# TAX TREATMENT OF THRIFT PARTNERSHIP

## JOINT HEARING

BEFORE THE

SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

AND THE

SUBCOMMITTEE ON
HOUSING AND URBAN AFFAIRS

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

ON

S. 1828

FEBRUARY 5, 1982

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# TAX TREATMENT OF THRIFT PARTNERSHIP

FRIDAY, FEBRUARY 5, 1982

U.S. SENATE, SUBCOMMITTEE ON TAXATION AND
DEBT MANAGEMENT OF THE COMMITTEE ON FINANCE,
AND SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS OF
THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
*Washington, D.C.*

The subcommittees met, pursuant to notice, at 9:00 a.m., in room 2221, Dirksen Senate Office Building, Hon. Bob Packwood presiding.

Present: Senator Packwood and Senator Lugar.

[The press release announcing hearing, the statement of Senator Lugar, the description of S. 1828 by the Joint Committee on Taxation, and the bill, S. 1828, follow:]

Press Release No. 82-103

**P R E S S   R E L E A S E**

FOR IMMEDIATE RELEASE
January 15, 1982

COMMITTEE ON FINANCE -
UNITED STATES SENATE
Subcommittee on Taxation
and Debt Management
2227 Dirksen Senate Office Bldg.

**FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT AND BANKING SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS SET JOINT HEARING ON THRIFT PARTNERSHIP TAX BILL**

The Honorable Bob Packwood, Chairman of the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance and the Honorable Richard Lugar, Chairman of the Subcommittee on Housing and Urban Affairs of the Senate Committee on Banking, Housing and Urban Affairs announced today that the Subcommittees will hold a joint hearing on Friday, February 5, 1982 on the proposed Thrift Partnership Tax Act.

The hearing will begin at 9:00 a.m. in Room 2221 of the Dirksen Senate Office Building.

The following proposal will be considered:

S. 1828--Introduced by Senator Lugar. S. 1828 would provide for special tax treatment of partnerships between thrift institutions and others. The partnerships would be used to help thrifts to dispose of low-yield mortgages by passing the loss on disposition to other taxpayer-partners who can use the losses to offset income. Specifically, S. 1828 would provide that (1) the character of gain or loss on the sale of mortgages by the partnership would be determined as if the mortgages were sold by the thrift institution, (2) a partner's distributive share of gain or loss from the sale of mortgages may be determined without regard to whether the allocation has substantial economic effect, (3) a contribution of mortgages to a partnership followed by their immediate sale by the partnership, would still be treated as a contribution of the mortgages themselves and not the proceeds of their sale, and (4) the character of the assets of the partnership will flow through proportionately to the thrift institution for determining whether it qualifies as a "domestic building and loan association."

STATEMENT OF SENATOR RICHARD G. LUGAR

FEBRUARY 5, 1982

HEARINGS ON S. 1828

I appreciate the thoughtfulness of Senators Packwood and Dole in scheduling this joint hearing between the Taxation and Debt Management subcommittee and the Housing subcommittee which I chair. S. 1828, the Thrift Partnership Tax Act which I introduced last year, has been referred to the Senate Finance Committee. However, it addresses a critical issue facing the nation's housing industry, and, specifically, the thrift industry which historically has financed housing in this country.

Let me simply say that I do not believe the financial difficulties facing the thrift industry can be overstated. As the months pass, more and more losses are sustained by thrift institutions across this nation. Unfortunately, the substantial interest rate relief needed to arrest this decline in net worth and earnings simply does not seem to be in the economic cards for some time to come. Even an economic recovery in other sectors resulting from a moderate reduction in interest rates will not bring the necessary relief to the thrift industry.

The problem is simple enough. Savings and loan and mutual savings banks have huge portfolios of low yielding mortgages which continue to be funded by expensive short term instruments.

The thrift industry has suffered from rapid one-sided deregulation. Having lived for years under regulation Q, all depository institutions abruptly found themselves as unequal, hampered participants in a high interest rate money market. Interest rate ceilings on customer accounts made competition for deposits very difficult. Alternative, higher yielding investment opportunities began pulling depositors away from the traditional depository institutions.

Before the introduction of the money market certificate in 1978, market-rate sensitive liabilities came to only 9.7 percent of the total assets of thrifts. By the middle of 1981, 60 percent of total assets were financed by rate-sensitive liabilities.

The other side of the balance sheet, has not kept pace with liabilities in the rate of return earned on loan portfolios. It was not until April of 1981 that most thrifts were authorized to offer truly flexible-rate mortgages. As a result savings and loans still hold massive numbers of low-yield fixed-rate loans in their portfolios. In September 1979, 79.4 percent of total thrift mortgages were at rates of less than 10 percent. In spite of the unprecedented increases in interest rates since then, however, this figure fell only 66.6 in 1980 and 61.4 percent in 1981.

The combination of this one-sided deregulation and high rates has produced the current hemorrhage at thrift institutions. By September of 1981, the average cost of funds was 11.37 percent while their portfolios yield was 9.82 percent. Not only has the current economic situation increased the cost of their

funds above the return on their portfolios, but it also has impeded the conversation of fixed-rate mortgages into the recently authorized rate-sensitive mortgages.
The thrift partnership concepts represents a private sector mechanism for disposing of many low-yielding mortgages without damaging the financial status of individual thrift institutions.

I look forward to the testimony to be presented today.

Before we begin, I ask unanimous consent that a letter from FHLBB Chairman Richard T. Pratt endorsing S. 1828 be printed in the Record. I also ask unanimous consent that a study prepared by Coopers and Lybrand entitled "Potential Economic Impacts of Thrift Partnerships."

# DESCRIPTION OF S. 1828

Relating to

THE TAX TREATMENT OF THRIFT PARTNERSHIPS

Scheduled for a Joint Hearing

before the

Subcommittee on Taxation and Debt Management

of the

Senate Committee on Finance

and the

Subcommittee on Housing and Urban Affairs

of the

Senate Committee on Banking, Housing and Urban Affairs

on

February 5, 1982

Prepared by the Staff
of the
Joint Committee on Taxation

February 5, 1982

JCX-2-82

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# INTRODUCTION

The Senate Finance Subcommittee on Taxation and Debt Management and the Senate Banking Subcommittee on Housing and Urban Affairs have scheduled a joint hearing on S. 1828 (introduced by Senator Lugar) on February 5, 1982. S. 1828 relates to the tax treatment of thrift partnerships. This document has been prepared by the Staff of the Joint Committee on Taxation in connection with this hearing.

The first part of this document is a summary of the bill. The second part is a description of the bill, including present law, issues, explanation of provisions, and effective date. The third part states the estimated revenue effect.

## I. SUMMARY OF THE BILL

There is no provision in present law specifically dealing with the taxation of partnerships between thrift institutions and non-thrift taxpayers. S. 1828 would amend the portions of the Code relating to the taxation of partnerships to provide special rules for a new type of partnership referred to as a "qualified thrift partnership." Under the bill, qualified thrift institutions could transfer portions of their mortgage portfolios to qualified thrift partnerships and characterize any gain or loss on the sale of the mortgages as an ordinary gain or loss to the partnership. The qualified thrift partnership could then allocate all such ordinary gain or loss to its non-thrift partners. The bill would apply to transactions occurring after December 31, 1981, in taxable years ending after that date.

## II. DESCRIPTION OF THE BILL

### A. Present Law

#### Tax treatment of partnerships

Under present law, a partnership is not itself a taxpaying entity. Rather, a partnership is a conduit for tax purposes. The various items of income, gain, loss, deduction or credit realized by the partnership are taken into account directly by the partners as if such items were realized directly from the source from which realized by the partnership or incurred in the same manner as incurred by the partnership (sec. 702(b)).

As a general rule, a partner's distributive share of any item of partnership income, gain, loss, deduction or credit must be allocated among the partners according to the partnership agreement (sec. 704(a)). This general rule will not apply, however, and the partner's distributive share of partnership income, gain, loss, deduction or credit must be determined in accordance with each partner's interest in the partnership (taking into account all facts and circumstances), if the partnership agreement makes no provision for the partner's distributive share of such items, or if the partnership agreement's allocation does not have substantial economic effect (sec. 704(b)).

The "substantial economic effect" requirement is designed to assure that all partnership allocations "may actually affect the dollar amount of the partners' shares of the total partnership income or loss independently of tax consequences." Treas. Reg. sec. 1.704-1(b)(2). For example, if all losses on the sale of depreciable partnership property are allocated in one taxable year to partner A who has no such gains individually, and an equal amount of losses of a different character are allocated to partner B in the same taxable year, the special allocation of losses to A will have no substantial economic effect because it will have no effect on A's

ultimate share of partnership economic income or loss. Thus, the special allocation of loss to A would be disallowed. Similarly, where a loss is allocated to a partner but not reflected in that partner's capital account and, under the partnership agreement, liquidating distributions are to be made in accordance with capital accounts, the Tax Court has held that the special loss allocation does not have substantial economic effect.[1/]

Because the characterization of items of partnership income, gain, loss, deduction or credit takes place at the partnership level, the character of any such item generated by the sale of contributed property may differ if the property is disposed of by the partnership after contribution than if the property is disposed of by the partner directly. Whether a sale or exchange is by a partner or the partnership depends upon the facts and circumstances. "In all cases, the substance of the transaction will govern, rather than its form." Treas. Reg. sec. 1.721-1(a). If property is contributed to a partnership and then immediately sold by the partnership in a preplanned transaction, the Internal Revenue Service could argue that the sale by the partnership should be ignored as a sham and the sale treated as if made by the contributing partner with the sale proceeds being contributed to the partnership.[2/]

Tax treatment of thrift institutions

Building and loan associations, cooperative banks, and mutual savings banks compute bad debt deductions under a special set of rules (sec. 593). Under one of these rules, called "the percent of taxable income method," these institutions are allowed a bad debt deduction equal to 40 percent of their taxable income (computed without regard to the bad debt deduction). However, to qualify for the full amount of this deduction, at least 82 percent of its assets in the case of a building and loan association or cooperative bank, or 72 percent of its assets in the case of a mutual savings bank, must be invested in certain assets (hereinafter called "qualified assets"). The 40 percent is reduced under a formula to the extent that the percentage of qualified assets is less than the 82- or 72-percent levels. The reduction in the case of building and loan associations and cooperative banks is three-fourths of one percent for each percentage point that the percent of qualified assets is less than 82 percent of all assets. The reduction in the case of mutual savings banks is 1-1/2 percent for each percentage point that the percent of qualified assets is less than 72 percent of all assets. Qualified assets consist of

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1/ See Harris, Jr. v. Commissioner, 61 T.C. 770 (1974); Martin Magaziner, et ux., v. Commissioner, T.C. Memo. 1978-205 (June 5, 1978).

2/ See, Court Holding Co. v. Commissioner, 324 U.S. 331 (1945).

(1) cash; (2) obligations of the United States or of a State or a political subdivision thereof not including obligations the interest on which is excludable from gross income under section 103; (3) certain certificates of deposit in, or obligations of, a corporation specifically authorized by State law to insure the deposits or share accounts of member associations; (4) loans secured by a deposit or share of a member; (5) certain loans secured by certain residential or church real property; and (6) other assets described in section 7701(a)(19)(C).

Section 582, which applies to all organizations described in section 593 and also applies to banks (sec. 585) and small business investment companies (sec. 586), provides that gains and losses on the sale or exchange of evidences of indebtedness are ordinary gain or loss.

Section 7701(a)(19) defines a "domestic building and loan association" generally as an insured institution, the business of which is to acquire the savings of the public and invest in loans, at least 60 percent of the total assets of which at the close of any taxable year (or at the election of the taxpayer the average assets outstanding during the taxable year) consists of qualified assets.

## B. Issues

The principal issues are, where a qualified thrift institutions transfers to qualified thrift partnerships portions of their mortgage portfolios, (1) whether any gain or loss on the sale of those mortgages should be characterized as ordinary gain or loss to the partnership, and (2) whether all such ordinary gain or loss may be allocated entierely to non-thrift partners.[3]

---

[3] It is understood that the bill is intended to permit the creation of partnerships in transactions similar to the following example. Assume that A, a qualified thrift institution, contributes below-market-rate mortgages on personal residences with a face value (and tax basis) of $1 million and a fair market value of $600,000 to a qualified thrift partnership, AB. B, an investor, contributes cash to AB equal to the difference between the face value of the contributed mortgages and their fair market value, or $400,000. Even though A contributes property worth only $600,000, A and B would agree that A's capital account would be $1 million. The purpose of AB is to sell the contributed mortgages and to reinvest the proceeds along with the cash contributed by B in market-rate residential mortgages.

Footnote 3/ continued

Shortly after the creation of the partnership, AB would sell the contributed mortgages for their fair market value of $600,000 and realize a loss of $400,000. Under the bill, the loss would be deemed to be the partnership loss even though the sale of the contributed mortgages was contemplated or arranged prior to the contribution of the mortgages to the partnership.

The partnership agreement would provide that the entire amount of the loss would be allocated to B and would reduce B's capital account from $400,000 to $0. Under the bill, this allocation could not be challenged by the Internal Revenue Service as not having substantial economic effect. Under the bill, the loss to AB would be an ordinary loss. Thus, B would be entitled to an ordinary loss for tax purposes of $400,000.

The bill would provide that, if A is a building and loan association, A would be deemed to own a share of the underlying mortgages of the partnership equal to the proportion that A's capital account bears to the total capital accounts of all partners for purposes of qualifying as a domestic building and loan association (under sec. 7701(a)(19)) and for purposes of computing A's bad debt deduction (~~under sec.~~ 593).

Under the partnership agreement, the cash flow of the partnership (e.g., the monthly payments on the market-rate mortgages) would be allocated as follows: first, to A such that A would be given a rate of return somewhat greater than the rate of return that A was receiving on the contributed mortgages (e.g., 1-1/2 percentage points greater than the rate on the contributed mortgages); second, to B in an amount necessary to provide B with a return on his investment and restore B's capital account to its original amount; and, third, to A and B as they deterine to the extent to any remaining cash flow. As a result of the arrangement, the qualified thrift institution would increase its rate of return on its mortgages (e.g. by 1-1/2 percentage points) and B would have deferred taxable income from the year of investment until subsequent years.

## C. Explanation of Provisions

The bill defines a new type of partnership, the "qualified thrift partnership," and provides special rules for the taxation of its partners.

### Computation of partnership's taxable income-- gains or loss on sale or exchange

Section 2(a) of the bill would amend the rule relating to computation of a partnership's taxable income and partnership elections (sec. 703) to provide that the character of any gain or loss on the sale or exchange by a qualified thrift partnership of loans secured by an interest in residential or church real property (*i.e.*, property described in sec. 7701(a)(19)(C)(c), hereafter "residential mortgage loans"), would be determined as if the residential mortgage loans had been sold or exchanged by the contributing qualified thrift institution and not by the partnership. Since, under present law (sec. 582), the gain or loss incurred on the sale or exchange of evidences of indebtedness by most "qualified thrift institutions" (defined below) is ordinary gain or loss, the effect of section 2(a) of the bill would be to provide that gains or losses recognized by qualified thrift partnerships on the sale or exchange of residential mortgage loans would be ordinary gains or losses.

### Partnership allocations

Section 2(b) of the bill would amend the requirement that partnership allocations must have substantial economic effect (sec. 704(b))2)) and the general rule on the allocation of items incurred with respect to contributed property (sec. 704(c)(1)) to provide that qualified thrift partnership agreements could allocate all of the gain or loss recognized on the sale or exchange of residential or church loans contributed to it by a qualified thrift institution partner to nonqualified thrift institution partners regardless of whether or not the allocation has substantial economic effect.

### Nonrecognition of gain or loss

Section 2(c) of the bill would amend the rule providing nonrecognition of gain or loss on the contribution of property to a partnership in exchange for an interest in the partnership (sec. 721) to provide that contributions of residential mortgage loans by a qualified thrift institution to a qualified thrift partnership followed by the sale by the partnership of such residential mortgage loans is to be treated as a sale of such assets by the partnership and not the contributing partner.

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Definitions

Section 2(d) of the bill would amend the definition of domestic building and loan association (sec. 7701(a)(19)) to provide that, for purposes of the 60-percent test of section 7701(a)(19) and the 82-percent test of section 593, a domestic building and loan association partner, but not any other sort of qualified thrift institution partner, would be deemed to own a share of the assets of qualified thrift partnership in proportion to its percentage interest in partnership capital.

Finally, section 2(e) of the bill would define "qualified thrift partnership" and "qualified thrift institution." Under the bill, a qualified thrift partnership would be a partnership which met four tests. First, at least one partner of the qualified thrift partnership would have to be a qualified thrift institution. Second, 95 percent of the assets of the qualified thrift partnership would have to be either residential mortgage loans or cash. In the case of (1) any contribution to a qualified thrift partnership of property which was not a residential mortgage loan or (2) the proceeds from the sale of a residential mortgage loan, the partnership would be treated as having met the 95-percent requirement if such contributions or sale proceeds were used to acquire residential mortgage loans within a one-year period after receipt. Third, all contributions by nonqualified thrift institution partners would have to be in cash. Fourth, the primary purpose of the qualified thrift partnership would have to be to invest in residential mortgage loans.

Under the bill, a qualified thrift institution would be defined as (1) a mutual savings bank, cooperative bank, domestic building and loan association, or other savings institution charactered and supervised as a savings and loan or similar institution under Federal or State law or (2) a credit union, the deposits or accounts of which are guaranteed under State law or insured under Federal or State law in a manner similar to a savings and loan institution.

D. Effective Date

The provisions of this bill would apply to transfers, sales and exchanges after December 31, 1981, in taxable years ending after that date.

III. REVENUE EFFECT

The total face value of residential mortgages currently earning interest at a rate below the prevailing market rate and held by qualified thrift institutions is almost $600 billion. The market value of these mortgages probably is less than $450 billion; therefore, the discount probably is more than $150 billion. If all of these mortgages were to be contributed to the qualified thrift partnerships, non-thrift partners could reduce their taxable income by the $150 billion. However, because this amount represents a significant proportion of all corporate and individual taxable income, it is unlikely that all of these mortgages will be contributed. If one-half of the mortgages are contributed, the revenue loss, beginning in 1982 and probably occurring over several years, would be approximately $30 billion.

II

97TH CONGRESS
1ST SESSION

# S. 1828

To amend the Internal Revenue Code of 1954 to clarify the tax treatment of thrift partnerships, and for other purposes.

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IN THE SENATE OF THE UNITED STATES

NOVEMBER 9 (legislative day, NOVEMBER 2), 1981

Mr. LUGAR introduced the following bill; which was read twice and referred to the Committee on Finance

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# A BILL

To amend the Internal Revenue Code of 1954 to clarify the tax treatment of thrift partnerships, and for other purposes.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 **SECTION 1. SHORT TITLE.**
4 This Act may be cited as the "Thrift Partnership Tax
5 Act of 1981".
6 **SEC. 2. TAX TREATMENT OF QUALIFIED THRIFT PARTNER-**
7 **SHIPS.**
8 (a) CHARACTERIZATION OF GAIN OR LOSS.—Section
9 703 of the Internal Revenue Code of 1954 (relating to part-

1 nership computations) is amended by adding at the end there-
2 of the following new subsection:
3 "(c) CHARACTERIZATION OF GAIN OR LOSS OF
4 QUALIFIED THRIFT PARTNERSHIPS.—Notwithstanding
5 subsection (a), the character of gain or loss on the sale or
6 exchange by a qualified thrift partnership of any property or
7 interest in property which—
8 "(1) is described in section 7701(a)(19)(C)(v), and
9 "(2) is transferred to such partnership in exchange
10 for a partnership interest by a partner which, at the
11 time of such transfer, was a qualified thrift institution,
12 shall be determined in the same manner as if such property
13 had been sold or exchanged by the institution.".
14 (b) ALLOCATION OF GAIN OR LOSS.—Section 704 of
15 such Code (relating to partner's distributed share in the case
16 of contributed property) is amended by redesignating subsec-
17 tion (f) as subsection (g) and by inserting after subsection (e)
18 the following new subsection:
19 "(f) CONTRIBUTED PROPERTY OF QUALIFIED THRIFT
20 PARTNERSHIP.—Notwithstanding subsection (b)(2) or (c)(1),
21 a partner's distributive share of gain or loss from the sale or
22 exchange by a qualified thrift partnership of property or an
23 interest in property which is described in section 703(c) shall
24 be determined by the partnership agreement.".

1 (c) CONTRIBUTION TO PARTNERSHIP.—Section 721 of
2 such Code (relating to nonrecognition of gain or loss on con-
3 tribution) is amended by adding at the end thereof the follow-
4 ing new subsection:
5 "(c) SPECIAL RULE FOR QUALIFIED THRIFT PART-
6 NERSHIPS.—If—
7 "(1) a qualified thrift institution transfers to a
8 qualified thrift partnership any property or interest in
9 property which is described in section 7701(a)(19)(C)(v)
10 for an interest in the partnership, and
11 "(2) the partnership sells or exchanges such prop-
12 erty or interest after such transfer,
13 such transfer shall, for purposes of subsection (a), be treated
14 as a contribution of such property (and not the proceeds from
15 the sale or exchange) to the partnership in exchange for such
16 interest.".
17 (d) TREATMENT OF CONTRIBUTED PROPERTY.—Sec-
18 tion 7701(a)(19)(C) of such Code (defining the term "domes-
19 tic building and loan association") is amended by adding at
20 the end thereof the following new sentence: "For purposes of
21 this subparagraph (C), each asset of a qualified thrift partner-
22 ship in which a domestic building and loan association has a
23 partnership interest shall be deemed to be an asset of the
24 domestic building and loan association to the extent of and in
25 proportion to its percentage interest in the partnership as

1 measured by the respective capital accounts of the part-
2 ners.".

3 **SEC. 3. DEFINITION OF QUALIFIED THRIFT PARTNERSHIP.**

4 Section 761 of the Internal Revenue Code of 1954 (de-
5 fining terms) is amended by redesignating subsection (e) as
6 subsection (f) and inserting after subsection (d) the following
7 new subsection:

8 "(e) QUALIFIED THRIFT PARTNERSHIPS.—For pur-
9 poses of this subchapter—

10 "(1) IN GENERAL.—The term 'qualified thrift
11 partnership' means a partnership—

12 "(A) at least one partner of which is a quali-
13 fied thrift institution,

14 "(B) the primary purpose of which is to
15 invest in property or interests in property de-
16 scribed in section 7701(a)(19)(C)(v),

17 "(C) 95 percent of the assets of which con-
18 sist of property or interests in property described
19 in clause (i) or (v) of section 7701(a)(19)(C)(v),
20 and

21 "(D) all of the contributions of partners
22 which are not qualified thrift institutions are cash.

23 In the case of any contribution to capital of the part-
24 nership of property not described in subparagraph (B)
25 or the proceeds from the sale or exchange of such

1 property, the partnership shall be treated as having
2 met the requirements of subparagraph (C) if such con-
3 tributions or proceeds are used to acquire such proper-
4 ty within the 1-year period after receipt.
5 "(2) QUALIFIED THRIFT INSTITUTION.—The
6 term 'qualified thrift institution' means a qualified insti-
7 tution within the meaning of section 128(c)(2) (deter-
8 mined without regard to subparagraph (A)(i) or the last
9 sentence thereof).
10 **SEC. 4. EFFECTIVE DATE.**
11 The amendments made by this Act shall apply to trans-
12 fers, sales, and exchanges after December 31, 1981, in tax-
13 able years ending after such date.

Senator PACKWOOD. The committee will come to order.

This is a joint hearing between the Tax Subcommittee of the Finance Committee and the Subcommittee on Housing and Urban Affairs of the Banking, Housing, and Urban Affairs Committee on S. 1828, which has been introduced by Senator Lugar and others, and an idea that I find has great merit, although our first witness this morning is from the Treasury Department, and I'm not sure the Treasury Department has discovered the merit in the idea yet.

Mr. William McKee, the Tax Legislative Counsel for the Department of the Treasury, will be the first witness.

Senator Lugar, do you have an opening statement?

## STATEMENT OF HON. RICHARD G. LUGAR, U.S. SENATOR FROM THE STATE OF INDIANA

Senator LUGAR. Yes, Senator Packwood.

I deeply appreciate, first of all, your thoughtfulness and that of Senator Dole in scheduling this hearing between the Taxation and Debt Management Subcommittee and the Housing Subcommittee, which I chair. S. 1828, the Thrift Partnership Tax Act which I introduced last year, has been referred to the Senate Finance Committee. However, it addresses a critical issue facing the Nation's housing industry, and specifically the thrift industry which historically has financed housing in this country.

