1996-SE-007280

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

BRIEFING

August 7, 1996

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

FROM: Roger L. Anderson RLA
Deputy Assistant Secretary
Federal Finance

Mozelle W. Thompson
Principal Deputy Assistant Secretary
Government Financial Policy

Victoria Rostow VR
Deputy Assistant Secretary
Banking and Finance

SUBJECT: SLMA and Connie Lee

You have asked for a summary of the issues involved in the legislation regarding the privatization of these two Government Sponsored Enterprises.

SLMA

- Treasury, on behalf of the Administration, had negotiated privatization language acceptable to SLMA.

- At the last minute, the Department of Education, raised two new issues:

  - The first would legislate Education's litigating position regarding SLMA's liability for a 30 basis point fee on Guaranteed Student Loans put into securitization vehicles.

  - The second would require SLMA to expand its marketing programs to schools whose students historically have poorer repayment records.

- OMB supported Education and refused to endorse the legislative language.

- We talked to Ellen Seidman about your interest in either NEC or Chief of Staff review of OMB's position. Ellen suggested calling Panetta.

CONNIE LEE

- Treasury has objected to three bill provisions that we believe would have a negative impact on the sale of Federally-owned Connie Lee stock. Taken together, we believe that these provisions will result in a "fire sale" of such stock. (The USG has invested $19 million in Connie Lee.) The bill:

  - requires that the stock be sold in six months (we asked for one year),

  - requires that such stock be sold to Connie Lee (if such stock is not sold within six months)

    -- based upon a **price approved by Connie Lee,**

    -- as determined by **a financial advisor chosen by Connie Lee,** and

    -- the **price cannot exceed a 1992 CBO estimated price of $7 million.**

TREASURY CLEARANCE SHEET

NO. ______
Date 8/7/96

MEMORANDUM FOR: [x] SECRETARY [x] DEPUTY SECRETARY [ ] EXECUTIVE SECRETARY
[ ] ACTION [ ] BRIEFING [ ] INFORMATION [ ] LEGISLATION
[ ] PRESS RELEASE [ ] PUBLICATION [ ] REGULATION [ ] SPEECH
[ ] TESTIMONY [ ] OTHER ______

RCA

FROM: DAS Anderson - Principal DAS Thompson - DAS Rostow
THROUGH: ______
SUBJECT: SLMA and Connie Lee

REVIEW OFFICES (Check when office clears)

[ ] Under Secretary for Finance
  [ ] Domestic Finance
  [ ] Economic Policy
  [ ] Fiscal
    [ ] FMS
    [ ] Public Debt

[ ] Under Secretary for International Affairs
  [ ] International Affairs

[ ] Enforcement
  [ ] ATF
  [ ] Customs
  [ ] FLETC
  [ ] Secret Service
[ ] General Counsel
[ ] Inspector General
[ ] IRS
[ ] Legislative Affairs
[ ] Management
[ ] OCC

[ ] Policy Management
  [ ] Scheduling
[ ] Public Affairs/Liaison
[ ] Tax Policy
[ ] Treasurer
  [ ] E & P
  [ ] Mint
  [ ] Savings Bonds

[ ] Other ______

NAME (Please Type)	INITIAL	DATE	OFFICE	TEL. NO.
INITIATOR(S)				
R. Anderson	RCA		Federal Finance	2-2640
REVIEWERS				
VPR - with change shown	VPR	8/07/96		

SPECIAL INSTRUCTIONS

[ ] Review Officer ______ Date ______ [ ] Executive Secretary ______ Date ______

1997-SE-001385

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

February 7, 1997

ACTION

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

THROUGH: John D. Hawke, Jr. JDH
Under Secretary (Domestic Finance)

FROM: Roger L. Anderson RLA
Deputy Assistant Secretary (Federal Finance)

SUBJECT: Sallie Mae Oversight

ACTION FORCING EVENT:

The scope of Treasury's oversight of the Student Loan Marketing Association (Sallie Mae) has been expanded and enhanced as part of last year's Government-sponsored enterprise (GSE) privatization legislation. Funding is provided for by annual assessments of Sallie Mae, capped at $800,000 adjusted for changes in the CPI.

RECOMMENDATION:

That you approve the creation of an Office of Sallie Mae Oversight as described below.

__________Agree __________Disagree __________Let's Discuss

BACKGROUND ANALYSIS:

Treasury was first charged with overseeing the financial safety and soundness of Sallie Mae by legislation in 1992. No additional resources were provided, however. At the time, the Office of the Deputy Assistant Secretary (Federal Finance) was assigned this responsibility because of its close involvement with Sallie Mae since the inception of the GSE in 1972, and because of the Office's extensive coverage of Sallie Mae operations during GSE studies conducted by Treasury in 1990-1991. Since then, we have carried out Sallie Mae oversight with one full-time professional supervised by the Director of the Office of Market Finance.

In mid-1996, GAO auditors looking at Sallie Mae expressed concern about the limited resources available for Treasury oversight. Treasury and the Administration demanded and received enhanced oversight and enforcement authority, as well as funding for oversight operations, as a condition for supporting Sallie Mae's privatization legislation last year.

The legislation requires enhanced oversight of Sallie Mae until the termination of its GSE status, which must occur not later than 2008 if Sallie Mae's shareholders elect to privatize or 2013 if Sallie Mae dissolves. The shareholders are expected to elect privatization at a

May 15, 1997 meeting. Sallie Mae would then become a GSE subsidiary of a completely private, state-chartered Holding Company during a transition period of up to 11 years. The Government would have no specific ties to or oversight authority of the Holding Company.

If Sallie Mae privatizes, Treasury must make sure that "fire walls" provided for by statute are erected in order to insulate the GSE from the activities of its parent and non-GSE affiliates. Treasury must also make sure that, once established, the "fire walls" are never breached. Uncertified dividend distributions to the parent cannot be permitted, and the GSE's compliance with its statutory capital ratio, which is to be increased from 2.0 to 2.25 percent in 2000, must be rigorously monitored and enforced. Treasury must assure that, among other things, restrictions on debt issuance, GSE name usage, and new business activities are not violated.

For a period of up to 11 years, Treasury must make sure that at all times there are no extensions of credit or any kind of credit guarantees by the GSE to other parties in the holding company structure, and that the assets of the GSE are never encumbered in any way by the other parties. Contracts with the Holding Company for loan servicing and for financial management and internal controls must be subjected to continuous scrutiny. All transactions must be carried out at arms length at costs and performance standards that are no less favorable than are available elsewhere. Oversight would be complicated substantially if the parent itself were acquired, such as by a foreign financial services firm.

If Sallie Mae dissolves, enhanced oversight could span 16 years. During that time, Treasury would need to focus on risks inherent in a company likely to lose expertise in management and internal control early on.

Sallie Mae's financial and operations management under either dissolution or privatization must always measure up to industry and Federal regulatory standards involving internal controls over credit risk, interest rate risk, risk arising from derivative transactions, adequacy of reserves for losses, and all other sources of risk. On December 31, 1996, Sallie Mae had assets of $47.6 billion with appropriately matched liabilities. In the third quarter, the nominal volume of financial derivatives totaled $44.6 billion.

An Office of Sallie Mae Oversight staffed by a SES-level Office Director, two professionals, one research assistant, and contract consultants with expertise in bank regulation and examination appears sufficient to meet the statutory oversight requirements. The consultants would be needed from time to time to assist the in-house staff develop the Treasury oversight plan; evaluate Sallie Mae's Reorganization Plan, and later on its Winddown Plan if the shareholders do not elect reorganization; and conduct periodic, on-site full-scale or selected-target examinations.

When we were planning the Office, we sought the advice of bank examiners at the OCC and the Fed. They concurred that a relatively small office with a technically strong, highly visible Director and support from contract consultants would be adequate for Treasury oversight of Sallie Mae. The case for a small office reflects (1) the fact that Sallie Mae's operations consist of standardized, highly repetitive computerized processes involving the purchasing and servicing of Government-guaranteed student loans, and (2) the fact that Sallie Mae currently utilizes well-established financial management and internal controls to minimize credit and interest rate risks. Our internal oversight evaluations have found that Sallie Mae has been very successful in controlling risks.

As a comparison, the Office of Federal Housing Enterprise Oversight, which has somewhat broader oversight authority for FNMA and FHLMC than Treasury does for Sallie Mae, has a budget of $15.5 million for fiscal year 1997 and a full-time staff of 72. That $15.5 million is approximately 3.0 percent of the combined assets of FNMA and FHLMC, while our $800,000 budget is only 1.7 percent of Sallie Mae's assets.

The Sallie Mae Oversight Office must develop a Treasury oversight operating plan while simultaneously providing for an analysis and evaluation of Sallie Mae's Reorganization Plan. Sallie Mae expects to submit a review copy of the Reorganization Plan to Treasury in February or March, before presenting the Plan for shareholder vote in May. A staff with expertise in sophisticated corporate financial management and credit analysis in a holding company structure, knowledge of the federally guaranteed student loan program, and the ability to anticipate challenges to oversight for a span of up to 11 or 16 years is the key to providing acceptable oversight.

If Treasury does not provide proper oversight, the Government could be exposed to risks that the Holding Company's management and internal controls might be inadequate to assure corporate separateness. One intent of the law, and of Treasury oversight, is to protect the GSE from business risks of the parent or its non-GSE affiliates. Treasury must determine that the terms and substance of a trust to be established by Sallie Mae upon termination of its GSE status are satisfactory to the Secretary for purposes of holding funds for the benefit of investors in remaining GSE debt. Currently, GSE debt totals $46.6 billion, of which $0.4 billion has a maturity date of 2022, or well beyond the maximum end date of 2008 or 2013 for termination of GSE status. If Sallie Mae experienced a financial crisis, investors might appeal to the Government for assistance, although GSE debt is not guaranteed by the Government. Sallie Mae has the ability to borrow up to $1.0 billion from the Treasury subject to the approval of the Secretary. (TAB C provides details on potential risk exposure.)

Sallie Mae agreed to the legislation requiring enhanced oversight, including the funding provisions. Sallie Mae's first semi-annual payment for FY 1997 ($400,000) has been received and is available to finance expanded oversight beginning as of October 1, 1996.

Attachments:

TAB A Organization Chart and Mission Statement
TAB B Personnel Needs and Budget
TAB C Overview of Potential Risk Exposure
TAB D Legislation and Schedule of Selected Dates

1997-SE-002065

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

February 25, 1997

MEMORANDUM FOR SECRETARY RUBIN

THROUGH: George Muñoz GM
Assistant Secretary (Management) and
Chief Financial Officer

FROM: John D. Hawke, Jr.
Under Secretary (Domestic Finance)

Mozelle W. Thompson MT
Principal Deputy Assistant Secretary
(Government Financial Policy)

SUBJECT: Privatization of Connie Lee

ACTION FORCING EVENT:

Pursuant to Section 603 of the Student Loan Marketing Association Reorganization Act of 1996, as enacted in the Omnibus Consolidated Appropriations Act of 1997 (Pub. L. 104-208), the Secretary of the Treasury is directed to sell the Connie Lee stock held by the Department of Education no later than February 27, 1997.

