banks in this country. There is an increasing impact of monetary policy on individual banks, and it is certainly assumed that the Fed will be able to help any major institution that is placed in real difficulty because of an unreal market situation created unilaterally for the Fed's own objectives. Nevertheless, this does not eliminate management's responsibility to maintain adequate capital.

The number one determinant of a capital deficiency is a comment from the bank examiner. Supervisory demands for increased capital can only be postponed for a limited period of time. The second factor is pressure for a good image with the bank's customers, depositors and stockholders. A third determinant is the management's own judgment related to a projected level of deposits, loans and assets. The latter is often more an exercise of forecasting the examiners' requirement, but it is essential to anticipate these requests and analyze them in advance.

Dividend Policy

The primary source of capital is retained earnings and this brings us to dividend policy. To be justified in retaining any earnings at all, a bank must assume that it has a higher investment opportunity rate than that which the stockholder can earn on his dividend after payment of personal income taxes. Retaining these funds has a cost which relates to the return the stockholder could earn on other investments if he had the funds to invest himself. Presumably, a growing bank will have to raise some kind of equity in the future and increased dividend payments could result in a higher price on the stock and a lower cost of equity at that time. Theoretically, a bank should increase its dividend up to the point at which the resulting increase in market price diminishes sharply.

In today's stock market, most purchases seem to be made for capital gains rather than for dividend income. The major New York City banks are yielding less than 4%. This compares with an 8 1/4% yield available on high-grade corporates which is the highest spread we have ever experienced in recent years. As long as a bank has a respectable yield such as something over 3%, not much will be gained by a dividend increase unless it results in an unusually high yield which today means as high as 5% to 6%.

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Appropriate dividend policy varies from bank to bank and there is no ideal cash payout. Most major banks have retained between 50% and 65% of their old-fashioned net operating earnings, which works out to be a higher percentage of net income when below-the-line items are taken into consideration. Small closely held banks tend to retain more earnings for the tax purposes of their owners and because retained earnings may have to provide most of the equity capital requirement due to the poor market for the stock. A bank that is a member of a holding company will naturally have its dividend policy dictated by the needs of the parent. In a large bank or holding company, the policy should be to increase the dividend within the limits of earnings growth until the stockholder is no longer impressed, and before you incur the risk of an equity capital requirement in the foreseeable future.

As for stock dividends, I consider them a tool to control the dollar market price of a stock. In fact, stock dividends and splits are only a reallocation of values among a new number of shares. Theoretically, the price of a stock should adjust to fully reflect the stock dividend on the ex-dividend date. In practice, however, stock dividends actually tend to give the stock a temporarily higher price. This is particularly true in the case of smaller banks where the market is slow to adjust if it does at all. A stock dividend also gives some stockholders the opportunity to sell off the dividend and treat it as a cash payment. Nevertheless, in the issuance of any stock dividends, care should be taken that the overall market value of the bank's stock is not depressed below a reasonable trading level. We usually think of $30 a share to be a respectable trading level and anything below $10 a share to be approaching the category of a "boiler room speculation".

To summarize dividend policy, let me repeat that there is no general rule to be followed in today's market and some banks may find less tangible reasons than I have described to set their dividend. Today, many banks could appropriately postpone an equity capital requirement and obtain more flexibility in the use of retained earnings through additional outside capital.

## Cost of Capital

In choosing a source of outside capital, a first consideration is usually to obtain the lowest cost capital. There is wide disagreement today as to how to measure the cost of various types of capital. However, it should be clearly understood that all types of capital have a cost, including the retained earnings that we just discussed.

The cost of retained earnings is related to the value the stockholder places on dividends. He may not value dividends as high as capital gains but they have some value. Looked at from another side, the cost per share of retained earnings may be the potential increase a dividend might have on the price of the common stock. This would increase the stockholders' value and also reduce the cost of any new equity that has to be raised. Retained earnings, therefore, are a means of raising equity from present stockholders without the necessity of going through a new issue.

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The cost of new equity, that is a stock issue, is a function of the future earnings that the stockholder gives up by issuing new shares and the current price at which the shares could be marketed. This is demonstrated in the following extremely rough example. If a bank has an earnings to market yield of 8%, this approximates the earnings that must be generated for every new dollar invested. The cost is something in the neighborhood of this 8% or more if higher earnings are expected in future years. This is an after-tax cost and compares with a cost of 4% on an 8% straight debenture assuming a 50% tax rate. In this example, the per share cost of new equity is at least twice that of straight debt.

It is probable, therefore, that a bank that has the capacity to sell debt securities will be able to raise capital at a lower price than one that must use common stock. Convertibles or warrants also involve the sale of common stock, but, in these cases, the amount of earnings dilution may be reduced and the time of impact postponed.

We have found recently that the use of a convertible debenture rather than a straight debenture can often result in saving a quarter to a third of the interest cost. During 1968, when many convertibles were sold with a 5% coupon, a similar straight debenture would have had to carry about a 7% coupon. The investor accepts lower current income due to the call he has on the stock. In market conditions such as those that existed in 1968, the conversion price could be 20% over the current market. Although the premium could not be as high in today's market, the possibility of any premium reduces the number of shares to be issued as compared with a common stock offering.

With a convertible security, the price of issuing common stock must eventually be paid, but it is to the stockholder's advantage to pay this bill as much later as possible. As long as the convertible pays a significantly higher income than the underlying common stock, the holder will not convert. In fact, there are other advantages to owning a debt security rather than common stock which might keep the debenture out even when the common stock dividend exceeds the interest coupon. The impact of conversion on the market price of the stock is somewhat anticipated in the market prior to conversion, but it is still considerably later than would have taken place in the sale of common stock.

Although we have just claimed convertible securities are a cheaper way of selling common stock, at the same time it can be shown in most markets that a convertible debenture is more expensive than a straight debenture in spite of the interest saving. A calculation is done comparing the present value of the interest saving while the convertibles are outstanding with the effect of earnings dilution in a future year. In an example where the conversion takes place within ten years and the bank is growing in the neighborhood of 6% to 8% per year, the cost of convertibles will appear higher than straight debt even if the coupon saving is 2%, that is, a reduction from a 8 1/2% to a 6 1/2% coupon. In addition, the accounting profession now shows the effect of conversion on earnings per share in published material. This undoubtedly increases the effect on the market price of any impending dilution and raises the cost of convertibles.

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Why then are banks all doing convertibles? In spite of the cost factor, bank managements pride themselves on having a sense of market timing. They have been embarrassed to come into the market of the last two years to raise debt at 7% to 9%, and, consequently, convertible debentures have predominated. Even though the convertibles may turn out to be more expensive, they could be done at substantially lower coupons, and with a ten-year noncall provision this approach may be appropriate.

As an extreme step to reduce earnings dilution when the issuance of common is mandatory, a debenture with warrants attached would probably require much less common stock. Warrant premiums in the past have been equivalent to a 50% premium on a convertible. This is due to the attractiveness of the leveraged position of the warrant. However, this type of security has not been commonly used in commercial banks unless they have been unseasoned or in difficulty, and there is some question as to the impact it would have on the bank's image.

Preferred stocks have a "bank holiday" ring to them similar to warrants. Convertible preferreds are readily used for tax-free exchange offers, and we have even seen a convertible preferred convertible into another preferred. Straight preferreds, however, sell at only slightly lower yields than debentures and the dividend is paid after taxes and cannot be expensed like the debenture coupon. The advantage of the preferred is that it is fairly permanent leverage on the common equity. The disadvantage of both preferreds and warrants is that no major institution has had the courage to lead the way in giving them respectability. Consequently, these securities seem to make most sense for banks that cannot come to market with a simple debt security.

Debt Capacity

The importance of debt securities as sources of capital to the U. S. commercial banking system is clearly indicated by the two billion dollars worth that has been issued by Federal Reserve members. This has all been done since December of 1962 when the Comptroller of the Currency ruled that they could be used to supplement the capital accounts of national banks, and you should be further impressed by the fact that debt securities accounted for 18% of member banks' total additions to capital from 1963 to 1968 even including the additions from retained earnings. In both 1964 and 1965 debt accounted for over one-third of capital additions again including retained earnings.

The capacity any bank or bank holding company has to carry debt in its capitalization depends on a number of factors. These include the breakdown of assets, asset quality and maturity, and the nature of the liabilities. They also include the characteristics of the bank's market area, the overall size of the bank, and the reputation and apparent competence of management. For most well-run banks with reasonable market diversification, a 25% ratio of debt to total capital funds including the loan loss reserve is now accepted as appropriate. This ratio might

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be pushed as high as 33 1/3% if a considerable part of the debt outstanding is related directly to real estate. It should be kept in mind, however, that it is not advisable to fully utilize the debt capacity of the bank or holding company in one offering unless it is expected that this capacity will be increased in the near future. This is simply the old precaution to reserve some long term borrowing power for bad times.

As to fixed debt limitations, in the case of a national bank, the Comptroller of the Currency has a fixed regulation as to maximum borrowings. As you know, this is 100% of capital stock and 50% of surplus. In addition, there also may be debt limitations in indentures that are outstanding. To date, however, marketing considerations generally restrict the issuance of debt before these fixed maximums are reached. I am speaking here of the maximum amount which can be issued without noticeably raising the interest cost above current market levels. It may often be possible to do higher amounts at a penalty rate but this seems unwise for a banking institution.

Unfortunately, bankers are often disappointed with their rate anyway. Bank and bank holding company debt securities have experienced relatively poor markets and have generally been sold at interest costs noticeably higher than current AA or AAA markets. There are a number of reasons for this. First, this is a new type of security which is experiencing the same educational problems as was faced by the World Bank some years ago. Second, all of these straight debentures were introduced to the investment community in a declining market and are now selling at discounts. Third, bank competition has reduced trust department interest in the securities of other banks. That's your friend across the street again. Fourth, the market has been limited significantly by legal limitations on some types of institutions such as savings banks and pension funds. And fifth, the two major rating agencies do not rate bank securities.

In summary, it appears that market conditions favorable to the issuance of bank debt may vary and that there are limitations on how large an issue can be marketed at any one time as well as on the overall debt capacity of a bank. These issues must be fitted into a long range plan to meet bank capital requirements.

Long Range Planning

Capital planning, of course, cannot be done in isolation. To be most effective, it must be a part of a bank's overall profit planning and control mechanism. In the last decade, many banks have begun to talk about techniques of forward planning. These tools have been developed much more fully in many other industries where better coordination of knowledge has enabled effective planning of overall business strategy, but progress is now taking place in both the banking and securities industries.

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Planning breaks down into two categories: first, strategic planning of the fundamental character and direction of the bank; and, second, operational planning of balance sheet and income items over the next several years. The starting point in developing planning skills on the operational side, is an annual budget which sets goals not only for expenses but also for income items. There is not sufficient time here to discuss budgeting or long range planning techniques in detail but these systems should be considered a major management tool and not just a record keeping process. Every level of management must participate in goal setting and must follow the results.

An ideal budget is generated from a wide spectrum of appropriate profit centers where individual middle managers can become involved in fitting their area's capability and profit potential into the overall profit goal. The next step after the one-year budget is probably a less detailed but equally carefully prepared long range profit plan. This should look into the future at least three years and perhaps five years or more. It involves forecasts of business opportunities, staff requirements, occupancy requirements, and the expected demand and supply of funds. Underlying the basic business model is the forecast of capital requirements and the potential sources of different types of capital.

It might appear that the simplest way of meeting capital needs would be to go to the market at the end of each year to upgrade the capitalization to the extent required. Unfortunately, this is not possible. It is disruptive to the bank's image to be continually in the market for capital funds, and, secondly, a trip to the market is expensive and should be made only in meaningful increments. These steps can be planned after the long range asset and liability projection has generated expected capital requirements. The bank, then, can plan to raise capital in anticipation of its present and future needs. In the projection of capital requirements, it will also be possible to estimate debt capacity in future years and to determine how much of the requirement can be satisfied with this lower cost form of capital. The whole process is simply a question of looking beyond the day-to-day operations. It is not desirable to increase capital too far in advance of the need as this can result in some dilution of earnings until you can generate your full deposit leverage. However, some anticipation is necessary to insure against having to come to market during unfavorable market swings.

While taking this forward look, consideration should also be given to the capital requirements that may arise in the event of a change in the scope of banks and bank holding companies due to new legislation. There is also the possibility of utilizing capital funds abroad. This is not to say that any of these funds should be raised immediately but some flexibility must be preserved in the capitalization of an industry which may be subject to as many changes as are now discussed for commercial banking. It is worth thinking about what the next generation of bankers will be doing.

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Specialized Financing

Financing of a specialized nature is often best accomplished through separate subsidiaries in a holding company or possibly in the bank itself. These might include: real estate, factoring, leasing, or consumer loans. We anticipate that the use of holding companies may enable a greater leverage with long term debt whether they are called "one-bank holding companies" or something else. The use of subsidiaries for short term financing in the commercial paper market is becoming increasingly important in banks and holding companies. As another example, 100% financing of bank buildings with debt securities may be done at a rate that is often better than would be possible with real estate mortgages. In addition, we may even come to the time when outside equity can be raised at high price earnings multiples as a minority interest of a subsidiary engaged in some bank related but reasonably exotic businesses. In spite of four decades of FDIC indoctrination some of the next generation of bankers are already here.