I shall not read the rest of the statement but ask that it be made a part of the record, except to say at the outset that I am certain that Senator Packwood and I share the view that we are not about to give up revenues lightly and at the same time face very considerable costs, as rescues are made of thrift institutions and as general catastrophy faces this industry, small banks, and others, during the current year.

In short, we are in a situation which is laden with high costs. The question, I suspect, will be how those costs can be minimized. Or, affirmatively, is it possible to find a plan which offers some potential growth for all of the participants including, the U.S. Treasury in terms of additional revenues from strength?

So with that optimistic thought, Mr. Chairman, I look forward to Mr. McKee's testimony and that of the other witnesses that we have.

Senator PACKWOOD. Mr. McKee, I might say to you and to all of the other witnesses, your statements in their entirety will be placed in the record, and you don't need to ask for consent to do so. We have been operating in this committee on a 5-minute limit on witnesses so that we have a chance to ask questions, and if the witnesses would confine themselves to that time and just put their statements in the record and just emphasize the major points, we would appreciate it.

Senator LUGAR. Mr. Chairman, may I also ask at the outset that unanimous consent be given that a letter from Chairman Richard T. Pratt of the FHLBB, endorsing S. 1828, be printed in the record and a study prepared by Coopers and Lybrand entitled "Potential Economic Impacts of Thrift Partnerships" be placed in the record.

Senator PACKWOOD. Without objection.

Mr. McKee.

[The information follows:]

Federal Home Loan Bank Board

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

RICHARD T. PRATT
CHAIRMAN

FEB 3 1982

Honorable Richard G. Lugar
1121 Dirksen Senate Office Building
Washington, D. C. 20510

Dear Senator Lugar:

This is in response to your request for our comments on S. 1828, the Thrift Partnership Tax Act of 1981, which you introduced on November 9, 1981. The Bank Board supports S. 1828. We believe the bill could provide many savings and loan associations with a useful means of alleviating the severe financial stress being generated by their portfolios of low-yield mortgage loans.

This stress, of course, is extremely widespread. The average thrift institution is suffering negative earnings, and the industry as a whole in 1981 lost approximately $5 billion in net worth. This situation is greatly reducing the ability of thrifts to fund America's housing needs, and, in addition, is placing an unprecedented burden on the Federal Savings and Loan Insurance Corporation. The FSLIC resolved a record 28 problem cases in 1981 at a present value cost to its insurance fund of over $1 billion, and 1982, given current interest rate trends, promises to be even worse.

The source of the problem is the thrift industry's longstanding practice, largely a result of government inducement and constraint, of basing long-term, fixed-rate mortgage loans on short-term savings deposits. This lending approach, acting in tandem with the rapid elimination of effective deposit rate controls in recent years, has had the unfortunate effort in the existing interest rate environment of generating a negative spread between savings institutions' earnings and their cost of money.

S. 1828 would address this problem through the tax mechanism. Basically, it would amend the Internal Revenue Code to permit thrifts to "sell" the enormous losses inherent in their submarket mortgage portfolios to investors seeking tax shelters. Thrifts would form partnerships with private investors, with the thrifts contributing low-yield mortgages at book value and the other participants providing cash in an amount approximately equal to the difference between the book and market values of the mortgages contributed by the thrifts. The partnerships then would sell the

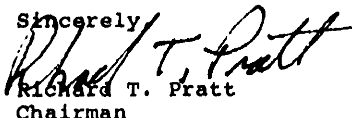
contributed mortgages in the secondary mortgage market, realize a loss from book value, and invest the cash realized from the sale plus the cash contributed by the private investors in mortgages carrying current market interest rates.

S. 1828 does not represent, of course, a panacea for the ills of the thrift industry. The market for tax shelters of this kind necessarily would be limited by competition from other types of shelters. Nevertheless, we believe the bill could provide important help in a significant number of cases.

Because S. 1828 would achieve its benefits through the tax system, it does have the potential for generating a revenue loss to the Treasury, although we have not attempted to estimate its possible extent. Given concern with the federal deficit, the Treasury Department's estimate of the size of this loss would be an extremely important factor for us to consider in terms of our providing continuing support for the bill.

I hope this has been responsive to your request. Please note that, in accordance with 12 U.S.C. § 250, this letter has not been reviewed outside the Federal Home Loan Bank Board and does not necessarily represent the views of the President.

Sincerely,



Richard T. Pratt
Chairman

# POTENTIAL ECONOMIC IMPACTS OF THRIFT PARTNERSHIPS

September 14, 1981

Coopers & Lybrand
1800 M Street N. W.
Washington, D.C. 20036

## Executive Summary

Our analysis in this study concentrated on the primary impact of thrift partnerships on the earnings of thrift institution participants and on the Treasury revenues generated by the thrift partnership participants. In order to study these impacts, we constructed simplified financial projections for an example thrift partnership. To facilitate the analysis, the projections were based on several assumptions concerning the viability, the structure, and the operations of the thrift partnership. These assumptions form an integral part of our analysis and must be taken into account in interpreting the results of the analysis.

Thrift partnerships should increase the earnings of participating thrift institutions. The increase results initially from the annual cash payment to thrift partners of an amount approximately 150 basis points greater than the average book value yield of the contributed mortgages. In later years of the partnership, after the private investors' original capital contribution has been repaid, this annual cash payment could be supplemented by additional payments. Because of the current low earning position of many thrift institutions, participation in partnerships could cause income to increase substantially.

Total Treasury revenues are projected to increase as a result of thrift institution and private investor participation in thrift partnerships. Revenues to Treasury from thrift institution participants would increase because thrift partnership participation would increase the taxable income of the thrift institutions.

Thrift partnership operations would also generate taxable income for the investor participants and would thus generate revenue to Treasury. However, it is impossible to quantify the total Treasury revenue impact resulting from investor partici-

pation in thrift partnerships without making assumptions as to alternative investments likely to have been made by the investors. In order to provide some measure of the total Treasury revenue impact, we compared estimated revenues to Treasury from investment in a thrift partnership with investment in (1) a housing project partnership and (2) municipal bonds. The thrift partnership generated greater Federal tax revenues than either of these two alternative investments.

## Introduction

This report presents our analysis of the impact of partnerships between thrift institutions and private investors on:

- the earnings of thrift institutions participating in such a partnership, and
- tax revenues to the Treasury from partnership participants.

The first section of our report briefly discusses the current problems of thrift institutions. Section II contains a general description of the potential role of thrift partnerships in solving the problems of the industry, outlines the basic structure of such a partnership, and mentions potential tax, accounting, and regulatory issues that may affect partnership operations. In Section III we detail our methodology and assumptions. Section IV presents the results of our analysis.

## I. Current Condition of Thrift Institutions

Thrift institutions, encompassing savings and loan associations, mutual savings banks, and credit unions, have long been an important segment of the nation's financial community. Although much of the following discussion is applicable to all thrift institutions, the focus is on savings and loan associations because this segment of the industry includes the majority of institutions and holds over 70 percent of all assets held by thrift institutions.

The generally high level of interest rates and their increasing short-run volatility have affected all aspects of economic and business activity in recent years and have seriously threatened the health of thrift institutions. Many of the earning assets held by thrift institutions are long-term, fixed interest rate assets, such as mortgage loans. The older of these mortgage assets typically carry interest rates that are well below current market rates. However, many thrift institution liabilities, such as depositors' funds, are short-term and carry

interest rates that vary more closely with the current market rates. Thus, the cost of attracting and holding depositors' funds has increased while the return from the long-term earning assets has remained relatively constant. The result has been a decrease in the earnings of thrift institutions.

The squeeze on thrifts' earnings has caused many of these institutions to realize operating losses which, in turn, are eroding their net worth. Liquidating the low yield assets in their existing portfolio, thus making cash available for investment in assets with a higher return, is one possible corrective action that thrift institutions could take in order to alleviate the squeeze on earnings.

However, liquidation of low yield assets in the current market environment would undoubtedly result in a loss from the book value of the assets for the thrift institutions. The pressures already bearing on the thrifts' net worth position make absorbing additional losses difficult. Indeed, according to a recent statement by Federal Home Loan Bank Board Chairman Richard Pratt, as many as one-third of the nation's 4,700 savings and loan associations are already in serious financial difficulty. Failure of these associations could result in losses of $45 billion.

II. Thrift Partnerships

A. Basic Description

Thrift partnerships have been proposed as a means to mitigate the current financial difficulties of thrift institutions. Such partnerships essentially offer thrift institutions a mechanism for converting older, below current market rate mortgages in their existing asset portfolio to an interest in a limited partnership with private investors. Thrift institutions contribute low-yield mortgage assets in their existing portfolio as capital to the new partnership. The mortgages are transferred to the partnership capital account at their book (face) value, and thus the thrift realizes no loss on the transfer. Private

investors contribute cash to partnership capital in an amount approximately equal to the difference between book and market value of the mortgages contributed by the thrift institutions. The partnership then sells the contributed mortgages in the secondary mortgage market, realizes a loss (from book value) on the sale of the low yield mortgages and invests the cash realized from the sale plus the cash contributed by the private investors in mortgages carrying current market interest rates.

The proposed thrift partnership allocates the loss realized on the sale of the contributed mortgages first to the private investor participants to the extent of their original capital contribution, then to the thrift institution participants to the extent of their original capital contribution. Income earned by the partnership is distributed as follows:

- first, an annual cash payment of approximately 150 basis points greater than the average book value yield of the contributed mortgages is made to thrift institution partners. The payment is computed as a percentage of the institutions' capital account.
- second, a similar annual cash payment is made to private investor partners. The payment is computed as a percentage of the investors' capital account.
- third, any partnership income in excess of the annual cash payments is allocated to any capital account showing a deficit from the amount of the original capital contribution.
- fourth, any remaining partnership income is allocated between the thrift institution participants and the private investor participants.

The proposed thrift partnership is limited to investments legally available to thrift institutions. The partnership may actively trade their portfolio and may engage in servicing the mortgage contracts that they initiate or acquire. Income in excess of the guaranteed payments that is distributed to participants' capital accounts may be reinvested by the partnership.

Thus, thrift partnerships propose to combine the capital contributions of the two classes of partnership participants (thrift institutions and private investors) and convert the capital contributions into investments that yield a return at the current market interest rate. Participation in a thrift partnership potentially provides thrift institutions with a mechanism to liquidate low yield mortgage assets without adversely affecting their net worth and to increase their earnings.

B. Tax, Regulatory, and Accounting Issues

The proposed creation of thrift partnerships raises several tax, regulatory, and accounting issues. These issues include:

- that the entity is considered a partnership for tax purposes;
- that the loss and income allocation is acceptable from a tax perspective;
- that the transfer of the contributed mortgages at book value is acceptable from an accounting and tax perspective;
- that the loss realized on the sale of the contributed mortgages is an ordinary loss for tax purposes; and
- that government regulations affecting thrift institutions' activities permit participation in such a partnership.

Our analysis has not included an investigation into these, or any other, tax, regulatory, or accounting issues. The analysis of the potential impacts of thrift partnership operations that follows assumes a favorable resolution of these issues.

## III. Methodology and Assumptions

As a basis for our analysis of the potential economic impacts of thrift partnerships on thrift institutions and Treasury revenues, we developed a hypothetical example of a thrift partnership. The financial results of this simple partnership were studied for their effects on the income of the thrift

institution participants and on taxes paid to the Treasury by the thrift and investor participants.

It must be borne in mind that the analysis involves examining three separate entities: the thrift partnership, the thrift institutions participating in the partnership, and the private investors participating in the partnership. Because the thrift partnership is not a taxable entity, the income generated by partnership operations flows through to the partnership participants and thus creates tax consequences for the participants.

Although our example partnership describes a situation in which the thrift contributes $1 billion in book value mortgages, the results can easily be translated to a larger or smaller partnership simply by multiplying the results by the appropriate factor. (For example, the aggregate impacts of partnerships with a total of $10 billion in contributed book value mortgages can be found by multiplying the results by 10.)

The results of our study are strongly influenced by the assumptions embodied in our example partnership. Recognizing this influence, we have analyzed the sensitivity of the results to the major assumptions. Nevertheless, since we cannot predict the accuracy of the assumptions, we obviously cannot predict the achievability of the results.

In addition to the assumptions made concerning certain tax and accounting issues affecting thrift partnerships (described in the preceding section), the assumptions made in constructing the example thrift partnership can be assigned to three major categories: the viability of the partnership, the structure of the partnership, and the computation of the financial and tax revenue impacts. Because many of our findings are so closely tied to our assumptions, we will list them in detail.

A. <u>Assumptions Relating to the Viability of the Partnership</u>: An extremely important assumption in our analysis is that the supply of new funds available for mortgages as a result of such partnerships can be matched by the demand for mortgage credit. We assume that, at the mortgage rates prevailing at the time the

partnership is initiated, the demand for mortgages will be sufficient for the successful operation of the partnership. The capacity of the market to absorb funds available for mortgages is not addressed in this report.

We further assume that the partnership provides investors with a suitable rate of return. We have not analyzed the attractiveness of this partnership as an investment for private investors and make no statement as to the return likely to be realized by participants in such a partnership.

B. Assumptions Relating to the Partnership Structure: We assume the following treatment for the allocation of income and losses generated by the partnership and for the reinvestment of such income:

- Income allocation:

  1. A guaranteed cash distribution to the thrift partners of 9.5 percent of the prior period's capital account balance. This payment is not allocated to the capital account.

  2. A guaranteed cash distribution to the investor partners of 9.5 percent of the original capital contribution or the prior period's capital account balance, whichever is greater. This payment is not allocated to the capital account.

  3. Income in excess of the guaranteed payments is allocated first to any partner's capital account showing a balance below the amount of the original capital contribution. When all partners' capital accounts show a balance equal to the original capital contribution, excess income is allocated half to the investor partners and half to the thrift partners. It is assumed that the initial capital account of the thrift partners is the book value of the contributed mortgages.

- Loss allocation: Losses are allocated first to the investor partners to the extent of their original capital contribution, then to the thrift partners to the extent of their capital contribution. The initial loss on the sale of the contributed mortgages is assumed to be the only loss and to be taxed as an ordinary loss.

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- Reinvested income: All income allocated to a partner's capital account is assumed to be reinvested. No cash-out distributions are made from the capital accounts during the life of the partnership, which is assumed to be 15 years. At the end of the partnership the capital accounts are distributed to their respective partners.

C. Computational Assumptions: In developing a hypothetical partnership and in analyzing its impact on thrift institutions' earnings and Treasury revenues, we have made the following assumptions:

- Original capital contributions:

  1. Thrift institutions: $1 billion (book value) in mortgages which have an average yield of 8 percent and an average remaining life of 22 years. Such mortgages represent mortgage loans made approximately six years ago with an average life of 28 years.

  2. Investors: $380 million in cash which represents the difference between book and market value of the contributed mortgages.

- Initial cash available for investment in new mortgages is $1 billion. This amount is raised by selling the contributed mortgages in the secondary mortgage market for 62 percent of their book value, or $620 million. A 38 percent discount from book value was assumed because the present value of the stream of payments on an 8 percent mortgage (with 22 years remaining life) discounted at 15 percent (the assumed reinvestment rate) is 38 percent. Therefore, a 38 percent discount from book value was assumed. The addition of the $380 million in investors' cash brings the total cash available for investment to $1 billion.

- In each year of the partnership, the average return on the investment is assumed to be 15 percent. This is approximately equal to the yield on conventional mortgages, as cited in the June 1981 Federal Reserve Bulletin.

- Tax treatment:

  - The loss realized by investor partners in the first year of partnership operations is assumed to be an ordinary income loss for tax purposes.

- The marginal tax rate for investor partners is assumed to be 50 percent.

- The marginal tax rate for thrift institution partners is assumed to be 30 percent. This figure represents the average effective tax rate for savings and loan associations during the 1970 to 1979 period. (U.S. League of Savings and Loan Associations Fact Book 1980.)

. The discount rate used in computing the present value of Treasury revenues is 9.5 percent. This estimates the effective cost to Treasury of alternative funds. (A current rate of approximately 13.5 percent on 20-year Treasury bonds costs the Treasury only 9.5 percent because approximately 30 percent of interest payments are returned as tax revenues.)

. Additional income resulting from rolling over and servicing mortgages is assumed to cancel out operating expenses of the partnership. Therefore, neither are considered in our example partnership.

The assumptions used in developing our financial projections are clearly an integral part of our analysis. However, we have tested the sensitivity of our analysis to two major assumptions: the return on investment and the discount rate. The discussion that is presented in the following section includes an analysis of the sensitivity tests.

## IV. Results of the Analysis

### A. Impact of Thrift Partnerships on Earnings of Thrift Institution Participants

First Year Impact: Participation in the example thrift partnership enables thrift institution participants to trade mortgage assets with an average yield of 8 percent on their book value for an interest in the partnership with a guaranteed yield of 9.5 percent on their capital contribution (which equals the book value of the mortgages). Thus, partnership participation is projected to increase the earnings of the thrift institutions by a minimum of 1.5 percent of the book value of the contributed mortgages.

Table 1 contains the pro forma results of the example thrift partnership operations for each year of the assumed fifteen year life of the partnership. The first year guaranteed payment to the thrift participants is projected to be $95 million. This represents an increase of $15 million over the $80 million that the thrift institutions would have earned had they continued to hold the mortgages contributed to the partnership. The projected $15 million in additional earnings is a direct cash infusion to the thrift institutions in the first year of partnership participation. On a per dollar basis, the thrift institution participants realize 1.5 cents in increased earnings for every book value dollar of mortgages contributed.

To assess the first year impact of such an increase in earnings on a specific savings and loan association, we have calculated selected financial data for an "average" association and have shown the changes in these selected data that result from partnership participation. The "average" savings and loan association data were derived from 1980 Federal Home Loan Bank Board composite data on all savings and loan associations with total assets of $250 million and over. S&Ls in this asset category hold 63 percent of the total mortgage assets held by S&Ls.

We assumed that this average savings and loan association contributes 25 percent of its mortgage portfolio to a thrift partnership. This assumption does not appear unreasonable given the fact that 70 percent of the mortgages held by all thrift institutions in 1980 bear interest rates of less than 10 percent. (Federal Reserve Bulletin, June 1981). In addition, the average effective yield on mortgages held by S&Ls in the asset category of $250 million or greater was 8.8 percent. This fact lends support to the presumption that an S&L might liquidate a substantial portion of such a portfolio in order to realize a greater return, assuming that liquidation would not have a negative impact on the S&L's equity position.

## TABLE 1

## INVESTMENT

| | Thrift Partners | Investors |
|---|---|---|
| Original Capital Contribution: | $1,000 (8% mortgages) | $ 380 (cash) |
| Loss Realized on Sale of Contributed Mortgages Allocated to Investors: | | $(380) |
| Capital Account beginning of Year 1: | 1,000 | $ 0 |

## FINANCIAL PROJECTIONS FOR THRIFT PARTNERSHIP
($ millions)

| | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 | Year 6 | Year 7 | Year 8 | Year 9 | Year 10 | Year 11 | Year 12 | Year 13 | Year 14 | Year 15 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Cash Available for Investment: | 1000.0 | 1018.9 | 1040.6 | 1065.6 | 1094.4 | 1127.4 | 1165.4 | 1209.2 | 1259.4 | 1317.3 | 1383.7 | 1459.8 | 1540.1 | 1624.8 | 1714.2 |
| Interest Income: | 150.0 | 152.8 | 156.1 | 159.8 | 164.2 | 169.1 | 174.8 | 181.4 | 188.9 | 197.6 | 207.6 | 219.0 | 231.0 | 243.7 | 257.1 |
| Guaranteed Payments: | | | | | | | | | | | | | | | |
| Thrift | 95.0 | 95.0 | 95.0 | 95.0 | 95.0 | 95.0 | 95.0 | 95.0 | 95.0 | 95.0 | 95.2 | 98.8 | 102.6 | 106.6 | 110.9 |
| Investor | 36.1 | 36.1 | 36.1 | 36.1 | 36.1 | 36.1 | 36.1 | 36.1 | 36.1 | 36.1 | 36.3 | 39.9 | 43.7 | 47.7 | 52.0 |
| Excess Income: | 18.9 | 21.7 | 25.0 | 28.7 | 33.1 | 38.0 | 43.7 | 50.3 | 57.8 | 66.5 | 76.2 | 80.2 | 84.8 | 89.4 | 94.2 |
| Credit to Capital Accounts: | | | | | | | | | | | | | | | |
| Thrift | - | - | - | - | - | - | - | - | - | 1.9 | 38.1 | 40.1 | 42.4 | 44.7 | 47.1 |
| Investor | 18.9 | 21.7 | 25.0 | 28.7 | 33.1 | 38.0 | 43.7 | 50.3 | 57.8 | 64.6 | 38.1 | 40.1 | 42.4 | 44.7 | 47.1 |
| Account Balances: Beginning of year | | | | | | | | | | | | | | | |
| Thrift | 1000.0 | 1000.0 | 1000.0 | 1000.0 | 1000.0 | 1000.0 | 1000.0 | 1000.0 | 1000.0 | 1000.0 | 1001.9 | 1039.9 | 1080.1 | 1122.4 | 1167.1 |
| Investor | 0.0 | 18.9 | 40.6 | 65.6 | 94.4 | 127.4 | 165.4 | 209.2 | 259.4 | 317.3 | 381.9 | 419.9 | 460.1 | 502.4 | 547.1 |

We additionally assume that the average yield on the contributed mortgages is 8 percent, that partnership participation imposes no additional operating costs on this average S&L, and that the increased income from partnership participation flows through to net worth on a dollar for dollar basis. Given these assumptions, the impact of partnership participation on selected financial data for the average savings and loan association is detailed in Table 2. It must be noted that the 1980 data are not fully reflective of the current financial condition of savings and loan associations; the financial condition of many S&Ls has deteriorated further in 1981.

Continuing Impacts: Participation in the thrift partnership is projected to result in increased earnings of a minimum of 1.5 percent of the book value of contributed mortgages in each year of the assumed fifteen year life of the partnership. In addition to this guaranteed payment in each year of partnership operations, the thrift participants are projected to earn an increased return on their investment in the partnership beginning in year ten of partnership operations. See Table 1 for detailed projections of total thrift institution earnings in years ten through fifteen.

B. Impact of Thrift Partnerships on Treasury Revenues

The participation in thrift partnerships by thrift institutions and investors will impact tax revenues received by the Treasury. In discussing these projected impacts, we have divided this section into four parts: (1) the projected impact on Treasury revenues from thrift partners, (2) the projected impact on Treasury revenues from investor partners, (3) an analysis of the sensitivity of these projected impacts to our assumed discount rate and yield on mortgage investment, and (4) general considerations.

Impact from Thrift Institutions: To estimate the projected impact of thrift partnerships on Federal tax revenues paid by thrift institutions participating in such partnerships, we analyzed the taxes paid in our example partnership presented in

## TABLE 2

### SELECTED FINANCIAL DATA WITHOUT PARTNERSHIP PARTICIPATION

Average Savings and Loan Association 1980
($ millions)

| Balance Sheet | | | | Income and Expense Statement | |
|---|---|---|---|---|---|
| Mortgage Assets: | 622.6 | Savings Accounts: | 612.7 | Mortgage Interest Income: | 54.9 |
| Other Assets: | 157.8 | Other Liabilities: | 128.8 | Other Income: | 16.6 |
| | | Total Liabilities: | 741.5 | Total Income: | 71.5 |
| | | Net Worth: | 38.9 | Operating Expense: | (9.7) |
| | | | | Cost of Funds: | (61.2) |
| Total Assets: | 780.4 | Total Liabilities and Net Worth: | 780.4 | Net Operating Income: | 0.6 |

### SELECTED FINANCIAL DATA WITH PARTNERSHIP PARTICIPATION

Average Savings and Loan Association 198X
($ millions)

| Balance Sheet | | | | Income and Expense Statement | |
|---|---|---|---|---|---|
| Mortgage Assets: | 466.9 | Savings Accounts: | 612.7 | Mortgage Interest Income: | 42.4 |
| Other Assets: | 157.8 | Other Liabilities: | 128.8 | Partnership Income: | 14.8 |
| Investment in Partnership: | 155.7 | Total Liabilities | 741.5 | Other Income: | 16.6 |
| | | | | Total Income: | 73.8 |
| Cash from Partnership Investment | 2.3 | Net Worth: | 41.2 | | |
| | | | | Operating Expense: | (9.7) |
| | | | | Cost of Funds | (61.2) |
| Total Assets: | 782.7 | Total Liabilities and Net Worth: | 782.7 | Net Operating Income: | 2.9 |

### IMPACT OF PARTNERSHIP PARTICIPATION ON SELECTED FINANCIAL DATA

- Net Operating Income increases $2.3 million
- Net Worth to Total Assets ratio increases from 5.0 to 5.3.
- Return on Mortgage Assets (including Investment in Partnership) increases from 8.8% to 9.2%.