RECOMMENDATION:

That you delegate your authority to Under Secretary Hawke and PDAS Thompson for the sale of the Connie Lee stock held by the Secretary of Education.

______Agree ______Disagree ______Let's Discuss

BACKGROUND/ANALYSIS:

Treasury understands that the sale of stock to Connie Lee will take place on February 27. To sign necessary documents on behalf of the Secretary, such as cross-receipts, the Office of General Counsel is of the opinion that a delegation of authority is necessary.

Tab A: A Temporary Order is attached for your signature.

BY ORDER OF THE
SECRETARY OF THE TREASURY

DATE:
TREASURY ORDER 103-02 (T)

Sunset Review:

SUBJECT: Delegation of Authority Relating to Connie Lee Privatization

1. By virtue of the authority vested in the Secretary of the Treasury, including the authority in 31 U.S.C. 321(b), I hereby delegate to the Under Secretary (Domestic Finance) and the Principal Deputy Assistant Secretary (Government Financial Policy), the authority of the Secretary of the Treasury under Section 603 of the Student Loan Marketing Association Reorganization Act of 1996, as enacted in the Omnibus Consolidated Appropriations Act of 1997 (Pub. L. 104-208) ("Section 603 of the Act") to exercise any right or power, make any finding or determination, or perform any duty or obligation which the Secretary of the Treasury is authorized to exercise, make or perform under Section 603 of the Act. Each of these officials may exercise this authority in his own right.

2. This Temporary Order shall be effective as of the date of enactment of Section 603 of the Act and it shall terminate without any further action on February 28, 1998. Termination of this Temporary Order shall have no effect upon actions taken within the scope of the Temporary Order prior to its termination.

Robert E. Rubin
Secretary of the Treasury

OPI: US (Domestic Finance)

TREASURY CLEARANCE SHEET

No. ________
Date ________

MEMORANDUM FOR: [x] SECRETARY [ ] DEPUTY SECRETARY [ ] EXECUTIVE SECRETARY
[ ] ACTION [ ] BRIEFING [ ] INFORMATION [ ] LEGISLATION
[ ] PRESS RELEASE [ ] PUBLICATION [ ] REGULATION [ ] SPEECH
[ ] TESTIMONY [ ] OTHER ________

FROM: Assistant Secretary (Management) and CFO
THROUGH: ________
SUBJECT: Proposed Treasury Order 103-02

REVIEW OFFICES (Check when office clears)

[ ] Under Secretary for Finance
[ ] Domestic Finance
[ ] Economic Policy
[ ] Fiscal
[ ] FMS
[ ] Public Debt

[ ] Under Secretary for International Affairs
[ ] International Affairs

[ ] Enforcement
[ ] ATF
[ ] Customs
[ ] FLETC
[ ] Secret Service
[ ] General Counsel
[ ] Inspector General
[ ] IRS
[ ] Legislative Affairs
[ ] Management
[ ] OCC

[ ] Policy Management
[ ] Scheduling
[ ] Public Affairs/Liaison
[ ] Tax Policy
[ ] Treasurer
[ ] E & P
[ ] Mint
[ ] Savings Bonds

[ ] Other ________

NAME (Please Type)	INITIAL	DATE	OFFICE	TEL. NO.
INITIATOR(S)				
J. Donahue	JD	2/25/97	Ofc. of Organizational Improvement	2-0075
REVIEWERS				
M. Shaw	JD	2/25/97	Act. Dir., Ofc. of Organizational Improvement	2-1068
S. Gould	[illegible]	2/25/97	DAS (DF&M)	2-2400
G. Muñoz	GM	2-25-97	AS (M)/CFO	2-0410
Ed Knight	[illegible]	2/25/97	General Counsel	2-0287

THIS ORDER MUST BE REVIEWED BY THE GENERAL COUNSEL PRIOR TO SUBMISSION TO THE SECRETARY

[ ] Review Officer Date [ ] Executive Secretary Date

1998-SE-013985

98-13985

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

INFORMATION

ASSISTANT SECRETARY

INFORMATION

December 10, 1998

to: Gensler
Carnell
Rubin

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

FROM: Gary Gensler
Assistant Secretary for Financial Markets

Richard S. Carnell RSC
Assistant Secretary for Financial Institutions

SUBJECT: Budget-Related Proposals re GSEs and Ginnie Mae

On December 9, we spoke with Josh Gotbaum of OMB about budget-related proposals for new fees on government-sponsored enterprises (such as Fannie Mae and Freddie Mac) and for selling rights relating to Ginnie Mae.

GSE Fees

We underscored the Secretary's desire to assist OMB in achieving its fiscal goals—and to do so in a way that would not lend credence to market perceptions that the government implicitly backs the GSEs.

critical

We outlined several proposals that would seek to achieve those dual objectives by imposing fees based on specific, identifiable benefits that the government provides to the GSEs: e.g., exemption from securities registration; exemption from state and local corporate income taxes; and the GSEs' federal charters themselves.

At Josh's request, we will prepare for OMB a more specific list of ideas along with rough estimates of the revenue they would raise. We will follow-up with Michael Deich, discussing the political feasibility as well as the substance of these ideas.

Josh specifically asked us to include a proposal requiring Fannie Mae to make some payment in lieu of the D.C. corporate income tax. (As Fannie Mae has the right to relocate within 50 miles of D.C., one might key the fee to the lowest of the D.C., Maryland, and Virginia corporate income tax rates.)

Ginnie Mae

OMB wants to continue developing a possible proposal for selling the right to collect Ginnie Mae's future revenues. Jack Lew informed Andrew Cuomo today of OMB's interest in this idea. We understand that Cuomo responded negatively, emphasizing possible adverse effects on first-time homebuyers and members of minority groups.

OMB now believes that under the Credit Reform Act, the government would not derive scorable receipts from selling the right to payments on Ginnie Mae's *existing* book of business. Accordingly, Josh has in mind selling the exclusive right to fees on Ginnie Mae's *future* business for a period on the order of 15 years.

Josh's goal is to raise some $2-2.5 billion in this manner. He has asked us to work closely with OMB in structuring and valuing such a proposal.

We note that such a proposal continues to face significant hurdles from the standpoint of housing policy, GSE policy, privatization policy, and political feasibility.

cc: Alan Cohen
Linda Robertson
David Wilcox

This is important

The Secretary of the Treasury

December 14, 1998

NOTE TO GARY GENSLER
RICK CARNELL

FROM: Bob Rubin

GSE Fees: Critical.

Ginnie Mae: This is important.

EXECUTIVE SECRETARIAT CORRESPONDENCE MEMO COVER SHEET

Thursday, December 10, 1998

PROFILE #: 1998-SE-013985

DATE CREATED: 12/10/1998

ADDRESSEE: Robert E. Rubin/Lawrence Summers
Secretary/Deputy Secretary

AUTHOR: Gensler, Gary/Carnell, Richard S.
Domestic Finance

SUBJECT: Budget-Related Proposals Re GSEs And Ginnie Mae

ABSTRACT: Budget-related proposals re GSEs and Ginnie Mae.

RM 3419 | TO REVIEWERS | TO EXECUTIVE SECRETARY

IN: | IN:

TO THE SECRETARY

To DI 12/10/98

DATE SIGNED:

DISTRIBUTION: US, DOMESTIC FINANCE

DI to REV
DI to LS (READING) 12/10/98

cc: MF
SS
NC/DI/PA/AR

2000-se-008024

2000-SE-008024

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.
August 3, 2000

ACTION

ASSISTANT SECRETARY

MEMORANDUM FOR SECRETARY SUMMERS
DEPUTY SECRETARY EIZENSTAT

THROUGH: Gary Gensler
Under Secretary (Domestic Finance)

FROM: Lee Sachs
Assistant Secretary (Financial Markets)

SUBJECT: Sallie Mae Oversight

ACTION FORCING EVENT:

The Student Loan Marketing Association Reorganization Act of 1996 (the Privatization Act) expanded Treasury's oversight of the Student Loan Marketing Association (the GSE). In 1997, former Secretary Rubin created the Office of Sallie Mae Oversight (the Oversight Office) under the Deputy Assistant Secretary for Federal Finance. The Oversight Office has conducted studies of the GSE's operations, and has developed an examination plan to monitor the GSE's safety and soundness and compliance with statutory provisions.

RECOMMENDATION:

That you direct the Oversight Office to prepare an annual examination report to assess the financial safety and soundness and the statutory compliance of the GSE as it moves to full privatization.

LS ok per NCG 9/7/00

Approve ✓ ______ Disapprove ______ Let's Discuss ______

BACKGROUND:

In 1997, the GSE was reorganized into a subsidiary of SLM Holding Corporation (SLM), with the authority to continue purchasing student loans until September 2007. The GSE must then dissolve and relinquish its charter by September 2008. During the transition, the holding company structure allows SLM to enter new lines of business through its non-GSE subsidiaries.

EXECUTIVE SECRETARIAT

EXECUTIVE SECRETARIAT CORRESPONDENCE MEMO COVER SHEET

Friday, August 04, 2000

PROFILE #: 2000-SE-008024

DATE CREATED: 08/04/2000

ADDRESSEE: Lawrence H. Summers
Secretary

AUTHOR: Sachs, Lee
AS, Financial Markets

SUBJECT: Sallie Mae Oversight

ABSTRACT: Sallie Mae Oversight

RM 3419

TO REVIEWERS

IN: To PA 8/4/00

TO EXECUTIVE SECRETARY

IN:

TO THE SECRETARY

DATE SIGNED:

DISTRIBUTION: US, DOMESTIC FINANCE

PA to NCC
PA cc AK/TR
8/4/00

NCC ready for LS'
action
NCC cc to SS
8/8/00 TS

08/04/2000 11:01:34 AM

2000-SE-008024

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.
August 3, 2000

ASSISTANT SECRETARY

MEMORANDUM FOR SECRETARY SUMMERS
DEPUTY SECRETARY EIZENSTAT

THROUGH: Gary Gensler
Under Secretary (Domestic Finance)

FROM: Lee Sachs
Assistant Secretary (Financial Markets)

SUBJECT: Sallie Mae Oversight

ACTION FORCING EVENT:

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RECOMMENDATION:

That you direct the Oversight Office to prepare an annual examination report to assess the financial safety and soundness and the statutory compliance of the GSE as it moves to full privatization.