To the imaginative banker, a capital deficiency does not always require new capital. In the bank's financial plan, we have to consider not only new additions to capital but also methods to improve the effectiveness of the capital at our disposal. Under the Federal Reserve capital adequacy formula, which is known to all of you, the requirement varies with the nature of the asset mix. As one most prominent example, a bank building requires a dollar of capital for each dollar invested in plant. These dollars, therefore, are unable to receive any deposit leverage, and this investment in bank premises must earn its owner a return of 20 times that of a long term government bond or 8 times that of commercial loans and other portfolio assets. This is a big order and I do not think that there are many buildings which can demonstrate this kind of return.

If the bank building were removed from the balance sheet, this pressure would be removed from the capital. Some years ago, it was possible to put it into a subsidiary of the bank. More recently, it has been necessary to put the real estate subsidiary into a holding company, but today there are some banking institutions that have gone so far as to sell their banking houses and lease them back on long term leases. When a bank enters into a long term lease on its main buildings rather than financing them with long term debt securities, a fixed obligation has been incurred just as if these were interest payments. In today's market, however, these long term leases are not capitalized and, unless total long term lease payments become excessive, the market tends to ignore them in measuring debt capacity. Therefore, whether or not you agree with the theory, at present, by using a long term lease rather than mortgage financing a bank is able to increase its debt capacity.

Some bankers are afraid of giving up the possible appreciation in bank premises. I would contend, however, that if it is realized at all it will be so many years in the future that the present value in today's dollars is very small. In addition, many bank buildings can only suitably be used as banking floors, saloons or roller skating rinks.

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In my view, one of the most important moves that a bank can make in capital planning today is to refinance its building account, possibly giving its depreciation to someone else with a higher tax bracket. We are presently working on a number of new methods of doing this type of financing, and we would be happy to expand on these or other techniques with anyone who is interested.

* * *

In conclusion, the possible combinations in a financing plan are extensive but not endless and they can be analyzed. Capital planning for commercial banks encompasses both long range philosophy and current market know-how. Most banks rely on outside advice from consultants and investment bankers to help them in formulating a planning approach, but "The Plan" must be generated within the bank itself by the people who will make it work. There is no use in raising new capital unless all levels of management are equipped to make the best use of this opportunity. In my view, the banking institutions that will move ahead of their competition in the next generation banking will be those that have a perspective on their business and a strategy for the future.

Robert M. Baylis
Vice President
Research Division

October 13, 1969

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EXECUTIVE
FI2
FG124

September 10, 1973

Dear Mr. Chairman:

Thank you for keeping the President informed on developments in the savings and loan industry and the activities of the Board. Although the actions which you have taken should provide some relief to the housing market, the current pressures faced by savings and loan associations further demonstrate the need for long term structural changes in the industry.

Sincerely,

/s/ Kenneth W. Dam

Kenneth W. Dam
Executive Director
Council on Economic Policy

Honorable Thomas R. Bomar
Chairman
Federal Home Loan Bank Board
101 Indiana Avenue, N.W.
Washington, D.C. 20552

DMM:ERB:ljs 9/10/73

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OCT 25 1973
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THE WHITE HOUSE
WASHINGTON

8.31.73

TO: Ken Dam

For Your Information: _____

For Appropriate Handling: ✓

_____

_____

_____

Robert D. Linder

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FEDERAL HOME LOAN BANK BOARD

WASHINGTON, D. C. 20552

101 INDIANA AVENUE, N. W.

FEDERAL HOME LOAN BANK SYSTEM
FEDERAL HOME LOAN MORTGAGE CORPORATION
FEDERAL SAVINGS & LOAN INSURANCE CORPORATION

THOMAS R. BOMAR
CHAIRMAN

August 30, 1973

The President
The White House
Washington, D. C.

Dear Mr. President:

Two disturbing residential mortgage market trends noted by the Board last month are confirmed in reports received from member savings and loan associations. Savings flows out of member associations exceeded deposits and conventional home mortgage interest rates rose for the third consecutive month.

Despite this unfavorable imbalance between available funds and rising interest rates, the Board's member associations reported over $4.8 billion in home mortgage loans for the month of July. This large volume of mortgage lending to meet a persistent consumer demand for home building funds was made possible by the Board's action of increasing lending from the twelve Federal Home Loan Banks and authorizing reduced liquid asset holding requirements.

The net increase in Federal Home Loan Bank advances to member institutions to meet savings withdrawals and sustain mortgage lending was a record $1.2 billion in July. Total Federal Home Loan Bank System credit advances now stand at over a record $13.1 billion.

These and other pertinent residential mortgage market developments are briefly summarized below:

Savings Flow

The Board's member savings associations reported a July net savings loss of $0.3 billion and this net withdrawal

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trend continued during the first twenty days of August. This was the first monthly savings loss reported since January 1970 and in marked contrast to the $2.2 billion of net savings funds received in July 1972. The Board believes this dramatic outflow of consumer savings from its member associations is a result of recent sharp yield increases on marketable securities and intensified commercial bank competition for those customer accounts in recently authorized higher interest rate certificates of deposit.

Mortgage Lending and Net Borrowing

In the face of continued savings outflow, member associations permitted future mortgage lending commitments to decline by $1.0 billion in July. Total commitments for the year through July were at $13.5 billion. This was 13 percent higher than a year earlier, but 14 percent below the peak reached on a seasonally adjusted basis early this year. Mortgage loans closed in July totaled $4.9 billion, down less than seasonally from June and close to earlier peaks after seasonal adjustment.

Interest Rates

Average effective interest rates on conventional home mortgage loans closed rose in July for the third consecutive month. The increase from early June to early July was 8 basis points for new homes and 5 basis points for existing home loans, bringing rates for both types of loans back to about the level of the fall of 1971, although they remain well below earlier peaks.

Rates on loans closed, however, lag rates at which lenders enter into commitments to make mortgage loans and commitment rates appear to have increased sharply recently.

Private housing starts increased slightly in July to a seasonally adjusted annual rate of 2.12 million units; because of earlier declines, however, the July rate of starts was 13 percent below the January peak and the trend seems clearly downward. If current savings rates trends continue, there will likely be a substantial reduction in housing starts unless corrective action is taken quickly.

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The Board took action in several regulatory areas last month. The most significant of these announcements and proposals were:

An interagency proposal following joint consultation with the Federal Reserve Board and the Federal Deposit Insurance Corporation to insure uniformity of regulation on advertising and disclosure regulations for certificates of deposit accounts.

A proposal to limit member savings association home loans to a "principal" place of residence rather than a second or vacation home.

A proposed restriction on "insider" sales of businesses to member savings association service corporations.

A proposed regulation to permit flexible payment mortgage loans.

Adopted an amendment to lower liquidity requirement for member institutions from 6-1/2 to 5-1/2 percent.

Adopted amendments to Federal Savings and Loan Insurance Corporation insurance premium regulations based on statutory amendments.

Adopted amendments preapproving additional activities and certain joint ventures for member savings association service corporations.

Sincerely,

Thomas R. Bomar

CEP#8-24

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(2)

EXECUTIVE

WH10/FRIEDERSDORF, MAX

FI2

CO160

September 11, 1973

Dear Owen:

Many thanks for sending along a copy of David Rockefeller's interview in World Magazine.

I did see Chase people in London at a luncheon hosted by American bankers. We had a most enjoyable and interesting trip.

With kind regards.

Sincerely,

Max

Max L. Friedersdorf
Deputy Assistant to
the President

Mr. Owen V. Frisby, Vice President
The Chase Manhattan Bank
900 - 17th Street, N.W.
Washington, D. C. 20006

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EXECUTIVE 15
IV/1973/FG 106
FG 19
FI 2
IN

Orig to D Parker
9.24.73
KDR

THE SECRETARY OF THE INTERIOR
WASHINGTON

September 20, 1973

Dear Mr. President:

I mentioned at a recent meeting, that a particularly innovative program was being put together which involved the establishment of an American Indian National Bank. I have been aware of this program for some time and, my Department together with the Department of Commerce, have assisted in activities directly related to the establishment of this Indian owned financial institution which is dedicated to improving the economic welfare of the American Indian.

Opening ceremonies, which will include the presentation of a Charter by the Comptroller of the Currency to the Chairman of the Board of Directors will be held at 1701 Pennsylvania Avenue, N.W., Washington, D.C. at 2:30 P.M. November 15, 1973. Incidentally, this Chairman is W. W. Keeler, a Cherokee, until recently Chairman of the Board of Phillips Petroleum Corporation.

It would be a distinct honor as well as a highly significant symbol if you would participate in these ceremonies of some 15 to 20 minutes duration.

Your presence would not only be of significance insofar as this program is concerned but would be concrete evidence of your continuing concern in assisting minority peoples to participate in the economic growth of this great Nation.

Most respectfully,

Rogers C. B. Morton

The President

The White House

Filed

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(2)

EXECUTIVE

WH10/FRIEDERSDORF, MAX

FI2

CO160

September 11, 1973

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Sincerely,

Max

Max L. Friedersdorf
Deputy Assistant to
the President

Mr. Owen V. Frisby, Vice President
The Chase Manhattan Bank
900 - 17th Street, N.W.
Washington, D. C. 20006

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X (3)

EXECUTIVE
FI 8
FI 2
FG6-16
FG6-3

THE WHITE HOUSE

WASHINGTON

October 11, 1973

ACTION

MEMORANDUM FOR: THE PRESIDENT

FROM: KEN COLE

SUBJECT: Interest Ceilings on Time Deposits

Monday, October 15 is the last day your action on an enrolled bill (S.J. Res. 160) sponsored by Senator Tower and seven others which would require the Secretary of the Treasury and the various Federal agencies which regulate financial institutions to limit the rate of interest paid on time deposits of less than $100,000. The actual ceilings would be left to the discretion of the regulatory agencies.

In order to secure the release of the FHA extension after twelve Senators had placed a hold on this legislation, Bill Simon of Treasury, accompanied by Fred Webber of the White House Congressional Relations Staff, told Senator Sparkman and Senator Tower that the Administration could live with a ceiling on time deposits if it were approached as in S.J. Res. 160. Despite this commitment, Herb Stein recommends that you veto S.J. Res. 160 on the grounds that:

- the current absence of time deposit ceilings provides an attractive inducement to save and thereby helps prevent an outflow of funds from banking and thrift institutions,

- the ceilings would penalize small depositors, while allowing corporations and wealthy individuals with deposits of $100,000 or more to earn prevailing market rates, and

- the enrolled resolution is inconsistent with the Administration's August 2, 1973 financial reform proposals which would phase out interest ceilings on deposits.

RECOMMENDATION

As a result of the Administration commitment to Senators Sparkman and Tower, I join with George Shultz, Bill Timmons, Roy Ash and Jim Lynn in strongly recommending that you sign

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7 gadt

Orig to D Parker 9.24.73 KDL

EXECUTIVE (5)
IV/1973/FG 106
FG 19
FI 2
IN

THE SECRETARY OF THE INTERIOR
WASHINGTON

September 20, 1973

Dear Mr. President:

I mentioned at a recent meeting, that a particularly innovative program was being put together which involved the establishment of an American Indian National Bank. I have been aware of this program for some time and, my Department together with the Department of Commerce, have assisted in activities directly related to the establishment of this Indian owned financial institution which is dedicated to improving the economic welfare of the American Indian.

RL

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It would be a distinct honor as well as a highly significant symbol if you would participate in these ceremonies of some 15 to 20 minutes duration.

Your presence would not only be of significance insofar as this program is concerned but would be concrete evidence of your continuing concern in assisting minority peoples to participate in the economic growth of this great Nation.

Most respectfully,

Rogers C. B. Morton

The President

The White House

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DG

THE SECRETARY OF THE TREASURY
WASHINGTON 20220

EXECUTIVE
FI 2
FI 8
FI 5-4
ST 5
FC6-11-1 / HULLIN, TOD R.

OCT 18 1973

Dear Governor Reagan: Ronald

Thank you for your letter of September 17 to the President regarding the savings flows to savings and loan associations and the home mortgage market in California.

The Administration shares your concern regarding the ability of thrift institutions, which supply the major share of funds to the home mortgage market, to compete for savers' funds in inflationary periods in which interest rates, especially short-term rates, rise sharply. I do not believe, however, that a return to the deposit ceilings in effect before July 5 would solve their problem, since these institutions would still have to compete with security market instruments which are not controllable except at immense cost to the economy.

Under today's regulations, the basic problem of savings and loans, as you point out, revolves around their statutory asset structure. In his message of August 3 to the Congress, the President recommended several ways to improve the economic viability of savings institutions. He proposed to permit them to invest in a limited amount of consumer loans, to invest in commercial loans closely related to housing, and to purchase high-grade private debt securities. In addition proposed legislation would strengthen the home mortgage market by a tax credit that would be related to mortgage lending activity of thrift institutions, commercial banks, insurance companies, pension funds and other investors.

These, of course, are proposals to restructure financial institutions in the longer term. Looking to the shorter run, we have taken administrative actions to increase the availability of money to savings and loans and to the home mortgage

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market. The Federal Home Loan Banks have been authorized to make about $2.5 billion of forward commitments to purchase home loans from member associations. The GNMA "tandem plan" has been reactivated, and we are asking Congress to authorize FHA to insure larger housing loans on a low downpayment basis for single family homes. The FHLB's have already advanced over $6 billion to member associations this year and FNMA has been active in purchasing home mortgages.

We have been limited in our ability to maintain the availability of home mortgage credit, however, by the exceedingly pressing need to restrain overall growth of credit. Inflation is our most important domestic problem, and this Administration firmly believes that the Nation is best served in the longer term by our vigorous efforts now to curb inflation.