Table 1. The taxes paid by a thrift contributing $1 billion in book value mortgages are demonstrated in Table 3a. In our analysis we assume that all income generated by the partnership is taxable. At a discount rate of 9.5 percent, the present value of the thrift institution partner's taxes equals $246.2 million.

However, this figure does not reflect the likelihood that, if the thrift had not participated in the partnership, some taxable income would have been generated from the interest payments on the 8 percent mortgages. Taxes paid on the taxable income from the 8 percent mortgages should be offset against the $246.2 million to estimate the net increase in Treasury revenues resulting from the thrift institutions's partnership participation.

To demonstrate the net effects of the thrift participation on Treasury revenues, we will assume that all income from the 8 percent mortgages is taxable. Although it is likely that such income would be reduced by associated expenses, we believe this assumption provides a fair estimate of the net increase in Treasury revenues from the thrift because we also assume that all partnership income is taxable. The present value of taxes paid on 8 percent payments over 15 years equals $187.9 million. Thus, the thrift partner participating in the hypothetical partnership would increase net Treasury revenues by $58.3 million ($246.2 minus $187.9) over the life of the partnership. This figure represents an increase in the present value of net Treasury revenues of 5.8 cents for every dollar of book value mortgages contributed to partnerships.

Although this figure provides a rough estimate of the net effect of thrift partnerships on Federal taxes paid by participating thrift institutions, the actual effect depends heavily on several factors. These conditions include the profit or loss situation of the thrift institution before participation, the ability of the thrift to utilize tax-loss carry-forwards and carry-backs, and the overall effect of the thrift partnership on

## TABLE 3a

### THRIFT INSTITUTIONS: ANNUAL TAXABLE INCOME AND TAXES PAYABLE
($ million)

| Results of Partnership Operations | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 | Year 6 | Year 7 | Year 8 | Year 9 | Year 10 | Year 11 | Year 12 | Year 13 | Year 14 | Year 15 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Annual Cash Return: | 95.0 | 95.0 | 95.0 | 95.0 | 95.0 | 95.0 | 95.0 | 95.0 | 95.0 | 95.0 | 95.2 | 98.8 | 102.6 | 106.6 | 110.9 |
| Annual Increase in Capital Account: | -0- | -0- | -0- | -0- | -0- | -0- | -0- | -0- | -0- | 1.9 | 38.1 | 40.1 | 42.4 | 44.7 | 47.1 |
| Annual Taxable Income: | 95.0 | 95.0 | 95.0 | 95.0 | 95.0 | 95.0 | 95.0 | 95.0 | 95.0 | 96.9 | 133.2 | 138.9 | 145.0 | 151.3 | 158.0 |
| Annual Taxes Payable: | 28.5 | 28.5 | 28.5 | 28.5 | 28.5 | 28.5 | 28.5 | 28.5 | 28.5 | 29.1 | 40.0 | 41.7 | 43.5 | 45.4 | 47.4 |

## TABLE 3b

### INVESTORS: ANNUAL TAXABLE INCOME AND TAXES PAYABLE
($ million)

| Results of Partnership Operations | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 | Year 6 | Year 7 | Year 8 | Year 9 | Year 10 | Year 11 | Year 12 | Year 13 | Year 14 | Year 15 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Annual Cash Return: | 36.1 | 36.1 | 36.1 | 36.1 | 36.1 | 36.1 | 36.1 | 36.1 | 36.1 | 36.1 | 36.3 | 39.9 | 43.7 | 47.7 | 52.0 |
| Annual Increase in Capital Account: | 18.9 | 21.7 | 25.0 | 28.7 | 33.1 | 38.0 | 43.7 | 50.3 | 57.8 | 64.6 | 38.1 | 40.1 | 42.4 | 44.7 | 47.1 |
| Annual Taxable Income: | 55.0 | 57.8 | 61.1 | 64.8 | 69.2 | 74.1 | 79.8 | 86.4 | 93.9 | 100.7 | 74.3 | 80.8 | 86.1 | 92.4 | 99.1 |
| Annual Taxes Payable: | 27.5 | 28.9 | 30.5 | 32.4 | 34.6 | 37.1 | 39.9 | 43.2 | 47.0 | 50.4 | 37.2 | 40.0 | 43.0 | 46.2 | 49.6 |

## TABLE 3c

### TOTAL ANNUAL TAXABLE INCOME AND TAXES PAYABLE
($ millions)

| | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 | Year 6 | Year 7 | Year 8 | Year 9 | Year 10 | Year 11 | Year 12 | Year 13 | Year 14 | Year 15 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Total Annual Taxable Income: | 150.0 | 152.8 | 156.1 | 159.8 | 164.2 | 169.1 | 174.8 | 181.4 | 188.9 | 197.6 | 207.5 | 219.7 | 231.1 | 243.7 | 257.1 |
| Total Annual Taxes Payable: | 56.0 | 57.4 | 59.0 | 60.9 | 63.1 | 65.6 | 68.4 | 71.7 | 75.5 | 79.5 | 77.2 | 81.7 | 86.5 | 91.6 | 97.0 |

the thrift's taxable income. Should partnership participation enable a thrift to avoid bankruptcy, the effect on the Treasury would be much greater than our estimate. In this situation, not only would the Treasury receive some increase in revenues, but it would also avoid the potentially considerable amount necessary for repayment of funds to the insured creditors of the bankrupt thrift.

Impact from Investors: To continue our example of a hypothetical thrift partnership, the annual taxes payable by investor participants is presented in Table 3b. In this case, assuming all income is taxable, the present value of the taxes actually paid to Treasury over the fifteen year life of the investment equals $287.7 million. This means that for every dollar contributed to the partnership by investors, the Treasury receives 75.7 cents. However, this figure should be matched against the Treasury loss of revenues in year one which results from the partnership loss on the initial sale of the 8 percent mortgages. The allocation of this loss to investor participants creates a decrease in Treasury revenues from investors of $173.5 million ($380 million taxed at fifty percent discounted one year at 9.5 percent). Thus, the present value of total revenues received by Treasury from investor participants in our example partnership is estimated to be $114.2 million ($287.7 million actually received minus the tax loss of $173.5 million), an amount which represents 30.1 cents for each dollar of investor participation.

In the discussion of the tax impacts from thrift participation, we estimated the net revenue that would accrue to Treasury as a result of partnership participation. An estimate of the net impacts resulting from investor participation cannot be so easily constructed in the absence of specific information about the alternative investments in which the investors would participate. However, it would seem reasonable that alternative investments would be subject to relatively similar patterns of income and loss and similar tax treatment. Therefore, in order

to estimate the net impact on Treasury revenues from investor participation, we have chosen two alternative investments that receive favorable tax treatment. These investments are a limited housing partnership and a municipal bond.

Table 4a shows the differences in tax revenue that would result were investors to invest in a thrift partnership rather than in a limited partnership that develops and operates housing projects which benefit from certain government assistance programs. The total investment in each partnership (columns 1 and 4) is the same. The investment is larger than that used in our example thrift partnership and is spread over six years in order to match the investment in the housing partnership, which was taken from the projections of operations contained in the offering document of an actual partnership. The investor portion of thrift partnership income (column 2) and the tax effect (column 3) were derived using the same methodology and assumptions previously detailed. Housing project partnership income and tax effect (columns 5 and 6) were taken from the projections in the offering document. The incremental tax effect from investors (column 8) is the difference between the tax effect from thrift partnership participation and the tax effect from housing project partnership participation. The total incremental tax effect, after combining the incremental tax revenue resulting from thrift institution participation and investor's changing from a housing project partnership to a thrift partnership is estimated to be $445,050 over the life of the partnership. Using a discount rate of 9.5 percent this figure has a net present value of $185,799.

A comparison of the tax revenue generated by an investment in thrift partnerships and in municipal bonds is presented in Table 4b. In this case, both investments are equal to $380 million, the same amount that was used in our example thrift partnership. The taxable income available for investment in municipal bonds would not be subject to a loss and thus would be taxable at

## TABLE 4a

## COMPARISON OF PARTNERSHIP TAX EFFECTS

| | THRIFT PARTNERSHIP | | | HOUSING PROJECT PARTNERSHIP | | | INCREMENTAL TAX EFFECT | | |
|---|---|---|---|---|---|---|---|---|---|
| Year | Investment (1) | Partnership Income (Loss) (2) | Tax Effect (3) | Investment (4) | Partnership Income (Loss) (5) | Tax Effect (6) | From Thrifts (7) | From Investors (8) | TOTAL (9) |
| 1 | $ 15,500 | $ (13,300) | $( 6,650) | $ 15,500 | $ (23,200) | $ (11,600) | $ 200 | $ 4,950 | $ 5,150 |
| 2 | 26,300 | (20,100) | (10,050) | 26,300 | (44,600) | (22,300) | 500 | 12,250 | $12,750 |
| 3 | 33,800 | (22,400) | (11,200) | 33,800 | (60,600) | (30,300) | 900 | 19,100 | 20,000 |
| 4 | 28,800 | (12,700) | ( 6,350) | 28,800 | (51,500) | (25,750) | 1,200 | 19,400 | 20,600 |
| 5 | 25,600 | (4,800) | ( 2,400) | 25,600 | (45,800) | (22,900) | 1,500 | 20,500 | 22,000 |
| 6 | 20,000 | 5,000 | 2,500 | 20,000 | (35,600) | (17,800) | 1,700 | 20,300 | 22,000 |
| 7 | 0 | 26,600 | 13,300 | 0 | (25,200) | (12,600) | 1,700 | 25,900 | 27,600 |
| 8 | 0 | 28,400 | 14,200 | 0 | (21,500) | (10,750) | 1,700 | 24,950 | 26,650 |
| 9 | 0 | 30,600 | 15,300 | 0 | (18,700) | ( 9,350) | 1,700 | 24,650 | 26,350 |
| 10 | 0 | 32,900 | 16,450 | 0 | (22,900) | (11,450) | 1,700 | 27,900 | 29,600 |
| 11 | 0 | 34,200 | 17,100 | 0 | (20,000) | (10,000) | 2,300 | 27,100 | 29,400 |
| 12 | 0 | 34,500 | 17,250 | 0 | (17,500) | ( 8,750) | 3,100 | 26,000 | 29,100 |
| 13 | 0 | 34,000 | 17,000 | 0 | (15,100) | ( 7,750) | 4,300 | 23,500 | 28,850 |
| 14 | 0 | 34,200 | 17,100 | 0 | (12,800) | ( 6,400) | 5,500 | 23,500 | 29,000 |
| 15 | 0 | 34,500 | 17,250 | 0 | (10,400) | ( 5,200) | 6,900 | 22,450 | 29,350 |
| 16 | 0 | 30,900 | 15,450 | 0 | ( 8,000) | ( 4,000) | 7,000 | 19,450 | 26,450 |
| 17 | 0 | 25,800 | 12,900 | 0 | ( 5,500) | ( 2,750) | 5,900 | 15,650 | 21,550 |
| 18 | 0 | 18,200 | 9,100 | 0 | (11,100) | ( 5,550) | 4,200 | 14,650 | 18,850 |
| 19 | 0 | 11,600 | 5,800 | 0 | ( 8,700) | ( 4,350) | 2,700 | 10,150 | 12,850 |
| 20 | 0 | 5,200 | 2,600 | 0 | ( 6,300) | ( 3,150) | 1,200 | 5,750 | 6,950 |
| TOTAL | $150,000 | $313,300 | $ 156,650 | $150,000 | $(465,000)* | $(232,500)* | $55,900 | $389,150 | $445,050* |

* Although the housing project partnership generates no taxable income to investors in years 1 through 20, the investors do realize a return on their investment over the life of the partnership. In addition, the usual structure of such partnerships calls for the sale of the housing project itself after a 20 year period. The taxable income produced by the sale of the property owned by the housing partnership here referenced was estimated to range from $340,600 to $800,000. Taxes associated with this income were estimated to range from $95,400 to $224,000, as this income would be taxed at capital gains rates rather than as ordinary income. This tax revenue would, of course, reduce the total incremental tax effect noted in the table above.

## TABLE 4b

## COMPARISON OF PARTNERSHIP TAX EFFECTS
($ millions)

| Year | THRIFT PARTNERSHIP | | MUNICIPAL BONDS AT 10% | | INCREMENTAL TAX EFFECT | | |
|---|---|---|---|---|---|---|---|
| | Partnership Income | Tax Effect | Investment Income | Tax Effect | From Thrifts | From Investors | Total |
| 1 | 435.0[1/] | 27.5[2/] | 399.0[1/] | 190.0[3/] | 4.5 | (162.5) | (158.0) |
| 2 | 57.8 | 28.9 | 19.0 | -0- | 4.5 | 28.9 | 33.4 |
| 3 | 61.1 | 30.5 | 19.0 | -0- | 4.5 | 30.5 | 35.0 |
| 4 | 64.8 | 32.4 | 19.0 | -0- | 4.5 | 32.4 | 36.9 |
| 5 | 69.2 | 34.6 | 19.0 | -0- | 4.5 | 34.6 | 39.1 |
| 6 | 74.1 | 37.1 | 19.0 | -0- | 4.5 | 37.1 | 41.6 |
| 7 | 79.8 | 39.9 | 19.0 | -0- | 4.5 | 39.9 | 44.4 |
| 8 | 86.4 | 43.2 | 19.0 | -0- | 4.5 | 43.2 | 47.7 |
| 9 | 93.9 | 47.0 | 19.0 | -0- | 4.5 | 47.0 | 51.5 |
| 10 | 100.7 | 50.4 | 19.0 | -0- | 5.1 | 50.4 | 55.5 |
| 11 | 74.3 | 37.2 | 19.0 | -0- | 16.0 | 37.2 | 53.2 |
| 12 | 80.8 | 40.0 | 19.0 | -0- | 17.7 | 40.0 | 57.7 |
| 13 | 86.1 | 43.0 | 19.0 | -0- | 19.5 | 43.0 | 62.5 |
| 14 | 92.4 | 46.2 | 19.0 | -0- | 21.4 | 46.2 | 67.6 |
| 15 | 99.1 | 49.6 | 19.0 | -0- | 23.4 | 49.6 | 73.0 |

Total Incremental Tax Effect Over 15 Year Period: 541.1

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1/ Includes original investment of $380 million plus income earned in year 1.

2/ Tax effect includes loss equal to investment in year 1.

3/ Tax base includes only the amount of the original investment ($380 million) in year 1 since interest earned on municipal bonds is not taxable.

the end of year one. The Treasury would then receive $190.0 million. As a result of the taxes paid on the income originally available for investment, investors, in effect, have only $190 million to invest.

If invested in municipal bonds earning 10 percent, the investors would receive non-taxable income annually of $19 million for fifteen years. This income represents a tax loss to Treasury of $142.5 million (annual income of $19 million for 15 years taxed at 50 percent.) Total revenues received by Treasury from investors in the municipal bond investment will then equal $47.5 million ($190.0 million minus $142.5 million). Including the incremental tax revenue resulting from thrift participation, the total additional tax revenue from a thrift partnership (assuming the investors' alternative investment is municipal bonds) is $541.1 million. This figure has a net present value of $188.9 million.

Sensitivity Analysis: It was emphasized above that the results of this study are dependent on the assumptions embodied in the example partnership. To assess more fully the impact of thrift partnerships on Treasury revenues, it is useful to test the dependence of the results on specific assumptions. The following discussion provides an analysis of the sensitivity of the results to two assumptions key to the projected level of taxes generated by thrift partnerships:

- the specified rate of return on the partnership investment
- the discount rate used in calculating the present value of revenues to Treasury.

The sensitivity analysis was performed by varying the value specified for each of these two assumptions, while holding all other assumptions constant. The *ceteris paribus* assumptions used were the same as those used in the example discussed above. In order to maintain comparability of results, the two assumptions tested were not varied simultaneously.

Tables 5a and 5b present the results of the analysis of the impact on the present value of projected tax revenues to Treasury of various rates of return earned on the partnership's investment of its assets. The assumed rate of return for the base case example discussed above was 15 percent and it can be seen that, given the other assumptions, Treasury revenues increase with a higher rate of return and decline with a lower rate of return.

The present value of projected net tax revenues from the investor partners (Table 5a) turn negative at a 12 percent rate of return. However, the probability of that scenario is very remote because at a 12 percent rate of return and based on the other assumptions of this analysis, the investor partners would not recover their original cash contribution over the life of the partnership. Consequently, they would be unlikely to enter into such an arrangement. This would be the case at any reinvestment mortgage yield below approximately 13.5 percent.

However, this analysis abstracts from correlative adjustments which the thrift partners would likely make in the yield of contributed mortgages. As the market rate declines, the mark-to-market losses of a portfolio of mortgages at a given rate also decline. Consequently, thrifts would likely contribute older vintage mortgages yielding an even lower return.

Tax revenues to Treasury from the thrift partners (Table 5b) are presented in terms of (a) the present value of total projected tax revenue from participating thrift insitutions and (b) the present value of the amount of increase represented by that total over tax revenues Treasury would have received had the partnership not been formed. In calculating the amount of increase we assumed, as in the base case example discussed above, that assets contributed to the partnerships would have been earning 8 percent in the absence of the partnership and that the tax incidence for the thrift partners would be the same in either case. Based on this analysis, it appears that Treasury would realize an increase in tax revenues from participating thrift institutions.

TABLE 5a

REVENUES TO TREASURY FROM INVESTORS UNDER VARIOUS ASSUMED RATES OF RETURN ON PARTNERSHIP INVESTMENT*
($ millions)

| Assumed Return on Investment (Percent) | Present Value of Tax Revenue | Present Value of First Year Tax Loss | Present Value of Total Tax Revenue |
|---|---|---|---|
| 12.0 | 103.0 | 114.4 | -11.2 |
| 12.5 | 136.6 | 123.3 | 13.3 |
| 13.0 | 167.6 | 137.0 | 30.6 |
| 14.0 | 228.2 | 155.3 | 72.9 |
| 15.0 | 287.7 | 173.5 | 114.2 |
| 16.0 | 350.0 | 187.2 | 162.8 |

TABLE 5b

REVENUES TO TREASURY FROM THRIFT INSTITUTIONS UNDER VARIOUS ASSUMED RATES OF RETURN ON PARTNERSHIP INVESTMENT*
($ millions)

| Assumed Return on Investment (Percent) | Present Value of Tax Revenue | Present Value of Increase in Tax Revenue** |
|---|---|---|
| 12.0 | 223.1 | 35.2 |
| 13.0 | 223.1 | 35.2 |
| 14.0 | 232.2 | 44.3 |
| 15.0 | 246.2 | 58.3 |
| 16.0 | 266.0 | 78.1 |

TABLE 5c

COMBINED REVENUES TO TREASURY
($ millions)

| Present Value of Tax Revenue From Investors and Thrift Institutions |
|---|
| 24.0 |
| 65.8 |
| 117.2 |
| 172.5 |
| 240.9 |

* Discount rate is assumed to be 9.5 in all cases.

** Assumes that assets contributed to the partnership would have been earning 8 percent in the absence of the partnership, and that the tax incidence for the thrift partners would be the same in either case

It is important to note that for Treasury to experience a decrease in tax revenue from the thrift partners, the return on the partnership investment would have to be less than the previous return on the assets contributed by the thrifts. Under these circumstances, there would be no incentive for thrifts to enter into such partnerships.

Tables 6a and 6b present the results of the sensitivity analysis with regard to the discount rate used to calculate the present value of projected Treasury revenues. We chose to examine the discount rate because the 9.5 percent discount rate used in the base case example is an estimate. Higher discount rates were analyzed because the use of a higher discount rate decreases the present value of revenue projections. For the discount rates examined, Treasury always realizes a positive revenue effect from thrift partnerships. The highest discount rate analyzed was 13.5 percent and it is unreasonable to assume anything higher since the discount rate should represent the effective cost to Treasury of alternative funds. The current yield on long-term Treasury bonds is 13.5 percent. Assuming that no portion of that cost is returned in tax revenues, this figure represents the maximum cost to Treasury of alternative funds. It should be reiterated that the rate of 9.5 percent employed in our baseline analysis was derived as the cost to Treasury of long term financing at current rates of approximately 13.5 percent less the effects of tax feedback.

The results of this sensitivity analysis indicate that under varying assumptions of (a) the rate of return to the partnership investment, and (b) the discount rate used in calculating the present value of revenues to Treasury, and given the other assumptions of this analysis, Treasury would under most circumstances realize positive revenues from thrift partnerships. Although there is a remote possibility that Treasury would realize negative revenues, this would depend on investors and thrift institutions entering into partnerships under terms that would be less than favorable to one party or the other.

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TABLE 6a

REVENUES TO TREASURY FROM INVESTORS UNDER VARIOUS DISCOUNT RATE ASSUMPTIONS*
($ millions)

| Assumed Discount Rate (percent) | Present Value of Tax Revenue | Present Value of First Year Tax Loss | Present Value of Total Tax Revenue |
|---|---|---|---|
| 9.5 | 287.7 | 173.5 | 114.2 |
| 11.0 | 261.7 | 171.2 | 90.5 |
| 13.5 | 225.7 | 167.4 | 58.3 |

TABLE 6b

REVENUES TO TREASURY FROM THRIFT INSTITUTIONS UNDER VARIOUS DISCOUNT RATE ASSUMPTIONS*
($ millions)

| Assumed Discount Rate (percent) | Present Value of Tax Revenue | Present Value Of Increase in Tax Revenue** |
|---|---|---|
| 9.5 | 246.2 | 58.3 |
| 11.0 | 224.3 | 51.7 |
| 13.5 | 194.0 | 42.8 |

TABLE 6c

COMBINED REVENUES TO TREASURY
($ millions)

| Present Value of Tax Revenue From Investors and Thrift Institutions |
|---|
| 172.5 |
| 142.2 |
| 101.1 |

* Rate of return on partnership investment is assumed to be 15 pecent in all cases.

** Assumes that assets contributed to the partnership would have been earning 8 percent in the absence of the partnership, and that the tax incidence for the thrift partners would be the same in either case.

General Considerations: On the basis of the analysis of our hypothetical partnership, it appears that the Treasury will receive a net increase in revenues from the thrift and investor participants in the partnership as long as the investment provides a positive return to investors. Although we have tested the sensitivity of our results to two major assumptions (the mortgage interest rate and the discount rate), variations in other assumptions could significantly impact our results.

Furthermore, our analysis has investigated only the first-order effects of thrift partnerships on Treasury revenues. Insofar as these partnerships could have wider positive macro-economic effects, tax revenues could well increase due to the impact of the increased investment in productive economic activity.

## STATEMENT OF WILLIAM S. McKEE, TAX LEGISLATIVE COUNSEL, DEPARTMENT OF THE TREASURY

Mr. McKEE. Thank you.

I am pleased to have this opportunity to present the views of the Treasury Department on S. 1828, entitled the "Thrift Partnership Tax Act of 1981." This bill would make a number of changes in the Internal Revenue Code to permit thrift institutions to market the unrealized losses in their mortgage loan portfolios as tax shelters for private investors. For the reasons set forth in this statement, Treasury opposes S. 1828.

I will omit the description of the bill in the interests of time but simply focus, if I may, on the major components of the bill.

First, it would add a new section 703(c) to the Code, which would insure that the losses would be ordinary losses rather than capital losses.

Second, the bill would amend section 704 of the Code to provide that tax allocations would be recognized despite having no substantial economic effect This provision is needed in order to permit the artificial tax loss allocations contemplated by the bill.

Third, the bill provides that a contribution of the mortgages will be treated as a contribution as such and not as a contribution of their sales proceeds.

Finally, section 7701(a)(19)(C) of the Code is amended to allow thrift institutions entering into these transactions to continue to qualify as thrift institutions.

Before discussing the bill from the standpoint of Federal tax policy, I would like to make it clear that the Treasury Department is quite aware that many of our Nation's thrift institutions are in difficult financial circumstances. We also know that thrift institutions have served a vital role in helping several generations of Americans to fulfill their dreams of owning their own homes. However, since other administration spokesmen have outlined on other occasions the administration's position on financial problems in the thrift industry, I will limit my remarks to the Treasury Department's concerns about the tax policy implications of S. 1828.

The bill contains several provisions which would override existing rules of general applicability in the tax law. The general rules that would be overridden—limitations on deductions for capital losses, prohibition of artificial loss allocations by partnerships, and the rules that attribute losses to the taxpayer who actually incurs them—are all designed to prevent distortions of a taxpayer's taxable income. The bill would negate these fundamental rules in an attempt to use the Federal income tax system as a means of reimbursing thrift institutions for losses resulting from past loan transactions.