Approve ______________ Disapprove ______________ Let's Discuss ______________

BACKGROUND:

In 1997, the GSE was reorganized into a subsidiary of SLM Holding Corporation (SLM), with the authority to continue purchasing student loans until September 2007. The GSE must then dissolve and relinquish its charter by September 2008. During the transition, the holding company structure allows SLM to enter new lines of business through its non-GSE subsidiaries.

EXAMINATION PLAN:

The attached document more fully describes the mission of the Oversight Office and the proposed examination and reporting process. The plan is consistent with the examination approaches used by Federal bank and government-sponsored enterprise regulators. To ensure a constructive examination process, the Oversight Office has also adopted several communication standards.

REPORTS:

An examination report would be issued annually, absent any cause for interim special examination reports. By law, examination reports are to be provided simultaneously to the Secretary, the GSE, and to the Secretary of Education. Examination findings are considered confidential and are not disclosed to the public. In addition, the Oversight Office may provide separate reports on the status of the GSE privatization or any other reports directed by the Secretary.

The annual examination report would generally include: (1) a description of risks associated with the GSE's business and how the risks are managed; (2) a description and assessment of the GSE's progress towards a winddown, and of specific risks arising from the privatization plan; (3) any examination findings requiring corrective action; and (4) an operating performance section.

Most recently the Oversight Office prepared an interim limited-scope examination report dated March 2000, which was forwarded to you under separate cover dated May 15, 2000.

Attachment:

Examination Plan

Department of the Treasury
Office of Sallie Mae Oversight
Examination Plan

The mission of the Office of Sallie Mae Oversight (the Oversight Office) is to carry out the oversight charge of the Secretary of Treasury established by Congress to (1) monitor the financial safety and soundness of the Student Loan Marketing Association (the GSE), and (2) monitor and enforce compliance with capital requirements and other statutory provisions. This mission will be carried out through ongoing off-site analysis of the company and periodic on-site examinations as described below.

I. Examination Communication Standards

A. **Transparency.** The Oversight Office seeks to foster an understanding of the philosophy, goals, approach, and evaluation criteria being used by the examiners. Procedures performed will be documented.

B. **Familiarity.** Before issuing a formal report, the Oversight Office will provide management with an opportunity to respond to any issues raised. Findings memoranda on the area covered will be provided to management. Routine meetings with the Audit Committee of the Board of Directors will be held.

C. **Ethical Understanding.** Information garnered from the company will be treated as confidential. Examiners will be sensitive to management concerns. Communications with management will be candid. Examiners and consultants will be free from financial interest in the GSE and its affiliates, including SLM Holding Corporation.

II. Examination Objectives - These include an assessment of:

- Management's expertise.
- Board of Directors' oversight.
- The adequacy of records and internal controls.
- Various risks faced by the company.

III. The Examination Approach

A. **Gather Information -** This is the first step toward understanding the GSE's business and assessing risk associated with the business. The Oversight Office expects to engage experts to assist in assessments of certain aspects of the GSE's business. General areas of examination are as follows:

- Credit Risk Management.
- Market Risk Management.
- Business Operations Risk.
- Corporate Governance Risk.
- Technology Management.
- Progress Towards Privatization.

B. Set Scope - Develop Examination Procedures

- Select exam procedures that are focused on precisely defined risks identified in the Gather Information segment.

C. Perform Examination Procedures (Execute Examination Plan)

- Interview Sallie Mae personnel
- Evaluate the adequacy of Sallie Mae policies and procedures
- Evaluate the appropriateness of the risk measurement and reporting system
- Evaluate the reliability and accuracy of management reports.

D. Assess Results and Management

E. Conclude/Resolve - Post On-Site Examination Procedures

- Prepare an annual Report of Examination with summary of findings, recommendations, compliance matters, and management response(s).
- Provide a copy of the Report of Examination to the GSE's Board of Directors and management.
- Discuss the Report of Examination with the GSE's Board of Directors.
- Require a written response by the Board of Directors to the Report of Examination, specifically addressing any outstanding items.
- Use reasonable good faith efforts to resolve findings that require corrective action with management. A review process may need to be developed.

HEDGE FUNDS

1998-SE-012871

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

November 13, 1998

INFORMATION

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS
UNDER SECRETARY HAWKE

FROM: Gary Gensler
Assistant Secretary (Financial Markets)

SUBJECT: Possible Recommendations on Derivatives and Hedge Funds Studies

Based on our discussions today, we have revised the list of possible recommendations for the studies on derivatives and hedge funds. We have highlighted in a new first section, on "Margin and Capital Requirements," some possible thoughts for addressing leverage. We also use this section to set down a marker calling for the exploration of ways to implement margin and capital requirements across a broader spectrum of financial activity. We will be developing further our own ideas on leverage.

We have set up meetings with staff of the Federal Reserve and the SEC on Monday. We also hope to meet with the CFTC next week. It was encouraging to hear of your meeting with Chairman Greenspan. We look forward to meeting with you and Larry on Tuesday to discuss these topics further.

ATTACHMENTS: Tab A: Possible Recommendations

Possible Recommendations

I. New Initiatives

a. Margin and Capital Requirements

- Possibly subject OTC equity derivatives to margin regulation.
- Possibly give regulators of broker-dealers and FCMs the power to impose capital requirements on trading and derivative affiliates ("consolidated supervision").
- Explore ways to implement margin and capital requirements across a broader spectrum of financial activity.
- Request the Bank for International Settlements ("BIS") to review its current capital requirements for derivatives and make adjustments where appropriate.
- Possibly embody Bessemer requirements in statute (taking hedge funds' assets and liabilities fully into the bank's own balance sheet).

b. Disclosure

- Give regulators of banks, broker-dealers and Futures Commission Merchants ("FCMs") the power to impose record keeping and reporting requirements on derivatives affiliates.
- Enhance Commodity Pool Operator ("CPO") and Commodity Trading Advisor ("CTA") filings to be quarterly, include summary derivatives information and potentially release to the public.
- Require financial institutions to disclose summary of exposures to other leveraged entities as footnote to financial statements.
- Require that financial institutions demand more information from leveraged entities. Require that creditors report this information to regulators on a summary basis, with the opportunity for regulators to obtain more information.

c. Stress Testing

- Require banks and broker-dealers (including their affiliates) to conduct regular stress tests on their exposures (institutionalize the Derivatives Policy Group ("DPG")).
- Require regulated entities to conduct an "integrated stress test" to measure their total credit and derivative exposure to leveraged entities.
- Summary results of such stress tests would be made available to regulators.

d. **Internal Controls**

- Give regulators of broker-dealers and FCMs the power to impose internal control requirements on trading and derivative affiliates.

e. **Best Practices**

- Encourage a group of financial institutions to draft and publish a set of best practices for relationships with leveraged entities.

- Encourage a group of hedge funds to draft and publish a set of best practices for their internal controls.

f. **International Approach**

- Improve international information exchange among national regulators
- Encourage offshore banking centers to comply with internationally-agreed standards.

II Providing Legal Certainty

a. **Swap Exemption**

- Legislate the Swaps Exemption and change it to an exclusion from the Commodity Exchange Act ("CEA").
- Continue to apply only to contracts between appropriate persons.
- Maintain existing requirement for credit considerations.
- Clarify that similar or industry standard terms do not equal fungibility.

b. **Equity Swaps**

- Expand Swaps Exemption to include swaps on non-exempt securities, *e.g.*, equity swaps, credit swaps, emerging market swaps.
- Make over-the-counter ("OTC") equity derivatives subject to at least Securities Exchange Commission ("SEC") anti-fraud jurisdiction.

c. **Board of Trade Issues**

- The Treasury Amendment would no longer use the term "Board of Trade."
- The Treasury Amendment would apply to all transactions in government securities, foreign exchange and other listed instruments not conducted on an organized futures exchange.

d. Organized Futures Exchange

- Swap exemption would no longer use the term "multilateral transaction execution facility."
- In its place, define the term "organized futures exchange" to include today's recognized exchanges, self-regulatory organizations ("SROs") and anything functionally identical, but to exclude clearinghouses and trading systems.

e. Broker or Dealer Trading Systems

- Continue with current approach, even if expanded to derivatives.
- Trading systems in securities are regulated by the SEC or Treasury.
- Trading systems in foreign exchange are unregulated.
- Trading systems which met the following conditions would not be an Organized Futures Exchange:
  a. trading only contracts on nonphysical commodities
  b. principal only business
  c. limited clearinghouse oversight
- Futures exchanges could establish electronic versions that meet the above conditions.

f. Limited Anti-Fraud Authority

- Give the Commodity Futures Trading Commission ("CFTC") specific authority to prosecute fraud in foreign exchange bucket shops, those entities that are not otherwise regulated that market foreign currency derivatives to retail.

III Further Possible Initiatives

a. Shad-Johnson

- Provide specific conditions for trading of single stock futures, subject to SEC jurisdiction.

b. Clearinghouses

- Clearinghouses that may develop for interest rate and currency swaps and foreign exchange could be overseen by the Fed.
- The CFTC would continue to oversee futures clearinghouses.
- The SEC would continue to oversee securities clearinghouses.

c. International Centralized Credit Database

- SEC Chairman Arthur Levitt has proposed a market-organized International Centralized Credit Database.

IV Tax Issues

a. Highlight Importance of Tax-Related Issues

- Treasury would address in a separate venue important tax-related issues for both derivatives and leveraged investors.
- In particular, because tax havens adversely affect transparency for tax purposes, consider measures to encourage U.S.-owned funds to domicile in non tax-haven jurisdictions.

TREASURY CLEARANCE SHEET

*Date*11/13/98

MEMORANDUM FOR: XSECRETARY X DEPUTY SECRETARY X UNDER SECRETARY

☐ ACTION ☐ BRIEFING ☐ INFORMATION ☐ LEGISLATION
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ EXECUTIVE SECRETARY ☐ TESTIMONY ☐ OTHER

FROM: ASSISTANT SECRETARY GENSLER
THROUGH
SUBJECT: DERIVATIVES AND HEDGE FUNDS STUDIES

REVIEW OFFICES (Check when office clears)

☐ Under Secretary for Finance
- ☐ Domestic Finance
- ☐ Economic Policy
- ☐ Fiscal
  - ☐ FMS
  - ☐ Public Debt

☐ Under Secretary for Int'l Affairs
- ☐ International Affairs

☐ Enforcement
- ☐ ATF
- ☐ Customs
- ☐ FLETC
- ☐ Secret Service

☐ General Counsel
- ☐ Inspector General

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- ☐ Management
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☐ Policy Management
☐ Scheduling
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☐ Tax Policy
☐ Treasurer
- ☐ E & P
  - ☐ Mint
- ☐ Savings Bonds

☐ Other ______________

NAME (Please Type)	INITIAL	DATE	OFFICE/ROOM NO.	TEL. NO.
INITIATOR(S)				
AShelton	AMS	11/13/98	Policy Analysis	2-0101
REVIEWERS				
Norman Carleton	NC	11/13/98	Policy Analysis	2-1855

SPECIAL INSTRUCTIONS--☐ Review Officer Date: ☐ Executive Secretary Date

To PA/NCC 11/13/98

NCC to RER 11/13/98
(information)

PA to LS (information) 11/13/98
PA cc MF
SS
NC/DC/PA/AK

Please log in.