Sincerely yours,

George P. Shultz

The Honorable
Ronald Reagan
Governor of California
Sacramento, California 95814

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THE WHITE HOUSE
Council on Economic Policy

Date 10/24/73

FOR: TOD HULLIN

FROM: KENNETH W. DAM

X For your information

_____ Per our conversation

Comment:

2nd Flr., W. Wing
456-6212

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MEMORANDUM

THE WHITE HOUSE

WASHINGTON

OCTOBER 11, 1973

FOR KEN DAM

I understand that Bill Simon has made some commitment on this with Senators Sparkman and Tower when he was pushing for the FHA extender.

This letter should be changed to reflect Simon's commitment.

Additionally, Governor Reagan's correspondence to the President deserves a little special attention, and I feel very strongly that the attached letter should be signed by George Shultz or Bill Simon.

Tod R. Hullin

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October 9, 1973

Dear Governor Reagan:

Thank you for your letter of September 17 to the President regarding the savings flows to savings and loan associations and the home mortgage market in California.

The Administration shares your concern regarding the ability of thrift institutions, which supply the major share of funds to the home mortgage market, to compete for savers' funds in inflationary periods in which interest rates, especially short-term rates, rise sharply. I do not believe, however, that a return to the deposit ceilings in effect before July 5 would solve their problem, since these institutions would still have to compete with security market instruments which are not controllable except at immense cost to the economy.

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Sincerely,

Kenneth W. Dam
Executive Director
Council on Economic Policy

The Honorable
Ronald Reagan
Governor of California
Sacramento, California 95814

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MEMORANDUM

THE WHITE HOUSE

WASHINGTON

SEPTEMBER 24, 1973

FOR KEN DAM

I would most appreciate receiving a copy of the response sent to Governor Reagan to his September 17 letter to the President (copy attached).

Many thanks.

Tod R. Hullin

cc: Jim Falk

CEP #9-15

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RONALD REAGAN
GOVERNOR

Ron Reagan

State of California
GOVERNOR'S OFFICE
SACRAMENTO 95814

September 17, 1973

2536

The Honorable Richard M. Nixon
President of the United States
The White House
Washington, D.C. 20500

Dear Mr. President:

Present events have occurred which places the home-building industry in the State of California in a potentially grave situation.

I am referring to the actions of the Federal Reserve Board, and subsequent actions by the Federal Home Loan Bank Board, which have caused a drastic reduction of funds in the savings and loan associations in our State. Since savings and loan associations are the major supplier of funds for home building in California, these actions on the part of the two Federal agencies have already had a marked detrimental effect on new home loans. This will inevitably damage the real estate industry, furniture and appliance sales, and the myriad of people whose employment and livelihood are dependent upon home construction.

Historically savings and loan associations have been permitted to pay a higher rate of interest on savings than banks. The reasons for this differential are sound and relate to the fact that banks can place their assets in a variety of investments such as business loans, installment loans, bonds, etc., in addition to first mortgage loans depending upon market conditions.

Savings and loans, on the other hand, have no such flexibility but must invest primarily in long-term (typically 30-year) first mortgage loans. They cannot avail themselves of temporary market opportunities and, therefore, must pay a higher rate of interest to assure a steady flow of funds for home building.

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The actions of the Federal Reserve Board and the Federal Home Loan Bank Board have changed these relationships in the following ways:

1. The interest differential on the basic savings passbook account has been reduced from ½% to ¼%.

2. The ceiling on maximum interest rates which can be paid on savings accounts has been removed entirely on accounts which have a minimum of $1,000 and are held at least four years.

The result has been a flow of funds from savings and loans to banks which invest such funds in more lucrative, shorter term, higher interest rate loans and securities rather than providing funds for home building.

If immediate relief for the savings and loan industry is not forthcoming, irreparable damage can be done to all ramifications of California's home building and its related industries.

Sincerely,

Ron

RONALD REAGAN
Governor

P.S. Illegitimus non Carborundum.

cc: Haig-5

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52997

EXECUTIVE
FI2
FG6-20
FG131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ROBERT C. HOLLAND
MEMBER OF THE BOARD

October 26, 1973

Mr. Peter M. Flanigan
Executive Director
Council on International
Economic Policy
The White House
Washington, D.C. 20500

Dear Peter:

Enclosed is a statement of principles regarding mutual nondiscrimination in international banking regulation that our Federal Reserve group has recently developed and adopted. To be more precise, it has been adopted by the Federal Reserve System Steering Committee on International Banking Regulation, which George Mitchell chairs and on which he, I, two other members of the Board and three Federal Reserve Bank Presidents serve.

This statement has not yet been formally adopted by the Board, but George suggested I send it to you to give your Interagency Committee on International Financial Competition a sense of the direction of Federal Reserve thinking on this subject. We expect to use the document to guide the more detailed studies we are making and also our conversations with other central banks and bank regulators. We have not planned to make it public--at least not at this stage--but you should certainly feel free to distribute copies as you see fit among those Government officials who are on your committee or working with it, either for information or for comment.

Yours sincerely,

Robert C. Holland

Enclosure

cc: Chairman Burns
Governor Mitchell
Mr. Erb

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CIEP CORRESPONDENCE PROFILE Gold

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Internal ____

From: HOLLAND, ROBT. C.
TO: Pres ____
PMF X
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SUBJECT: MEMBER OF THE BOARD, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM PROVIDES PMF WITH PAPER "A STATEMENT OF PRINCIPLES REGARDING MUTUAL NONDISCRIMINATION IN THE INTERNATIONAL BANKING REGULATION DEVELOPED AND ADOPTED BY THE FRS"

Originator's Ref. No. ____

Xeroxing Instructions ____

| INTERNAL ROUTING AND DISTRIBUTION | ACTION | INFO | REC CY FOR |
|---|---|---|---|
| ADVANCE CYS TO | | | |
| Executive Secretary | | X | |
| Deane Hinton | | X | |
| Ray Sternfeld | | X | |
| Robert Morris | | | |
| Jon Rose | | X | |
| Gus Weiss | | | |
| Larry Brady | | | |
| John Niehuss | | | |
| Dick Erb | X | | |
| Bill Hawley | | X | |
| SAFIR | | X | |

ACTION REQUIRED

MEMO FOR PMF ( )
MEMO FOR PRES ( )
REPLY FOR PMF SIGNATURE ( X )
( )
MEMO ____ TO ____ ( )
RECOMMENDATIONS ( )
( )
Refer to ____ ( )
ANY ACTION NECESSARY ( )
CONCURRENCE ( )
DUE DATE: NOV 2, 1973 +
COMMENTS: (Including Special Instructions)

| DATE | FROM | TO | S | ACTION REQUIRED | Init |
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EXECUTIVE
FI2
FI8

(2)

# THE WHITE HOUSE OFFICE

THRU: Mr. Len Garment
Special Consultant to
the President

**REFERRAL**

To: Federal Home Loan Bank Board
ATTN: Federal Savings and Loan
Advisory Council

Date: October 31, 1973

## ACTION REQUESTED

__x__ Draft reply for:
_____ President's signature.
_____ Undersigned's signature.
__x__ Mr. Laird's signature
_____ Memorandum for use as enclosure to reply.

_____ Direct reply.
_____ Furnish information copy.

_____ Suitable acknowledgment or other appropriate handling.
_____ Furnish copy of reply, if any.

_____ For your information.

_____ For comment.

**NOTE**

*Prompt action is essential.*
If more than ~~72 hours~~ ten days delay is encountered, please telephone the undersigned immediately, Code 1450. (456-6424)

Basic correspondence should be returned when draft reply, memorandum, or comment is requested.

REMARKS:

None

Description:

__x__ Letter: _____ Telegram: Other:

To: Melvin R. Laird
From: Don H. Clausen, Representative in Congress
Date: 31 Oct
Subject: Savings and Loans Problems

By direction of the President:

LTC JACK WALKER
Military Assistant to Melvin R. Laird

(White House Suspense Copy)

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THE WHITE HOUSE
WASHINGTON

Federal Home Loan Bank Board
(Federal Savings and Loan
Advisory Council) is handling.

"MHL has seen"

THE WHITE HOUSE
WASHINGTON

Recommend forwarding to FEDERAL
Home Loan Bank Board (Federal
Savings and Loan Advisory
Council).

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DON H. CLAUSEN
REPRESENTATIVE IN CONGRESS
1ST DISTRICT, CALIFORNIA
"THE REDWOOD EMPIRE DISTRICT"

WASHINGTON OFFICE:
2433 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, D.C. 20515
PHONE: 225-3311
AREA CODE 202

DISTRICT OFFICE:
206 ROSENBERG BUILDING
306 MENDOCINO AVENUE
SANTA ROSA, CALIFORNIA 95401
PHONE: 545-8844

# Congress of the United States
## House of Representatives
### Washington, D.C. 20515

October 31, 1973

COMMITTEE:
PUBLIC WORKS

SUBCOMMITTEES:
WATER RESOURCES
TRANSPORTATION
ECONOMIC DEVELOPMENT
INVESTIGATION AND REVIEW

COMMITTEE:
INTERIOR AND INSULAR AFFAIRS

SUBCOMMITTEES:
IRRIGATION AND RECLAMATION
NATIONAL PARKS AND RECREATION
PUBLIC LANDS
TERRITORIAL AND INSULAR AFFAIRS

Honorable Melvin R. Laird
The White House
Washington, D. C.

Dear Mel:

Pursuant to my discussion with the President and you last month, I am enclosing several letters I received in response to my request for information on the problems facing savings and loans in my Congressional District.

I was impresssed with the quality of the views I got and I am sure they will be helpful to you in dealing with the problems that have been created.

Enactment of S. J. Res. 160, which the President has signed, will be helpful but, of course, is not the complete answer. Please let me know whenever I can be of assistance to you.

With warmest personal regards.

Sincerely,

DON H. CLAUSEN
Representative in Congress

DHC:g

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Central files

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NAPA FEDERAL SAVINGS
AND LOAN ASSOCIATION

October 22, 1973

Mr. Don H. Clausen
Congress of the United States
House of Representatives
Washington, D.C. 20515

Dear Congressman Clausen,

Thank you for your letter of September 27, 1973 evidencing concern over the current economic conditions affecting our industry.

We are a small, newly chartered Association whose assets are in excess of $6,000,000, and dealing exclusively with Napa Valley people. Our concern is that during the months leading up to June of 1973, our Association made home loans for single family residents between $500,000 and $600,000 per month at an average rate of 7% and 7.50%.

The effect of the interest rise in July and the so-called, "Wild Card", excellerated interest and reduced our loan potential to $200,000 per month at an average rate of 8 3/4%.

It would appear, as the smoke clears away, that the "Domino Theory" has taken over; namely, Associations cannot meet the high competitive rates, no funds available to home purchasers and builders, restricted sales by the realtors, losses of income to the trades people and on and on.

We realize that the depositor whose money we operate with is entitled to a fair and reasonable rate; however, there must be some form of Federal guide lines that would dictate what these rates should be.



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It would be our hope, that when the proper authorities set the rate schedules that the open account at 5.25% is feasible with a maximum rate of 6.75%.

Thanking you again for your interest in our problems.

Very truly yours,

Joseph P. Dillon

Joseph P. Dillon
Vice President

JPD/ds

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MENDOCINO-LAKE SAVINGS AND LOAN ASSOCIATION

Ukiah Office
October 3, 1973

The Honorable Don H. Clausen
Representative in Congress
2433 Rayburn House Office Bldg.
Washington, D. C. 20515

OCT 5 1973

Dear Don:

I am writing in response to your September 27, 1973 query concerning the effects of current "economic problems" on our industry but more particularly this Association. I appreciate your interest and this opportunity to provide input which may assist you and others in better understanding the problems in order that appropriate solutions may be reached.

For the record, this Association has experienced losses of savings capital in each of the last three months (July, August and September, 1973). At all times during this period commencing with the July 5, 1973 authority to pay higher interest rates which was made retroactive to July 1, we have offered the maximum interest allowed by law on insured savings. It is our opinion that the sudden and unpredictable act to increase the legal interest rate on savings capital paid by insured institutions simply aroused an already interest rate conscious saver and aggrevated the issue through creating ruinous interest rate competition in the four year wild card account category, particularly benefiting the commercial banking industry which possesses greater flexibility in investments, not having been restricted by act of law and regulation to long term real property secured lending as are members of our industry.

At the same time this Association and to our knowledge our entire industry which had, prior to July, experienced positive savings inflows were obligated on commitments on new lending including future delivery. To meet these commitments, in view of the complete reversal of savings capital flows (from positive to negative), it was necessary to impose more stringent underwriting requirements on prospective home buyer/borrowers and time and time again qualified borrowers' requests were not considered simply because funds were not available to meet the public's individual housing demands and needs.

We have not observed in our area, at least, any real restraints on housing and loan demand as a consequence of today's high interest rates. Demand simply has not been met due to absence of lendable funds. Housing was viewed



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by a prospective purchaser/borrower as an absolute necessity and the prospect appeared to take the increased interest burden philosophically as just a further increase in his cost of living. A further result of the interference by Government regulation and control in the economic arena is the high rate of appreciation for suitable residential real property and spectacularly high rents on units which were not subject to price control.

It should be recognized that under this system in which our financial institutions are now structured and operating, management's ability to take positive measures are greatly restricted by regulatory controls and the imposition of penalties for not strictly adhering to the same. A good example of such a control is the liquidity requirements imposed on the savings and loan industry which is enforced on a countrywide basis without regard or consideration to the individual requirements and needs of a specific institution or geographical area. In our judgement, the broad imposition of regulations of this nature and others have placed Associations in a position of being a public service institution not unlike that of telephone, electric and power companies where competition is limited by law.