Indeed, S. 1828 would make it more advantageous for a thrift institution, whether or not it is currently profitable, to transfer the low-yield mortgages in its portfolio to a qualified thrift partnership for sale. Losses realized on a direct sale of the mortgages by a profitable thrift institution would provide a maximum tax benefit equal to approximately 28 percent of the loss, since 28 percent approximates the maximum income tax rate applicable to thrift institutions after taking into account the special deduction provided by section 593 of the Code. By using the partnership device to sell its unrealized losses to individual investors in the 50-percent tax bracket, the institution could increase the tax benefits to 50 cents rather than 28 cents per dollar of loss. The ability to engage in this sort of tax rate arbitrage would cause even the most profitable thrifts to use these partnerships to obtain unwarranted tax advantages.

We are also concerned about the impact that the marketing of these tax shelter schemes would have on the general public's perceptions as to the fairness of our tax system. Authorization of these partnerships would launch an unprecedented marketing program for the sale of Government certified tax shelters to individuals in the highest income tax brackets. The tax benefits being marketed would not be attributable to any new capital investments and would not provide any new incentives for economic growth. Rather, they would simply reimburse thrifts for economic losses incurred in loan transactions consummated many years in the past.

Viewed as it should be—as an attempt to use the tax system to grant Federal subsidies to distressed thrift institutions—S. 1828 has other defects. Since a qualified thrift partnership could be formed by any thrift institution, the bill would not limit its extraordinary tax benefits to distressed institutions. Moreover, the benefits to the thrifts would be reduced by transaction costs and by the fact that the large volume of losses being marketed at one time would drive down their value. Because of these and other factors, the revenue loss to the Treasury would exceed by far the benefits flowing to thrift institutions. Our preliminary analysis indicates that the revenue loss from the bill could be as much as $50 billion.

Senator PACKWOOD. In 1 year?

Mr. MCKEE. Yes, sir, assuming that the bill is revised to deal only with losses on mortgage loans now in existence. This would be vastly more expensive to the Federal Government than any program of direct subsidies or supports for thrift institutions in financial distress.

Even if S. 1828 could be revised to meet the objections noted above, we would still oppose it on tax policy grounds, because it

seeks to use the tax system to grant Federal subsidies to a particular industry group. Any additional subsidies to these institutions should be granted directly so that normal budgetary and appropriations procedures can be followed and Federal benefits can be allocated in the most efficient manner.

In conclusion, the Treasury Department opposes S. 1828 for many reasons of tax policy. The bill would provide special exceptions to established tax rules that are designed to prevent distortions of a taxpayer's taxable income. The bill would open the way to tax rate arbitrage by thrift institutions and would present a significant potential for abuse. The marketing of interests in qualified thrift partnerships as tax shelters for high bracket investors would damage the public's perceptions concerning the fairness of our tax system. As a subsidy mechanism, the bill would be inefficient and ineffective and its cost would be prohibitive. Finally, the bill is contrary to sound public policy because it would circumvent the normal budgetary and appropriations procedures.

That concludes my prepared remarks. Thank you very much.

Senator PACKWOOD. We follow the first-come-first-served rule in asking questions here, Dick, and you arrived shortly before I did, so you are first.

Senator LUGAR. Well, Mr. McKee, let me ask this question first of all. Granted that the potential partners looking for these partnerships would be seeking tax shelters, is it not fair to assume that in the event those persons did not find shelter in these new thrift partnerships that they would have in fact found shelter elsewhere? In short, in estimating this rather large $50 billion loss, hasn't that already been lost, and aren't we really talking now about the relative merits of which shelter someone might find?

Mr. McKEE. No, sir. The Treasury Department believes that these will be additional tax losses marketed in the system. There are presently a large number of taxpayers in the 50-percent bracket who might find it attractive to enter into a transaction blessed by the Federal Government in a statute that guarantees them tax losses with no risk. In addition to getting their tax losses they are able to participate in a reasonably sound financial transaction. Most tax shelters, as you know, that are marketed today involve substantial risks, and the tax losses are not perhaps as solid as the ones that would be contemplated by this bill. So we view these as additional tax losses to those available in the system now.

Senator LUGAR. To the full extent of this $50 billion loss that you are talking about, what conceivable study would offer that type of assertion?

Mr. McKEE. The potential unrealized tax losses in the thrift institutions today are approximately $150 billion. As we pointed out, the marginal tax rate of a thrift institution is 28 percent, and the marginal tax rate of a high bracket taxpayer is 50 percent, so it makes economic sense for a thrift institution to move all of those tax losses into the private sector. If the entire $150 billion of unrealized losses were sold, it would have a revenue cost of $75 billion. Our revenue estimators feel that not all of these losses will be moved over and, as you suggest, not all of them will be marketed at the 50-percent bracket and, as you also suggest, perhaps some of

these losses will take the place of some other losses that are in the system already.

Nevertheless, having looked at the numbers, the Treasury Department estimates a $50 billion possible revenue loss.

Senator LUGAR. Does the Treasury believe or is it its speculative thought that somehow or other these losses will disappear in the system; that is, that they simply will be unrealized on the basis that interest rates will rise or that some other fortuitous economic circumstances will simply banish these losses, leaving aside whether they are realized by thrift partners?

Mr. MCKEE. The losses that are presently in the system, Senator, are locked up in the thrift institution sector, and the ability of the thrift institution sector to use these in the outyears depends on them becoming profitable in the future. The revenue estimate that we are looking at, and it is obviously an estimate—that's what revenue estimates are—assumes that those losses will be realized in the present timeframe in the sense that these are losses that occur all at once; all you have to do is sell the mortgage portfolio. It triggers the potential $150 billion of losses all in 1 year; unlike a number of other tax shelters that move out into the outyears.

Admittedly, if the thrift institutions turn profitable at some point in the outyears—it may take 10 or 15 years for them to absorb all these losses—the losses would be offset against profits generated by the thrifts. Here we move those losses into the current year where they offset ordinary income earned by doctors and lawyers and other professionals.

Senator LUGAR. So your general assumption is that the loss to the Treasury would be greater because the losses would come all in the first year. And if the losses in fact were scattered over several years, the loss to the Treasury would be less. Otherwise, you would be speculating that somehow or other good times were going to come to the thrifts and, therefore, the losses would dissipate.

Mr. MCKEE. Again, Senator, the losses, if they are kept in the thrifts, are only offsettable against 28-percent income. If you move them out into the private sector, it goes at 50. So, right there, it almost doubles the revenue loss because of what we call bracket arbitrage or rate arbitrage. Then, as I suggested, and as you pointed out, the ability of the thrifts to use the losses depends upon them being able to generate that much profit in the outyears, which may take some period of time.

Finally, it is possible that if interest rates do come down those losses will never arise. If the interest rates come down, of course, the value of the mortgages goes up, and the losses will disappear. The problem from our point of view with this bill is that it allows an institution to trigger all those losses immediately. And then, of course, if they reinvest in mortgages and the interest rates come down, the value of those mortgages will go up. But that will be unrealized appreciation, and the Treasury won't get any revenue from those for some period of time.

Senator LUGAR. Some have suggested that interest rates might go up, in which case the problem becomes worse. Your suggestion is that, still, these losses are all locked up presently in thrifts, as opposed to being liberated to 50-percent advantage that you would suggest. But it is conceivable the losses, even as we are speculating

about this, may become larger; that is, the $150 billion may become a bigger figure.

Some have suggested that even if the good news were to come, and interest rates were to come down substantially, that might only occur along with a general deflation of real estate values and a great unease in which some of the underlying assets of the mortgages also deteriorated; in other words, that there isn't any way out of this without somebody taking the losses including the U.S. Treasury given these losses that are in the system.

I suppose I am intrigued with your thought that even if the losses have to be taken at some point, locked up as they are in the thrifts, this is more advantageous to the Treasury. The dilemma, of course, and this is not necessarily your responsibility, is that the insurance agencies covering the thrifts then begin to work their way through the $6 or $7 billion of reserves, and the $150 billion goes well beyond that pretty fast.

Have you thought down the trail as to what agency of the Federal Government comes to the rescue if we have this $150 billion out here somewhere and insurance for maybe $7 billion of it, and have you thought about where that loss bobs up to the Treasury or in the budget system?

Mr. McKEE. Let me emphasize again that the Treasury understands the plight of the thrift institutions, and I want to address my remarks only to this particular approach to solving the plight of the thrifts.

Again, the bill is not limited to financially distressed thrifts. A number of profitable thrifts also, obviously, have losses in their portfolio. Those are losses that the investors ought to bear. They invested their money in a business venture, and it didn't turn out so well. We don't feel that those institutions ought to be able to take their 28-cent losses and sell them for 50 cents on the dollar. We think that is patently unreasonable.

Senator LUGAR. Does this imply some threshold in which if a thrift is sufficiently in trouble your objection dissipates?

Mr. McKEE. The Treasury Department, as I suggested, has a number of objections to the bill. From the big-picture point of view, we don't like to see the tax system utilized as a way to provide assistance to this kind of a problem. It is a very blunt instrument. We suggest that if you want to help the thrift institutions you should do it directly.

Inevitably, the tax system is a very cumbersome tool for providing this assistance, and I think this bill illustrates that. It doesn't target it to the people that need it, and it doesn't give the right amount of money to the right people. It is a problem that is inherent in almost all uses of the tax system to do other than raise revenues for the Treasury Department.

Senator LUGAR. Thank you very much.

Senator PACKWOOD. Mr. McKee, is it true that you were the principal inventor of the tax credit leasing rules?

Mr. McKEE. I was certainly involved in the efforts of the Office of Tax Policy to solve the problem that we felt leasing solved. That is correct.

Senator PACKWOOD. By use of the tax code.

Mr. McKee. The problem that leasing is designed to solve is a problem that was created by the Federal tax code. The problem, as you know, in the leasing area is that Congress had decided, I think on both sides of the aisle, to provide substantial incentives for new investment. Notice that this bill has no incentive feature at all. It is designed to solve past problems. Leasing was a forward looking situation in which we were trying to take the incentives to make new investments and make them available to all parties. So it involved new incentives. It was prospective only; it did not deal with past problems, but only with credits and deductions for new investment.

We specifically limited that provision, Senator, to the corporate sector for precisely the reason that I suggested, as a fairness perception. Certainly the press and some Members of Congress feel that leasing involves a perception problem even though we limit it to the corporate sector, but we did so limit it in a direct response to the feeling that there was a perception problem.

Finally, let me just say, there was no bracket arbitrage in the leasing provisions. Corporations in the 46-percent bracket are transferring those deductions and credits also to other corporations in the 46-percent bracket. So the value of the incentive that the Congress wanted to have made available was simply transferred, full dollar for dollar, to another institution. So it is an incentive provision for future-looking investments, not a bailout for past problems.

Senator Packwood. I want to separate, however, your philosophy from bailing out past versus future incentives. Your last sentence is, "Finally, the bill is contrary to sound tax policy because it would circumvent the normal budgetary and appropriations procedures." So, does the tax leasing circumvent the normal budgetary and appropriation procedures?

Mr. McKee. Not the tax leasing provision, Senator. If you view either the cost recovery provisions or the investment tax credit, if you choose to view those as direct expenditures, then I would have to agree with you.

Senator Packwood. Tell me what you mean by "the normal budgetary and appropriation procedures."

Mr. McKee. Our thought is that, if the Congress wants to provide assistance to the thrift institutions because of financial distress, they should provide that through the direct appropriations process.

Senator Packwood. Why through the direct appropriation process there, when we were not reluctant at all to use the Tax Code for other incentives, not appropriation incentives, tax incentives, in a variety of ways in the bill we passed last summer?

Mr. McKee. I think the difference is primarily that the tax incentives that both sides of the aisle wanted to put into the tax system last summer were a much broader based, not restricted to a particular industry, were a forward-looking notion trying to reduce the cost of new capital investments across the board to all industries in the United States. And that is substantially different than a tax provision aimed at a particular industry dealing with past problems.

You will recall, for example, the Treasury Department strongly opposed the unlimited or long-term tax credit carryback to the so-called distressed industries last summer for reasons similar to those for which we oppose this bill. It was targeted to a few industries; it dealt with past problems; it wasn't a forward-looking proposal.

Senator PACKWOOD. But isn't this a fair statement, because it is endemic to all Treasury Departments: In the 10 years I have been on this committee, the Treasury Department has opposed tax incentives for schemes that they don't like and are in favor of tax incentives for schemes that they do like.

Mr. McKEE. I think that the Treasury Department is by and large opposed to the utilization of the tax system for nontax objectives.

Senator PACKWOOD. Now, say that again. The Treasury Department is what?

Mr. McKEE. Is opposed to the use of the Federal income tax system to accomplish nontax related goals as a general proposition.

Senator PACKWOOD. Do you mean like the mortgage interest deduction for homeowners?

Mr. McKEE. The Treasury Department has not taken——

Senator PACKWOOD. Following that theory, they would be opposed to that, however.

Mr. McKEE. No. That is a definition of what is the appropriate tax base in terms of what is the pool of money that we use to measure an individual's ability to pay. And Congress has long held and this Treasury Department has agreed, although the last Treasury Department took some contrary positions in some cases, that interest is an amount of money that the individual does not have available in terms of measuring his ability to pay income taxes. There is no question that the literature is filled with debates about whether or not interest should be in or out of the tax base. This Treasury Department has not suggested that interest should be put back into the tax base.

Senator PACKWOOD. I have no other questions.

Mr. McKEE. Thank you very much.

[The prepared statement follows:]

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February 5, 1982

STATEMENT OF WILLIAM S. McKEE
TAX LEGISLATIVE COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE SENATE FINANCE COMMITTEE
AND THE SUBCOMMITTEE ON HOUSING
AND URBAN AFFAIRS
OF THE SENATE BANKING COMMITTEE

To the Chairmen and Members of the Subcommittees:

I am pleased to have this opportunity to present the views of the Treasury Department on S. 1828, entitled the "Thrift Partnership Tax Act of 1981." This bill would make a number of changes in the Internal Revenue Code to permit thrift institutions to market the unrealized losses in their mortgage loan portfolios as tax shelters for private investors.

For the reasons set forth in this statement, Treasury opposes S. 1828.

## Description of S. 1828

S. 1828 is designed to enable thrift insitutions to form partnerships with private investors in order to obtain financial benefits from the unrealized losses in their mortgage loan portfolios. As contemplated by the bill, a thrift institution could contribute low-yield mortgages in its existing portfolio and private investors could contribute cash to a "qualified thrift partnership." Because the partnership would take carryover bases in the mortgages that are significantly above the fair market values of those

assets, the mortgages would have "built in" unrealized losses for income tax purposes. The partnership would then sell the mortgages to realize the losses, allocate the losses to the investors for income tax purposes, and invest the cash realized from the mortgage sales and the cash received from the investors in other mortgage loans. Through this mechanism the thrift institution could effectively market its unrealized losses as tax shelter investments for private investors.

The bill would make a number of changes in the Internal Revenue Code to enable these partnership arrangements to work. First, a new section 703(c) would be added to the Code to provide that the losses realized by the partnership on the mortgage sales would be treated as ordinary losses rather than as capital losses. This change is needed to insure that the investors receive the maximum tax benefit from the use of the losses to offset their income from other sources. Second, the bill would add a new paragraph to section 704 of the Code to provide that the tax loss allocations in the partnership agreement will control without regard to the general rules of sections 704(b)(2) and (c)(1), which provide that tax loss allocations in partnership agreements will be respected only if they have substantial economic effect. This special rule is needed to permit the artificial loss allocations to the investors that are contemplated in the partnership agreements.

Third, the bill would add a new paragraph to section 721 of the Code to provide that a thrift institution's transfer of mortgages to a qualified thrift partnership followed by the sale of the mortgages by the partnership will be treated as a contribution of the mortgages (and not their sales proceeds) to the partnership in exchange for a partnership interest. This prevents the application of general tax rules that otherwise could attribute the sales of the mortgages (and, hence, the tax losses) to the thrift institution rather than the partnership. Finally, the bill would amend section 7701(a)(19)(C) of the Code to take mortgages held by the partnership into account in determining whether the thrift institution has sufficient mortgage investments to qualify for preferential tax treatment as a domestic building and loan association after formation of the partnership.

## Treasury Position

Before discussing S. 1828 from the standpoint of Federal tax policy, I would like to make it clear that the Treasury Department is quite aware that many of our nation's thrift institutions are in difficult financial circumstances. We

also know that thrift institutions have served a vital role in helping several generations to fulfill the American dream of owning their own homes. Since other Administration spokesmen have outlined on other occasions the Administration's position on the financial problems in the thrift industry, I will limit my remarks to the Treasury Department's concerns about the tax policy implications of S. 1828.

S. 1828 purports to clarify the application of existing law to qualified thrift partnerships. Nevertheless, the description of the bill set out above makes it clear that the bill would override numerous existing rules of general applicability in the tax law. The general rules that would be overridden -- the limitations on deductions for capital losses, the prohibition of artificial loss allocations by partnerships, and the rules that attribute losses to the taxpayer who actually incurs them -- are all designed to prevent distortions of a taxpayer's taxable income. The bill would negate these fundamental rules in an attempt to use the Federal income tax system as a means of reimbursing thrift institutions for losses resulting from past loan transactions.

Indeed, S. 1828 would make it more advantageous for a thrift institution, whether or not it is currently profitable, to transfer the low-yield mortgages in its portfolio to a qualified thrift partnership for sale. Losses realized on a direct sale of the mortgages by a profitable institution would provide a maximum tax benefit equal to approximately 28% of the loss, since 28% approximates the maximum income tax rate applicable to thrift institutions after taking into account the special deduction provided by section 593 of the Code. By using the partnership device to sell its unrealized losses to individual investors in the 50% income tax bracket, the institution could increase the tax benefits to 50 cents (rather than 28 cents) per dollar of loss. The ability to engage in this sort of tax rate arbitrage would cause even the most profitable thrifts to use these partnerships to obtain unwarranted tax advantages. Moreover, it could motivate thrift institutions to structure mortgage loans with large front-end payments and below market nominal interest rates, since the initial payments would be taxable at the maximum 28% rate and the devalued mortgage loans would produce potential tax losses for sale to investors in the 50% bracket.

We are also concerned about the impact that the marketing of these tax shelter schemes would have on the general public's perceptions as to the fairness of our tax system. Authorization of these partnerships would launch an

unprecedented marketing program for the sale of "government certified" tax shelters to individuals in the highest income tax brackets. The tax benefits being marketed would not be attributable to any new capital investments and would provide no new incentives for economic growth. Rather, they would simply reimburse thrifts for economic losses incurred in loan transactions consummated many years in the past.

Viewed as it should be -- as an attempt to use the tax system to grant Federal subsidies to distressed thrift institutions -- S. 1828 has other defects. Since a qualified thrift partnership could be formed by any thrift institution, the bill would not limit its extraordinary tax benefits to distressed institutions. Moreover, the benefits to the thrifts would be reduced by transaction costs and by the fact that the large volume of losses being marketed at one time would drive down their value. Because of these and other factors, the revenue loss to the Treasury would exceed by far the benefits flowing to thrift institutions. Our preliminary analysis indicates that the revenue loss from the bill could be as much as 50 billion dollars, assuming that the bill is revised to deal only with losses on mortgage loans now in existence. This would be vastly more expensive to the Federal government than any program of direct subsidies or supports for thrift institutions in financial distress.

Even if S. 1828 could be revised to meet the objections noted above, we would still oppose the bill on tax policy grounds because it seeks to use the tax system to grant Federal subsidies to a particular industry group. Any additional subsidies to these institutions should be granted directly, so that normal budgetary and appropriations procedures can be followed and the Federal benefits can be allocated in the most efficient manner.

## Conclusion

The Treasury Department opposes S. 1828 for many reasons of tax policy. The bill would provide special exceptions to established tax rules that are designed to prevent distortions of a taxpayer's taxable income. The bill would open the way to tax rate arbitrage by thrift institutions and would present a significant potential for abuse. The marketing of interests in qualified thrift partnerships as tax shelters for high bracket investors would damage the public's perceptions concerning the fairness of our tax system. As a subsidy mechanism, the bill would be inefficient and ineffective and its cost would be prohibitive. Finally, the bill is contrary to sound tax policy because it would circumvent the normal budgetary and appropriations procedures.

Senator PACKWOOD. Next we will take William Rule, the director of economic analysis for Coopers & Lybrand.

Mr. RULE. Good morning.

Senator PACKWOOD. Good morning, Doctor, go right ahead. Your entire statement will be in the record.

## STATEMENT OF WILLIAM T. RULE II, DIRECTOR OF ECONOMIC ANALYSIS, COOPERS & LYBRAND, WASHINGTON, D.C., ON BEHALF OF THE SECURITIES GROUP, WASHINGTON, D.C.

Mr. RULE. My name is William Rule, and I am director of economic analysis in the Washington office of Coopers & Lybrand. It is my pleasure to appear before you today and to briefly summarize the study conducted under my direction which culminated in the report entitled "Potential Economic Impacts of Thrift Partnerships."

Coopers & Lybrand was engaged by the Securities Group in the summer of 1981 to conduct an independent study of the potential tax revenue and other economic impacts of a proposed limited partnership arrangement which has since become to be known as a thrift partnership.

Senator PACKWOOD. Let me interrupt. What is The Securities Group?

Mr. RULE. The Securities Group is a New York based investment banking firm.

Senator PACKWOOD. A single firm?

Mr. RULE. Yes; I believe so.

Senator PACKWOOD. All right.

Mr. RULE. The only input provided by our client was detail concerning the operational mechanics of such a partnership. We were otherwise left to conduct the study and reach our conclusions independent of the interests of our client or of any other group.

I will omit, in the interests of time, a rather complex description of how these partnerships work and just summarize the concept that thrift partnerships propose to combine the capital contributions of the two classes of partnership participants, thrift institutions and private investors, and convert the capital contributions into investments that yield a return at the current market rate of interest. Participation in a thrift partnership potentially provides thrift institutions with a mechanism to liquidate low-yield mortgage assets without adversely affecting their net worth and to increase their earnings.

Our approach to the analysis of the economic impacts of thrift partnerships was based primarily on simulation of the financial performance of a hypothetical partnership. We abstracted from a draft partnership document what we considered to be the key structural elements of its operations and developed a computer model designed to simulate operations over 15 years. In order to generate projections, however, we were required to make certain assumptions regarding financial and economic variables. These assumptions were based on relevant economic magnitudes at the time of the study. You will find documentation of these assumptions in our report which has been entered into the record.

The focus of our quantitative analysis was on the tax effects of partnership operations both on the participants and on the Department of the Treasury. We concluded that, based upon our analysis, the thrift institution participant would sustain a net increase in taxable income and in taxes payable. We further concluded that although initial tax losses would be sustained by the private investors, and thus revenue losses by the Treasury, on balance the private investors would over time pay more taxes than under a number of alternative investments. Finally, we concluded that the present value of Treasury revenues would increase under most circumstances as a result of partnership operations, but the timing of those receipts would shift.

Specifically, based on our analysis the present value of Treasury tax revenues from thrifts would increase by approximately $60 million per billion dollars of conventional mortgages. Estimates of net revenue impacts from investor participation are more difficult to derive. We analyzed a number of alternative scenarios and found that these net impacts ranged from essentially zero to increases of nearly $190 million. Thus the overall net revenue increases range from $60 to $250 million per billion dollars of contributed mortgages.

Certain other aspects of thrift partnerships could have significant positive impacts, although we did not attempt to quantify them. First, to the extent that partnerships do succeed in averting the bankruptcy of some insured thrift institutions, the Federal Government may avoid the insurance losses that might otherwise be incurred in settling depositors' claims.

Second, to the extent that partnerships' operations successfully infuse the mortgage market with new capital, home construction activity and other related economic activity may be encouraged with consequent benefit to society.

Thus, on balance, our analysis indicated that thrift partnerships have the potential to moderate the depressive effects of high current mortgage rates on thrift performance through a private sector solution. As an indication of the potential relief such partnerships may offer thrifts, we analyzed the financial statements of the average large savings and loan as of 1980 and concluded that participation could increase net income by as much as 400 percent. Moreover, such partnerships appear to provide such relief without a present value tax revenue loss to the Treasury. Finally, indirect effects, although not quantified, nevertheless appear favorable to the economy as a whole and to reinforce estimated positive economic impacts.

That concludes my prepared statement. At this time I would be happy to answer your questions on our study.

Senator PACKWOOD. Dick.

Senator LUGAR. Thank you, Mr. Chairman.

Obviously, the testimony that you have given differs substantially from the testimony that we have heard from Mr. McKee at the Treasury Department. For the benefit of the record, would you attempt to reconcile the statement that you have made that the benefits to the Treasury could be in the range of $60 to $250 million per billion of contributed mortgages, that is, additional revenue coming into the Treasury, to the statement that we have just

heard that the initial Treasury loss in the first year could be of the order of $50 billion? There is such a monumental, almost mind-boggling differential between those two analyses, that it just seems to me for the benefit of the record we need to get some melding together so that honest observers can make a judgment.