TREASURY CLEARANCE SHEET

Date 11/13/98

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SPECIAL INSTRUCTIONS-- ☐ Review Officer Date: ☐ Executive Secretary Date

1999-SE-001421

DEPARTMENT OF THE TREASURY
WASHINGTON

February 9, 1999

INFORMATION

ASSISTANT SECRETARY

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

FROM: Gary Gensler
Assistant Secretary
(Financial Markets)

Lee Sachs
Deputy Assistant Secretary
(Government Financial Policy)

SUBJECT: President's Working Group on Financial Markets Study of Hedge Funds: Consensus Recommendations and Options for Additional Actions by Treasury

Congress expects to receive the Working Group's study of hedge funds by winter's end. Moreover, it is becoming increasingly important to resolve certain issues for OASIA, as they move forward on many international commitments and approach the G-7 summit this summer.

On February 17, Chairmen Greenspan and Levitt will meet with the two of you to discuss the report's conclusions. Part I of this memorandum lists the expected consensus recommendations of the Federal Reserve, the SEC and the Treasury. We believe that your meeting with Chairman Greenspan on Wednesday, February 10, would be an opportunity to advance the consensus recommendations.

Specifically, we suggest that you press Chairman Greenspan to support the consolidated supervision of broker-dealers, in order to extend the regulatory net to broker-dealers' affiliates. We believe that Chairman Greenspan might not be enthusiastic, but that you might have success in winning his support for consolidated supervision.

Part II discusses whether Treasury should go beyond the expected consensus recommendations to put its position on the public record. We lay out some options that we would like to discuss with you, concerning whether to go public and, if so, in what fora. This is basically a political decision as to whether Treasury should say publicly that, while we support the Working Group recommendations, we believe that additional action is warranted.

I. Working Group Recommendations

Although Treasury has been consistently working toward achieving its goals, consensus appears to fall short of our position. The consensus recommendations agreed upon thus far by Fed, the SEC, and Treasury focus on four primary areas: (a) disclosure and reporting, (b) minimum standards, (c) supervisory oversight, and (d) international approach. Discussions with the CFTC lead us to believe that they agree with most of these items; however, they might be closer to the Treasury position.

It appears that the Working Group (ex-CFTC) is close to consensus on the following:

- Disclosure and Reporting
  - Require financial institutions to disclose a summary of exposures to highly leveraged complex financial entities as a footnote to their financial statements.
  - Require more frequent reporting by commodity pool operators (CPOs) to the CFTC.
  - Require CPO filings to include more meaningful measures of market risk that reflect the risk of both on-balance sheet and off-balance sheet positions (e g. value at risk or stress-testing).
  - Make CPO filings public.
- Minimum Standards
  - Encourage a group of financial institutions to draft and publish a set of minimum standards for risk management and relationships with leveraged complex financial institutions. For example, a group of twelve major, internationally active commercial and investment banks recently formed the "Counterparty Risk Management Policy Group."
  - Encourage a group of hedge funds to draft and publish a set of minimum standards for their risk management and internal controls.
- Supervisory Oversight
  - Promote the further development of risk-based capital rules (value at risk methodologies).
  - Issue guidance on the credit approval process and ongoing monitoring of credit quality.
  - Issue guidance concerning limits on counterparty credit exposures.
  - Issue guidance on improving procedures for estimating potential future credit exposures and stress testing.
  - Issue guidance concerning the use of collateral.
  - Expand the SEC's FOCUS reporting requirements, under which firms report detailed broker-dealer positions, to include more information about credit exposures. (The SEC is still reviewing this.)
- International Approach
  - Encourage offshore banking centers to comply with internationally-agreed standards.
  - Endorse the Basle agenda to revise the Capital Accord in the short term and overhaul it in the long term; and to develop standards for creditor lending to highly leveraged complex financial institutions.

- Endorse the IOSCO agenda to examine the need for improved internal control standards and risk management practices for securities firms, and to examine the appropriateness of disclosure standards and regulation of hedge funds.

We have also explored expanding the regulatory net, by instituting the consolidated supervision of broker-dealers with the SEC and the Federal Reserve. While the SEC supports consolidated supervision of broker-dealers, they are concerned about a negative response from Capitol Hill. The SEC might support including some language in favor of consolidated supervision in the Working Group's report. The Federal Reserve is hesitant about endorsing the consolidated supervision of broker-dealers. Of all the possible measures to broaden the scope of regulation, however, this is the one with which Federal Reserve staff has been most sympathetic. This is a point that you might have better success pursuing directly with Chairman Greenspan during your meeting on Wednesday.

If we do not achieve consensus on the need for consolidated supervision of broker-dealers, we might be able to accomplish some of the benefits of consolidated supervision through the following measures. These will require legislation.

- Enhance the SEC's risk assessment authority to include reporting, record-keeping and examination authority for all broker-dealer affiliates.
- Update the SEC's risk assessment rules, which require broker-dealers that meet threshhold requirements to report about positions held by "Material Associated Persons" (or "MAPs"). Update the risk assessment rules by requiring firms to: improve risk assessment measures when they or their MAP deal with highly leveraged complex financial institutions; report on credit risk by counterparty; and provide sensitivity analyses.
- Consider SEC preventative action against broker-dealers for excessive holding company risk (double leverage).

II. Options

While public statements could highlight the differences of opinion within the Working Group, they could further Treasury's agenda and place our position on the historical record.

Option A: Articulate a More Proactive Agenda

Treasury could advocate continued efforts to enhance existing regulations and broaden their reach to currently unregulated entities. If we do so, it would be critical to stress our continued support for the Working Group recommendations. The benefits of being proactive include:

- helping to ensure ongoing study and debate of the potential need for additional enhanced regulatory capital requirements;

- preserving our options for the international debate (although it could complicate our position to suggest that we favor something that we are later unable or unwilling to deliver);
- maintaining our position on the "high ground" in the international debate as well as establishing it domestically (subject to the same caveat as above);
- more accurately reflecting Treasury's position;
- putting this position "on the record" for the short term (for the next financial crisis);
- putting this position "on the record" for historical purposes, to set the framework for possible future legislation; and
- possibly adding to the debate on financial modernization legislation.

Treasury's message could consist of three parts: (a) reiterate the problem, (b) continue to support the Working Group Recommendations; and (c) highlight the ongoing need to study and consider additional actions.

Reiterate the Problem. Treasury's message should include our concern that market movements - both up and down - are exaggerated by excessive leverage. We should stress the need to find additional ways to ensure that excessive leverage is reduced. As last fall's events begin to fade from the collective memory, Treasury's message should serve as on ongoing reminder of the need to attempt to reduce excessive leverage and mitigate systemic risk.

Support the Working Group Recommendations. Treasury would continue to support the Working Group Recommendations.

Highlight the Ongoing Need to Study and Consider Additional Actions. Treasury would also advocate continued efforts to broaden the reach of existing regulation to currently unregulated entities. Treasury may want to advocate:

- consolidated supervision by the SEC of broker-dealers (unless you are successful in persuading Chairman Greenspan to support this);
- potential regulation of unaffiliated derivatives dealers; and
- potential regulation of other highly leveraged complex financial institutions.

Fora for conveying the message. There are four main fora for conveying a Treasury message on the need for additional actions.

- Hedge Fund Study: Treasury may want to state its position in the hedge fund study itself. This would starkly outline our differences with the other agencies, but it would most clearly place our position in the historical record.

- Speeches: We could insert Treasury's position into various speeches. Secretary Rubin's recent speech at Davos is an example of how future speeches could include details related to broadening the net of regulation.

- Testimony: We could insert Treasury's position into Testimony by Treasury officials. Opportunities exist as early as your testimony on Financial Modernization before the Banking Committee on February 12, but we do not think we would be prepared by then.
- Meetings: We could enunciate Treasury's position at domestic and international meetings. The G-7 Financial Ministers Meeting, which will take place on February 20, is one opportunity, however, it may be awkward for you and Chairman Greenspan to be taking different positions in that meeting. Since most G-7 countries do not have hedge funds, all the issues of direct regulation, as opposed to indirect influence through banks, are easy for others to call for but require difficult action in the U.S.

Additional opportunities to convey the Treasury message may be created by the G-7 outreach seminar to be held in the U.S. in April and the upcoming debate around the reauthorization of the CFTC.

OPTION B: Announce Treasury's Desire to Go Beyond the Working Group Recommendations, While Providing Little Detail

It might be prudent for Treasury to characterize the Working Group recommendations as useful first steps in dealing with excessive leverage. In addition, we could say that we will continue to watch the markets carefully and that, if these steps are not successful in dealing with excessive leverage, further steps will be needed. We would not specify now what those steps might be. The benefits of this approach would be:

- Treasury would be on the public record, and
- there would be less appearance of disagreement with other Working Group agencies.

The drawbacks of this stance would be:

- Treasury's position would not be fully articulated on the public record.

Option C: Do Not Announce Treasury's Position in Public Fora

Not announcing Treasury's position would avoid the following risks:

- public disagreement with Chairman Greenspan;
- low likelihood of support from other agencies;
- proposing something that is unlikely to pass Congress may be of particular concern on the international front; and
- strong industry opposition.

The drawbacks to this approach are that we would forego the benefits of articulating a more pro-active agenda (Option A). In addition, it might appear that Treasury only supports the status quo.

TREASURY CLEARANCE SHEET

*Date*2/8/99

MEMORANDUM FOR: SECRETARY DEPUTY SECRETARY UNDER SECRETARY

☐ ACTION ☐ BRIEFING ☒ INFORMATION ☐ LEGISLATION
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ EXECUTIVE SECRETARY ☐ TESTIMONY ☐ OTHER

FROM: ASGensler and DAS Sachs
THROUGH
SUBJECT:President's Working Group on Financial Markets Study of Hedge Funds: Consensus Recommendations and Options for Additional Actions by Treasury

REVIEW OFFICES (Check when office clears)

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☐ Other

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INITIATOR(S)				
AShelton	AMS		Financial Markets	2-0101
REVIEWERS				
Caroline Atkinson	CA	2/9/99	DAS(International Monetary & Financial Policy	2-0489
Bob Cumby	RC	2/8/99	DAS Macro Economic Analysis	2-0572
Norman Carleton	NC	2/9/99	Director, Fed. Finance Policy	2-1855

Comments to Alison Shelton in Room 2203 ASAP! Thanks,

SPECIAL INSTRUCTIONS-- ☐ Review Officer Date: ☐ Executive Secretary Date

DI to RER (READING) 2/7/99
DI to LS

cc: MF
SS
NCIDI / PA / AK

PLEASE LOG IN

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

April 22, 1999

MEMORANDUM FOR THE PRESIDENT

FROM: Robert E. Rubin R.E.R.