Our industry performs a valid and most desirable service to the individual and the community and from a strictly economic point of view those benefits may be measured in terms of the number of accountholders and borrowers who have selected the savings and loan industry on a competitive basis to meet their needs for financing housing and to reward thrift.

Among other things the Hunt Commission has recommended an eventual conversion of the institutions in our industry to a "consumer banking" status. Adoption of this program as recommended by the President would make our institutions neither fish nor fowl in the sense that we would be neither a bank nor a savings and loan as we know them today. It is our judgement that the Commission's recommendations are mischievious and fail in understanding the nature of the consumer's needs for housing, its related financing and the function of savings and loan associations in bringing this about. I do not recall who said it but certainly the remarks are appropriate: "One fool is one fool, two fools is two fools but 5,000 or 10,000 fools is a history making event."

It is important that we recognize the function of savings and loan institutions, that of encouraging thrift and home ownership (which are national institutions) as public service institutions with profit incentives. Realistically, there is no difference in services performed by one savings and loan association versus another anymore so then a difference in the delivery of electrical power to the residence of an individual user. Under these circumstances, it would appear that charters and branch licensing should be confined to the basic consideration of serving community needs and not to mere political considerations. Long term solutions to the problem can be better accomplished by:

1. Eliminating the fractional reserve system which enables commercial banks to create credit. If credit is to be created under Governmental control as is money supply, etc., it should be created directly by Government and made available at a cost to the user whether it be a reailer or a whole saler or a consumer. And, such credit created should be supported by tangible evidence of wealth.

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2. Allow each institution and its industry to stand on its own merits without Government interference in its operation, thereby providing the consumer or user of those services to cast the ultimate vote as to whether or not the services are needed and desired through the consumer's willingness to pay for them.

3. Eliminate sectional flows of credit by declaring unconstitutional or unlawful any and all restraints imposed by usery laws. For the protection of the consumer, it is essential that ample disclosure be made but the ultimate decision should vest with the consumer.

4. Stop inflation by imposing constitutional restraints on Government spending so as not to exceed revenues except instances of national emergencies or national defense as may be established by Act of Congress and cease the practice of monatizing debt.

Don, I hope I have not gone too far afield in this response. The foregoing points, though, are very real and I believe merit consideration. Given time, I am certain we could produce a volume equal in size to the Hunt Commission report but, hopefully, one which would recognize the realities of our today.

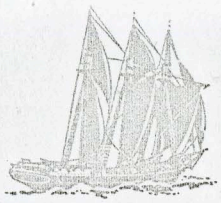
Sincerely yours,

MENDOCINO-LAKE SAVINGS AND LOAN ASSOCIATION

Ira N. Brannon, President

INB:ar

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HUMBOLDT
FEDERAL
SAVINGS & LOAN
ASSOCIATION

October 8, 1973

The Honorable Don H. Clausen
The House of Representatives
Washington, D. C. 20515

Dear Don:

Thank you for your letter of September 27, 1973. I am indeed grateful for the opportunity to express to you my concern over tight money in the home loan market, high interest rates, the outflow of funds from savings and loans into commercial banks and the zooming increases in the cost of home construction.

First let me thank you for your support of the Senate Joint Resolution 160 which, if signed by the President, will effectively eliminate "Wild Card" CD's by requiring rate ceilings on all certificates under $100,000. We do not, unfortunately, have the earning power to compete for consumer savings on equal terms with commercial banks and at the same time make mortgage money available to the average home buyer at reasonable rates. It just cannot be done. We must have a rate differential to survive.

Don, I don't mind in the least to see a slowdown in savings, loans and profits if I could believe such a slowdown was for the good of the economy and the country. But when I see instead the advantage being shifted to the commercial banks and away from the mortgage market I become very concerned.

In the past when we have had a slowdown in savings we were able to import funds by selling mortgage paper on the secondary mortgage market. Today this is impossible. We cannot afford to sell a great many loans from a portfolio with an average yield of 7.37%. It is also economically unfeasible to make up for lost savings by selling the few loans we are currently making at today's high rates of 9% and 9¼%. Where is the money to come from to make mortgage loans in Humboldt County? Certainly the commercial banks will not fill the vacuum when alternative investment opportunities yield a much greater return.

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I don't have all the answers, but I can assure you that if we find some way to cause the return of money to savings and loan associations money will once again be available for housing at a more reasonable cost. I do have some solutions to offer, however, such as:

1. Eliminate the "Wild Card" CD's and require federal agencies to establish rate ceilings.

2. Re-establish appropriate rate differentials for thrift institutions.

3. Increase insurance of accounts to $50,000.

4. Provide 100% insurance by the FSLIC and FDIC for the deposits of state and local governments in financial institutions.

You can be assured that given the proper tools and support we shall do our part to see that the low and middle income families of Humboldt County receive a decent break in obtaining adequate housing at a more reasonable cost.

Thanks again.

Yours very truly,

Jack C. Feigal
President

JCF:sk

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IMPERIAL SAVINGS

Imperial Savings
and Loan Association
of the North

Santa Rosa Office:
90 Santa Rosa Avenue
Santa Rosa, California 95404
Telephone (707) 546-0544

October 10, 1973

Congressman Don H. Clausen
2433 Rayburn House Office Bldg.
Washington, D. C. 20515

Dear Congressman Clausen:

Thank you for your letter and I am pleased to respond to your inquiry on current conditions of the Savings & Loan business.

It would appear that recent regulations in regard to new interest rates, particularly in regard to the so called no-ceiling "wild card" account have resulted in the loss of substantial sums from our savings accounts. Banks, with their larger savings base, and the "wild card" account, coupled with their ability to make high paying installment credit loans and commercial loans now have a definite advantage in the competition for savings. In addition to this the competition of high rates on Treasury Bills has also complicated the situation and resulted in loss of funds.

In some 13 years of experience in this business, this is the third time this tight money situation has developed, and each time the regulatory authorities have seen fit to raise rates, and this time to also put the Savings & Loan at a disadvantage. It would be my feeling that a rate change at this time was not needed, and the only result will be higher loan interest rates in the long run, just as has happened in the past.

This area is a prime construction area. Half of our loans are for construction. Altho we are continuing to fund existing construction loans, this market will not feel the present cutback on construction loans for the next 4 to 6 months. Due to the shortage of savings we are not currently funding a volume of construction loans, so consequently at the end of the period mentioned above, construction money will be greatly deminished and this area will suffer the impact of reduced employment in the construction business and the ramifications that go with it.

I would hope that after having the same situation develop three times there would be some solution to the problem. If Savings & Loans are to continue functioning as the nations major home lender (which they have been) consideration should be given to preferential rates for our thrift institutions, elimination of ceiling free accounts on less than 100,000. and possibly some thought given to tax break on savings accounts in Savings & Loans to encourage stability of savings.

With best personal regards.

Sincerely,

Michael Panas
Vice President

MP:eh



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NORTHBAY SAVINGS AND LOAN ASSOCIATION

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AND CONTROLLER
BERTHA BALFOUR
ASSISTANT SECRETARY

OCT 11 1973

October 8, 1973

The Honorable Don H. Clausen
Representative in Congress
Congress of the United States
House of Representatives
Washington, D.C. 20515

Dear Don:

We appreciate receiving your letter of September 27th, regarding the current economic problems faced by the savings and loan associations, not only in California but throughout the United States. We here in California are very little different than all of the other associations, but very shortly the construction activity that has been a substantial industry in this state will come to a very abrupt halt and the building contractors, together with all other allied fields, will find themselves facing a lack of employment.

As is quite apparent to everyone who applies for a loan to either construct or purchase a home, there is a substantial shortage of funds and, in many instances, none are available and have not been for thirty to sixty days. So far as the savings and loan associations are concerned, we must attribute this lack of funds to the attempt by the Federal Reserve Bank and others in Washington to "cool off" the economy by way of tightening the money supply through increased returns on government obligations of all types and the authorized increases in savings interest rates, more particularly the "wild card certificates". It is imperative that a number of items be given top priority in order to assist in correcting this deplorable situation in which we find ourselves, and some of them are as follows:

1. There should be legislation requiring Federal Banking agencies to establish immediate rate ceilings with appropriate differential for thrift institutions for all classes of consumer savings deposits and certificates. The ceiling free, four year, $1,000. minimum "wild card certificate" of deposit should be immediately controlled, as it has been and will continue to be the cause of havoc within the financial field.

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2. In order to assist both the commercial banking institutions and the thrift institutions in obtaining additional deposits, 100% insurance should be provided by the FSLIC and FDIC for deposits of state and local governments (public funds).

3. An immediate increase to $50,000. by both the FSLIC and FDIC for insurance of accounts.

4. A tax incentive for savings used to make home loans should be provided. This should give a partial exemption from taxation on interest earned on savings deposits in thrift institutions.

5. The Treasury Department and other federal agencies should immediately be called upon to increase the minimum denominations on their securities issues to at least $25,000. The smaller denominations are a great disruption to the home savings market.

6. To assist in holding down the inflationary trend, an across the board control on consumer credit should be considered.

We find it quite difficult to convince our present customers and potential borrowing applicants that this present "monetary crunch" is not a serious one, and they all seem to expect it to correct itself very shortly with little disruption to their purchasing or construction plans. We certainly hope that this can be made to come true by any or all of the aforementioned actions and by any actions that might be presented in the near future.

Very truly yours,

Herold Mahoney
President

H.E. Tomasini
Executive Vice President
and Manager

HET/lss

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FEDERAL HOME LOAN BANK BOARD

WASHINGTON, D. C. 20552

101 INDIANA AVENUE, N. W.

FEDERAL HOME LOAN BANK SYSTEM
FEDERAL HOME LOAN MORTGAGE CORPORATION
FEDERAL SAVINGS & LOAN INSURANCE CORPORATION

THOMAS R. BOMAR
CHAIRMAN

September 20, 1973

The Honorable Donald H. Clausen
House of Representatives
Washington, D. C. 20515

Dear Congressman Clausen:

You requested certain information relative to the housing, and, more specifically, the savings and loan picture in California and, as well, nationally.

As we discussed, much of the information I will provide is not statistically confirmed and won't be for a couple of months. Additionally, this information has been conveyed to key people in the administration and efforts are underway to help with the problems. The situation is as follows:

1. The high money rates believed necessary to stem inflationary pressure work the greatest hardship on the housing sector. This is true because S&Ls which supply the majority of the housing credit cannot compete for funds above a certain level of rates. They can't compete as they are locked into fixed yield mortgages and thus their income can't expand, except over long periods. Thus, they are effectively shut out of the market in high rate periods and, as well, existing deposits leave being attracted to higher yields elsewhere.

2. Until July, we had positive savings flows and a good level of loan closings.

   Savings Flows:

| | |
|---|---|
| Jan. thru July in California | $1,007 million |
| Jan. thru July nationally | $9,626 million |
| July in California | -$193 million |
| July nationally | -$291 million |

   For August, we haven't all the data to be conclusive and it is dangerous to estimate in such periods due

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to error potential. Our sample isn't always completely accurate. It is possible to say that outflows for August will be very large for California and for the nation.

There is very early indication that gross savings flow numbers in early September were better than in August for reasons we can't explain yet. A positive flow would seem to be a short-lived situation, however. We must anticipate savings outflows when the investors of funds can get much more by placing their funds in market securities.

There is a correlation between the changes in rates allowable for banks and S&Ls in early July and the beginning of the serious problems. The reason is no doubt the tremendous publicity given rates due to the advertising done by S&Ls and banks of higher rates. The "wild card" certificate (4 year, $1,000 minimum, no rate ceiling) touched off destructive rate wars. Earnings will suffer, of course, as cost of funds increase materially and income can increase only slowly.

3. The prospects for the S&L industry are of even greater concern if we start 1974 with market interest rates at these levels. Approximately 11% of the S&L industry's (generally true in California and nationally) savings certificates mature in the first three months of 1973. That's about $30 billion nationally. A withdrawal of even half this amount would be a problem of unprecedented magnitude and could damage the industry for years to come.

   The S&L industry won't fail. We have enough backstop capacity with the FHLBB, in addition to its own resources, able to call on Treasury and the Fed to assure viability. Coming back from such a low point would be very difficult, however.

4. When S&Ls start running short of money, they very naturally begin to approach any additional commitments with great caution. A builder needs commitments for funds in many cases before being prepared to start new houses. Therefore, a slowdown in commitments will have the effect of slowing housing starts and very quickly. This is happening now.

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5. In California, large builders tell me they expect (under current conditions) a 50% reduction in housing starts. This reduction will result from a shortage of funds, high rates, and, as well, the environmental impact statement problem. This latter matter is a problem to builder and logic would seem to tell us that probably environmental protection has been overdone in some cases but is extraneous to this letter.

Now with that happy review of the current picture, let me deal with what we are trying to do.

1. There is little, if anything, the FHLBB can do to alleviate high interest rates which cause the problem. In 1970 a subsidy approach was tried using appropriated funds*, but, to put it kindly, it enjoyed small success and got the Board sued. We could subsidize again trying to learn from past mistakes and I wish we had the emergency capacity to do so. However, to try and get the appropriation through Congress and get the money in time would be a problem. Our FHLBs, after our last experience, are not enthusiastic about such a prospect. The Fed will allow rates to drop when convinced inflationary pressure is under better control.

2. Until rates drop back to the point where S&L accounts and certificates are again attractive, we (FHLBB) will make available all the funds at our command to help stem the shortfall. To date we have provided over $7 billion. That is about twice the amount (in eight months) ever provided in any full year period. The previous record was $4 billion in advances in 1969.