Mr. RULE. I will attempt to reconcile them as best I can. I had read the revenue estimate presented by Mr. McKee; however, I am unclear as to what methodology they used. I suspect that the focus of that estimate was on the first-year losses and concentrated primarily on the tax losses experienced by the investors, the cash investors.

Our approach was based on a number of assumptions, a number of philosophical assumptions. First of all, that this was a program whose impacts were felt over time, that one needed to consider more than just the first-year impact in order to get a true picture.

Second, we felt that we needed to analyze the effects on all of the participants, not just the cash investors. And in that light, then, we proceeded to analyze the tax effects over the full, anticipated 15-year life of such a partnership. We did, in addition, adopt the philosophical orientation that individuals who would be investing in such partnerships, presumably for the first-year tax benefits to them, would otherwise have invested in some other investment which had a similar profile of tax effects for them.

Taking all of that into account, we analyzed the revenue year by year and concluded that, if properly discounted back to a present value, that the Treasury would not indeed lose any revenues. In effect, the philosophy being that if the Treasury had a first-year revenue loss, that it could borrow at prevailing market rates, repay the borrowing, and end up on balance with more Treasury tax revenues than they would have otherwise.

Senator LUGAR. Is your estimate even over the 15-year period of the $60 to $250 million per billion of gain, is there any reference point in terms of the present value of money? Have you discounted back to the present so that there is some comparison with the Treasury's instant analysis for at least this first year?

Mr. RULE. Senator, the $60 to $250 million per billion is a present value number.

Senator LUGAR. I see.

So that is part of your estimate?

Mr. RULE. That is part of the estimate, yes.

Senator LUGAR. Having read your analysis earlier on when you produced it in September, I asked the question, as you will recall, would this not be just a substitution for those seeking tax shelter elsewhere? Mr. McKee's judgment was that this would be additional money or at least additional search for tax shelter. It would not be a substitute because there would be this differential between 28-percent relief and 50-percent relief.

What sort of comment do you have with regard to that? Why do you feel it's a substitution as opposed to Mr. McKee's assertion that this is almost a leadpipe cinch, that this brings all kinds of new money in because the risks are substantially different and the rewards are much greater?

Mr. RULE. Well, Senator, I should, as a representative of Coopers & Lybrand, restrict myself to comments on this study. We did not

look into the economics of that kind of substitution. However, speaking as a professional economist and as an individual, my view on that issue is that the financial markets are enormously resourceful and that presumably it is currently saturated with so-called tax shelter schemes. Therefore, if another tax shelter comes on the scene it is not going to draw new money into tax shelters, rather it will dilute, it will draw money away from other such schemes and not create new tax sheltered money.

Senator LUGAR. Is there validity in the claim that this substitution, even if true, still results in a greater loss to the Treasury because of the differential between the 28-percent rate and the 50-percent as cited by Mr. McKee?

Mr. RULE. I am reluctant to conclude anything. We did not do any calculations of that effect, and I would be reluctant to state one way or the other.

Senator LUGAR. But, to be tedious about it, your testimony, on the basis of a professional study by your institution, is that, as opposed to a loss, a substantial loss, to the taxpayers, that in fact the thrift partnership idea would gain the taxpayers in terms of present value of money discounted back to the present from $60 to $250 million per billion of contributed mortgages. So that, regardless of how much participation there is in this, as a matter of fact if there is more participation, if more of this hypothetical $150 billion of loss out there comes into this scheme, the benefits to the taxpayers grow, literally. Is it a direct ratio? Is there a break-even point? Or is this essentially a gain from the first billion onward?

Mr. RULE. We considered that aspect when we conducted the study and concluded that we could not pin down with sufficient accuracy the effects on the mortgage markets. We would have to acknowledge that as the volume of such mortgage conversions grows there might indeed be an effect on the financial markets. But, apparently, so long as the concept of the partnership remains attractive to both participants, the Treasury does indeed gain net revenue for each new dollar of mortgages converted.

Senator LUGAR. So it doesn't change to a negative at any point?

Mr. RULE. Not within the scope of our analysis.

Senator LUGAR. One final question. Given the fact there are other shelters out there, as you have pointed out and they are competing for these dollars, presumably, even if this is a very good one, what assumptions can we make as to how much money is out there seeking shelter? In other words, the assertion, as I recall, made by Mr. McKee is that this is obviously such a good thing that we could anticipate maybe two-thirds of this $150 billion mountain of difficulty might be dissipated in the first year as people avidly sought these opportunities. That is a large shift of money in this country, $100 billion, seeking these partnerships. What would be your estimate? In other words, really what kind of participation, given all the alternatives, is it realistic to assume?

Mr. RULE. Again, Senator, we attempted to gage the extent of so-called tax-sheltering activity and were frustrated at every point. It is apparently a very large amount of money. We were never able to pin it down to an amount with sufficient accuracy that we would want to place it in our study. Then again, my personal suspicion is that (a) it is unrealistic to expect that all $150 billion will roll

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through the capital markets in a year. A more realistic estimate might be in the range of $20 to $25 billion per year, and my personal professional feeling is that the capital markets are probably very well structured to handle that kind of a flow.

Senator LUGAR. So, obviously, at $25 billion a year, even if the worst of the assumptions of the Treasury were true, then we diminish by the order of five-sixths the potential loss of that estimate. Of course, we diminish also the gains from your estimate. If we get only $25 billion, then we are talking about only $60 to $250 million of gains per billion. So we have narrowed substantially maybe from a negative $6 or $7 billion on the Treasury side to a positive $6 or $7 billion on yours, what we see from this.

Mr. RULE. Yes.

Senator LUGAR. Thank you very much.

Senator PACKWOOD. Doctor, I have no questions. Thank you very much for the study.

Mr. RULE. Thank you.

[The prepared statement follows:]

# ECONOMIC IMPACTS OF S. 1828
# RELATING TO
# THE TAX TREATMENT OF THRIFT PARTNERSHIPS

Hearings

before the

Subcommittee on Taxation and Debt Management

of the

Senate Committee on Finance

and the

Subcommittee on Housing and Urban Affairs

of the

Senate Committee on Banking

February 5, 1982

Dr. William T. Rule

Director of Economic Analysis

COOPERS & LYBRAND

My name is William Rule and I am Director of Economic Analysis in the Washington office of Coopers & Lybrand. It is my pleasure to appear before you today and to briefly summarize the study conducted under my direction which culminated in a report entitled "Potential Economic Impacts of Thrift Partnerships."

Coopers & Lybrand was engaged by The Securities Groups in the summer of 1981 to conduct an independent study of the potential tax revenue and other economic impacts of a proposed limited partnership arrangement which has since come to be known as a "Thrift Partnership." The only input provided by our client was detail concerning the operational mechanics of such a partnership. We were otherwise left to conduct the study and reach our conclusions independent of the interests of our client or of any other group.

Before I describe for you our approach to this analysis and the conclusions we reached, let me briefly outline the concept of the "Thrift Partnership" upon which our study was based.

Thrift Partnerships have been proposed as a means to mitigate the current financial difficulties of thrift institutions. They essentially offer thrift institutions a mechanism for converting older, below market rate mortgages in their existing asset portfolios to an interest in a limited partnership with private

investors. Thrift institutions contribute low-yield mortgage assets in their existing portfolios as capital to the new partnership. The mortgages are transferred to the partnership capital account at their book value, and thus the thrift realizes no loss on the transfer. Private investors contribute cash to partnership capital in an amount approximately equal to the difference between book and market value of the mortgages contributed by the thrift institutions. The partnership then sells the contributed mortgages in the secondary mortgage market, realizes a loss (from book value) on the sale of the low yield mortgages and invests the cash realized from the sale plus the cash contributed by the private investors in mortgages carrying current market interest rates. The partnership allocates the loss realized on sale of the contributed mortgages to the private investor participants.

Income earned by the partnership is distributed to the participants according to a system of guaranteed payments to each party. The thrift participant realizes an increased return on its contributed mortgages relative to its former earnings since the guarantee is based on a rate higher than contributed mortgages. Private investors are also allocated a payment out of the partnership income so that in each year except the first the investor has partnership income.

The proposed thrift partnership is limited to investments legally available to thrift institutions. The partnership may actively trade its portfolio and may engage in servicing the mortgage contracts that it initiates or acquires. Income in excess of the guaranteed payments that is distributed to participants' capital accounts may be reinvested by the partnership.

Thus, thrift partnerships propose to combine the capital contributions of the two classes of partnership participants (thrift institutions and private investors) and convert the capital contributions into investments that yield a return at the current market interest rate. Participation in a thrift partnership potentially provides thrift institutions with a mechanism to liquidate low yield mortgage assets without adversely affecting their net worth and to increase their earnings.

Our approach to the analysis of the economic impacts of thrift partnerships was based primarily on simulation of the financial performance of a hypothetical partnership. We abstracted from a draft partnership document what we considered to be the key structural elements of its operations and developed a computer model designed to simulate operations over fifteen years. In order to generate projections, however, we were required to make certain assumptions regarding financial and economic variables.

These assumptions were based on relevant economic magnitudes at the time of the study. You will find documentation of these assumptions in our report, which has been entered into the record.

The focus of our quantitative analysis was on the tax effects of partnership operations both on the participants and on the Department of the Treasury. We concluded that, based upon our analysis, the thrift institution participant would sustain a net increase in taxable income and in taxes payable. We further concluded that although initial tax losses would be sustained by the private investors, and thus by the Treasury, on balance the private investors would over time pay more taxes than under a number of alternative investments. Finally, we concluded that the present value of Treasury revenues would increase under most circumstances as a result of partnership operations, but the timing of those receipts would shift.

Specifically, based on our analysis the present value of Treasury tax revenues from thrifts would increase by approximately $60 million per billion dollars of contributed mortgages. Estimates of net revenue impacts from investor participation are more difficult to derive. We analyzed a number of alternative scenarios and found that these net impacts ranged from essentially zero to increases of nearly $190 million. Thus the overall net revenue increases

range from $60 to $250 million per billion dollars of contributed mortgages.

Certain other aspects of thrift partnerships could have significant positive impacts although we did not attempt to quantify them. First, to the extent that partnerships do succeed in averting the bankruptcy of some insured thrift institutions, the Federal government may avoid the insurance losses that might otherwise be incurred in settling depositors' claims.

Second, to the extent that partnerships' operations successfully infuse the mortgage market with new capital, home construction activity and other related economic activity may be encouraged with consequent benefit to society.

Thus, on balance, our analysis indicated that thrift partnerships have the potential to moderate the depressive effects of high current mortgage rates on thrift performance through a private sector solution. As an indication of the potential relief such partnerships may offer thrifts, we analyzed the financial statements of the average savings and loan as of 1980 and concluded that participation could increase net income by as much as 400%. Moreover, such partnerships appear to provide such relief without a present value tax revenue loss to Treasury. Finally, indirect effects although not quantified, nevertheless appear favorable to the economy as a whole, and to reinforce estimated positive economic impacts.

That concludes my prepared statement. I would be happy to answer any of your questions on our study at this time.

Senator PACKWOOD. Now if we can go to a panel of Mr. Robert McKinney, the chairman of the First Federal Savings & Loan in Indianapolis and the former Chairman of the Federal Home Loan Bank Board, and Ms. Linda Yang, the economist and savings and loan commissioner of the State of California.

Senator LUGAR. It is a great pleasure to welcome both of you. I have had just a chance to greet you, Ms. Yang, briefly as we came in. We are grateful that you have come all the way from Sacramento today. And it's a special personal privilege to welcome Bob McKinney from Indianapolis and to hear his testimony again this morning.

Would you proceed first of all, Ms. Yang, with your testimony? And then Mr. McKinney. And then I will ask questions. Or, if we are joined by others, we will get into questioning them.

STATEMENT OF LINDA TSAO YANG, ECONOMIST AND SAVINGS AND LOAN COMMISSIONER, STATE OF CALIFORNIA, LOS ANGELES, CALIF.

Ms. YANG. Good morning. My name is Linda Tsao Yang. I am an economist by my educational background, and my areas of concentration are regulation of thrift institutions, monetary policy, and business fluctuations. And it is certainly indeed a pleasure and an honor to appear on the same panel with Mr. McKinney, whom I admire and have heard of for a long, long time.

I thank you, also, Senator Lugar, for inviting me to come before you today to offer my personal views on Senate bill 1828, the Thrift Partnership Tax Act. I deeply appreciate this honor.

I strongly support the purpose and the general concept of this bill. Let me tell you why.

No. 1, the bill will enhance the flow of funds to the potential home buyer. And, in fact, a positive effect of this bill could be rather immediate.

Second, the bill, more than any other piece of legislation that I have seen, really goes to the heart of the problem of the thrifts, and that is the bleeding of their net worth caused mainly by the low coupon mortgages in their portfolio. And, as you correctly pointed out, Mr. Lugar, in your introductory remarks, that the thrifts did not get themselves into this situation voluntarily. They did not. They did a very good job in promoting home ownership, which they were mandated to do.

I believe this bill will enable the thrifts to convert those mortgages without having to book losses on the transfer and which means they can keep up their net worth to asset ratios and at the same time to expand almost immediately the stream of income down the line.

Now, the ability to keep net worth to asset ratio is not just for paper only; it has tremendous practical applications. As you know, when a thrift, say if their net worth to asset ratio falls below statutory limits, even though they may have a license on hand to open a branch they cannot open a branch.

Third, this bill would have a very significant salutary effect as far as the regulators are concerned. And I believe the Treasury would appreciate the salutary effect of this bill, because the im-

proved income stream and enhanced liquidity of the institutions could remove a large number, a fairly good number, of thrifts from the endangered category. So, therefore, the bill, in effect, could help to contain the risk exposure of the FSLIC, the FDIC, and, of course, the potential recourse to the Treasury. And this consideration is just as important to the State regulators as it is to the Federal regulators, and should be to the Treasury.

Now, having stated my views, I would like to present some facts and figures gained from my California experience.

California associations, both Federal and State, have a total loan portfolio of around $103 billion. About 20 percent of that portfolio are currently yielding less than 9 percent. Now, this percentage is better than the national average. I believe the Nation averaged about one-third of the portfolio yielding less than 9 percent.

On top of that, in California another 30 to 40 percent of this portfolio are yielding more than 9 but less than 10 percent. The cost of funds is around 12¼ percent. Thus, this negative carry of at least 325 basis points on about 20 percent of the portfolio and at least 225 basis points on another 30 to 40 percent of the portfolio really constitutes the heart of the problem that has plagued the thrifts and eroded their net worth.

Now, please, as I say, understand that the thrifts really did not voluntarily strap themselves into this situation; in fact, it is Government regulation that until very recently simply left them with very few alternatives. And in an environment of net savings outflow, which we have seen in recent months, this wide negative yield spread has forced the thrifts to cut back sharply the loans to the potential home buyer. In fact, for instance, gross lending by the California savings and loans slumped to only $9.6 billion in the first 11 months of 1981, compared with $14.6 billion and $24.3 billion for comparable periods in 1980 and 1979. And many potential home buyers simply have been squeezed out of the market.

Now, suppose we have a mechanism as to the one proposed in this bill, Senator, to convert just that 20 percent of the portfolio that is yielding less than 9 percent. And, of course, I would like to emphasize it is going to take time to convert that portfolio. We bear in mind the realities of the market, that it would be difficult to convert all at once. But just to say that we have a mechanism to do so, I can say with some degree of confidence that savings and loans will be able to recycle a good deal of this money into new mortgages. So, therefore, it is also prospective, not just retrospective, the effect.

And the California associations have a good liquidity position at this time. In fact, it's almost a historical high. So therefore, even allowing a paydown of some of the advances on the Federal Home Loan Bank of San Francisco, they are in a good position to accommodate the loan demands of the potential home buyer. And, more importantly, having been freed from those low coupon loans, the savings and loans would be able to offer the potential home buyer rates that could be significantly below what we see today.

I would like to give you an example. We have a $1¾ billion association in California which has about $400 million in under 9-percent loans, about in line with the national average but higher than

the California average. They are still in the lending market, but they have to charge 16½ percent, 1 to 1½ points of fees.

I talked to them. I said, "Well, suppose you have a mechanism to convert over time that under 9-percent loan. What would you do with the money?" They said, "Well, we will use some of the money, not much, to repay some of the balance, low advances. But we certainly would be in a good position to offer loans anywhere between 13½ to 14½ percent, which leaves 200 basis points below what they are offering today. And certainly you can qualify a far greater number of new home buyers at 200 basis points below." Furthermore, they believe they will be in a position not only to initiate loans, but if they cannot generate enough loans there are plenty of places they can buy the loans to utilize that money.

Now, that association in 1981 granted only 500 loans, about $25 million. So, of course, not to be ignored, the association would not only be able to convert those low yielding loans and generate income down the road but, of course, the loan fees that it can generate immediately will be of tremendous help.

So I see the purpose and the general concept of S. 1828 as a significant step toward breaking up the logjam in the flow of funds to the potential home buyer. It will go a long way to restore the health of the thrifts. Although I do not see the bill purely as a bailout for the thrifts, it would help the regulators in their effort to insure the safety and soundness of the institutions.

I applaud you, Senator Lugar, for introducing this bill, and I will be very happy to answer your questions.

Thank you.

[The prepared statement of Linda Tsao Yang follows:]

UNITED STATES SENATE

TRANSCRIPT OF TESTIMONY OF

LINDA TSAO YANG

BEFORE THE

SENATE HOUSING AND URBAN AFFAIRS SUBCOMMITTEE

AND THE

SENATE TAXATION AND DEBT MANAGEMENT SUBCOMMITTEE

JOINT HEARING ON

S.1828

WASHINGTON, D.C.

FRIDAY, FEBRUARY 5, 1982

MY NAME IS LINDA TSAO YANG. I AM AN ECONOMIST. MY AREAS OF CONCENTRATION ARE REGULATION OF THRIFT INSTITUTIONS, MONETARY POLICY AND BUSINESS FLUCTUATIONS.

MAY I THANK YOU, SENATOR LUGAR, AND MEMBERS OF THE SENATE HOUSING AND URBAN AFFAIRS SUBCOMMITTEE AND THE SENATE TAXATION AND DEBT MANAGEMENT SUBCOMMITTEE FOR INVITING ME TO COME BEFORE YOU TODAY TO OFFER MY PERSONAL VIEWS ON S.1828, THE THRIFT PARTNERSHIP TAX ACT. I DEEPLY APPRECIATE THIS HONOR.

I SUPPORT THE PURPOSE AND THE GENERAL CONCEPT OF S.1828. LET ME TELL YOU WHY:

(1) THE BILL WOULD ENHANCE THE FLOW OF FUNDS TO THE POTENTIAL HOME BUYER. IN FACT, THE POSITIVE IMPACT OF THIS BILL COULD BE IMMEDIATE.

(2) THE BILL, MORE THAN ANY OTHER PIECE OF LEGISLATION I HAVE SEEN, REALLY GOES TO THE HEART OF THE PROBLEM OF THE THRIFTS: THE BLEEDING OF THEIR NET WORTH CAUSED MAINLY BY LOW-COUPON MORTGAGES IN THEIR PORTFOLIO.

THIS BILL WOULD ENABLE THE THRIFTS TO CONVERT THESE MORTGAGES WITHOUT HAVING TO BOOK LOSSES ON THE TRANSFER. THIS WOULD HELP THE THRIFTS TO KEEP UP THEIR NET WORTH TO ASSET RATIOS AND, AT THE SAME TIME, TO EXPAND ALMOST IMMEDIATELY, THEIR STREAM OF INCOME DOWN THE LINE.

FINALLY, THE BILL WOULD HAVE A SIGNIFICANT SALUTORY EFFECT AS FAR AS THE REGULATORS ARE CONCERNED . . ..

THE IMPROVED INCOME STREAM AND THE ENHANCED LIQUIDITY OF THE INSTITUTIONS WOULD REMOVE A NUMBER OF THE THRIFTS FROM THE ENDANGERED CATEGORY. THUS THE BILL, IN EFFECT, WOULD HELP TO CONTAIN THE RISK EXPOSURE OF THE FSLIC AND THE FDIC. THIS IS JUST AS IMPORTANT TO THE STATE REGULATORS AS IT IS TO THE FEDERAL REGULATORS.

NOW, HAVING STATED MY VIEWS, I WOULD LIKE TO PRESENT SOME FACTS AND FIGURES GAINED FROM MY CALIFORNIA EXPERIENCE.

CALIFORNIA ASSOCIATIONS, BOTH FEDERAL AND STATE, HAVE A LOAN PORTFOLIO OF $103 BILLION.

ABOUT $20 BILLION OF THAT PORTFOLIO YIELD LESS THAN 9%. ANOTHER $30 - $40 BILLION OF THE PORTFOLIO YIELD BETTER THAN 9% BUT LESS THAN 10%.

THEIR COST OF FUNDS IS AROUND 12-1/4%. THIS NEGATIVE CARRY OF AT LEAST 325 BASIS POINTS ON 20% OF THE LOAN PORTFOLIO AND 225 BASIS POINTS ON ANOTHER 30-40% OF THE PORTFOLIO CONSTITUTES THE VERY HEART OF THE PROBLEM THAT HAS PLAGUED THE THRIFTS AND ERODED THEIR NET WORTH.

PLEASE UNDERSTAND THAT THE THRIFTS DID NOT VOLUNTARILY STRAP THEMSELVES TO THIS HEAVY BURDEN. GOVERNMENT REGULATION, UNTIL VERY RECENTLY, SIMPLY LEFT THEM WITH VERY FEW ALTERNATIVES.

IN AN ENVIRONMENT OF NET SAVINGS OUTFLOW WHICH WE HAVE SEEN IN RECENT MONTHS, THIS WIDE NEGATIVE YIELD SPREAD HAS FORCED THE THRIFTS TO CUT BACK SHARPLY LOANS TO THE HOMEBUYER.

IN FACT, GROSS LENDING BY CALIFORNIA S & L's SLUMPED TO $9.6 BILLION IN THE FIRST 11 MONTHS OF 1981 COMPARED WITH $14.6 BILLION AND $24.3 BILLION FOR COMPARABLE PERIODS IN 1980 AND 1979.

MANY POTENTIAL HOMEBUYERS SIMPLY HAVE BEEN SQUEEZED OUT OF THE MARKET.

SUPPOSE WE HAVE A MECHANISM, AS THIS BILL PROPOSES TO PROVIDE, TO CONVERT JUST THAT 20% OF THE PORTFOLIO YIELDING LESS THAN 9% WITHOUT HAVING TO BOOK THE LOSSES.

I CAN SAY WITH SOME DEGREE OF CONFIDENCE THAT THE S & L's WILL RE-CYCLE A GOOD DEAL OF THE CASH TO PROVIDE NEW MORTGAGES.

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CALIFORNIA S & L's HAVE A GOOD LIQUIDITY POSITION AT THIS TIME . . . AT $11.4 BILLION, IT IS ALMOST AT A HISTORICALLY HIGH LEVEL. THEIR ADVANCES FROM THE FEDERAL HOME LOAN BANK OF SAN FRANCISCO STAND AROUND $19 BILLION (NOVEMBER 1981 DATA).

SO EVEN ALLOWING, SAY, A PAY DOWN OF ONE-THIRD OF THE OUTSTANDING ($6 BILLION) THE S & L's WOULD STILL BE IN A GOOD POSITION TO ACCOMMODATE THE LOAN DEMAND OF THE POTENTIAL HOMEBUYER.

MORE IMPORTANTLY, BEING FREED FROM THE LOW-COUPON PORTFOLIO, THE S & L's WOULD BE IN A GOOD POSITION TO OFFER THE POTENTIAL HOMEBUYER RATES SIGNIFICANTLY BELOW WHAT WE SEE TODAY.

LET ME GIVE YOU AN EXAMPLE. WE HAVE AN $1.75 BILLION ASSOCIATION WHICH CARRIES $400 MILLION IN UNDER 9% LOANS. THEY ARE STILL IN THE LENDING MARKET BUT THE RATE IS 16-1/2% WITH 1-1/2 POINTS OF LOAN FEES.

THEIR AVERAGE LOAN AMOUNTS TO $50,000.00. THEIR PRESENT COST OF FUNDS IS AROUND 12-1/4%. IF THEY COULD FIND A WAY TO CONVERT THE $400 MILLION OF BELOW 9% PORTFOLIO WITHOUT BOOKING LOSSES, THEY COULD GRANT NEW LOANS NOT AT 16-1/2%, BUT AT 13-1/2 TO 14%! AND THEY WOULD BE ABLE TO GRANT 5,000 LOANS.