SUBJECT: Report of the President's Working Group on Financial Markets on Hedge Funds and Long-Term Capital Management

Next Thursday, the President's Working Group on Financial Markets plans to release a report entitled "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management." After the near collapse of Long-Term Capital in September, 1998, the Working Group decided to study the activities of firms such as Long-Term Capital and their relationships with their creditors. This memorandum summarizes the Working Group's conclusions and recommendations. Although the Working Group could have issued a report reflecting the differing views of the various agencies, it was our judgment that the report would be stronger if it were supported by all the agencies. We included a section on additional measures for further consideration if the need arises in the future.

We anticipate that the international community, financial institutions, Capitol Hill and the press will be very interested in the report. It is likely that several committees in the House and the Senate will hold hearings on this issue. Separately, the Working Group is preparing a study of the regulation of over-the-counter derivatives.

Background

Events in global financial markets during the summer and fall of 1998 demonstrated that excessive leverage can greatly magnify the negative effects of any financial market event. Although leverage can play a positive role in our financial system, it can also increase the chance that problems at one financial entity could be transmitted to other entities, thereby increasing the risk to the financial system as a whole. Our market-based economy relies on market participants to provide discipline, but market discipline can break down. In the case of LTCM, none of its investors, creditors, or counterparties provided an effective check on its overall activities. In addition, market history indicates that even painful lessons recede from memory with time.

Although LTCM is a hedge fund, this issue is not limited to hedge funds. Other financial institutions, including some banks and securities firms, are larger, and generally more highly leveraged, than hedge funds.

Recommendations

In response to these concerns about excessive leverage and systemic risk, the Working Group recommends a number of measures designed to constrain excessive leverage in the financial system. Many of the key measures are aimed at improving the information available to creditors, and creditor's risk management practices.

- More frequent and meaningful information on hedge funds should be made public. (This measure requires legislation.)

- Public companies, including financial institutions, should publicly disclose additional information about their financial exposure to highly leveraged institutions, including hedge funds.

- Financial institutions should improve their practices for counterparty risk management.

- Regulators should encourage improvements in the risk-management systems of regulated financial firms for both credit and market risk (including backtesting of value at risk models).

- Regulators should attempt to make capital charges more sensitive to risk (including revisions to the Basle Accord that are currently underway).

- Regulators should expand risk reporting related to the unregulated affiliates of broker-dealers and futures commission merchants. (Chairman Greenspan's decision not to endorse this measure is noted in a footnote to the report.) (This measure requires legislation.)

- Congress should enact the provisions proposed by the President's Working Group on Financial Markets to improve financial contract netting in the United States in the event of a bankruptcy. (This measure requires legislation.)

- Regulators should consider stronger incentives to encourage offshore financial centers to comply with international standards.

Given the nature of today's global financial markets, the Working Group believes that it is important that similar steps be taken in other countries, where relevant.

The Working Group will be monitoring and assessing the effectiveness of the measures outlined above. If further evidence emerges that indirect regulation of currently unregulated market participants is not working, there are several matters that could be given further consideration to address concerns about leverage. Additional potential measures could include:

- consolidated supervision of broker-dealers and their currently unregulated affiliates;
- direct regulation of hedge funds; and/or
- direct regulation of derivatives dealers unaffiliated with a federally regulated entity.

These additional potential measures are described in the report, although the Working Group is not recommending any of them at this time.

Finally, the Working Group is not making any recommendations regarding the tax policy and administrative issues raised by the presence of hedge funds and other financial entities in tax havens. These issues are being addressed separately by Treasury.

Link to Financial Architecture Study

The Working Group has been working closely with my Financial Architecture Task Force. Many of the Working Group's recommendations are incorporated in the financial architecture documents that will be distributed during the Bank-Fund and G-7 meetings this coming weekend.

Potential Reaction

This report will likely be received as a serious and thoughtful effort. The recommendations enjoy the support of all the Working Group agencies: the Treasury, the Federal Reserve Board, the SEC and the CFTC. In addition, the NY Federal Reserve, CEA, FDIC, NEC, OCC, and OTS also participated in the drafting of this study. While most of these recommendations can be implemented by the regulatory agencies or directly by the private sector, there are three that will require legislative support: the call for expanded disclosure and reporting, the call for enhanced risk management by financial institutions, and the call for improving financial contract netting in the United States in the event of a bankruptcy. The bankruptcy legislation was submitted to Congress last year although it did not become law.

We expect that our recommended measures will advance disclosure and risk management where highly leveraged financial institutions are concerned, and some, particularly in industry, will argue that we have gone to far. Some parties, however, in the international community and on Capitol Hill, would prefer that the report endorse the direct regulation of hedge funds, or other measures to expand the regulatory net with the aim of constraining leverage. We do not believe that such measures would be realistic in the current political and regulatory climate. Moreover, such measures do not enjoy the support of all the Working Group agencies. We believe that it is important for the Working Group to present a jointly-agreed set of recommendations.

TREASURY CLEARANCE SHEET

Date: April 16, 1999

MEMORANDUM FOR: SECRETARY DEPUTY SECRETARY ☐ U [redacted] Y
☐ ACTION ☐ BRIEFING ☐ INFORM [redacted] N
☐ PRESS RELEASE ☐ PUBLICATION ☐ R [redacted] CH
☐ EXECUTIVE SECRETARY ☐ TESTIMONY ☐ [redacted]

FROM: SECRETARY RUBIN

THROUGH:

SUBJECT: **Memo to the President RE Report of the President's Working Group on Fin. Markets on Hedge Funds and Long-Term Capital Management**

REVIEW OFFICES **(Check when office clears)**

☐ Under Secretary for Finance
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☐ Other ________

NAME (Please Type)	INITIAL	DATE	OFFICE/ROOM NO.	TEL. NO.
INITIATOR(S)				
Gary Gensler			Assist Secy (Fin. Markets	622-1882
Alison Shelton			Fin. Markets	622-0101
REVIEWERS				
Ed Knight	ES	4/22	General Counsel	622-0287
Tim Geithner			Under Secretary, (International Affairs)	622-0656
Jon Talisman			Tax Policy	622-0140

SPECIAL INSTRUCTIONS- SIMULTANEOUS CLEARANCE. PLEASE RETURN COMMENTS TO ALISON SHELTON (622-0101) BY 11:00, THURSDAY, APRIL 22.

TREASURY CLEARANCE SHEET

Date: April 16, 1999

MEMORANDUM FOR: SECRETARY DEPUTY SECRETARY ☐ UNDER SECRETARY
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☐ PRESS RELEASE ☐ PUBLICATION ☐ REGU[redacted]ON ☐ SPEECH
☐ EXECUTIVE SECRETARY ☐ TESTIMONY [redacted] OT[redacted]

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To NCC 4/22/99

NCC to RER 4/22/99

RER signed 4/22/99

Orig original to WH 4/22/99

NCC cc RER
LS (reading)

PA cc ~~NG~~
SS
NC/01/PA/AK

Please log in.

Interstate Banking

1997-SE-012792

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ACTION

November 26, 1997

MEMORANDUM FOR SECRETARY RUBIN

FROM: Victoria Rostow VPR
Deputy Assistant Secretary
(Banking and Finance)

SUBJECT: Final report under the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 to members of the Treasury Advisory Committee and the Federal Reserve System

ACTION:

Last Monday, November 17, 1997, we released this report titled, "American Finance for the 21st Century." We need to transmit this report to the members of the Advisory Committee and the Federal Reserve System.

RECOMMENDATION:

That you approve the attached letters to 12 members of the Treasury Advisory Committee, and 8 members of the Federal Reserve System.

ATTACHMENTS: Letters for approval

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

November 26, 1997

Mr. John G. Heimann
Chairman
Global Financial Institutions
Merrill Lynch & Co., Inc.
World Financial Center
250 Vesey Street
New York, New York 10281-1332

Dear John:

I am pleased to enclose a copy of the final report that we are submitting to the Congress under the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. Your service as a member of the Advisory Commission that worked with us on this project was extremely valuable to us.

The lively and insightful comments of the members of the Commission, both in our meetings and in follow-up discussions with Treasury staff, helped us immeasurably in gaining insights into the future of this rapidly changing industry. We are very much indebted to you, and we hope that you will find the report to be a valuable contribution to the dialogue on the financial services industry.

Sincerely,

Bob

Robert E. Rubin

Enclosure

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

November 26, 1997

Mr. Glenn H. Hutchins
General Partner
The Blackstone Group
345 Park Avenue
31st Floor
New York, New York 10154

Dear Glenn:

I am pleased to enclose a copy of the final report that we are submitting to the Congress under the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. Your service as a member of the Advisory Commission that worked with us on this project was extremely valuable to us.

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Sincerely,

Bob

Robert E. Rubin

Enclosure

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

November 26, 1997

Mr. Orin S. Kramer
General Partner
Kramer Spellman, L.P.
2050 Center Avenue
Suite 300
Fort Lee, New Jersey 07024

Dear Orin:

I am pleased to enclose a copy of the final report that we are submitting to the Congress under the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. Your service as a member of the Advisory Commission that worked with us on this project was extremely valuable to us.

The lively and insightful comments of the members of the Commission, both in our meetings and in follow-up discussions with Treasury staff, helped us immeasurably in gaining insights into the future of this rapidly changing industry. We are very much indebted to you, and we hope that you will find the report to be a valuable contribution to the dialogue on the financial services industry.

Sincerely,

Bob

Robert E. Rubin

Enclosure

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

November 26, 1997

Mr. John F. Sandner
Chairman
Board of Governors
Chicago Mercantile Exchange
3050 S. Wacker Drive
Chicago, Illinois 60606

Dear John:

I am pleased to enclose a copy of the final report that we are submitting to the Congress under the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. Your service as a member of the Advisory Commission that worked with us on this project was extremely valuable to us.

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

November 26, 1997

Mr. Robert C. Pozen
General Counsel and Managing Director
Fidelity Investments
82 Devonshire Street
Boston, Massachusetts 02109

Dear Bob:

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

November 26, 1997

Mr. Franklin D. Raines
Director
Office of Management and Budget
Room 252 OEOB
Washington, D.C. 20503

Dear Frank:

I am pleased to enclose a copy of the final report that we are submitting to the Congress under the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. Your service as a member of the Advisory Commission that worked with us on this project was extremely valuable to us.