3. We have authorized a new special series certificate of deposit and advances program which will become operational in California around October 1. This is a mechanism whereby S&Ls can bid for money via FHLBs who will in effect buy the money for them at a market price from other S&Ls. S&Ls nationally, even now,

* These were the first appropriated funds ever obtained as the FHLBB is self-supporting.

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have around $15 billion in liquid assets. This mechanism, we expect, will help us use that liquidity more productively. This is an entirely new approach never used before.

4. The President announced yesterday that the FHLBB will authorize up to $2-1/2 billion in forward commitments for advances. The purpose of this is to give S&Ls the assurance they need to forward commit funds to builders who in turn need such assurance to start new homes. This move will help keep housing starts from falling and S&Ls meet the needs of their builder customers. This is also entirely new and has never been done before.

5. We have cut liquidity required to be held by S&Ls to 5-1/2% of savings, a record low.

Treasury sells bonds with low denominations which hurts us. They feel they must or face the counter criticism of Congress of denying small investors access to high rate investments. Fed tightens money which hurts us. They have little choice due to the pressure of inflation. We obviously don't like either of these things, but are mindful of the responsibilities of our sister agencies and departments. Even though this is the case, both Fed and Treasury have gone to great lengths to help us and are cognizant of the severity of our problem. Unfortunately, it is at times not possible to publically discuss the ways we are being helped due to the confidential nature of their actions.

Even with all these efforts, which greatly exceed anything ever done before to help the S&L industry through such a period, it isn't enough. The only real solution for the S&L industry is to make changes in the way they are allowed to do business so as to allow them to compete in periods such as at present. The industry is in agreement that we must change and fast. The industry is not in agreement as to what to do. This makes it tough as Congress in total hears multiple views from their constituents and finds it hard to reach a consensus under such conditions.

We (FHLBB) are trying to act as a catalyst to pull these opinions into a unified block through the S&L industry trade organizations and directly with the industry. That

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wouldn't be easy if we had lots of time. We have little time due to our other multiple responsibilities. Our approach is to say, let's go after all the remedies. The President has advanced a group of proposals. These proposals move in the correct direction as they hit at the basic problem, which is the imbalance of long assets and short liabilities. In addition, we are advocating a means whereby S&Ls could secure longer term liabilities via the FHLBs and others. We advocate a variable rate mortgage. Work is being done with Treasury and IRS on the regulations (which are highly technical) which would allow mortgages to be sold more easily and thus become more liquid.

We are expanding S&L lending authorities as fast as we can under existing law. An approach is being taken on the conversion of mutual to stock associations which could produce more housing funds and add to S&Ls competitive strength.

I think in the past we have tried to find one solution to our problem. There is no solution but there are multiple solutions. If we can demonstrate their effectivity, we are hopeful the industry and Congress will go along with us.

This is a horribly complex matter. It seems, however, we are probably closer now than ever before to a recognition of the real problems and to having the resolve to produce the solutions. I am very optimistic about the S&L industry's future. Your interest in this situation and the efforts you are making in behalf of the S&L industry are very helpful and we are grateful for your support. If you need data of any type on the S&L industry and housing for California or nationally, let me know and we will get it for you.

Hope to see you soon.

Sincerely,

Thomas R. Bomar

cc: Ralph Stone
Maurice Mann

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FEDERAL HOME LOAN BANK BOARD
WASHINGTON, D. C. 20552
101 INDIANA AVENUE, N. W.

THOMAS R. BOMAR
CHAIRMAN

FEDERAL HOME LOAN BANK SYSTEM
FEDERAL HOME LOAN MORTGAGE CORPORATION
FEDERAL SAVINGS & LOAN INSURANCE CORPORATION

November 1, 1973

The President
The White House
Washington, D. C.

Dear Mr. President:

For August the Board reported a $1.2 billion net loss in consumer savings withdrawals from its member savings and loan associations. This was at a time when conventional home mortgage rates on loans closed were at their highest since early 1971. The outlook was critical both for the homebuyer and our member savings institutions, the nation's major and traditional supplier of home ownership funds.

Since then, home mortgage rates have continued to rise but consumer net withdrawals from savings associations have slowed substantially and sample data for the first twenty days of October indicates a further improvement.

Brief summaries of these and other significant home finance market developments in the last month are outlined below:

Savings Flow

In September net withdrawals of savings from member savings and loan associations slowed substantially. This savings flow trend turned positive during the first twenty days of October. In September savings withdrawals exceeded new savings receipts by $0.3 billion, substantially less than the $1.2 billion of net withdrawals in August. Moreover, the crediting of quarterly interest to savers' accounts produced a net increase in customer account balances of $1.8 billion.

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Sample data suggest a further improvement in savings flow for October. The Board's member associations are estimated to have had net new savings receipts (excluding interest credited) of $0.9 billion during the first twenty days of the month. This amount would be the largest net new savings receipts since last May. The Board believes this recent upturn in savings flows improvement since August reflects the recent declines in short-term money market interest rates from historic peaks and a marked decline in consumer spending.

Mortgage Lending and Net Borrowing

The Board's member associations reported September reductions in mortgage lending volume and cut-backs on outstanding commitments for future mortgage lending volume. Outstanding home loan commitments were reduced by $1.4 billion. Total commitments outstanding at the end of September were $10.7 billion, the lowest since the spring of 1972 and about 25 percent below the peak reached on a seasonally adjusted basis early this year.

Actual mortgage lending volume declined sharply in September to $3.1 billion. This amount is one-third less than reported for last month. It is the smallest seasonally adjusted total since early 1971. Consumer demand for home loan funds in September were met by member associations from loan repayments, from a reduction in liquid asset holdings, and from borrowing. Loan repayments declined last month as a result of reduced housing activity and member associations liquid assets were at their lowest relative level on record.

September net borrowing from the Federal Home Loan Banks by Board member institutions to meet savings withdrawals and permit mortgage lending totaled $0.8 billion, moderately below the $1.0 billion plus volume of the preceding several months. Additional borrowing during the first twenty-three days of October amounted to only $0.4 billion. Federal Home Loan Bank advances outstanding on October 23 were a record $14.7 billion. In addition, the Board's 12 Regional Banks had received applications from member associations for about $1.6 billion of forward commitments for advances offered pursuant to the President's Housing Policy Recommendations.

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Interest Rates

Average effective interest rates on conventional mortgage loans closed rose sharply further from early August to early September. The increase was 23 basis points for new home loans and 25 basis points for existing home loans. At the early September level, rates on conventional mortgage loans closed were the highest since early 1971. This figure was 25-35 basis points below 1970 peak levels. Rates on mortgage loans closed, however, do not yet fully reflect the rise in rates on loans commitments. Consequently, even though there is some evidence that commitment rates have recently ceased rising, earlier increases in such rates will tend to push rates on loans closed upward over the next few months.

Private housing starts declined 15 percent in September to a seasonally adjusted annual rate of 1,763 thousand units. This was 29 percent below the January 1973 peak and the lowest monthly rate since late 1970.

The Board was active in several regulatory and legislative areas last month. Its most significant actions were:

Adoption of amendments and resolutions delegating authority to regional Federal Home Loan Bank Presidents to approve unprotested branch office applications by Federal and District of Columbia savings associations.

In conjunction with the Federal Reserve Board and Federal Deposit Insurance Corporation, adopted amendments setting a 7.50 percent interest ceiling on 4-year, $1,000 certificate accounts pursuant to Public Law 93-123.

Adoption of amendments making the delegation of authority to permit Federal Home Loan Banks to set interest rates on Bank deposits and more flexible terms for advancing funds to member institutions.

Adopted an amendment removing the requirement of escrowing hazard insurance premiums for single family dwelling loans in excess of 80 percent of value.

Proposed amendments to impose civil penalties for violation of rate control regulations.

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Provided drafting service to the Department of the Treasury to implement the recommendations of the President for change in the U. S. financial system. Submitted comments to Office of Management and Budget regarding the recommendations.

Sincerely,

Thomas R. Bomar

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PMS THE PRESIDENT OF THE UNITED STATES
WHITE HOUSE DC

TO ASSIST HOUSING IN THIS PERIOD OF CRITICALLY SHORT MORTGAGE FUNDS, I URGE YOU TO DIRECT THE SECRETARY OF THE TREASURY IMMEDIATELY TO AUTHORIZE FEDERAL SAVINGS AND LOAN ASSOCIATIONS TO ACCEPT TAX AND LOAN ACCOUNTS AND TO DEPOSIT U.S. GOVERNMENT FUNDS IN SUCH INSTITUTIONS TO THE EXTEND POSSIBLE. WHERE AUTHORIZED BY STATE LAW, STATE CHARTERED ASSOCIATIONS INSURED BY FSLIC SHOULD BE INCLUDED.

THERE IS PRESENTLY ON DEPOSIT IN COMMERICAL BANKS APPROXIMATELY $11.3 BILLION OF U.S. GOVERNMENT FUNDS, EARNING NO INTEREST, AND AVAILABLE TO SUCH BANKS FOR LENDING TO BUSINESS FIRMS AT HIGH RATES. THESE DEPOSITS REPRESENT A MASSIVE SUBSIDY TO THE COMMERCIAL BANKING INDUSTRY. A PORTION OF SUCH DEPOSITS PLACED IN S&L ASSOCIATIONS COULD EARN SUBSTANTIAL INTEREST FOR THE TAXPAYER AND PROVIDE BADLY NEEDED FUNDS FOR THE RESIDENTIAL MORTGAGE MARKET.

SUCH ACTION BY YOU COULD PROVIDE OVER ONE HUNDRED THOUSAND HOUSING UNITS.

GILBERT G. ROESSNER, PRESIDENT
NATIONAL LEAGUE OF INSURED SAVINGS ASSOCIATIONS

NNNN

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WHITE HOUSE MAIL ROOM

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EXECUTIVE
FO 4-3
FG 6-20
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FI 2 W/H
1 cys

November 29, 1973

Dear George:

As part of its overall effort, the CIEP work group is continuing to refine its proposals dealing with the competitive position, in the international markets, of banks domiciled in the United States. As you recall, the work group had extended the principle of nondiscrimination to the international activities of banks domiciled in the United States and had identified regulations Q and D as inhibiting U.S. based banks from competing in the international money markets. In addition, the group outlined two proposals for modifying regulations Q and D in order to improve the competitive position of U.S. based banks. The development of these proposals will be completed by the work group within three weeks.

In order that we understand the full implications of these proposals to modify regulations Q and D, I would like to ask that your staff conduct a parallel review in the same time period. Since there will be changes in the capital control programs next year, and since the international competitive position of U.S. based banks will have an important influence on the impact of removing the controls, it is important to move this work along as quickly as possible.

Sincerely,

PETE

Peter M. Flanigan
Assistant to the President
for International Economic Affairs

Honorable George W. Mitchell
Board of Governors
Federal Reserve System
Washington, D.C.

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THE SECRETARY OF THE TREASURY
WASHINGTON, D.C. 20220

1-18 Staffed to Ash, Jones, Flanigan, Timmons, Buzhardt, Gergen + Cole
1-28 to Jones for handling

EXECUTIVE
FI 2
FI 5
FG 12

JAN 12 1974

MEMORANDUM FOR THE PRESIDENT

Subject: Federal Financing Bank

The Federal Financing Bank Act of 1973 (P.L. 93-224, approved December 29, 1973) establishes a Federal Financing Bank to provide for coordinated and more efficient financing of Federal and federally-assisted borrowings from the public.

The Act provides that "The Bank shall be subject to the general supervision and direction of the Secretary of the Treasury" and that "The Bank shall have a Board of Directors consisting of five persons, one of whom shall be the Secretary of the Treasury as Chairman of the Board, and four of whom shall be appointed by the President from among the officers or employees of the Bank or of any Federal agency."

To assure coordination with Treasury debt management, it would be desirable to integrate the activities of the Bank with those of the Department. To that end I recommend that you appoint the following key Treasury officials by position, rather than by name, to the Board.

The Deputy Secretary of the Treasury

The Under Secretary of the Treasury for Monetary Affairs

The General Counsel of the Treasury

The Fiscal Assistant Secretary of the Treasury

To help assure broader understanding and support for the Bank, as well as to provide for more effective coordination of agency financing, I recommend that you establish a Federal Financing Bank Advisory Council

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consisting of the following heads of agencies currently expected to be the major users of the Bank. I recommend that these appointments also be made by position, rather than by name.

The Secretary of Agriculture

The Secretary of Commerce

The Secretary of Health, Education, and Welfare

The Secretary of Housing and Urban Development

The Secretary of Transportation

The President of the Export-Import Bank of the United States

The Postmaster General of the United States

Attached is a draft memorandum which I recommend that you send to your appointees to the Advisory Council.

Attached also is a proposed announcement of your appointments.

George P. Shultz

Attachments

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MEMORANDUM TO: The Secretary of Agriculture
The Secretary of Commerce
The Secretary of Health, Education, and Welfare
The Secretary of Housing and Urban Development
The Secretary of Transportation
The President of the Export-Import Bank of the United States
The Postmaster General of the United States

On December 29, 1973 I signed into law the Federal Financing Bank Act. This important piece of legislation will allow us, through the Treasury Department, to coordinate the vast majority of Federal agency finance through one financing entity. This is a major breakthrough and will afford us the opportunity to provide financing flexibility at low relative interest costs to the entire Federal establishment.

I have today announced the board of directors for this agency and at the suggestion of the Secretary of the Treasury am also announcing the formation of a "Federal Financing Bank Advisory Council."