JUST FOR COMPARISON, THAT ASSOCIATION GRANTED 500 LOANS IN ALL OF 1981. SUCH IS THE BENEFICIAL IMPACT OF THIS BILL TO THE POTENTIAL HOMEBUYER!

NOT TO BE IGNORED, OF COURSE, IS THE ALMOST IMMEDIATE JUMP IN THE ASSOCIATION'S INCOME FROM LOAN FEES PLUS THE STREAM OF CASH FLOW DOWN THE ROAD.

SENATOR LUGAR AND MEMBERS OF THE COMMITTEE ... I SEE THE PURPOSE AND THE GENERAL CONCEPT OF S.1828, THE THRIFT PARTNERSHIP ACT, AS A SIGNIFICANT STEP TOWARD BREAKING UP THE LOGJAM IN THE FLOW OF FUNDS TO THE POTENTIAL HOMEBUYER.

IT WOULD GO A LONG WAY TO RESTORE THE HEALTH OF THE THRIFTS.

IT WOULD HELP THE REGULATORS IN THEIR EFFORT TO INSURE THE SAFETY AND SOUNDNESS OF THE INSTITUTIONS.

I APPLAUD YOU, SENATOR LUGAR, FOR INTRODUCING THIS BILL.

* * * * * * * *

LINDA TSAO YANG Born and educated in Shanghai, China. Married to Dr. An Tzu Yar Professor of Mechanical Engineering, University of California, Davis Campus. Mother of two sons -- Yuelin T., a sophomore at Stanford, and Eton Y., a ninth-grader.

Mrs. Yang earned her undergraduate degree in economics from St. John's University, Shanghai, China. She earned a M.Sc. degree from the Graduate School of Business, Columbia University, and a Master of Philosophy (in economics) degree from the Faculties of Political Science, Philosophy, and Pure Science, Columbia University. Areas of concentration: monetary policy, banking and finance, business fluctuations

Mrs. Yang has been Savings and Loan Commissioner of the Department of Savings and Loan, State of California, since April 1, 1980. From January, 1977 to March, 1980, she served on the Board of Administration, Public Employees' Retirement System, State of California. She was elected Vice President of the Board and Vice Chairman of the Board's Investment Committee which oversees the management of the System's $13 billio portfolio. She serves as a member of the Policy Advisory Committee, College of Agricultural and Environmental Sciences, University of California, Davis Campus, and member of the Advisory Board, Center for Real Estate and Urban Economics, University of California, Berkeley.

Mrs. Yang is a member of the Academy of Political Science, the National Economist Club, Washington, D.C., the Downtown Economist Luncheon Group, New York City, the. National Association of Business Economist, and the American Economic Association.

Mrs. Yang is a member of the Board of Directors of the National Association of State Savings and Loan Supervisors. In this capacity, she serves on the Association's National Legislative Committee.

Senator LUGAR. Thank you very much for your testimony.
Mr. McKinney.

STATEMENT OF ROBERT McKINNEY, CHAIRMAN, FIRST FEDERAL SAVINGS & LOAN, INDIANAPOLIS, IND., FORMER CHAIRMAN, FEDERAL HOME LOAN BANK BOARD

Mr. MCKINNEY. Senator Lugar, I am particularly pleased to be here today with my home State Senator and a long-time personal friend, the champion of housing and the thrifts.

And, Ms. Yang, I have heard greatly of you, and I am pleased to be on the same podium with you.

Ms. YANG. Thank you, sir.

Mr. MCKINNEY. Thank you very much.

I am present today out of a serious concern for the survival of the housing industry and thrift institutions. Recent figures illustrate the disastrous toll that continued high, fluctuating interest rates have taken on these industries.

In my brief testimony, one, I wish to call the committee's attention to the bleak prospects in store for thrifts and housing in this country; two, voice my support for Senator Lugar's proposal, but I would like to point out some pitfalls; and, three, because of those pitfalls I would like to suggest two other possible alternatives, Senator.

I will not attempt to predict interest rates. Many have tried and most have failed. Unfortunately, several factors do point toward continued high rates. Let me emphasize, however, the particular sensitivity of thrifts to volatile high rates. Most of the earning assets held by thrifts are long-term low-yield mortgage loans carrying interest rates well below current market rates. You have heard a lot of this lately, I know. Thrifts' liabilities are principally short term and carry interest rates closely alined with market trends. As interest rates increase, thrift earnings dramatically decrease.

Last spring I testified before this Senate Housing Subcommittee and confirmed my philosophical support for the Federal Reserve Board's efforts to control monetary growth. However, I am once again compelled to voice my concern about the Fed's methodology. Their policy began in October of 1979 and the subsequent wide swings of interest rate figures has created havoc in the marketplace and played a major role indeed in bring thrift and housing industries to their knees. Daily movements of 100 to 200 basis points in the Federal funds market are not uncommon today. Financial planning has been rendered impotent. It would appear that interest rates will remain at destructively high levels well into 1983.

In the year 1981 alone, the net worth of savings and loans in this country fell almost $5 billion. Assuming a continuation of high interest rates in 1982, S. & L.'s are predicted to lose another $8 to $10 billion, bringing their beginning net worth of $32 billion in January of 1981 down to nearly $17 to $18 billion at the close of 1982—a tragic loss, indeed. The ratio of average net worth to savings would fall below 3 percent for the entire industry, with hundreds of savings and loans having less than a 1-percent net worth ratio. This would leave thrifts practically helpless to deal with

future housing needs; potentially wiping out middle-income, single-family mortgage opportunities.

In addition, this $8 to $10 billion loss in 1982 translates into the failure of hundreds of savings and loans and savings banks, causing a serious drain on the FDIC: The FSLIC, and the imminent danger here being the prospect of a Federal infusion of funds when these insurance agencies are depleted. An additional concern is that even if interest rates fall considerably this year, and we have run a scenario on this, thrifts will still lose net worth in excess of $2 billion in 1982. In other words, it is already built in for 1982.

Without thrifts as active mortgage lenders, housing will have another tragic year in 1982. Funds are just not flowing into thrifts. Single-family housing development is at its lowest level since records have been maintained. Lenders for housing are in the worst financial condition in respect to earnings since the Great Depression.

As we know, thrifts have been the primary source of funds for housing. It is a common misconception that if the thrifts fail someone will pick up the mortgage market. This is not necessarily so. We all remember when insurance companies were the major suppliers of home mortgage credit, as were commercial banks. As other investments arise, just as they did for the commercial banks and life insurance companies, these other lenders will move into those investments, becoming another fair weather friend for the housing market. The only home buyer able to borrow today and in the foreseeable future is the high-income family. There are no loans for the Americans of lower and middle income. All that is left of the housing market is regional and class segmented, that is, located in the Sun Belt or primarily for those few affluent Americans who can afford mortgage rates of 17 to 19 percent. The young and the middle class have been priced out of the market.

The administration's goal of bringing down interest rates and granting new powers for thrifts are worthy long-term objectives, but they do not appear to be attainable in the short term, nor will they be substantial enough to help the current problems.

What is really needed is some method to convert thrifts' long term assets on loan portfolios into liquidity without suffering great loss, and then have the ability to reinvest these funds into housing. Current regulations attempt to alleviate the thrifts' asset burden, but fall very short of success. A great many of the Nation's thrifts are already in serious financial difficulty with a net worth approaching zero. The depositors must be protected; yet, the consequence of a Federal bailout are, of course, unattractive in view of the projected huge Federal Government deficits. But there may well be bailouts. Insurance funds are not unlimited. Last spring I called for action before this Housing Subcommittee. Unfortunately, little congressional action was forthcoming. The all-savers certificate was authorized, but it has crucial limitations and has been of limited assistance.

The Thrift Partnership Act of 1981 is a straightforward attempt to deal with the basic problem of thrift institutions, that is, retaining low-yielding mortgages in their loan portfolios while at the same time their liabilities are competing with the unregulated rates paid by money market funds. This is the very crux of the

problem facing the thrifts. The legislation merely clarifies existing law. I will let others testify as to its fiscal effects. There is some room for debate on how much it would increase the rate of return on an existing portfolio, but in any event it would be a step in the right direction.

The proposed legislation does have a major pitfall, however. While it aids the tax posture for the private investor in the partnership, it does not cure the accounting problem for the thrift institution. The accounting standards executive committee, called ACSEC, took action by a substantial majority last summer to hold that a transfer of mortgage loans to such a partnership by a mortgage lender would be, in effect, a completed transaction, and that the lender would have to recognize a loss on the transfer in spite of the economic substance of the transaction wherein there was no loss. If the accounting profession would stay with this position, the passage of this legislation would be of little real value to either housing or the thrifts, since the large bulk of thrift institutions comply with edicts of the accounting profession. The Bank Board has attempted to change the situation also by regulation, allowing savings and loans to amortize losses from loan sales over the remaining life of the loans. But again, the accounting profession has intervened and has not allowed this if you follow GAAP rules. So it is a very similar situation as to this legislation.

The only real hope, therefore, is that the accounting profession, in reaching its decision in the summer of 1981, in part relied upon the fact that the tax law was fuzzy and that they were really not voting directly on this issue of the contribution of mortgage loans to the partnership. I have been assured by some leaders of the accounting profession that the passage of this legislation would at least cause the members of ACSEC to take a fresh look at this problem.

In summary, what we have then is favorable legislation which does the following: It clarifies existing tax law, and, two, it lends some persuasion to the accounting profession to change their accounting rules relative to thrift partneships. But this may well not happen, and even if it does, it may take months or years.

I disliked testifying so equivocally on this legislation, and I therefore offer the following two proposals which I think in principal have great merit.

The first I have called the all-American mortgage. And with a name like that, I don't see how we can go far wrong, Senator. I have attached exhibits A and B relative to the all-American mortgage, which describes and gives examples of what I intend. The basic concept is as follows:

First, this legislation would create a new type of mortgage to be issued by the usual mortgage lenders. The borrowers would be the home buyers of today who have been particularly squeezed out of the mortgage market; that is, our middle and lower income families.

Second, the interest on this particular mortgage would not be deductible for Federal income tax purposes by the borrower. And the gentlemen here from the Treasury would love to hear that, I know.

Third, the interest on the mortgage would also be tax exempt to the lender, which would cause the interest rate to be substantially

less to the borrower, more than making up for the loss of the interest deduction to the lower and middle income family, as I demonstrate on exhibit B. In other words, we have run a table to show how this would happen.

Fourth, the lender could pool his own mortgages or pool mortgages in conjunction with other lenders, thereby creating additional funds for mortgage lending, lowering the costs for the mortgage lender, and helping to bring about profitability to these lenders and lower mortgage costs.

Fifth, since the mortgages would be new mortgages, it would be a stimulus to the housing market.

Sixth, this would allow the home buyer to qualify and to in fact buy "more home."

Seventh, of great interest to the committee is that it should cause no loss of funds to the U.S. Treasury.

Eighth, I give an example of the all-American mortgage and its effect. There is a great benefit to the taxpayer earning less than $30,000, with the benefit disappearing to taxpayers over $35,000. But this is the area where help is most needed, and the all-American mortgage could really live up to its name.

I also have one other brief suggestion which I have attached as exhibit C and called the thrift housing bond to give another alternative. This would attack the problem in a different way, allowing the holder of existing single family mortgage loans to "liquify" these old loans for reinvestment in new mortgages for new home buyers. The principal points of thrift housing bonds are, briefly, as follows:

First, they would be issued by the holders of single family loans today.

Second, they would be the direct obligation and be collateralized by mortgage loans.

Third, the interest on the bonds would be exempt from Federal income tax.

Fourth, this puts the private sector back into the market where it belongs.

Fifth, this would help prevent additional public funding of the FSLIC and the FDIC in the troubled days ahead.

Sixth, by placing the thrifts back into a profitmaking mode, this could have a positive effect on Treasury receipts, reducing tax carryback provisions and creating taxable income.

In conclusion, Mr. Chairman, my sole purpose for coming here today is to speak for the lower and middle income Americans who no longer have a chance for the great American dream—to own their own home. A year ago I called upon this committee to take action to save housing and the thrift industry before massive Federal assistance was required.

We are now approaching the last turn in that road. I commend you for this legislation and emphasize the urgency of your mission.

Thank you, and I would be pleased to answer your questions.

[The prepared statement follows:]

TESTIMONY OF

ROBERT H. McKINNEY

CHAIRMAN

JEFFERSON CORPORATION,

FIRST FEDERAL SAVINGS AND LOAN ASSOCIATION OF INDIANAPOLIS,

AND PARTNER, BOSE, McKINNEY AND EVANS

BEFORE THE

SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS

OF THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

AND THE

SUBCOMMITTEE OF TAXATION

OF THE

COMMITTEE ON FINANCE

February 5, 1982

## I. INTRODUCTION

I am present today out of a serious concern for the survival of the housing industry and thrift institutions. Recent figures illustrate the disastrous toll that continued high, fluctuating interest rates have taken on these industries. In my brief testimony:

(1) I wish to call the Committee's attention to the bleak prospects in store for thrifts and housing in this country,

(2) voice my support for and point out some pitfalls in Senator Lugar's Thrift Partnership Legislation, and

(3) suggest two tax related alternatives.

## II. INTEREST RATES AND THE SENSITIVITY OF THRIFTS

I will not attempt to predict interest rates. Many have tried, and most have failed. Unfortunately, several factors do point toward continued high rates. I will review these factors but first, let me emphasize the particular sensitivity

of thrifts to volatile, high rates. Most of the earning assets held by thrifts are long-term, low-yield mortgage loans, carrying interest rates well below current market rates. However, thrifts' liabilities are principally short-term and carry interest rates closely aligned with market trends. As interest rates increase, thrift earnings dramatically decrease.

Last Spring, I testified before this Senate Housing Subcommittee and confirmed my philosophical support for the Federal Reserve Board's (FRB) efforts to control monetary growth. However, I once again am compelled to voice my concern about the FRB's methodology. In October of 1979, the FRB announced it would no longer exercise control of monetary policy by the setting of the rate paid on Federal Funds, but instead would directly control the growth of monetary aggregates, letting the Federal Funds rate, and thereby other interest rates, move freely in the marketplace. This policy, and the subsequent wide swings of interest rate figures, has created havoc in

the marketplace and played a major role in bringing thrift and housing industries to their knees. Daily movements of 100 to 200 basis points in the Federal Funds market are not uncommon. Financial planning has been rendered impotent.

It would appear that interest rates will remain at destructively high levels for a considerable period for the following reasons:

(1) Crowding-out phenomena - The Treasury, due to massive deficits, is forcing the private sector out of the market, pushing interest rates upward, and soaking up the pool of funds otherwise available for housing.

(2) Proposed massive deficits will force the FRB to maintain a restrictive monetary policy with continued high interest rates.

(3) The spectre of deficits continuing in the future will create an uncertain financial atmosphere fostering the continuation of high interest rates in the years ahead.

III. EFFECTS OF INTEREST RATES ON THRIFTS

In the year 1981 alone, the net worth of Savings & Loans fell almost five billion dollars--this just in one year. Assuming a continuation of high interest rates in 1982, S & L's are predicted to lose $8 to $10 billion--bringing their total net worth of $32 billion in January of 1981 down to nearly $17 - $18 billion at the close of 1982. The ratio of average net worth to savings would fall below 3% for the entire industry, with hundreds of S & L's having less than a 1% net worth ratio. This would leave thrifts practically helpless to deal with future housing needs; potentially wiping out middle-income single-family mortgage opportunities. In addition, this $8 - $10 billion dollar loss in 1982 translates into the failure of hundreds of S & L's and also many savings banks, causing serious drain on the FDIC and FSLIC; the imminent danger here being the prospect of Federal infusion of funds when these insurance agencies are depleted. An additional concern is that even if interest rates fall considerably, thrifts will lose net worth in 1982 due to

deposit costs already built in for the year.

## IV. EFFECTS OF INTEREST RATES ON HOUSING

Without thrifts as active mortgage lenders, housing will have another tragic year. Funds are just not flowing into thrifts. In addition, when rates are volatile and prone to increases, borrowers are either frightened of a mortgage contract, or cannot qualify for one. Lenders either don't have the funds or don't want to be locked into fixed rates when savings rates are unpredictable. The variable rate mortgage, while an excellent idea, came at a time when rates were high and volatile, making it often unacceptable in the marketplace of today. While the theory is great, it is not working well in the climate created by the FRB and the Reagan Administration.

Although housing starts had a brief "up tick" in December due to multi-family starts, prospects are bleak indeed for 1982. Single family housing development is at its lowest level since records have been maintained. Lenders for housing are in the

worst financial condition, in respect to earnings, since the Great Depression.

V. FUTURE OF HOUSING MORTGAGE MARKET

Thrifts have been the primary source of funds for housing. It is a common misconception that if the thrifts fail, someone will pick up the mortgage market. This is not necessarily so. We all remember when insurance companies were major suppliers of home mortgage credit, as were commercial banks. As other investments arise, just as they did for the commercial banks and life insurance companies, these other lenders will move into those investments, becoming another "fair weather friend" for the housing market. The only home buyer able to borrow today, and in the forseeable future, is the high income family. There are no loans for the Americans of lower and middle income. All that is left of the housing market is regional and class segmented, i.e. located in the "sun belt" or primarily for those few affluent Americans who can afford mortgage rates at 17½ - 19%. The young and the middle class have been priced out of the market.

VI. MEASURES NEED TO BE TAKEN

The Administration's goal of bringing down the interest rates and granting new powers for thrifts are worthy, long-term objectives, but do not appear to be attainable in the short term, nor will they be substantial enough to help current problems. Even if interest rates do drop in 1982, thrifts will be manacled with low-yield, long-term mortgage loans. Under current market conditions, liquidation of these low-yield assets would result in a significant loss to the institution thereby further eroding the thrifts' net worth.

What is really needed is some method to convert thrifts' long-term assets on loan portfolios into liquidity, without suffering great loss, and then have the ability to reinvest these funds into housing. Current regulations attempted to alleviate the thrifts' asset burden--but fall very short of success. A great many of the nation's thrifts are already in serious financial difficulty with net worth approaching zero. The depositors must be protected, yet the consequences of a Federal bail-out are, of course, unattractive in view of the

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projected huge Federal Government deficits. But there may well be bail-outs--insurance funds are not unlimited. Last Spring, I called for action before this Housing Subcommittee. Unfortunately, little Congressional action was forthcoming. The All Savers Certificate was authorized, but it has crucial limitations and has been of limited assistance.

## VII. THE PROPOSED LEGISLATION

The Thrift Partnership Act of 1981 is a straightforward attempt to deal with the basic problem of thrift institutions, i.e. retaining low-yielding mortgages in their loan portfolios while at the same time their liabilities are competing with the unregulated rates paid by money market funds. This is the very crux of the problem facing the thrifts and we must remember the thrifts did not get themselves into this difficulty through bad management. In fact, they were merely carrying out the mandate set by Congress of housing Americans.

The legislation merely clarifies existing tax law. I will let others testify as to its fiscal effects. There is some room for debate on how much it would increase the rate of return on an existing portfolio, but in any event, it would be a step in the right direction. It certainly would not be the solution to all the problems of housing and of the financial stability of the thrifts in this Country, but it does represent a serious, affordable attempt at solving a problem.

The proposed legislation does have a major pitfall, however. While it aids the tax posture for the private investor in the partnership, it does not cure the accounting problem for the thrift institution. The Accounting Standards Executive Committee (ACSEC) took action by a substantial majority vote in the Summer of '81 to hold that a transfer of mortgage loans to such a partnership by a mortgage lender would be, in effect, a completed transaction, and that the lender would have to recognize a loss on the transfer in spite of the economic substance of the transaction, wherein there was no loss.

If the accounting profession would stay with this position, the passage of this legislation would be of little real value to either housing or the thrift industry, since the large bulk of thrift institutions comply with the edicts of the accounting profession. The FHLBB has attempted to change the situation by regulation allowing S & L's to amortize losses from loan sales over the remaining life of the loans. But again, the accounting profession has not agreed, which has made the regulatory action of little real assistance. The same thing may well occur with the passage of this legislation.

The only real hope, therefore, is that the accounting profession, in reaching its decision in the Summer of '81, in part relied upon the fact that the tax law was "fuzzy" and that they were really not voting directly on the specific issue of the contribution of mortgage loans to the partnership. I have been assured by some leaders of the accounting profession that the passage of this legislation would at least cause the members of ACSEC to take a fresh look at the problem.

In summary, what we have then is favorable legislation which does the following:

(1) Clarifies existing tax law for the private investor in a thrift partnership without changing basic legislation.

(2) Lends some persuasion to the accounting profession to change accounting rules relative to such Thrift Partnerships--but this may well not happen, and even if accomplished, may take months or years.

## VIII. ALTERNATIVES

I disliked testifying so equivocally on the proposed legislation; and have given some thought to alternative ideas. I have intentionally not gone down the usual path relating to those issues now pending before the Senate and House Banking Committees as to financial structure, powers and regulations. I understand that I am testifying before a tax oriented subcommittee in connection with the Housing Subcommittee, and I therefore offer the following two proposals

which I think in principle have great merit, and I would hope would be given serious consideration by these subcommittees.

## IX. THE ALL-AMERICAN MORTGAGE

My first suggestion is what I have entitled "The All-American Mortgage", and with a name like that, I don't see how we could go very far wrong. I have attached Exhibits A and B relative to the All-American Mortgage which describe and give examples of what I intend. The basic concept is as follows:

(1) This legislation would create a new type of mortgage to be issued by the usual mortgage lenders, that is, S & L's, mutual savings banks, commercial banks, etc. The borrowers would be the home buyers of today who have been particularly squeezed out of the mortgage market; that is, our middle and lower income families.

(2) The interest on this particular mortgage would not be deductible for Federal Income Tax purposes by the borrower.

(3) The interest on the mortgage would also be tax exempt to the lender, which would cause the interest rate to be substantially less to the borrower, more than making up for the loss of the interest deduction to the lower and middle income family, as I demonstrate on Exhibit B.

(4) The lender could pool his own mortgages or pool mortgages in conjunction with other lenders, placing them through investment bankers or by private placements, thereby generating additional funds for mortgage lending, creating lower costs to the mortgage lender, helping to bring about profitability to these lenders and relieving the pressure on increasing interest rates in the mortgage market.

(5) Since the mortgages would be new mortgages, it would be a stimulus to the housing market, particularly in that area of the housing market

that has all but disappeared--the middle and lower income home buyer.

(6) This would allow this home buyer to qualify and, in fact, to buy "more home". The great tragedy today is the inability of the middle and lower income home buyer to qualify for a home, i.e. to make the payments on a mortgage at these high interest rates.

(7) Of great interest to this Committee and to all of us is that this would cause no loss of the funds to the U.S. Treasury.

(8) Exhibit B gives an example of the All-American Mortgage and its effect. Certain assumptions are used which could be changed, but it is necessary to present some assumptions for the purpose of illustration. What is clear is that using these assumptions, there is a great benefit to the

taxpayer earning less than $30,000 with the benefit disappearing to taxpayers over $35,000. This is the area where help is most needed, and the All-American Mortgage could really live up to its name.

X. THRIFT HOUSING BONDS

The other suggestion that I've attached as Exhibit C is entitled "Thrift Housing Bonds". These would attack the problem in a different way, by allowing the holder of existing single family mortgage loans to "liquify" these old loans for reinvestment in new mortgages for new home buyers. Again, this approaches the problem on a tax related basis. The principal points of Thrift Housing Bonds are as follows:

(1) They would be issued by the holders of single family mortgage loans.

(2) They would probably be underwritten by investment bankers and be the direct obligation of the issuer, collateralized by the mortgage loans of the issuer.

(3) The interest on the bonds would be exempt from Federal Income Tax and I have suggested that they have a term of 10 years and be collateralized by 150% of the outstanding principal amount of the bonds.

(4) These would allow the private industry to do what state and local housing agencies have been doing and relieve these agencies of the necessity to issue additional debt. This puts the private sector back into the market where it belongs.

(5) This would be a free enterprise way of helping solve the financial needs of the thrift institutions and help prevent additional public funding of the FSLIC and FDIC in the troubled days ahead.

(6) By placing the thrifts back into a profit making mode, this could have a positive effect on Treasury receipts, reducing tax carryback provisions and creating taxable income.

Thank you. I will be pleased to answer any questions.

## THE ALL-AMERICAN MORTGAGE

LENDER: Banks, Savings & Loans, etc.

BORROWER: All Americans, but in particular, middle and lower income families.

PROVISIONS:

1) Interest on mortgage not deductible by Borrower.
2) Interest on mortgage tax exempt to lender, and at substantially lower interest rate to borrower, more than making up the loss of interest deduction to the lower and middle income family.
3) Lender could pool and sell mortgages, generating additional funds for mortgage lending.