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

November 26, 1997

Mr. Alan Greenspan
Chairman
Federal Reserve System
20th & C Streets, N.W.
Washington, D.C. 20551

Dear Alan:

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

November 26, 1997

Ms. Alice M. Rivlin
Vice Chairman
Federal Reserve System
20th & C Streets, N.W.
Washington, D.C. 20551

Dear Alice:

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

November 26, 1997

Mr. Edward W. Kelley, Jr.
Federal Reserve System
20th & C Streets, N.W.
Washington, D.C. 20551

Dear Ed:

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

November 26, 1997

Mr. Stephen J. Brobeck
Executive Director
Consumer Federation of America
1424 16th Street, N.W., Suite 604
Washington, D.C. 20036

Dear Mr. Brobeck:

I am pleased to enclose a copy of the final report that we are submitting to the Congress under the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. Your service as a member of the Advisory Commission that worked with us on this project was extremely valuable to us.

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

November 26, 1997

Ms. Beth Hodges
Executive Vice President
First National BAnk of Panhandle
Box 990
Panhandle, Texas 79068

Dear Ms. Hodges:

I am pleased to enclose a copy of the final report that we are submitting to the Congress under the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. Your service as a member of the Advisory Commission that worked with us on this project was extremely valuable to us.

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

November 26, 1997

Ms. Mary A. Houghton
President
Shorebank Corporation
7054 S. Jeffery Blvd.
Chicago, Illinois 60649-2096

Dear Ms. Houghton:

I am pleased to enclose a copy of the final report that we are submitting to the Congress under the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. Your service as a member of the Advisory Commission that worked with us on this project was extremely valuable to us.

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

November 26, 1997

Mr. Donald A. Moore, Jr
Managing Director
Morgan Stanley & Co.
Investment Banking Division
1585 Broadway, 31st Floor
New York, New York 10036

Dear Mr. Moore:

I am pleased to enclose a copy of the final report that we are submitting to the Congress under the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. Your service as a member of the Advisory Commission that worked with us on this project was extremely valuable to us.

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

November 26, 1997

Ms. Rachel F. Robbins
Managing Director and Deputy General Counsel
J.P. Morgan Securities Inc.
60 Wall Street
New York, New York 10260

Dear Ms. Robbins:

I am pleased to enclose a copy of the final report that we are submitting to the Congress under the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. Your service as a member of the Advisory Commission that worked with us on this project was extremely valuable to us.

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Robert E. Rubin

Enclosure

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

November 26, 1997

Mr. Clyde W. Ostler
Vice Chairman
Wells Fargo Bank
420 Montgomery Street - 12th Floor
San Francisco, California 94104

Dear Mr. Ostler:

I am pleased to enclose a copy of the final report that we are submitting to the Congress under the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. Your service as a member of the Advisory Commission that worked with us on this project was extremely valuable to us.

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

November 26, 1997

Ms. Susan M. Phillips
Federal Reserve System
20th & C Streets, N.W.
Washington, D.C. 20551

Dear Ms. Phillips:

I am pleased to enclose a copy of a report prepared for the Department of Treasury by Robert E. Litan and Jonathan Rauch entitled, "American Finance for the 21st Century." The Riegle-Neal Interstate Banking and Efficiency Act of 1994 directed the Treasury Department to examine the strengths and weaknesses of the banking system in this period of rapid development and change. This report evolved from that mandate. We hope that it will be useful to you as you consider the many challenges that the industry will face in the years ahead.

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Robert E. Rubin

Robert E. Rubin

Enclosure

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

November 26, 1997

Mr. Laurence H. Meyer
Federal Reserve System
20th & C Streets, N.W.
Washington, D.C. 20551

Dear Mr. Meyer:

I am pleased to enclose a copy of a report prepared for the Department of Treasury by Robert E. Litan and Jonathan Rauch entitled, "American Finance for the 21st Century." The Riegle-Neal Interstate Banking and Efficiency Act of 1994 directed the Treasury Department to examine the strengths and weaknesses of the banking system in this period of rapid development and change. This report evolved from that mandate. We hope that it will be useful to you as you consider the many challenges that the industry will face in the years ahead.

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Enclosure

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

November 26, 1997

Mr. Edward Gramlich
Federal Reserve System
20th & C Streets, N.W.
Washington, D.C. 20551

Dear Mr. Gramlich:

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

November 26, 1997

Mr. Roger Ferguson
Federal Reserve System
20th & C Streets, N.W.
Washington, D.C. 20551

Dear Mr. Ferguson:

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Robert E. Rubin

Enclosure

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Executive Director
Consumer Federation of America
1424 16th Street, N.W., Suite 604
Washington, D.C. 20036

Ms. Beth Hodges
Executive Vice President
First National BAnk of Panhandle
Box 990
Panhandle, Texas 79068

Mr. Glenn H. Hutchins Glen
General Partner
The Blackstone Group
345 Park Avenue
31st Floor
New York, New York 10154

Mr. Donald A. Moore, Jr.
Managing Director
Morgan Stanley & Co.
Investment Banking Division
1585 Broadway, 31st Floor
New York, New York 10036

Ms. Rachel F. Robbins
Managing Director and Deputy General Counsel
J.P. Morgan Securities Inc.
60 Wall Street
New York, New York 10260

Mr. Robert C. Pozen
General Counsel and Managing Director
Fidelity Investments
82 Devonshire Street
Boston, Massachusetts 02109
Rob

Mr. John G. Heimann John
Chairman
Global Financial Institutions
Merrill Lynch & Co., Inc.
World Financial Center
250 Vesey Street
New York, New York 10281-1332

Ms. Mary A. Houghton
President
Shorebank Corporation
7054 S. Jeffery Blvd.
Chicago, Illinois 60649-2096

Mr. Orin S. Kramer Orin
General Partner
Kramer Spellman, L.P.
2050 Center Avenue
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Chairman
Board of Governors
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Mr. Franklin D. Raines
Director
Office of Management and Budget
Room 252 OEOB
Washington, D.C. 20503
Frank

Alice

Mr. Alan Greenspan
Chairman
Federal Reserve System
20th & C Streets, N.W.
Washington, D.C. 20551

Ms. Alice M. Rivlin
Vice Chairman
Federal Reserve System
20th & C Streets, N.W.
Washington, D.C. 20551

Ms. Susan M. Phillips
Federal Reserve System
20th & C Streets, N.W.
Washington, D.C. 20551

Mr. Edward W. Kelley, Jr.
Federal Reserve System
20th & C Streets, N.W.
Washington, D.C. 20551

Mr. Laurence H. Meyer
Federal Reserve System
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Mr. Edward Gramlich
Federal Reserve System
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Mr. Roger Ferguson
Federal Reserve System
20th & C Streets, N.W.
Washington, D.C. 20551

TREASURY CLEARANCE SHEET NO. ____________

Date: 11/25/97

MEMORANDUM FOR: ☐ SECRETARY ☐ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY

☐ ACTION ☐ BRIEFING ☐ INFORMATION ☐ LEGISLATION

☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH

☐ TESTIMONY ☐ OTHER

FROM: Victoria Rostow, Legislative Affairs

THROUGH:

SUBJECT: Report prepared for the Department of the Treasury by Robert Litan and Jonathan Rauch entitled "American Finance for the 21st Century."

REVIEW OFFICES (Check when office clears)

- ☐ Under Secretary for Domestic Finance
  - ☐ Financial Institutions Policy
  - ☐ OCC
  - ☐ OTS
  - ☐ Fiscal
  - ☐ FMS
  - ☐ Public Debt
- ☐ Under Secretary for International Affairs
  - ☐ International Affairs
- ☐ Enforcement
  - ☐ ATF
  - ☐ Customs
  - ☐ FLETC
  - ☐ FinCEN
  - ☐ FAC
  - ☐ Secret Service
- ☐ Legislative Affairs
- ☐ General Counsel
- ☐ Economic Affairs
- ☐ Management
- ☐ Treasurer
- ☐ Mint
- ☐ Engraving & Printing
- ☐ Savings Bonds
- ☐ Public Affairs
- ☐ Tax Policy
- ☐ Inspector General
- ☐ IRS
- ☐ Public Liaison

☐ Chief of Staff ☐ Other

NAME (Please Type)	INITIAL	DATE	OFFICE	TEL. NO.
INITIATOR(S)				
Victoria Rostow			Legislative Affairs	622-1910
REVIEWERS				
Jerry Hawke			Domestic Finance	622-1703
Ed Knight			General Counsel	622-0291
Rick Carnell			Domestic Finance	622-2600
David Fischer	OBF	11/25	Economic Policy	622-2004

SPECIAL INSTRUCTIONS: **PLEASE PROVIDE COMMENTS/CLEARANCE ASAP, NOVEMBER 25, 1997, TO ROOM 3134, 622-1910.**

☐ Review Officer Date ☐ Executive Secretary Date

TREASURY CLEARANCE SHEET NO. ____________

Date: 11/25/97

MEMORANDUM FOR: ☐ SECRETARY ☐ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY
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~~Rick Carnell~~ Gary [illegible]	[illegible]	11/25/97	Domestic Finance	622-2600
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Date: 11/25/97

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☐ Review Officer   Date   ☐ Executive Secretary   Date

MARKET CRASHES

1997-SE-011083

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INFORMATION

October 16, 1997

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

FROM: David W. Wilcox DW

SUBJECT: Stock Market Crashes

The attached paper sketches the history of the U.S. stock market crashes of 1929 and 1987, and the Japanese plunge of the early 1990s. The paper follows up on the discussions we had earlier about the risks of a downturn in today's market.

We attempt to adopt a contemporary perspective, and pretend that we don't know the actual historical outcome. We then try to provide a representative sampling of market commentary. A primary goal of this exercise is to investigate the extent to which contemporary market participants perceived the extraordinary risks that lay ahead. Not surprisingly, the answer is that these crashes were not clearly anticipated. In every instance, there were serious, responsible, establishment figures who were convinced that financial markets could continue along their recent trajectories. Although some observers did warn of dire possibilities, their message would have been difficult to disentangle from the chorus of more optimistic voices.