This Council will be composed of the seven agency and department heads who are likely to be among the earliest and largest users of the facilities of the Financing Bank.

I ask that you or your delegate serve on the Council, consult with the Board, and attend its meetings. I ask that you do this in a spirit of cooperation which will insure that a new and important instrumentality of our Government be given the benefit of your counsel and that the financing of the important programs under your charge be appropriately represented and coordinated within the Bank's operations.

Thank you.

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FEDERAL FINANCING BANK APPOINTMENTS

President Nixon today announced the appointment of seven members to the Federal Financing Bank Advisory Council.

The Bank was created by the Federal Financing Bank Act of 1973. The purpose of the Act is to provide for coordinated and more efficient financing of Federal and federally-assisted borrowings from the public.

The Advisory Council will consist of the heads of the agencies currently responsible for major market financing activities. The members named by the President today are:

-- The Secretary of Agriculture
-- The Secretary of Commerce
-- The Secretary of Health, Education, and Welfare
-- The Secretary of Housing and Urban Development
-- The Secretary of Transportation
-- The President of the Export-Import Bank of the United States
-- The Postmaster General of the United States

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The Secretary of the Treasury will be the Chairman of the Advisory Council.

As provided by the Act, the Secretary of the Treasury will be the Chairman of the Board of Directors of the Federal Financing Bank and will be responsible for the general supervision and direction of the Bank. The Board will also include four Treasury officials appointed by the President. The four members named by the President to the Board are:

-- The Deputy Secretary of the Treasury

-- The Under Secretary of the Treasury for Monetary Affairs

-- The General Counsel of the Treasury

-- The Fiscal Assistant Secretary of the Treasury

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DG

EXECUTIVE (3)
ME 3/E *
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January 15, 1974

Five years ago, in my first message to an Inter-American Savings and Loan Conference as President of the United States, I commended the Latin American and Caribbean savings and loan industry on its achievements -- 104 savings and loan associations in nine countries -- 730,000 savers with $223 million in deposits -- 90,000 homes financed.

Since that time, the growth of the industry has been truly impressive -- it now boasts 169 associations in 16 countries; 2,236,000 savers with $998 million in deposits; and a total of 305,000 homes financed.

Moreover, the growth of savings and loan systems can increasingly be attributed to generation of savings and other domestic capital. This trend is gratifying inasmuch as it is contributing toward relationships of greater equality, shared initiatives and mutual responsibilities which my country proposed at the meeting of the Organization of American States in November 1972.

I want to affirm the interest of the United States in the continued success of the savings and loan movement in this hemisphere. This activity, along with our many other cooperative ventures, reinforces the new dialogue in which we are currently engaged.

You have my warmest congratulations on your past accomplishments, and my best wishes for an even brighter future.

/s/ Richard Nixon

Sent to: Honorable Daniel Parker
Administrator of the Agency
for International Development
Department of State
Washington, D.C.

RN:AID:kar
cc: Rose Mary Woods/J. Warren/W. Phelan/J. David,NSC (FYI)/
E. Nasek/CF
Event: January 19-24 Requested by Dr. Parker Cleared by NSC

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EXECUTIVE
HU2-5
FI2
LC/New York City
FG6-11-1/Hirschberg, Vera

January 15, 1974

Dear Cliff:

I am attaching a copy of a study done recently by Councilwoman Carol Greitzer of New York City on sex discrimination in personnel policies of commercial banks in New York City.

Would like to get together with you sometime soon to discuss this whole problem.

Happy New Year!

Sincerely,

Vera Hirschberg
Director of Women's Programs

Mr. Cliff Sessions
Executive Director, Communications
The American Bankers Association
1120 Connecticut Avenue, N.W.
Washington, D.C. 20006

Attachment

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(3)

EXECUTIVE
IN
FG 18-9
FI 2

MARK REARDON

Ph. 343 7134

Pam
Know
him?
J.

28 Jan 74

Mrs. Armstrong:

I wrote this official Profile of the newly-chartered Indian Bank, the only one of its kind in our history.

This is one of the projects I have completed as communications adviser to the Bureau of Indian Affairs.

Other projects involve film documentaries, about which I wrote to you last week.

Mark R.

1974

FILES

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FI2
FG131

January 29, 1974

Dear George:

On Thursday, January 31, a meeting of the Council on International Economic Policy will be held at 11:00 A.M. in Room 208, OEOB. Inlcuded on the agenda are two subjects concerning international banking regulation. The enclosed papers provide the background and options for discussion and decision by the Council.

I would like to invite you to attend Thursday's meeting and participate in the discussion of these issues. Your insights on these issues, based on the work you have been directing within the Federal Reserve System and your discussions abroad, would contribute substantially to our decisions.

Sincerely,

Peter M. Flanigan
Executive Director
Council on International
Economic Policy

The Honorable George W. Mitchell
Board of Governors
Federal Reserve System
Washington, D.C.

PMF:ERB:ljs

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EXECUTIVE

FI2
FG 124

FEDERAL HOME LOAN BANK BOARD

WASHINGTON, D. C. 20552

101 INDIANA AVENUE, N. W.

FEDERAL HOME LOAN BANK SYSTEM
FEDERAL HOME LOAN MORTGAGE CORPORATION
FEDERAL SAVINGS & LOAN INSURANCE CORPORATION

THOMAS R. BOMAR
CHAIRMAN

Dwight Brooks 2.4.74 RBL

February 4, 1974

The President
The White House
Washington, D. C.

Dear Mr. President:

The Board's member savings and loan associations continue to report a positive consumer funds savings flow trend which has now gone on for over four months. For calendar year 1973, net new savings receipts reported by the Board's member associations totaled $10.5 billion. This amount is less than one half the record 1971 and 1972 totals and brings into focus the sharp dropoff of consumer savings flows reported last summer.

Reflecting last year's month-to-month dropoff in consumer savings inflow and a continued reduced volume of mortgage loan repayments, the Board's member associations increased their borrowing by $0.8 billion in December. They also reported slight reductions of liquid assets, after rebuilding such holdings substantially in October and November.

Home mortgage rates continued to rise but at a relatively moderate rate. The Board still believes, as reported last month, that loan rates on new mortgage commitments will stabilize in the very near future at lower levels than currently reported.

Brief summaries of these and other significant home financing market developments are given below:

Savings Flows

Savings flow to savings and loan associations slowed down more than seasonally in December from the substantially improved inflow of a month earlier, but then rebounded sharply in early January to the largest volume in a year. Net new savings receipts of member associations totaled $0.4 billion in December. This is $0.7 billion less than the $1.1 billion reported for November.

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Interest credited to savings accounts in December totaled to a record $2.4 billion. The increase in savings balances at member associations and the higher interest return being paid on them brought the total savings gain for the month to $2.8 billion. This was only 14 percent less than in December 1972.

Sample data for the first twenty days of January suggest net new savings receipts for this period of $1.6 billion, only 35 percent below the record volume received a year earlier.

Mortgage Lending and Net Borrowing

Mortgage lending by member associations declined slightly in December to the smallest volume since early 1971. The Board believes that this decline reflects the savings outflow experienced by its member associations last summer. Commitments outstanding for future mortgage lending rose modestly for the second consecutive month portending increased lending activity for the months ahead.

Actual mortgage loans closed by associations totaled $2.4 billion in December. This was slightly more than reported for November, but the rise was smaller than typical at yearend and 45 percent less than for December 1972.

As a result of the slower savings inflow last month, member associations drew down their holdings of liquid assets slightly after several months of rebuilding from the sharply reduced levels caused by the savings outflow last summer. They also borrowed more funds in December than in the last few months.

Net borrowing from the Federal Home Loan Banks totaled $0.3 billion in December, bringing the total outstanding at yearend to a record $15.1 billion.

Interest Rates

Average effective interest rates on conventional home mortgage loans closed rose by a moderate 10 basis points to 8.49 percent from early November to early December for new homes. There was a 3 basis points rise to 8.61 percent for loans on previously occupied homes. The rate of increase in mortgage rates on loans closed has continued to slow in the most recent period reported. Interest rates at which lenders were making commitments for future mortgage lending appear to have edged

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down further last month. The Board believes this suggests there will be little further increase in rates on loans closed.

Private housing starts declined 20 percent further in December to a seasonally adjusted annual rate of 1,355 thousand units. This was 46 percent below the peak reached in January of 1973 and the smallest monthly rate since the spring of 1970.

The Board took action last month on a variety of regulatory and legislative matters. The most significant of these were:

Adoption of a temporary regulation authorizing member savings and loan associations to operate a place-of-business funds transfer system with prior Board approval.

Adoption of amendments pursuant to the Flood Disaster Protection Act of 1973 incorporating new and more liberal regulations for home and property owners.

Adoption of amendments pursuant to 1973 legislation on state housing corporations.

Proposed amendments relating to advisory boards of directors and advisory committees for Federal savings and loan associations.

Proposed amendments relating to acquisition and control of newly converted insured savings and loan institutions.

Proposed amendments to allow insured institutions to issue certificates of deposit which are negotiable.

Proposed legislation to:

1. Authorize Federal stock savings and loan charters,

2. Amend provisions relating to conversion of mutual savings and loan associations to a stock form, and

3. Authorize standby regulatory conversion moratorium regulations.

Amended holding company provisions so as to require approval of activities of unitary savings and loan holding companies

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(similar to that now required for activities of multiple savings and loan holding companies).

Sincerely,

Thomas R. Bomar

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EXECUTIVE

FE2
FO4

February 15, 1974

MEMORANDUM FOR: MEL BLAKE

FROM: RICHARD D. ERB

SUBJECT: PROPOSED CABLE REQUESTING BANK INFORMATION

This is just a follow-up to our telephone conversation.

1. We should collect this information, if it is not already available in the Fed.

2. I doubt if we will get very useful information unless our Embassy people go out and ask questions at banks

3. I think we can be open about the fact that we are studying international banking regulations along the lines described in Chapter 4 of the CIEP Report.

4. If our Embassy people go out and ask questions they should make clear that we believe in competition and non-discriminatory treatment and that we are not proposing to discriminate against foreign banks in the U.S.

cc: Ralph Korp

R.D.ERB:gm - XXXX - 2/15/74
cc: Chron/Reading/ExSEC

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EXECUTIVE
FG6-20
FI2
FG12-4

FEB 15 1974

Dear Jim:

As you are aware, during the past few months a CIEP Work Group has been studying the impact of U.S. banking regulation on international bank competition. At a recent meeting of the Council, consideration was given to the issues dealt with in the enclosed two options papers. It was decided to postpone final decision until early March.

Because of the potential impact of some of the proposals, I would like to be sure that we have considered all aspects of the issues. As a consequence, I would find your formal or informal comments on these options of great interest.

Sincerely,

PETE

Peter M. Flanigan
Assistant to the President
for International Economic Affairs

Honorable James E. Smith
Comptroller of the Currency
Main Treasury - Room 3205
Washington, D. C. 20500

Enclosures: (2)

R.D. Erb: gm - 2/14/74 (Retyped)
cc: Chron/Reading/EXSec

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EXECUTIVE (3)
FG 6-20
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FG 120

FEB 15 1974

Dear Frank:

As you are aware, during the past few months a CIEP Work Group has been studying the impact of U.S. banking regulation on international bank competition. At a recent meeting of the Council, consideration was given to the issues dealt with in the enclosed two options papers. It was decided to postpone final decision until early March.

Because of the potential impact of some of the proposals, I would like to be surethat we have considered all aspects of the issues. As a consequence, I would find your formal or informal comments on these options of great interest.

Sincerely,

PETE

Peter M. Flanigan
Assistant to the President
for International Economic Affairs

Honorable Frank Wille
Chairman
Federal Deposit
Insurance Corporation
550 17th Street, NW.
Washington, D. C. 20429

Enclosures: (2)

R.D.Erb: gm - 2/14/74 (Retyped)
cc: Chron/Reading/ExSec

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(3)

EXECUTIVE
FI 2
CO
FG6-20

March 20, 1974

MEMORANDUM FOR: PETER M. FLANIGAN

FROM: RICHARD D. ERB

The Costanzo proposal deviates from ours in two important ways. First, it does not probibit interstate branching by foreign banks which choose to enter the U.S. through state charters. Second, it does not subject foreign banks, operating in the U.S. through branches, to the bank holding company provisions. Thus, such foreign banks can continue to engage in security industry activities, etc.

Of all the deviations from national treatment, those two are the most significant and controversial.

Attachment

R.D.ERB:gm - 3/20/74
cc: Chron/Reading/ExSec

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EXECUTIVE FO4-3 FI2 FG6-20 FG131

THE WHITE HOUSE

WASHINGTON

April 2, 1974

Dear George: H. Mitchell

In your February 27 letter, you requested comments on the draft legislation for regulating foreign banks operating in the United States. Since last fall this subject has been under examination by a CIEP inter-agency work group. In the January executive session of the CIEP, in which you participated, the policy issues concerning the regulation of foreign bank activities in the United States were considered. Based on the discussion at that session, as well as the Administration's overall policy concerning foreign investment in the United States, I will address myself to the policy questions underlying your draft legislation. Detailed technical comments will be submitted to you by individual Executive Department members of the CIEP.

Concerning the basic thrust of the legislation, two general principles are of special importance to the Administration. First, foreign bank regulation should be consistent with the principles of national treatment: foreign banks should not be discriminated against, nor should they have special priviledges vis a vis U. S. owned banks. Second, if the regulation and activities allowed to foreign banks are changed, some type of grandfathering procedure should be applied to avoid retaliation.