ADDED BENEFITS:

1) Helps the middle and lower income home buyer to "qualify" for a home, or buy "more home"
2) The "housing cost" for the middle and lower income family is less due to the lower mortgage interest rate, even with the loss of deduction of interest for Federal Income Taxes.
3) Stimulates housing market.
4) No loss to the U.S. Treasury.

EXHIBIT A

EXHIBIT B

## THE ALL AMERICAN MORTGAGE

**Assumptions:**

1. Interest rate is 13% if non-deductible, and 17% if deductible.
2. Home Buyer will spend 33% of gross monthly income (on a tax equivalent basis) for Principal and Interest.
3. Mortgage is a 30 year fixed rate instrument based on 80% of the house selling price.
4. Taxes based on 1982 rates with a $3,400 zero bracket, Married Filing Joint Return.

| Annual Income | Home Cost | Mortgage | 1st Year Interest | Zero Bracket | Tax Deduction | Annual Tax Savings | Monthly Tax Savings | Before Tax Home Payment | Non-Deductible Home Payment | Mortgage | Home Cost | % More Home |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| $10,000 | 24,111 | 19,289 | 3,277 | 3,400 | - | - | - | 275 | 275 | 24,860 | 31,075 | 28.9% |
| $15,000 | 36,211 | 28,969 | 4,922 | 3,400 | 1,522 | 289 | 24 | 413 | 389 | 35,135 | 43,957 | 21.4% |
| $20,000 | 48,223 | 38,578 | 6,555 | 3,400 | 3,155 | 788 | 66 | 550 | 484 | 43,753 | 54,692 | 13.4% |
| $25,000 | 60,322 | 48,258 | 8,199 | 3,400 | 4,799 | 1,166 | 97 | 688 | 591 | 53,426 | 66,783 | 10.7% |
| $30,000 | 72,334 | 57,867 | 9,832 | 3,400 | 6,432 | 1,828 | 152 | 825 | 673 | 60,839 | 76,049 | 5.1% |
| $35,000 | 84,434 | 67,547 | 11,477 | 3,400 | 8,077 | 2,690 | 224 | 963 | 739 | 66,805 | 83,507 | (1.1%) |

## THRIFT HOUSING BONDS

ISSUER: Holder of single family mortgage loans.

UNDERWRITTEN BY: Investment Banker

SECURITY: Direct obligation of the Issuer collateralized by mortgage loan assets.

INTEREST RATE: Exempt from Federal Income Tax, payable semi-annually.

TERM: 10 years - redeemable at par.

COLLATERAL: 150% of outstanding principal amount of bonds.

PURPOSE OF ISSUE:

Tax Exempt mortgage backed bonds would be issued to liquify existing below market rate mortgages. The improved liquidity would provide relief to the current thrift earnings squeeze, plus provide new investment funds for the housing market. By being issued on a tax exempt basis, the cost would be lower and potentially could provide new mortgages at a lower cost to the home buyer.

ADDED BENEFITS:

1. Relieve the need for state and local housing agencies to issue additional debt.
2. Avoids added financial needs for FSLIC and FDIC to bail-out troubled thrifts.
3. Would have a positive impact on Treasury receipts, added thrift income which would reduce carry-back features or create off-setting taxable income.

EXHIBIT C

Senator LUGAR. Thank you very much, Mr. McKinney.

Both of you in your testimony have emphasized the dilemma faced by the low-income person or middle-income person who is trying to buy a home. And, of course, we are deeply interested right now in the survival of thrift institutions as a group and individually. But the Housing Subcommittee's basic mission is to try to make certain that people get into housing in this country. The thrifts play a very important part in that.

Mr. McKinney, you have indicated that during this year it is likely that the reserves that are held by thrifts collectively will decline, and even if interest rates were to come down substantially, which you do not predict, that we are locked into some further declines. You have indicated, at least if I read your testimony correctly, that at the current rate of affairs a very large number of thrifts will dip below a 1-percent reserve ratio. Do you have any further testimony in this regard?

I suppose what I would like to highlight for the record, is some sense of the situation as seen from a grassroots level, as well as the collective figures that you have assumed. What is going to happen, in your judgment, during the course of 1982 if no legislation, whether it be this bill or the all-American mortgage or anything else, happens? What sort of a scenario do you see for the thrift industry?

Mr. MCKINNEY. Well, the two scenarios that I have worked on some, Mr. Chairman, have been, one, assuming new rates do not come down and remain reasonably high. And that's the scenario that I pointed out where we would lose another $8 to $10 billion in the industry, bringing its total net worth down to almost one-half where it began just 2 years before.

Senator LUGAR. It started at $32 billion in 1981, in your figures.

Mr. MCKINNEY. Yes.

Senator LUGAR. And you figured, then, it would be down to $17 or $18 billion.

Mr. MCKINNEY. I figured it would lose about $15 billion in 2 years, which is close to one-half of its net worth.

Senator LUGAR. And that's the total of all of those that are doing well and those that are doing poorly lumped together.

Mr. MCKINNEY. Yes, sir. And what that obviously indicates is that many would fail. There would be hundreds that would fail.

Senator LUGAR. Now, in the Wall Street Journal today there is a suggestion already that another merger has occurred out in Illinois. But here I think there were 2 institutions involved out of 4,500, or whatever. When we are talking about hundreds, physically, from your experience in the Government, how is this to be managed? In other words, how do hundreds of institutions either come together, or merge, or find partners or what happens when hundreds fail?

Mr. MCKINNEY. Well, fortunately, I am not the Chairman of the Bank Board today. The problems are immense. And I don't want to sit here and act too alarmist, because that could be taken wrong, also. We have a serious problem, and we don't want to overstate the problem; but the problem could well become unmanageable, Mr. Chairman.

Senator LUGAR. By "unmanageable" do you mean we would exceed the resources of the insurance agency?

Mr. MCKINNEY. And the ability of their personnel to put the deals together in time to not close some doors. They have done a superb job to date and an imaginative job to date of trying to save the meager assets of those two agencies, considering the total assets that we know are combined.

You referred a few minutes ago, yourself, to the $6 billion in the FSLIC and what a small percentage that is to the potential problem. So I commend the Bank Board today in their efforts to retain that. But as this trend continues and as these numbers multiply, it is going to become more and more difficult for them to be able to put these thrifts together.

What I have done, and it is early in the season to have done so because the figures are just now in for last year, was to take the figures as the end of last year, and then running two interest rate scenarios on computer models, one being with interest rates remaining fairly high, and unfortunately there is likely to be a scenario like that, and then with another one, hopefully having rates come down into the 10-percent level on the 6-month certificates and staying there for the rest of the year, which you will have to admit is a rather hopeful scenario. In that first one was the $8 to $10 billion loss. What that does, that brings the average net worth-to-savings ratio of thrifts down to about 2.8.

You will recall the Bank Board just recently lowered the requirement from 4 percent to 3 percent. I think it was more of a help to the Bank Board than it was to the thrifts, just changing the rules as to who is in trouble, because certainly it would be better if everybody had a 4-percent net worth than a 3-percent net worth in today's climate. But the point is, under those facts, the average savings and loans would have less than a minimum required by the Bank Board under the reduced regulation. So that emphasizes the seriousness of it.

Under the scenario where the rates do fall substantially, which we all hope will happen but there isn't that much likelihood, even that brings about a loss in the industry of $2 billion, which is almost one-half of what we lost this year again. The problem is one that, not only are the thrifts losing money on the bottom line but they are not gaining deposits. And by not having deposits, they can't reinvest their funds to try to recover some of these losses. Last year alone the thrifts had a net outflow of $25 billion. That is a net outflow of funds. So they are just out of the mortgage market; again, pointing out that's why loans are not available to the lower and middle income people.

Senator LUGAR. Just following up for just a moment, I think you have touched upon the fact, suggested by others, that if the thrifts fail and simply are no longer in the mortgage market, surely, capital being a fungible commodity someone else will step up and provide the mortgages. Why would that not be the case? In other words, why is there a specific public policy issue, particularly a housing policy issue, in the survival of thrift institutions?

Mr. MCKINNEY. Well, in the first place, they are experts in mortgage lending. To create some new experts in mortgage lending will take a long time. Congress, in its wisdom, saw fit back in the De-

pression to create these thrifts, and they have done a superb job for our country.

Participants who have entered somewhat into the marketplace in recent years have been interested primarily in the large mortgage loans that have been packaged for sale in the secondary market. Again, they are not interested in the $20,000 to $50,000 mortgage loans; they are interested in the $100,000 to $200,000 mortgage loans.

So, again, the whole theme of my wanting to be here today is I have my deep concerns, as I know you have, over the middle income and lower income American. There is going to be no housing for them. They are just being priced out of the market. And with the administration's cutting back even further in areas like the FHA, I see even further problems for middle and lower income Americans.

Senator LUGAR. As you know, the subcommittee has been attempting through other legislative initiatives to gain changes in ERISA policies so that pension funds might get into the mortgage market. But I suppose the point you are making here is that those funds are more likely to take the form of secondary instruments or packages of mortgages, and the unique quality of the thrifts is this person-to-person, almost retail function in the initiation of the small mortgage.

Mr. McKINNEY. That's right.

Senator LUGAR. Ms. Yang, you mentioned an intriguing thought, that if legislation such as we are discussing today or some comparable business comes along the pike, interest rates in California might decline for some fortunate people seeking mortgages to 13½ to 14½ percent. How can this be? In other words, will you go through your reasoning a little bit more to amplify that intriguing thought?

Ms. YANG. Well, thank you very much, Senator.

First of all, I have to confess that I am an unashamed housing advocate.

Senator LUGAR. Good.

Ms. YANG. Because I see housing not just a durable consumption item but rather an investment in social stability. And I would also like to add to what Mr. McKinney said about what are we doing with the middle and lower income people.

My favorite grocery store clerk, the other day when I went in there to pick up some groceries, said, "Well, Mrs. Yang, I earn $17,000 a year. My wife earns $8,000 working part time. But together, we think we get a very good income. But when can we ever be able to own our own house?" And I couldn't answer that question. I couldn't.

Now, to answer your question. You see, the reason that the savings and loans has to charge 16½ percent today vis-a-vis a cost of funds of 12¼ percent, such a wide margin, is because they need that extra wide margin to carry that unproductive, illiquid, low-coupon mortgage in their portfolio for which they have no hope of being able to liquidate.

Now, if they could recycle that money with the considerable up-front loan fee income and be able to upgrade that mortgage to a high interest rate, they wouldn't need that almost 400 basis point

spread. And that's why they would be able to lower very significantly the rates they would charge to new borrowers.

I would like, if I may, to make a few comments on the Treasury representative's, although it may not be fair since he is not here to defend himself. But if you allow me, I would like to do so.

Senator LUGAR. Please proceed.

Ms. YANG. Thank you.

The Treasury representative emphasized the fact that this bill would address retrospective problems, not prospective. And I would like to dispute that. As you noted, his claim of $50 billion of loss is an astounding sum. But none of us really know what kind of key assumptions he used; he did not expand on that. And as you know, conclusions are only as good as the assumptions used.

First of all, in an environment where the Government, the preferred borrower, is likely to borrow at least $100 billion a year, to say that all of that low-coupon mortgage of $150 billion would be unloaded in 1 year is perhaps not quite close to the realities of the capital market.

No. 2, to say that all of that $50 billion in losses would be new losses to the Treasury, again is not taking into account that the tax shelter buyers are not necessarily all new ones. Just as you said earlier, there will be a tremendous amount of substitutions, say from oil and gas, into this kind of a shelter.

Third, just to think of the new revenues that could be generated as a result of recycling of the funds, take a look at the housing starts—1.1 million in 1981, the lowest since 1946. Or take the unemployment in the construction industry—18 percent, twice the average, and going higher and higher. Or take the allied industries that serve the housing business. Take a look at the appliance industry—General Electric recently announced the third layoff in 5 months, another 1,500 people laid off in Louisville. Or take the lumber industry—the State of Oregon, the State of Washington is suffering because of the 750 sawmills one-third is being closed down and one-third is only operating half time. Or take the plumbing supply people—in Torrence, Calif., American Standard recently closed shop; another 300 people out of jobs. Or take the building industry. There are about 1.2 million homebuilders. Already a quarter-million of them are out of business; another half of them are losing money. All these people were taxpayers. Now they are not paying taxes. A number of them will be standing in line, claiming unemployment insurance. Just think of that effect on the Treasury.

So to say that all of that $50 billion of tax loss will be generated in 1 year and there will be no compensating secondary and tertiary revenues, I find it rather difficult to accept.

Senator LUGAR. Thank you very much for that testimony.

Let me just say, first of all to Mr. McKinney, that there are two important problems to this legislation which have been highlighted today. One is the effect on the Treasury. I would just say as a practical matter, in the event that losses, as were suggested by the Treasury witness, were in fact to occur, Congress would not seriously consider this bill or any other bill that lost $50 billion in 1 year. That would be simply ridiculous.

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The question, of course, is that we have conflicting testimony from Coopers and Lybrand that believe that this is a winner. Leaving aside the assumptions you have made, Ms. Yang, that in fact there are secondary effects as people come back to work and unemployment declines and so forth, just on the face of it, this testimony indicates that it makes money for the Treasury. So there is a wide discrepancy here that will have to be reconciled for Senators to try to figure out whether we have a winner or a loser, just on a fiscal basis.

Now, Mr. McKinney has brought forward another important point, and that is that accountants, when they first caught wind of this idea, did meet and decided that losses had to be reflected instantly. That decision has some very severe implications with regard to the desirability of doing this. As Mr. McKinney says, maybe they would change their mind if we passed the bill; maybe they wouldn't. We don't know. And it makes a big difference in terms of the operation of a thrift what the accountants have to say about this. It is conceivable that many of the ideas with regard to the turnaround for thrifts may be knocked out of the water by accounting assumptions. Even if people eventually change their minds, it might well be after the history of this situation has played out.

So in both of those cases we have two very difficult problems. The dilemmas that we have as people in Government are also difficult, too. I think Mr. McKinney is correct, we shouldn't over-hype the crisis. But on the other hand, the Treasury and all of us will have some dilemmas in the event the insurance funds run out, in the event that for some reason all of this doesn't pull together, just the thrifts themselves. The housing industry will have a catastrophy in the event there is general failure of the thrifts. I don't think testimony has shown any necessary substitutes coming in, particularly for the lower income home buyer. So there are a lot of potential losses here, both technical as well as actual.

From your proposal today of this so-called all-American mortgage—you have had some experience in presenting ideas before the Congress and your associates—how rapidly could that idea, just in the technical sense of making it work out in the field, take hold? Is this an idea that you think has a salability in terms of an easy concept so that people would enter into these? Or would people with income of less than $30,000, who in a technical sense you have analyzed would do well on this as opposed to those of higher income, above $35,000, would they agree with that and would they give up the tax exemption even if you could demonstrate that this is all going to work out well for both the lending institution and the Treasury as well as them? In other words, what kind of marketability and in what time frame would you see for the all-American mortgage idea?

Mr. McKINNEY. Well, the biggest difficulty I could see would be that many persons would think that this was getting the camel's head in the tent by taking the tax deductibility away in this one sector and the Government would use that to take it away somewhere else. And being a taxpayer, I could be worried about that myself.

The concept is fairly simple. It does make economic sense. I think that it could be put into place, Senator, reasonably well. But I have to admit, having had some political experience, that there would be many factions who would be very concerned about any change in the tax deductibility of interest on a home for any good purpose. So you would have some interesting hearings on that, I'm afraid, before you would finally get it in.

Senator LUGAR. Recently, as you know, the Senate, so as not to be ambiguous, passed a resolution instructing the President, the Treasury, or whoever the powers might be, not to touch that deductibility issue. The vote was 96 to 0, or some such figure. This leads to problems, I think, in considering this approach even though it quite rightly tries to zero in on how you get the lower income person into these markets, provided the thrifts were still there to loan the money and someone could find the availability for this sort of retail service.

Mr. MCKINNEY. And we can't overemphasize the fact that we are in an emergency situation. And I think you understand that. The year 1982 is a crucial year for housing and the thrifts. It is tragic the way all these homebuilders are going out of business. We are so inefficient in this country, the way we allow these cycles to occur, to where we have homebuilders and then they all disappear and all of the skilled laborers disappear. Then we try to come back in the homebuilding, which raises the cost of homebuilding. It is inefficient. And the social fabric idea is one that is just tragic in this country.

I do think my idea of the all-American mortgage, though, has merit. I do think that the testimony of the Government witness was very short-sighted. He took one little issue alone rather than examining the broad picture. So I would hope the committee would not accept just his evidence, and I am sure you will not, on its face.

Senator LUGAR. Well, we will have to weigh all of the evidence. And clearly, as I indicated, the tax issues and the accounting issues are important ones if we are to have success with this idea, or really with any other of a family of ideas that are somehow related.

We deeply appreciate your coming today, both of you. Your testimony reveals a deep compassion for people and a keen interest in housing as well as broad experience in both public and private policy. Thank you for coming.

Ms. YANG. Thank you, sir.

Mr. MCKINNEY. Mr. Chairman, thank you very much.

Senator LUGAR. The Chair would like to call now our second panel of Mr. William B. O'Connell, president, U.S. League of Savings Associations in Washington, D.C., and Mr. Stuart D. Root, president of the Bowery Savings Bank in New York, N.Y.

Mr. O'CONNELL. Thank you, Mr. Chairman.

Senator LUGAR. We welcome your appearance today, and if you would proceed with your testimony, Mr. Connell, and then to Mr. Root, and then we will have questions.

## STATEMENT OF WILLIAM B. O'CONNELL, PRESIDENT, U.S. LEAGUE OF SAVINGS ASSOCIATIONS, WASHINGTON, D.C.

Mr. O'CONNELL. My name is William B. O'Connell. I am in Chicago and Washington, I should say. I am the president and chief executive of the U.S. League of Savings Associations. The U.S. League represents more than 4,000 savings and loan associations which hold about 99 percent of the assets of the savings and loan business.

I might say that we welcome this opportunity to testify in support of your bill, Senator, and I applaud your initiative. I might say also that I, on behalf of the league and on behalf of the business, appreciate particularly your understanding and sympathetic statement that you made at the start of the hearing.

We support S. 1828 because we think it will remove various Tax Code impediments to the development of joint ventures between investors and thrift institutions burdened with unproductive mortgage loans. These joint ventures, in our judgment, can provide an important option for savings and loan associations burdened with portfolios of unproductive home mortgage loans. Those loans were originated years ago at rates of 6, 7, and 8 percent, and in some cases even lower, by our institutions in performance of their congressional mandate to provide thrift and to encourage homeownership in their communities, and on the assumption, I should say, that the Government would keep inflation and interest rates within reasonable bounds.

Under the best known proposal developed in connection with this bill, and that's one developed by Ameribond Securities Associates, the thrift institution receives a 1.5-percent guaranteed spread over the average yield on the contributed low-rate loans in the partnership. While very helpful, 1.5 percent is far below the improvement needed in today's interest rate environment to restore profitability return above savings cost and permit most of our institutions to resume profitable operations.

While thrift institutions could realize greater benefits ultimately through reinvesting in the higher rate assets over time as old loans amortize, the opportunity to upgrade loan portfolios immediately could have considerable appeal for many managers.

The major question marks from our perspective about this bill are the breadth and depth of the secondary market for subpar mortgage loans and the availability of high-bracket taxpayers as investor-partners seeking tax loss opportunities. The reduction from 70 to 50 percent in the top rate for unearned income in the Economic Recovery Tax Act of 1981 raises doubts about the number of potential investors who would be interested in such partnerships. The depressed state of the secondary market for purchasing loans from the partnerships is also an uncertain factor.

I would note in passing that the ability of federally chartered savings and loans to participate in such partnerships would be assisted by enactment of one portion of S. 1720, Chairman Garn's financial institution restructuring legislation now pending before the full Banking, Housing, and Urban Affairs Committee. In the opinion of the Federal Home Loan Bank Board, section 131 of that proposed legislation would remove any doubt as to the ability of Feder-

al associations to form joint ventures with investors to facilitate the sale of old, low-yielding mortgages.

We have two minor recommendations for alteration in the language presented. The definition of "qualified thrift institution" for participation in the partnership should include subsidiaries such as service corporations of savings and loan associations. In some circumstances these subsidiaries may be more appropriate as partners than their parents; for example, if State law prevents a joint venture by the parent. Second, that the requirement that cash and residential mortgage loans comprise 95 percent of the assets of the qualified thrift partnership is quite restrictive; other investments which meet the Tax Code's definition of "domestic building and loan association" should be permitted.

Again, we want to emphasize that, while this is a welcome step and in the right direction, it does not by any matter or means really deal with a major part of the problem of the low-yielding long-term mortgages which confront our institutions.

The chart attached as exhibit 1 presents the mortgage portfolio of the savings and loan business as of September 1, 1981: $63 billion in loans under 8 percent, $163 billion under 9 percent, $285 billion under 10 percent, and $318 billion, or two-thirds, under 10½ percent. By contrast, more than two-thirds of our savings deposits now pay today's market rates of 13, 14, and 15 percent. This mismatch readily explains the well publicized negative earnings performance of the savings and loan business.

If we are to continue to function as the backbone of housing finance for American communities, we must arrest the earnings and net worth deterioration of the thrift business. Our numbers of low-yielding mortgages are so large that it is clear a variety of mechanisms must be considered by the business and by the Government to upgrade portfolio performance.

This month and next month, for example, we are sponsoring seven clinics across the country for managers in savings associations and savings banks to share self-help suggestions for coping with the low-yielding mortgage problem. We have also been working very diligently with the National Association of Mutual Savings Banks to develop practical legislative proposals to address this enormous problem. And we had a meeting earlier this week in Atlanta. I think we are fairly close to final agreement on the proposals we will submit to the Congress, hopefully in the very near future.

Again, I appreciate this opportunity on behalf of the league, and again I appreciate your sympathetic and understanding statement that you made at the start of the hearing.

Senator LUGAR. Thank you, Mr. O'Connell.

[The prepared statement follows:]

Statement of William B. O'Connell
President, U.S. League of Savings Assns.
To a Joint Hearing, Finance Subcommittee on Taxation
and Debt Management and Banking Subcommittee on Housing
and Urban Affairs
United States Senate

February 5, 1982

MR. CHAIRMAN:

My name is William B. O'Connell of Chicago, Illinois. I am President of the United States League of Savings Associations*, representing over 4,000 savings and loan associations nationwide and 99% of the assets of our business.

The U.S. League welcomes this opportunity to testify in support of S. 1828, the Thrift Partnership Tax Act, and applauds your initiative, Chairman Lugar, in introducing this important legislation.

S. 1828 would remove various Tax Code impediments to the development of joint ventures between investors and thrift institutions burdened with unproductive mortgage loans.

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*The U.S. League of Savings Associations has a membership of 4,000 savings and loan associations representing over 99% of the assets of the $650 billion savings and loan business. League membership includes all types of associations -- Federal and state-chartered, stock and mutual. The principal officers are: Roy Green, Chairman, Jacksonville, FL; Leonard Shane, Vice Chairman, Huntington Beach, CA; Stuart Davis, Legislative Chairman, Beverly Hills, CA; William B. O'Connell, President, Chicago, IL; Arthur Edgeworth, Director-Washington Operations; Glen Troop, Legislative Director; and Phil Gasteyer, Associate Director-Washington Operations. League headquarters are at 111 E. Wacker Dr., Chicago, IL 60601. The Washington Office is located at 1709 New York Ave., N.W., Wash., D.C. 20006. (Telephone: (202) 637-8900.)

These joint ventures can provide an important option for savings and loan associations burdened with portfolios of illiquid, unproductive home mortgage loans. These loans were originated years ago at rates of 6%, 7%, and 8% by our institutions in performance of their Congressional mandate to provide thrift and encourage home ownership in their communities, and in the belief that the Government would keep inflation and interest rates within reasonable bounds.

As I understand it, the transactions encouraged by S. 1828 would work as follows:

#- First, the thrift institution would contribute to the partnership low-rate loans at par, thus realizing no loss on the transfer;

#- Second, investor-partners would contribute cash in an amount approximately equal to the difference between book and market value of the loans;

#- Third, the low-rate loans would then be sold by the partnership to outside purchasers at discount to yield market returns:

#- Fourth, the loss on the sale would be available to the investor partners as an ordinary loss, thanks to the Thrift Partnership Tax Act;

#- Fifth, the proceeds of the sale and cash contributed by the investor-partners would be reinvested in new mortgages or other assets (at current rates) and the income earned thereby allocated between the thrift institution and investor partners.

Under the best-known proposal, developed by Ameribond Securities Associates, the thrift institution receives a 1.50% guaranteed spread over the average yield on the contributed low-rate loans. While very helpful, 1.50% is far below the

improvement needed in today's interest-rate environment to restore portfolio return above savings costs and permit most institutions to resume profitable operation.