Please let us know if additional work along these lines would be useful.

cc: Hawke
Gensler

LESSONS FROM THE PAST
What Previous Episodes Suggest About Advance Signs of Trouble

Summary

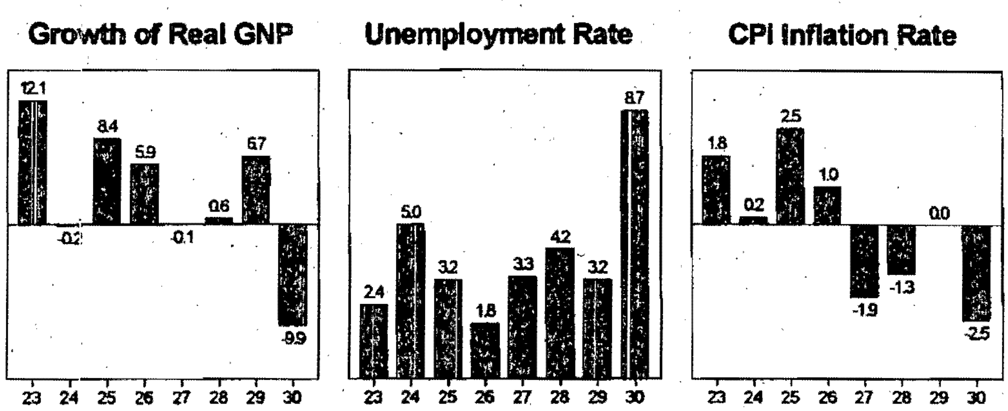
This paper sketches the history of the U.S. stock market crashes of 1929 and 1987 and the Japanese plunge of the early 1990s. A key objective is to provide a representative sampling of market commentary before each episode, with an eye toward understanding the extent to which there were advance indicators of trouble. A recurrent theme is that monetary policy has often played a crucial role, either as a stabilizing or destabilizing force.

The 1929 Crash

The Setting: As is illustrated in the charts below, real growth during the 1920s was strong and inflation was low: from 1922 to 1929, even including the recessions of 1923-24 and 1926-1927, real GNP grew 4.7 percent per year on average, the unemployment rate averaged only 3.3 percent, and the CPI advanced only 0.3 percent per year.

ECONOMIC CONDITIONS: 1923-1930

Annual Data, Percent



- The boom in the 1920s was stimulated in part by the development of new technology -- especially automobiles and radios -- combined with modern management techniques and realized economies of scale, and financed largely by equities. The last upswing in stocks which led to the 1929 crash began in March 1928.

Prepared by James Girola

- The Federal Reserve began a policy of tightening in January 1928 that lasted throughout 1929. The express purpose was to rein in loans for stock market speculation.

- Real activity peaked in August 1929, and then entered the 43-month contraction that was to become known as the Great Depression.

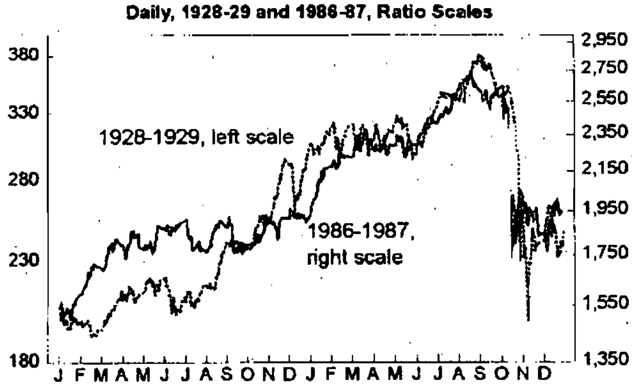
- The Dow Jones industrial average peaked at 381.17 on September 3, 1929 – almost coincident with the August peak in the economy -- and remained steady for about a month.

  – The price/earnings ratio for Standard & Poor's Composite Stock Price Index (now called the 500 Composite) was 17.6 at year-end 1928, and an estimated 20.2 in September 1929, based on the preceding twelve months' worth of earnings. (The chart on page 6 shows the S&P p/e ratio from 1926 forward.)

- The market crashed in October: the Dow fell by 10.3 percent from Saturday, October 19, to Saturday, October 26, with early trading on Black Thursday, October 24, driven by panic. On Black Tuesday, October 29, the Dow plunged another 12.8 percent. The following chart illustrates the decline, and includes the 1987 episode. (The chart scales for the two episodes have been chosen so that equal distances in each scale represent equal percent changes.)

THE DOW JONES INDUSTRIAL AVERAGE

Daily, 1928-29 and 1986-87, Ratio Scales



  – The unemployment rate rose from 3.2 percent in 1929 to 8.7 percent in 1930. Even so, the Fed maintained a restrictive stance, contributing in the view of much academic opinion to the deepening of the Depression. The Dow continued to fall, and by mid-1932 was about 89 percent below its 1929 peak.

- Irving Fisher, John Maynard Keynes, and others argued that stocks were not overvalued in 1929 in light of the justifiably strong *ex ante* earnings expectations which arose during the 1920s expansion. From this perspective, the crash could be viewed as stemming from an *ex post* revision of earnings expectations after the August 1929 cyclical peak.

Market Views: During the year or so before the 1929 crash, a prospective investor could reasonably have been confused by the divergence in views about the stock market. The bulk of the commentary expressed optimism that the strength of the economy would propel the market ever upward. However, a significant minority pointed to indications of trouble, and by 1929, much of their discussion was devoted to concerns about the overvaluation of stock and the dangers of speculation.

- President Hoover, of course, was consistently optimistic in public statements, although privately he was fearful of speculation. Treasury Secretary Andrew W. Mellon was also optimistic.

- One of the best-known optimists was John J. Raskob, who was a director of General Motors and the Chairman of the Democratic National Committee. He received wide acclaim for proposing a special trust based upon the assumption that stocks would rise. In a famous interview in the Ladies' Home Journal entitled "Everybody Ought to be Rich" in August 1929 right before the crash, he stressed the benefits of the stock market for women investors.

- Another well-known optimist was Charles E. Mitchell, Chairman of the Board of the National City Bank in New York and a director of the New York Fed. He was so bullish that his bank lent money in March 1929 to ensure that the market would keep rising.

- Many leading academics were also confident, including Joseph Lawrence and Edwin Kemmerer of Princeton, Irving Fisher of Yale, Joseph Davis of Stanford, and Edmund Day of Michigan. Just before the crash, Fisher said that stocks had attained a permanently high level. Kemmerer and Fisher became associated with investment trusts.

- The Harvard Economic Society was set up by economics professors for the purpose of forecasting economic conditions. They were somewhat pessimistic early in 1929, but then became more optimistic as stocks continued to rise during 1929. For a while after the crash they repeatedly said that there would be no depression, after which they disbanded.

- Another well-known bull was Charles Amos Dice of Ohio State University. He was continually optimistic about the future of the economy, and allayed concerns regarding brokers' loans. Just before the crash, in August 1929, he argued that the high stock prices were justified by economic fundamentals.

- Bernard Baruch was also optimistic, and he spoke positively about world economic conditions in a famous interview in June 1929. However, he himself moved out of the market before the crash.

- And, in general, most of the press continued to express confidence throughout 1929. Bankers were positive, perhaps because many of them were speculating themselves. And periodicals such as Time and the Saturday Evening Post all had good things to say about investing in the market.

In contrast, there was a substantial minority who held much less favorable views about the ability of the stock market to sustain its advance:

- Some managers said that the price of their stock was overvalued. For example, when the price of Canadian Marconi, a radio firm, soared from \$3 to \$28.50, management stated publicly that the stock might be overvalued, prompting a price decline of \$12. A.P. Giannini, head of Bancitaly (later Bank of America), also made such a statement in 1928 causing the stock of his company to fall.

- In March 1929, Paul M. Warburg of the International Acceptance Bank, whose views were highly regarded, stated that stock prices were too high and said that excessive speculation could lead to a crash and depression. Similar comments were published in Poor's Weekly Business and Investment Letter and The Commercial and Financial Chronicle.

- During 1929, one of the most widely-read sources of commentary was a continuing series of editorials by financial editor Alexander Dana Noyes of The New York Times, who stressed the potential dangers in the market.

  -- For example, as early as January 1, he discussed "an era of violent speculation ... in due time, if continued, ... converts the comfortable credit situation into one of great stringency ..."

- Consistent with tight Fed policy, Fed Chairman Roy Young warned against speculation. In May, E.H.H. Simmons, president of the New York Stock Exchange, expressed similar sentiments.

- The "Babson Break" occurred on September 5 right after the September 3 peak, when the financial adviser Roger Babson predicted a crash and a big recession at a luncheon before the National Business Conference. Babson's forecasts had been derided before, but on that occasion he was listened to. The market closed almost 10 points lower, and from then on, there were ever more pessimistic forecasts from brokerage houses, and the market became more bearish and took seriously the possibility of a crash.

- One well-known episode which was interpreted as indicating pessimism toward the soaring market was the denial of Boston Edison's request for a 4 to 1 stock split by the Massachusetts Department of Public Utilities on October 11. The Department said that Boston Edison's stock price was excessive and the split would lead to more speculation.

- Interest rates on brokers' loans soared from 1928 on, indicating that lenders were concerned about speculation and felt reduced confidence in the market. The higher rates also reflected the tight Fed monetary policy. Lender concern was further indicated by increases in margin requirements.

- On October 23, right before Black Thursday, a Wall Street Journal editorial stated that the bull market was over and the bear market had begun.

The 1987 Crash

The Setting: In November 1987, the economy was nearing the end of its fifth year of expansion from the 1982 economic trough. By fall, the unemployment rate had fallen below the 6.0 percent level then regarded as the NAIRU, capacity utilization was rising rapidly, and the core CPI had accelerated by half a percentage point since the start of the year.

- Concerns about overheating led the Fed to tighten, and interest rates rose from August through mid-October: the discount rate was raised from 5-1/2 percent to 6 percent on September 4, and the federal funds rate increased from below 7 percent in late August to about 7.6 percent at the time of the crash.

  – Chairman Greenspan had taken office in mid-August, and at that time there was a much lower level of confidence in the Fed's ability to contain inflation than today.

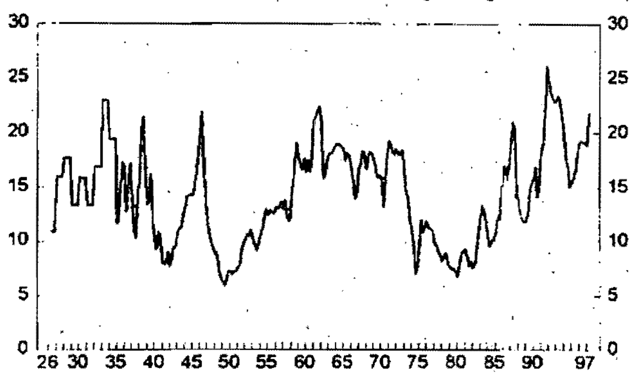
- The Dow reached a record peak of 2,722.42 on August 25, 1987. After that, as in 1929, the Dow remained stable for about two months before the crash. The decline began on Wednesday, October 14, and continued through Black Monday, October 19, when the Dow plunged 508 points. From October 13, Tuesday, through Black Monday the Dow dropped a total of 30.7 percent. The daily movement of the Dow during this period is illustrated in the chart on page 2.