The legislative proposals concerning Federal Reserve membership, multi-state branching, non-bank activities, FDIC Insurance, Edge Act activities and national bank charters are all broadly consistent with the principle of national treatment. In a technical legal sense, requiring Federal Reserve membership for foreign banks could be construed as a deviation from national treatment, but since U. S. banks competing with foreign banks are almost all members of the Fed, the practical impact will be consistent with national treatment.

The proposal to grandfather permanently the existing multi-state banking operations of foreign banks is a reasonable way to deal with a difficult problem. Since most multi-state operations are located in the major

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cc: Messrs. chron/sub/EXSEC/Flanigan/Ralph Korp/Joe Kvasniska/
Edward Rastatter/ Bill Witherell/Carl Stem/J. Niehuss/A. Safir

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MEMORANDUM OF INFORMATION FOR THE FILE

EXECUTIVE
FG 6-20
FO 4
FI 2
FG 131

DATE 4/29/74

LETTER, MEMO, ETC.

TO: Peter M. Flanigan

FROM: Arthur Burns

SUBJECT: CIEP proposal to establish special international banking facilities at domestic offices of U.S. banks

Special Files

CORRESPONDENCE FILED CENTRAL FILES – CONFIDENTIAL FILE

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EXECUTIVE
FG12-14-1
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THE WHITE HOUSE

WASHINGTON

May 6, 1974

MEMORANDUM TO:

The Secretary of the Treasury
The Secretary of Agriculture
The Secretary of Commerce
The Secretary of Health, Education, and Welfare
The Secretary of Housing and Urban Development
The Secretary of Transportation
The President of the Export-Import Bank of the United States
The Postmaster General

On December 29, 1973, I signed into law the Federal Financing Bank Act. This important piece of legislation will allow us, through the Treasury Department, to coordinate the vast majority of Federal agency finance through one financing entity. This is a major breakthrough and will afford us the opportunity to provide financing flexibility at low relative interest costs to the entire Federal establishment.

I have today announced the board of directors for this agency and at the suggestion of the Secretary of the Treasury, I am also announcing the formation of a "Federal Financing Bank Advisory Council." The Secretary of the Treasury will serve as Chairman of this Advisory Council.

This Council will be composed of the eight agency and department heads who are likely to be among the earliest and largest users of the facilities of the Financing Bank.

I ask that you or your delegate serve on the Council, consult with the Board, and attend its meetings regularly. I ask that you do this in a spirit of cooperation which will insure that a new and important instrumentality of our Government be given the benefit of your counsel and that the financing of the important programs under your charge be appropriately represented and coordinated within the Bank's operations.

Richard Nixon

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May 6, 1974

EXECUTIVE ORDER

# 11782

ESTABLISHING THE FEDERAL FINANCING BANK ADVISORY COUNCIL

By virtue of the authority vested in me as President of the United States of America, it is hereby ordered as follows:

Section 1. There is hereby established the Federal Financing Bank Advisory Council. The Council shall consist of:

(1) The Secretary of the Treasury (Chairman).

(2) The Secretary of Agriculture.

(3) The Secretary of Commerce.

(4) The Secretary of Health, Education, and Welfare.

(5) The Secretary of Housing and Urban Development.

(6) The Secretary of Transportation.

(7) The President of the Export-Import Bank of the United States.

(8) The Postmaster General.

Sec. 2. The Council shall provide advice and assistance to the Board of Directors of the Federal Financing Bank established by the Federal Financing Bank Act of 1973 (Public Law 93-224; 87 Stat. 937) concerning the administration of that act. It shall also serve as a coordinating forum to insure a broader understanding of, and support for, the Bank.

Sec. 3. The Department of the Treasury shall, to the extent permitted by law, provide administrative support for the Council.

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THE WHITE HOUSE,
May 6, 1974.

Announced 5/6/74
To Archives 5/6/74

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EXECUTIVE
FI2
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FG139

May 7, 1974

MEMORANDUM FOR

THE HONORABLE ARTHUR F. SAMPSON
ADMINISTRATOR OF GENERAL SERVICES

Request your office provide us with background material in discussions with the Citizens Trust Bank in Atlanta. As you know, the Citizens Trust Bank is a participant in the President's minority banking program, and we would like to review their status prior to a meeting with their representatives.

Please advise as soon as possible.

Stanley S. Scott
Special Assistant
to the President

Attachment

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(3)

RINFRET
BOSTON
ASSOCIATES INC.

641 LEXINGTON AVENUE, NEW YORK, N.Y. 10022

OFFICE OF THE PRESIDENT

May 15, 1974

President Richard M. Nixon
The White House
Washington, D. C. 20500

Dear Mr. President:

I am writing this from Manila while on an extended tour to observe Asian and Middle Eastern economies.

I have just come from Japan and am going on to Singapore, Jakarta, Israel and Cyprus.

In Japan and in the Philippines there is despair about inflation. The opinion of government officials is that they cannot control inflation unless the United States leads the way. They do not blame the United States for inflation, but it is fair to say that they cannot protect themselves from our inflation.

Secretary Simon asked me recently to suggest to him guidelines for economic policy. I have done so and have placed emphasis on stimulating investment and savings.

I do not need to tell you that we are dealing with a new set of problems; and if I may be of help to you, please do not hesitate to call upon me.

With best regards and ever in friendship,

Sincerely yours,

Pierre jr

Pierre A. Rinfret

PAR:jbe

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Cable Address: Forecast New York Telex: 62602 Telephone: 212/688-2620

Rinfret Associates France Telex: 65545 Telephone: Paris 770 90 80

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EXECUTIVE

FI 2

June 14, 1974

Dear Mr. Hubble: GARFIELD R.

Thank you for your letter to Bruce Herschensohn which he referred to this office for reply.

The loss which you describe is most unfortunate and one which we can agree should never have occurred. Your specific request was referred to Chairman Frank Wille of the Federal Deposit Insurance Corporation who offered the following explanation:

The Subordinated Capital Notes held by Mr. Hubble clearly state that they were part of a series of notes issued pursuant to a Subordinated Note Agreement dated December 29, 1972. Payment of the principal and interest on these notes is subordinated to the extent and in the manner specified in that agreement. According to the terms of the Agreement, the claims of non-subordinated general creditors of the United States National Bank must be paid in full before subordinated capital note holders are paid principal or interest.

The United States National Bank, San Diego, California, was closed by the Comptroller of the Currency on October 18, 1973, and the Federal Deposit Insurance Corporation was appointed Receiver thereof. In such capacity, we are proceeding to liquidate the remaining assets of the United States National Bank in an orderly manner for the benefit of its creditors. Every effort is being made to realize a maximum recovery on the assets of the bank. This inures to the benefit of all concerned including debenture holders who would be entitled to share in any proceeds remaining after payment in full of the claims of creditors who are not subordinated.

We regret that Mr. Hubble and the other holders of the Subordinated Capital Notes are not entitled to participate in the distribution of the bank's assets until such time as all non-subordinated claims against the

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closed bank's estate have been fully discharged. At this point in time, it is impossible to determine if such non-subordinated creditors will be paid in full or when such payment will be made.

Mr. Hubble states that he read the FDIC had loaned the "Westgate Corporation 50 million dollars" when, in fact, the Corporation as Receiver advanced $500,000 to Westgate California Corporation on November 30, 1973 to allow Westgate to meet immediate expenses and continue in business pending resolution of its financing problems. The purpose of this advance was to protect the value of certain assets held by the Receiver and this advance will be recovered in full.

I trust that the foregoing will answer your question, and regret that we could not be more encouraging. We can only hope that the matter will be resolved with as little loss as possible to you and others in the same position.

Sincerely,

Dudley Chapman
Associate Counsel to the President

Mr. Garfield R. Hubble
15865 S. W. Queen Victoria Place
King City, Oregon 97223

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FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D.C. 20429

OFFICE OF THE CHAIRMAN

April 16, 1974

J. Fred Buzhardt, Esquire
Counsel to the President
The White House
1600 Pennsylvania Avenue
Washington, D.C. 20500

Dear Mr. Buzhardt:

This is in response to your April 9, 1974 referral of correspondence addressed to Mr. Bruce Herschensohn from Mr. Garfield R. Hubble of King City, Oregon regarding his investment in Subordinated Capital Notes issued by the now defunct United States National Bank, San Diego, California. Mr. Hubble asks, "Is it not possible that President Nixon can direct the Federal Deposit Insurance Corporation to pay at least the interest on the notes until such time as the liquidation proceedings are completed?"

A

The Subordinated Capital Notes held by Mr. Hubble clearly state that they were part of a series of notes issued pursuant to a Subordinated Note Agreement dated December 29, 1972. Payment of the principal and interest on these notes is subordinated to the extent and in the manner specified in that agreement. According to the terms of the Agreement, the claims of non-subordinated general creditors of the United States National Bank must be paid in full before subordinated capital note holders are paid principal or interest.

The United States National Bank, San Diego, California, was closed by the Comptroller of the Currency on October 18, 1973, and the Federal Deposit Insurance Corporation was appointed Receiver thereof. In such capacity, we are proceeding to liquidate the remaining assets of the United States National Bank in an orderly manner for the benefit of its creditors. Every effort is being made to realize a maximum recovery on the assets of the bank. This inures to the benefit of all concerned including debenture holders who would be entitled to share in any proceeds remaining after payment in full of the claims of creditors who are not subordinated.

We regret that Mr. Hubble and the other holders of the Subordinated Capital Notes are not entitled to participate in the distribution of the bank's assets until such time as all non-subordinated claims against the closed bank's estate have been fully discharged. At this

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point in time, it is impossible to determine if such non-subordinated creditors will be paid in full or when such payment will be made.

Mr. Hubble states that he read the FDIC had loaned the "Westgate Corporation 50 million dollars" when, in fact, the Corporation as Receiver advanced $500,000 to Westgate California Corporation on November 30, 1973 to allow Westgate to meet immediate expenses and continue in business pending resolution of its financing problems. The purpose of this advance was to protect the value of certain assets held by the Receiver and this advance will be recovered in full.

Pursuant to your request, we are returning Mr. Hubble's correspondence.

Sincerely,

Frank Wille

Frank Wille
Chairman

Enclosure

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**FEDERAL DEPOSIT INSURANCE CORPORATION**
**Office of the Chairman**

## CORRESPONDENCE REFERRAL RECORD

| DATE OF CORRESPONDENCE | DATE OF REFERRAL |
|---|---|
| April 9, 1974 | April 10, 1974 |

| REFERRED TO | REFERRAL NO. |
|---|---|
| Mr. Hill | |

NAME AND ADDRESS OF CORRESPONDENT

J. Fred Buzhardt
Counsel to the President
The White House
1600 Pennsylvania Avenue
Washington, D. C. 20500

SUMMARY OF SUBJECT

USNB - capital notes purchased by Garfield R. Hubble, King City, Oregon. "Is it not possible that President Nixon can direct the FDIC to pay at least the interest on the notes until such time as the liquidation proceedings are completed?" Mr. Buzhardt requests a draft reply.

**DISPOSITION INSTRUCTIONS**

- [X] **Prepare reply for Chairman's Signature**
- [ ] **Reply direct** *(Provide copy for Chairman's file)*
- [ ] **For necessary attention**
- [ ] **Information**
- [ ] **Other** *(Specify)*

**COPIES TO**

- [X] **Chairman**
- [X] **Director**
- [ ] **Director (C/C)**
- [ ] **Deputy to Chairman**
- [ ] **Asst. to Director**
- [X] **Asst. to Director (C/C)**
- [X] **Special Asst. to Chairman**
- [ ]
- [ ] **Controller**
- [X] **Gen. Counsel**
- [ ] **Director, LIQ.**
- [X] **Director, DBS**
- [ ] **Director, RES.**
- [ ] **Director, OMSFA**
- [ ] **Exec. Secy.**

B

*Frank Wille, Chairman*

NOTE: *Make or extract necessary copies for your files.*

BY REB:ram

FDIC 1211/01 (7-73)

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# THE WHITE HOUSE OFFICE

## REFERRAL

**To:** The Honorable Frank Wille
Chairman
Federal Deposit Insurance Corporation

**Date:** April 9, 1974

## ACTION REQUESTED

__x__ **Draft reply for:**
_____ **President's signature.**
__x__ **Undersigned's signature.**

_____ **Memorandum for use as enclosure to reply.**

_____ **Direct reply.**
_____ **Furnish information copy.**

_____ **Suitable acknowledgment or other appropriate handling.**
_____ **Furnish copy of reply, if any.**

_____ **For your information.**

_____ **For comment.**

**NOTE**

*Prompt action is essential.*

**If more than 72 hours' delay is encountered, please telephone the undersigned immediately, Code 1450.**

**Basic correspondence should be returned when draft reply, memorandum, or comment is requested.**

**REMARKS:**

**Description:**

__x__ **Letter:** _____ **Telegram: Other:**

**To:** Bruce Herschensohn
**From:** Garfield R. Hubble, 15865 S.W. Queen Victoria Pl., King City, Oregon 97223
**Date:** April 4, 1974 ( pm April 5, 1974)
**Subject:** See attached letter.

**By direction of the President:**

J. Fred Buzhardt
Counsel to the President

**(Copy to remain with correspondence)**

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THE WHITE HOUSE
WASHINGTON

4/8

For: Mr. Buzhardt

From: Bruce Herschensohn

For reply.

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April 4, 1974

Mr. Bruce Herschensohn
Deputy Special Assistant to the President
The White House
Washington, D. C.

Dear Sir:

This weeks Time magazine carried an article by Hugh Sidey which headlined you as Richard Nixon's morale booster and the first lead in line to the article was, "They call him Dr. Happiness".

This letter is being written in hope that through your close association with the President that you may call to his attention that we need a "Dr. Happiness" and "a morale booster".

Last spring we purchased twenty thousand dollars worth of capital notes issued by the U.S. National Bank of San Diego, California. They were purchased through a broker for the First California Company of Portland, Oregon. As you must know the bank was closed by the Comptroller of Currency last October 18th and goes down in history as the largest bank failure in the country where people have learned to trust in the safety of our banking system. I have a letter from the Crocker National B ank of San Francisco stating that the 88 million dollars that they paid for the U.S. National included the assets and only the clean liabilities of the defunct bank. I also have a letter from a Mr. Fontaine Storm of the F.D.I.C. of San Diego. He wrote that we are not entitled to participate in the distribution of the Bank's assest until the un-subordinated claims against the bank have been discharged.

The Wall Street Journal has written that the Franklin Naional Bank of New York purchased 5 million dollars worth of the above notes, 6 million dollars worth were sold to investors through the First California Company and 3 ½ million were sold to institutions such as insurance companies, etc. The Journal also reported that the F.D.I.C. had loaned the Westgate Corporation 50 million dollars as operating funds and shortly thereafter Westgate was declared bankrupt and new officers were chosen to liquidate it's holdings.

As Mr. N ixon knows, his friend and supporter, C. Arnholt Smith has been the key figure in this classic case of corporate manipulation. I am a retired citizen who invested a substantial part of our life savings in one of the largest of the California banks and looked forward to the 8% interest as a sound investment. I knew that the Federal Government through the F.D.I.C. and the Comptroller of the Currency conducted regular audits through it's bank examiners and therefore feel that a great deal of this loan manipulation by Mr. Smith should have been discovered long before the bank failed. Also, after the failure, the government's principal concern was to ward off a run on the bank's deposits and to protect the depositors. My question is what concern the Federal Government has for the hundreds of investors like ourselves? Is it not possible that President Nixon can direst the F.D.I.C. to pay at least the interest on the notes until such time as the liquidation proceedings are completed? We have been advised that this may take many years.

In a letter from the Franklin National Bank we are advised that their lawsuit against the bank and certain of it's officers and directors has been initiated

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but discovery in the suit has not commenced and they assume that any trial of the matter is still a long way off.

We realize that our President has his own serious problems but our moral support for him will go up 100% if you can help to bring our problem to his attention and bring about some early action on the matter. My wife says that it will take a miracle to get Mr. Nixon's attention and reaction to our plight. My answer was that I will try for the miracle and hope that "Dr. Happiness" can help us.

Sincerely,

Garfield R. Hubble

Garfield R. Hubble
15865 S. W. Queen Victoria Pl.
King City, Oregon 97223

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RUSH-39

EXECUTIVE
BE5-3
PR7-1
FG6-11-1/Rush, Kenneth
FG12
FG6-16
FG131
FG6-3
FI4
FI2

THE WHITE HOUSE

WASHINGTON

June 21, 1974

MEMORANDUM FOR: William Simon
Roy Ash
Dr. Arthur Burns
Herbert Stein

FROM: Kenneth Rush K.R

SUBJECT: Meeting with the President

We shall be meeting with the President on Monday, June 24, 1974, at 11:00 a.m. for one of a series of meetings designed to review possible Presidential initiatives to keep inflation in check. The focus of our discussion will be a review of budget alternatives for FY 1975 and FY 1976 and a brief run-down of monetary policy and conditions of banks.

cc: Glen Stafford

RECEIVED
JUN 24 1974
CENTRAL FILES

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RUSH: 109

Info KR JM DW

(3)

EXECUTIVE
FI2
FI9
F04-2
FG131

CHAIRMAN OF THE BOARD OF GOVERNORS
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

June 28, 1974

MEMORANDUM FOR THE PRESIDENT

FROM: Arthur F. Burns

You have asked for my assessment as to whether the extensive use of short-term deposits by banks to finance long-term loans poses serious potential problems for the future, particularly in the Euro-dollar market.

In recent years, U.S. bank assets have expanded rapidly, and banks have come to rely increasingly on the use of short-term funds purchased in money markets rather than on the deposits of customers. Abroad, the Euro-dollar market, in which U.S. banks are active participants, has grown even more rapidly. In this market, banks rely mainly on money-market funds; the participating banks obtain funds by bidding for them, and the transactions are large and impersonal. The Euro-dollar banks assume that the bulk of the funds they need will always be available at some price. They use a portion of these funds to

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make medium-term loans at interest rates which are adjusted periodically to the going rate for deposits plus a margin to cover the risk and cost of servicing the loan and yield some profit.

There has been increasing concern recently that the Euro-dollar banks may be incurring excessive liquidity risks. This worry has been prompted by three developments. (1) Very large sums of money are being deposited in Euro-dollar banks at short term by the oil-exporting countries, whose earnings have greatly increased. (2) Substantial sums are being lent to the oil importing countries and others at medium term -- 5 to 7 years or even longer -- with provision, as noted above, for interest rates to be adjusted as deposit rates change. (3) A few banks in the United States, Britain, Germany, and Switzerland have gotten into trouble recently (in every case as a result of fraud or mis-management quite unconnected with Euro-dollar business), and have then experienced liquidity difficulties as depositors or sellers of money market funds have withdrawn their balances from the banks in question.

The publicity given to the difficulties of these few banks -- particularly Franklin National in the United States -- has made

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people wonder whether additional banks might also be likely to encounter difficulties. Rumors abound that this or that bank is having difficulty raising funds, or is having to pay a premium in order to attract deposits. Prices of the stocks of many banks have declined sharply in recent weeks. People worry especially about banks in the Euro-dollar market because it is said they are not subject to close regulation, do not have behind them a lender of last resort, and may have tended in a fiercely competitive market to take unwarranted risks.

The Federal Reserve and other central banks, and the commercial banks themselves, are well aware that liquidity risks are real and need to be closely assessed. But our monitoring of the situation of American banks, including their position in the Euro-dollar market, leads us to believe that the rumors of bank difficulties at this time are exaggerated. Some banks in the United States, and in the Euro-dollar market, do have to pay a premium for funds. But it does not seem to have been the case thus far that they have been unable to obtain the funds they must have to meet their commitments.

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The deposits of the oil-exporting countries in the Euro-dollar market, though nominally short-term, may remain in the Euro-dollar market for some time, since the depositors will have no need to spend them for many years. The large American banks in the Euro-dollar market, and probably other banks as well, have recently been discouraging further short-term deposits by the oil exporters, and encouraging longer-term investments, by offering lower interest rates on short-term deposits or in some cases declining to accept them. They are looking more carefully at new loan proposals, and they maintain a sizable proportion of liquid assets against liabilities to insure their ability to meet possible deposit drains.

While it is true that there is no single regulator or lender of last resort in the Euro-dollar market, all the big banks in that market have access to the central banks of their respective countries. The Federal Reserve is committed to its member banks, including branches that are located abroad, to serve as a lender of last resort in the event of a liquidity squeeze, so long as the member bank is solvent. I presume that the same is the case for the other central banks, in relation to their constituent

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banking organizations. Provided that all of us do our jobs, the risk of a major calamity in the Euro-dollar market appears remote.

The problem of liquidity risks in commercial banking nevertheless requires careful attention by the bankers and their regulators alike. Some loose practices have crept into banking behavior in the last few years, and there can be no doubt that the risks are larger in this period of inflation, tight money, and rapid change than at other times. We at the Federal Reserve are monitoring closely the position of U.S. banks, both domestically and in the Euro-dollar market, and we will take action to modify banking practices whenever this seems beneficial to the public interest.

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CORRESPONDENCE CONTROL PROFILE SHEET FOR THE OFFICE OF KENNETH D. RUSH

109

DESCRIPTION

FROM: BURNS, ARTHUR

CLASSIFICATION: UNCLASSIFIED

TO: PRESIDENT X RUSH ____ OTHER ____ ACTION ____ LOG ONLY X

DATE OF CORRESPONDENCE JUNE 28, 1974 DATE RECEIVED JULY 1, 1974

SUBJECT: CHAIRMAN OF THE BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM SENDS MEMO TO THE PRESIDENT re EXTENSIVE USE OF SHORT-TERM DEPOSITS BY BANKS TO FINANCE LONG-TERM LOANS ON THE EURO-DOLLAR MARKET

DIST/ACTION/INFO

| | ACTION | INFO | RECORD CY |
|---|---|---|---|
| CIEP SECRETARIAT | XXXXX | 1 | XXXXXXX |
| READING FILE | | X | |
| KENNETH RUSH | | | |
| DENNIS WOOD | | X | |
| JAMES McLAIN | | X | |
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| | | | |
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ACTION REQUIRED:

Reply for RUSH Signature .....( )
Memo for RUSH Signature .....( )
Any Action Necessary .....( )
Recommendation/Comments .....( )
Refer to ____ Direct Reply..( )
Other ____

ACTION DUE DATE:

INTERNAL/INTERIM ROUTING

IF NO ACTION - RETURN W/PROFILE FOR FILES. IF CONVENIENCE CY NEEDED, PLEASE INDICATE

| DATE | FROM | TO | ACTION REQUIRED (OR TAKEN) | INITIAL |
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DISPOSITION

DATE DISPATCHED: ____

SPECIAL DISPOSITION: ____

CROSS REFERENCE W/NO. ____

FILING INSTRUCTIONS

WH CENTRAL FILES X
RETAIN IN RUSH OFFICE ____

COMMENTS

COMMENTS/SPECIAL INSTRUCTIONS:

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JUL 2 1974
CENTRAL FILES

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EXECUTIVE
FI 3
FI 2

July 5, 1974

MEMORANDUM FOR: FILE

FROM: DENNIS WOOD

SUBJECT: Variable Bonds

As a result of the meeting between Rush, Simon, Mitchell, Lynn, Stein and Bennett on July 5, at 1:30 p.m. it was decided that:

Jack Bennett would convene the inter-agency group which has considered this issue up to now to draft an appropriate letter setting out policy as to the pending variable bonds issued and the savings and loan industry. Once our views are gathered as to this letter it will be forwarded to Mr. Rush, probably for a Presidential decision.

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EXECUTIVE

PR13-2/FALLSBURG

FI2

July 15, 1974

Dear Mr. Holzhauer:

The President has received your letter enclosing the copy of the resolution adopted by the Fallsburg Town Board. He appreciates your courtesy in bringing this expression of views to his attention.

With best wishes,

Sincerely,

Roland L. Elliott
Special Assistant
to the President

Mr. James D. Holzhauer
Administrative Assistant
Town Hall
South Fallsburg, New York 12779

kt

cc and original incoming to W. Dewey Clower

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EXECUTIVE
MC3-9
PR7-1
THE PRESIDENT HAS SEEN.
TR113
BE4
LA
FI2
BE5
BE5-3

# MEETING WITH BUSINESS, LABOR, BANKING AND ECONOMIC LEADERS

Tuesday, July 23, 1974
10:00 a.m. (90 minutes)
Conference Room

From: Kenneth Rush K.R.

## I. PURPOSE

To demonstrate concern about the inflation problem, to indicate to leading business and economic leaders you are interested in long-term economic stability, not immediate quick solutions, to solicit views on anti-inflation actions which should be taken by government and by the private sector.

## II. BACKGROUND, PARTICIPANTS AND PRESS PLAN

A. Background: This meeting is a follow-up to your meeting Friday with your economic advisors and your earlier meeting with leading businessmen and economists in Washington. It is a part of your effort to establish a dialogue on inflation and economic stability with all segments of the economy.

B. Participants: See TAB A.

C. Press Plan: Press photo opportunity. Mr. Rush will brief the press in the press room at Laguna Beach following the meeting.

## III. TALKING POINTS

A. Welcome: I appreciate your coming to San Clemente to discuss the economy with me and my advisors.

B. Format: I would first like to ask Kenneth Rush to begin with some brief remarks about the economy. Then I very much want to hear your ideas about the outlook for the economy, how we can solve the problem of inflation,

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EXECUTIVE
FO4-2
FI2
FI9
C075
FG12

July 24, 1974

MEMORANDUM FOR EDWARD C. SCHMULTS

FROM: PETER FLANIGAN

RE: Borrowings by Foreign Financial Institutions from U.S. Commercial Banks

This memo is in response to yours of July 16 with attached tables. Set forth below are the figures which seem relevant.

Short Term Foreign Dollar Claims by U.S. Banks

(Billions)

| End of Period | Total | Claims on Japanese (1) |
|---|---|---|
| 1972 | $14.8 | $4.2 |
| 1973 | $20.0 | $6.4 |
| 1974 (May) | $28.7 | $9.8 |
| Increase in 17 mos. | $13.9 | $5.6 |

(1) May include minor amounts payable in foreign currencies.

The above indicates that in the past 17 months total foreign claims by U.S. banks have approximately doubled, increasing by almost $14 billion. Of these advances by U.S. banks, about $5 1/2 billion have been to Japanese borrowers. In absolute amount and in increase this is enormously larger than claims on any other country. Perhaps more significantly, I am told that the claims since May 31 have risen at an increasing rate. Perhaps you could get more up to date figures.

I would be interested in your comment as to how these increases in claims (1) relate to increases in the U.S. banking system's total ~~liabilities~~, and (2) what portion of the U.S. increased money supply is represented by this increase in foreign dollar claims.

cc to: Ken Rush
Herb Stein

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JUL 24 1974
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