– The price/earnings ratio for the S&P Composite from 1926 onward is plotted in the following chart. Based on quarterly data published by Standard & Poor's, which provide for each quarter the price at the end of the quarter divided by the earnings for the preceding year. Data for 1926-1934 are annual.

S&P COMPOSITE PRICE/EARNINGS RATIO

Quarterly, 1926:I-1997:II, Annual Data for 1923-1934

End of Quarter Price Over 4-Quarter Trailing Earnings



-- The chart shows that right before the 1987 crash, the p/e ratio was above 20, which is high historically. This was similar to the level prior to the 1929 crash.

- The period before the crash was also characterized by a weak dollar, and large budget and trade deficits, both of which some regarded as intractable and likely to bring about higher interest rates and inflation.

  – In The New York Times a week before the crash, Michael Quint wrote about the "doubts and worries" in financial markets, referring to the budget and trade deficits.

  – On Wednesday, October 14, the reported merchandise trade deficit figure for August came out at $15.7 billion, which was much bigger than expected and was seen by some as a motivating factor in the crash.

Market Views: In contrast to 1929, the financial market commentary prior to the 1987 crash appears to have been characterized much more by consensus. Most commentators were concerned that the market was overvalued, and thought that there would be a correction of about 150 points, certainly less than 250 points. The correction was expected to be gradual, perhaps taking several months, after which the Dow would continue its ascent to the 3,000 level and beyond. Few if any saw the magnitude of the coming crash.

- The belief that a correction was needed arose as early as February and became more widespread as the year progressed.

- Around early September, Al Frank, who wrote market letters, was expressing worries about the situation, but thought that the Dow would continue to rise after the correction. Martin Zweig, a well-known commentator, was more pessimistic and concerned about a possible crash. Publisher Dan Sullivan was also expecting a correction.

- One of the best-known forecasters of the time was Robert Prechter, a Dow-theory practitioner. In early September he thought that the outlook was for a rising stock market, but by early October he switched to the view that the outlook was for a falling market. Nevertheless, he remained basically optimistic for the future.

- Many others felt similarly that there would be a correction followed by continued gains. Included were Roger Ford of Prudential Equity Management Associates, Steven Goldstein of Knight-Ridder, and Steve Leeb who wrote market letters.

- Up to the time of the crash, investment banks expressed similar views, including Drexel Burnham Lambert, Byron Wein of Morgan Stanley, and Salomon Brothers.

- On a more pessimistic note, in 1986 and into 1987, former Secretary of Commerce Peter G. Peterson examined the economic imbalances of the time. In an extended analysis in the October Atlantic, he emphasized the trade and budget deficits, and suggested that a crash could be coming.

- Commentators were also concerned that the Japanese stock market would crash and pull down the U.S. market. As outlined below, the Japanese crash did not begin until 1990.

- One analyst who foresaw the magnitude of the crash was Beatrice E. Garcia, writing October 12, one week before the crash, in the column "Abreast of the Market" in the Wall Street Journal. She pointed to the interaction of program trading with portfolio insurance as the mechanism which could cause the market to spiral downward. (This mechanism no doubt exacerbated the plunge once it got started, but it was probably not the source of the crash: the crash was worldwide and occurred in countries which did not have program trading or portfolio insurance.)

The Japanese Crash of the 1990s

The Setting: In the late 1980s, the Japanese stock market had perhaps the biggest bubble of any stock market in this century. The bubble burst in a sharp decline which started at the beginning of 1990. There are some important distinctions between the Japanese experience and any likely U.S. experience. Importantly that in Japan the market ascent and subsequent crash were engineered by government policy in the context of a very different institutional background.

- Japanese stocks tripled in value in the second half of the 1980s to astronomical levels; their price/earnings ratio -- while not entirely comparable with U.S. measures -- rose above 60, and the Japanese stock market at the peak was worth 1-1/2 times all U.S. equities. (By comparison, Japanese GDP was only 37.7 percent of U.S. GDP in 1989.) The stock market boom occurred in tandem with a real estate boom which saw land values double to the point where metropolitan Tokyo ended up being worth as much as all the land in the U.S.

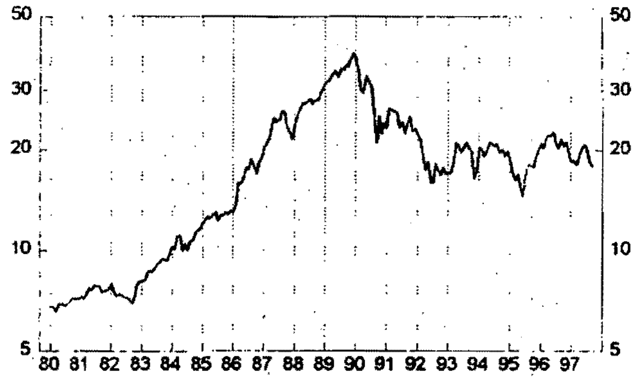
- Both the stock market and real estate booms were encouraged by the Ministry of Finance (MOF), which wanted to make it easy for Japanese corporations to raise funds. Corporations were allowed to have speculative trading accounts with tax advantages, monetary policy was easy, and interest rates were kept low to encourage borrowing for speculation. Banks were encouraged to support the speculation through loans.

- The big increases in value were fueled by the perception that stocks would always rise and, especially, that land values could never decrease. Indeed, land could be used as collateral to purchase more stock. There was also the belief that the MOF had rigged the market and would use regulations to prevent a crash.

  -- The power of the MOF was shown in the 1987 crash. The Japanese market had fallen along with the U.S. market in that crash; however, Japanese brokerage houses together with the MOF halted the decline the day after Black Monday and restored the bull market in Japan.

- As shown in the next chart, the peak in the Nikkei index at around 40,000 was reached at the end of 1989. By that time corporate profitability was declining, land in foreign countries was much cheaper, inflation was accelerating, and there were scandals in the securities market.

NIKKEI STOCK AVERAGE
End of Month, Thousands of Yen, Ratio Scale



- The Japanese government then decided that the stock market should decline, and the Bank of Japan tightened monetary policy and raised interest rates sharply. Starting at 2-1/2 percent in February 1987, the official discount rate was moved up several times, and reached 6 percent by August 1990.

- The stock market fell more precipitously than the government had anticipated or desired: the index quickly sunk to 25,000, then dropped further to a level below 16,000 around mid-1992 for a total decline of almost 60 percent from its peak.

Market Views: Typical market commentary of the time took note of the run up in stock prices and the high price/earnings ratios. Commentators usually expressed concern that there might be a crash, although such fears seemed to be tempered by the belief that the Japanese system, built upon an alliance between government and the private sector, had the power to prevent a serious downturn. In general, market commentary was not particularly prescient with regard to the timing or the nature of the crash.

- At the end of 1988, some analysts, such as Dave Marvin of Marvin and Palmer Associates in New York, felt that the overvaluation of Japanese stocks was not extreme.

  -- In an interview in Barron's in October 1988, Paul Tudor Jones, who managed futures funds on Wall Street, said "I don't think the Japanese market is overvalued to the tune of 40% or 50%. But I do think Japanese stocks are 10%-20% too high by the valuation standards one might apply to other world stock markets."

- However, in 1989, the speculative bubble began to cause more concern. Speculation was seen not only in stocks and real estate, but even in memberships in golf clubs, and speculation was widespread among Japanese.

- At the beginning of the year, the possibility of a crash was noted by such commentators as the well-known consultant Keniichi Omae, Gregory Clark at Sophia University in Tokyo, Masaru Yoshitomi who directed the research institute at the government Economic Planning Agency, and Richard Russell who authored Richard Russell's Dow Theory Letters.

- Fears of inflation and higher interest rates increased several months into the year. Satoshi Sumita of the Bank of Japan issued inflation warnings in April.

- It is interesting that official opinion, always somewhat constrained, was surprisingly sanguine in the face of the soaring Japanese stock market. In World Economic Outlook issued by the International Monetary Fund in April, the rise in stock prices is noted without concern or any hint that it might be an important macroeconomic influence.

  -- A year later in the May 1990 World Economic Outlook, the IMF deemphasized the possibility of any lasting adverse effects from the declining Japanese stock market.

- By September, a substantial segment of analysts thought that the Japanese economy had reached a peak, and discussed the possibility of a decline in stocks and the economy in general. However, this was a minority view: the majority of observers continued to have confidence in the Japanese economic expansion and the stock market.

  -- Those who were concerned that the Japanese economy and stock market were about to turn down included Kenichi Ito of Japan Forum on International Relations, Johsen Takahashi at the Mitsubishi Research Institute, and Charles Wolf Jr. of the Rand Corporation.

- By November, increases in interest rates were prompting some reallocation of investment funds from stocks into bonds, increasing fears of a crash. Persons at Yamaichi Securities Company, Daiwa Securities Company, Nikko Securities Company, and the Tokyo office of Shearson Lehman Hutton Inc. were all concerned that money should be reallocated away from stocks.

- In contrast, the 1988/89 OECD Economic Survey for Japan, published in December, while taking note of the rise in stock prices, evidenced little concern about a crash, and emphasized the strength in the Japanese economy.

- Ultimately, as pointed out before, tightening by the Bank of Japan played a substantial role in bringing about the crash. By early 1990, right after the market peak, many observers had become convinced that the crash was on its way.

Conclusions

Since all historical episodes have unique characteristics, the circumstances surrounding the 1929 and 1987 crashes cannot be easily compared with today's situation.

There were solid, respectable observers on both sides of the issue in 1929. In 1987, there was more of a consensus, but again there were optimists and pessimists. Both episodes suggest that once a correction gets started, it can quickly become deeper and faster than anyone had foreseen. In 1987, even the pessimists tended to believe that any correction would be brief and relatively mild. And in a sense, they were not too far wrong, given that it was only 22 months after the crash that the market surpassed its earlier peak.

The 1920s were a period of strong growth and low inflation, as have been the last few years, and even though the economy peaked in August 1929, economic conditions were still strong at the time of the crash. Conditions were also good in 1987, although with the twin deficits and an accelerating inflation, they were not as good as now.

Prior to both crashes, the Fed had embarked on a policy of monetary tightness with rising interest rates. The Japanese experience, despite institutional differences with the U.S., may be interpreted as further evidence that monetary tightening can be important in precipitating a crash.

After the 1929 crash, continued tight monetary policy deepened the Depression and pulled the market down further. The Bank of Japan also maintained a relatively restrictive policy as their market was falling during 1990. In contrast, after 1987 the Fed supplied ample liquidity, possibly averting an immediate recession and allowing the market to resume its upward path within a year.

E: 10/16/97

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FROM: David W. Wilcox

THROUGH:

SUBJECT: Stock Market Crashes

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