While thrift institutions could realize greater benefits ultimately through reinvesting into higher-rate assets over time as old loans amortize, the opportunity to upgrade loan portfolios immediately could have considerable appeal for many managers.

The major question-marks from our perspective are the breadth of the secondary market for subpar mortgage loans and the availability of high-bracket taxpayers as investor-partners seeking tax loss opportunities. The reduction from 70% to 50% in the top rate for unearned income in the Economic Recovery Tax Act of 1981, in particular, raises doubts about the numbers of potential investors who would be interested in such partnerships. The depressed state of the secondary market for purchasing loans from the partnership is also an imponderable factor.

I would note, in passing, that the ability of Federally-chartered savings and loan associations to participate in such partnerships would be assisted by enactment of one portion of S. 1720, Chairman Garn's financial institution restructuring legislation now pending before the full Banking, Housing and Urban Affairs Committee. In the opinion of the Federal Home Loan Bank Board, Section 131 of that proposed legislation would remove any doubt as to the ability of Federal associations to form joint ventures with investors to faciliate the sale of low-yield mortgages.

S. 1828 successfully accomplishes the tax law changes needed to pursue these joint venture arrangements. Proposed Code Section 703(c) avoids the possibility of a capital loss to the partnership by treating the loss as if the loans were sold by the thrift institution directly. The proposed amendment to Section 721(c) assures that the loss will be realized at the partnership level, even when loan sale proceeds are contributed, as in prearranged sale circumstances.

I have two minor recommendations for alteration in the language presented. The definition of "qualified thrift institution" for participation in the partnership should include subsidiaries, such as service corporations of savings and loan associations. In some circumstances, these subsidiaries may be more appropriate as partners than their parents (e.g., if state law prevents a joint venture by the parent). Secondly, the requirement that cash and residential mortage loans comprise 95% of the assets of the qualified thrift partnership is quite restrictive; other investments which meet the Tax Code's definition of "domestic building and loan association" should be permitted.

While the Thrift Partnership Tax Act is a welcome beginning in coping with the tremendous handicap represented by our portfolios of low-yielding long-term mortgages, it is important that your Subcommittees appreciate the magnitude of our problem. The chart attached as Exhibit I presents the mortgage portfolio of the savings and loan business as of September 1, 1981: $63 billion in loans under 8%; $163 billion under 9%; $285 billion under 10%; $318 billion, or two-thirds, under 10-1/2%.

By contrast more than two-thirds of our savings product now pay today's market rates of 13%, 14%, and 15%. This mismatch readily explains the well-publicized negative earnings (in the aggregate) performance of the savings and loan business. If we are to continue to function as the backbone of housing finance for American communities, we must arrest the earnings and net worth deterioration of the thrift business.

Our numbers of low-yielding loans are so large that it is clear a variety of mechanisms must be considered by the business and the Government to upgrade portfolio performance. Our trade association is sponsoring seven clinics for managers in February and March to share "self help" suggestions for coping with the low-yielding mortgage portfolio problem.

We are also working diligently with the National Association of Mutual Savings Banks to develop practical legislative proposals to address this enormous loan portfolio drag on our ability to serve the public. These proposals will minimize the exposure of the Federal Government to institutional failures (and payoff of insured depositors) while providing cost-effective ways of dealing with the low-yielding mortgage problem and rejuvenating housing finance.

We will be presenting these proposals to appropiate Committees of the Congress in the very near future.

I appreciate this opportunity to discuss the Thrift Partnership Tax Act and look forward to your questions.

EXHIBIT I

Mortgage Portfolio Structure

Savings and Loan Assns.

As of September, 1981

| | $ millions | $ cumulative | % | % cumulative |
|---|---|---|---|---|
| Under 6% | $6,158 | $6,158 | 1.26% | 1.26% |
| 6.00 - 6.49 | 7,289 | 13,447 | 1.49 | 2.75 |
| 6.50 - 6.99 | 7,187 | 20,634 | 1.47 | 4.22 |
| 7.00 - 7.49 | 17,912 | 38,546 | 3.66 | 7.88 |
| 7.50 - 7.99 | 24,462 | 63,008 | 4.99 | 12.87 |
| 8.00 - 8.49 | 23,769 | 86,777 | 4.85 | 17.72 |
| 8.50 - 8.99 | 76,494 | 163,271 | 15.61 | 33.33 |
| 9.00 - 9.49 | 65,796 | 229,067 | 13.43 | 46.76 |
| 9.50 - 9.99 | 56,560 | 285,627 | 11.54 | 58.30 |
| 10.00 -10.49 | 32,597 | 318,204 | 6.65 | 64.95 |
| 10.50 -10.99 | 31,941 | 350,145 | 6.52 | 71.47 |
| 11.00 -11.49 | 21,213 | 371,358 | 4.33 | 75.80 |
| 11.50 -11.99 | 21,589 | 392,947 | 4.41 | 80.21 |
| 12.00 -12.49 | 18,475 | 411,424 | 3.77 | 83.98 |
| 12.50 -12.99 | 15,819 | 427,243 | 3.23 | 87.21 |
| 13.00 -13.49 | 12,372 | 439,615 | 2.52 | 89.73 |
| 13.50 -13.99 | 9,783 | 449,398 | 2.00 | 91.73 |
| 14.00 -14.49 | 8,654 | 458,052 | 1.77 | 93.50 |
| 14.50 -14.99 | 5,920 | 463,972 | 1.21 | 94.71 |
| 15.00 -15.49 | 5,782 | 469,754 | 1.18 | 95.89 |
| 15.50 -15.99 | 4,150 | 473,904 | 0.85 | 96.74 |
| 16.00 -16.49 | 3,701 | 477,605 | 0.76 | 97.50 |
| 16.50 -16.99 | 2,332 | 479,937 | 0.48 | 97.98 |
| 17.00 and over | 10,001 | 489,938 * | 2.04 | 100.00 |

Nationwide $489,966

* Detail may not add to total because of rounding.

Senator LUGAR. Mr. Root, would you testify?

STATEMENT OF STUART ROOT, PRESIDENT, BOWERY SAVINGS BANK, NEW YORK, N.Y.

Mr. ROOT. Mr. Chairman, I would like to echo Mr. O'Connell's gratitude, as speaking for myself as well. It is indeed a privilege to appear before your subcommittee and to speak to the need for the Thrift Partnership Tax Act and for the need for curing the major ills which prompt the proposal in the first place.

There is an obvious need for the proposal and for the accompanying changes in accounting treatment to make it feasible for institutions to transfer assets which, although of high quality, have earnings potential which are ravaged by inflation. This bill, if accompanied by the accounting changes required, would allow for much needed earnings improvements and would permit the benefits to be achieved by tax expenditures rather than by relying on appropriations.

Historically, of course, savings institutions have contributed greatly to the economic health of this Nation. They have given their depositors great assurance of repayment through investment in high-quality assets; they have given their depositors the benefit of earnings produced by a positive-yield curve; and they have given their communities and communities across the great land funds for stable and dependable investment, investment on which rates of return could be computed and profitably projected, in the case of loans for commercial ventures, or on which homeowners could project their living costs in the case of residential mortgages, so important for the stability to which other observers here this morning have alluded.

Savings institutions today are described as having low-yielding mortgages or as having asset-liability mismatches. Sometimes that description is made as though that were the source of their problem. But, as your opening remarks point out, these phenomena are merely byproducts of an inflated interest rate structure and the glorification of a relatively nonproductive short term financial instrument market, both national and international.

In order to restore the great benefits which savings institutions have conferred on this Nation, there must be a return to economic health, restoration of a reasonable interest rate structure, and severe reduction in inflation. In the absence of a healthy environment, there will be great pressures brought to bear for restructuring the industry, but there will be a great risk presented as well, namely, the risk that we accommodate the disease rather than struggle to overcome it.

The Thrift Partnership Tax Act is directed at preserving the benefits of the savings industry through increasing the earnings capacity of savings institutions. It is most welcome, indeed. But, as previous speakers have indicated, more is needed. Perhaps most immediately, a plan of capital maintenance is required. Other asset-enhancement plans are needed, and of course liability costs must be reduced with, I hope, incentives for savings plans.

Accordingly, I perceive the need for a multifaceted attack on the specific ills afflicting savings institutions. I also perceive the need

for a far greater understanding than we can boast at present of the causes of our inflated interest rate structure and of our runaway debt creation money supply phenomena. These subjects are all developed in the written testimony which I have submitted for today's hearing.

I would observe that, in the event we do not preserve savings institutions, we eventually shall have to reinvent them.

Thank you for the opportunity to make these remarks.

[The prepared statement follows:]

Statement of
STUART D. ROOT
President of The Bowery Savings Bank

Submitted to a Joint Hearing of the
Finance Subcommittee on Taxation and
Debt Management
and
Banking Subcommittee on Housing and
Urban Affairs

United States Senate
February 5, 1982

Summary of Testimony

1. Senate 1828 aims to increase the earnings potential of savings institutions' portfolios. It is greatly needed, as the current status of those portfolios amply demonstrate.

2. The short run also will require stabilization of capital reserves or net worth, and reduction in liability costs.

3. But the underlying problems of inflation must be addressed as well. The central causes are unbridled growth of debt, national and international, and a severe lag in productivity.

4. Savings institutions are needed to combat these joint ills. If they are not preserved, we will lose a major ($800 Billion) shield of stability. Instead we will succumb to a financial system in which the "narcotic attraction of borrowing" is predominant - at least for a while.

5. Eventually, in such an event, we will have to recreate savings institutions so as to achieve:

a) security for depositors;
b) higher yield for deposits; and
c) productive investment for society.

6. Senate 1828 will help assure preservation of savings institutions, but the other ingredients of a multifaceted solution are also required.

Testimony of Stuart D. Root
President of The Bowery Savings Bank

It is a privilege to appear before your Subcommittees and speak to the need for the Thrift Partnership Tax Act, and to the need for curing the major ills which prompt the proposal of S.1828.

I have submitted a memorandum of technical comments on the Bill which I would asked to be put in the record to accompany this testimony. It has been developed by counsel for the Bank, Cadwalader, Wickersham & Taft, and I would invite any questions or amplifications sought by the staff members to be addressed to Charles Adelman, Esq., of that Firm in New York City.

There is an obvious need for the Thrift Partnership Tax Act, and for accompanying changes in accounting treatment to make it feasible for institutions to transfer assets which, although of high quality, have earning capacities which are ravaged by inflation. This Bill, if accompanied by the accounting changes required, would allow for much needed earnings improvements, and would permit these benefits to be achieved by tax expenditures rather than relying on appropriations.

But, as I am sure you will appreciate, the earnings pressures on savings institutions are not to be solved by any one piece of legislation. In the interest of giving a more complete analysis of the need for a multi-faceted solution, I offer the following:

a) The savings industry is made up of institutions needed in today's economy, perhaps as never before, to encourage savings, to promote productivity growth and thereby combat inflation. They are needed to continue serving as capital formation institutions which have provided - on a micro level - for the renewal of 42nd Street in New York City, as well as the best housed nation in the world.

b) At present this industry continues to promote savings, and to hold longer term assets which contribute extraordinary stability - or economic "ballast" - to an otherwise inflation torn system.

c) This stability relying as it does on the net worth of the institutions affected, serves to shield debtors throughout the country from the disruptive force of volatile rates and thereby protect them from indexation of debt costs which otherwise would be severely destabilizing.

d) The shield is becoming a sieve. Capital reserves of savings institutions are the victim of failed expectations of lower interest rates. The cost of maintaining deposits, and hence assets as well, of savings institutions remains locked in, in very large measure, six months in advance. Now it's also becoming locked in for 2 1/2 years as well.

e) Financial entities only recently attracted to savings, namely commercial banks and their holding companies, are characterized as "white knights" presumably with new armour and shields, ready to ride to the rescue. The theory has the overtones of an "economic natural selection."

f) But, I submit, what we are witnessing instead is – unnatural selection. We see a process of "selection" taking place in an unhealthy - or inflation diseased - economy. A major component of this disease is the great increase in debt - national and international. One student of this phenomena, Albert Wojnilower, has called attention to Walter Bagehot's admonition that "money will not manage itself" and states that this admonition is "only one of a long series of observations, traceable through millenia of human history, that recognizes the narcotic attraction of borrowing and the related phenomena of gambling and asset - price speculation."

g) Accordingly, the combination of continued high inflation and historically high real rates of return exact a penalty on those savings institutions which have contributed mightily to American financial stability and productivity. And now the competition for the public's savings is most strongly waged by "those who have learned to play the inflation game best" - albeit with some grave questions raised about asset quality of the "white knights." If we succumb to "unnatural selection" we will quietly perpetuate the disease which we struggle vociferously to combat.

Accordingly, I repeat, there is great need for a multi-faceted solution. In the short run we must be concerned with enhancing the earnings of assets - as is the object of this Bill; in addition we must reduce liability costs; and perhaps most immediately we must stabilize net worth.

We must be concerned with the long run as well - not merely for savings institutions, but for the preservation of the society which they have served for the past 150 years. There is no alternative to a consistent, persistent and inevitably painful anti-inflationary fight which heretofore has been undertaken, at best, only sporadically. As to this I offer these observations:

1) Looking backward we see a dramatic bias in the United States against savings. For decades taxes have increased consistently faster than the economy. Simultaneously, ~~with what has~~ been left after taxes, consumption has been promoted at the expense of savings.

(2) Productivity growth has lagged badly in this country. Indeed over the past four years it has vitually disappeared, which has been yet another contribution toward inflation. This lag is clearly related to savings,

but is only dimly understood. The most recent savings incentive program installed by Congress (universal IRA) has little relationship to U.S. productivity. True, gold is ineligible for investment, but shares of gold mining companies are not. Further, saving for retirement may beget purchasing financial instruments from sellers who have no obligation to return even the principal on the savings, although they do have a public relations incentive to do so. There is a difference between savings by depositing and buying something. To illustrate, one seller of instruments touts shares of companies in the Western Pacific (or "Pacific Basin") as eligible for an IRA program. This stretches to intolerable limits even the semantics of "savings," or "incentives for savings," and raises, I believe, some profound questions of government dispensations for non-deposit incentive programs.

3) The issues surrounding money supply continue to confound:

(A) Anthony Solomon, President of the Federal Reserve Bank of New York, spoke on December 28th of the lack of adequate guidance given by monetary aggregate figures. These perplexities will increase as technology continues to make its leaps forward.

(B) Dr. Charles A. E. Goddard, Chief Advisor on Monetary Policy for the Bank of England has repeatedly called attention to the lack of reliability of any one money aggregate, pointing out the ingenuity within the marketplace for shifting the means of moving transactions balances. Specifically Dr. Goddard states: "Any statistical regularity will tend to collapse once pressure is placed upon it for control purposes." This contrasts dramatically with Milton Friedman's article in Monday's Wall Street Journal wherein he chides the Federal Reserve for "juggling a number of targets" instead of "selecting a single monetary target." Just whom are we to believe? And if it is Dr. Friedman, on which "target" should we fasten, now that M1B has risen, in the first eleven months of 1981, at an annual rate of 2.5 percent?

(C) We increasingly have turned to using debt instruments outside the Federal Reserve system as a basis for money, or a medium of exchange. The seminal step in the validation of this process was, I believe, the willingness on the part of United States Treasury to accept checks drawn on money market funds as payment for tax bills (subject to collection - as with any check drawn on a bank of deposit).

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(D) Mr. Paul McCracken, on December 31, 1981, summarized the inflationary effect of a 10% M-2 monetary aggregate growth supporting a 14% per year increase in demand within an economy having a real output increase of 2% to 3% per year.

(E) Some serious questions deserve to be raised, I believe, about the concept that domestic money supply can be controlled - at least with the tools we commonly look to. For example, reserve requirements (especially when reporting is lagged), open market operations and discount rates can be rendered impotent in the wake of massive shifts of highly mobile dollars in international transactions. And, as we know, the $1.3 trillion commercial banking system is mirrored by the Eurodollar deposits outside domestic jurisdiction. If interest were paid on domestic demand deposits, as it is on Eurodollar demand deposits, would we be inundated? Twenty years ago this question could not have even been framed. But today we talk of controlling money supply as though that ocean of unregulated wealth did not exist.

These issues may appear far afield from the problems affecting savings institutions. But in my estimation savings institutions are not in trouble because of "asset/liability mismatches" or from "low yielding mortgages." Instead they suffer far more fundamentally from the culmination of economic forces which produce those characterizations as by-products of an inflated interest rate structure and the glorification of the relatively non-productive short term financial instrument market, national and international. It is a market which ignores Walter Bagehot's admonition that "money will not manage itself"; it is a market which fits the description of a "narcotic attraction of borrowing". It is not accidental that one money market fund manager has just announced plans for furnishing our people with instant access to more debt by borrowing against home equity. Again - "the related phenomena of gambling and asset-price speculation."

In concluding, I make only these two additional points.

1. I started this testimony from the brain, but I finish it from the heart.

2. The Bowery Savings Bank has inscribed over its main portal this statement: "Dedicated to Service of our Citizens that the Fruits of Their Labor may be made Secure." Savings banks seek security for their depositors. They also seek to enhance productive investment. In a healthy economic environment, high quality and productive assets earn more than those with short maturities. In an unhealthy economy, which we developed during the 1970's, the combination of security, sustainable high earnings, and productive investment is simply not achievable. If savings institutions are to be restored to adequate health so that they may make productive risk-taking investments, rather than be overshadowed by the narcotic dispensers, their portfolios must be enhanced. Hence, in my estimation, the need for earnings opportunities such as those available in S. 1878.

Thank you for the opportunity to appear in these Joint Subcommittee Hearings.

January 29, 1982

MEMORANDUM FROM: Stuart D. Root
President, The Bowery Savings Bank

TO: United States Senate, Subcommittee on Housing and Urban Affairs of the Committee on Banking, Housing and Urban Affairs

RE: Thrift Partnership Tax Act of 1981, S. 1828

In connection with the pending legislation entitled "Thrift Partnership Tax Act of 1981," S. 1828, I support such legislation and recommend that the following changes be considered to carry out its purposes more effectively:

1. Section 2(b) of the Bill adds a new subsection (f) to section 704 of the Internal Revenue Code of 1954, as amended (the "Code"), providing that the partnership agreement will determine a partner's distributive share of gain or loss from the sale or exchange by a "qualified thrift partnership" of residential mortgage loans or interests therein, nothwithstanding subsections (b)(2) or (c)(1) of section 704 of the Code. Section 704(b)(2), as amended by the Tax Reform Act of 1976, disallows special partnership allocations if they lack "substantial economic effect." Prior to such amendment, a special allocation was disregarded if "the principal purpose" of the allocation was "the avoidance or evasion of any tax." In making the amendment, the legislative

history (S. Rep. No. 94-938 (Part I), 94th Cong., 2d Sess. 100 (1976)) leaves room for the interpretation that the requirement of non-tax avoidance or bona fide business motives continues to exist for a special allocation to avoid challenge under amended section 704(b)(2). Proposed section 704(f) does not address this concern. To remove all doubt as to the validity of the thrift partnership allocation of gain or loss on the sale of residential mortgage loans, I recommend that the end of proposed section 704(f) be modified to read: "shall be determined solely by the partnership agreement without taking into account any other factors." A similar technique was used in Code section 168(f)(8)(C), as added by the Economic Recovery Tax Act of 1981, concerning the requirements for "safe harbor" leases.

2. New Code section 761(e)(1)(A), as added by section 3 of the Bill, requires that at least one partner of a qualified thrift partnership be a qualified thrift institution. I believe that the purposes of the Bill would be preserved, indeed strengthened, if the thrift institution were permitted to invest in the partnership through other investment vehicles wholly within its control. In many cases, state laws may preclude a thrift institution from acting as a partner, thus requiring an investment in a partnership to be made indirectly through a subsidiary or otherwise. Thus, the entire intent of the legislation may be vitiated if this section is not broadened. Accordingly, I recommend that proposed section 761(e)(1)(A) be amended to read: "at least one partner of which is a qualified

thrift institution, a wholly-owned subsidiary of such an institution, a trust of which such an institution is grantor and sole beneficiary, or a corporation 100 percent of the stock of which is owned by such a trust."

3. New Code section 761(e)(1)(C), as added by section 3 of the Bill, requires that 95 percent of the assets of a qualified thrift partnership consist of property or interests in property described in clause (i) (cash) or clause (v) (residential mortgage loans) of Code section 7701(a)(19)(C). This requirement is much narrower than either the required percentage or the classes of assets qualifying for investment by thrift institutions and would hamper, if not make impossible, the functioning of a thrift partnership as a viable business entity. I would therefore recommend three changes in this paragraph of the statute. First, the 95 percent of assets requirement appears to assume that the thrift partnership will passively invest and reinvest in residential mortgage loans. However, the purposes of the Bill in increasing the availability of mortgage financing would be enhanced if the partnership were permitted, for example, to conduct an active business of maintaining a secondary market in mortgage loans. It is not clear that the 95 percent of assets requirement would provide sufficient leeway for the conduct of such a business. Accordingly, I recommend that the required percentage be not greater than 80%. Second, the category of permissible investments should be expanded to

include the categories of property described in section 7701(a)(19)(C)(ii) (government obligations), (viii) property acquired upon liquidation of defaulted mortgage loans, and (x) property used in the conduct of the partnership's trade or business. Third, the implication that the percentage test is to be met at all times during the taxable year should be removed and a rule provided comparable to that in section 7701(a)(19)(C) that such test be met at the close of the taxable year. In summary, I recommend that proposed section 761(e)(1)(C) be amended to read as follows: "[x] percent of the assets of which (at the close of the taxable year) consist of property or interests in property described in clause (i), (ii), (v), (viii) or (x) of section 7701(a)(19)(C), and".

Senator LUGAR. Thank you, Mr. Root.

Both of you gentlemen have commended the good intent of the bill that we discussed today, S. 1828, as a step in the right direction. Both of you have, however, added that there are such substantial problems that, although this is well intentioned and a helpful step, a great deal more will analysis will need to be done.

Mr. Root, of course, and Mr. O'Connell, you have mentioned that a legislative package may be forthcoming.

I suppose that I would ask both of you, first of all, in the two technical problems that have been raised earlier in the hearings, what is your analysis as to the tax effects of this with regard to Treasury gains or losses and the accounting problems posed by the accounting association's rulings as to how these transactions would be considered?

Mr. O'CONNELL. First of all, I thought, frankly, that the testimony of the Treasury witness was quite exaggerated, maybe preposterous. I don't know where he got a $50 billion figure.

It is clear that a program like this would be slow, I think, in unfolding. I think that the statement of the witness from Coopers & Lybrand is much more accurate, that there would be a fairly limited use of this program and that the impact, therefore, on the Treasury would be much, much less than suggested by the Treasury witness.

Senator LUGAR. If I could stop you at that point, Mr. O'Connell, in fact in your testimony, it seems to me, you have stressed that, and we discussed this substitution factor for tax shelters earlier on, your feeling is that the discovery of the opportunity will take some time, that it would be limited.

Mr. O'CONNELL. They are assuming that literally there is going to be a tremendous influx of funds into this area. We don't see that. We think it takes time.

I would say, with respect to the accounting question that you raised before, and as Mr. McKinney suggested, there are problems, I think, in connection with the accounting treatment in this pro-

gram for stock associations. But I don't think that those problems apply to mutual institutions in our savings and loan business, because I think that the accounting rule enacted last fall by the Federal Home Loan Bank Board (with our substantial encouragement) clearly would make it possible for mutual savings and loan institutions to use this program without running into trouble with the accountants. It would be another matter, however, for the stock institutions, and they are obviously a very important factor in our business.

Senator LUGAR. Mr. Root, do you have comments on the tax accounting situation?

Mr. ROOT. I would certainly subscribe to what Bill has said about the tax treatment. I think the Treasury, as we might come to expect, protests too much. I also subscribe to the view that the benefits to the institutions and to the users of this program would be somewhat slow in coming. I think it would take the people a while to get used to what the intricacies of this type of investment partnership would be.

In the meantime, I do think that with it in place it allows the users of the funds to get ready for it. As you must know, housing or any real estate development has got a leadtime, and if there is a program in place that is a dependable program and that has a market that appears to be developing, even though it is slow in coming, its dependability factor allows for commitments to be made. And commitments really are the basis for ensuing real estate development. It just doesn't happen. Lumber mills don't start churning right away; they churn on the basis of eventual commitments.

So I think even though it may be slow in developing, the dependability factor that this bill would allow for the tax benefits is of immense importance. And over the longer run, I would certainly would say that the Coopers & Lybrand study much more comports with my experience than certainly the Treasury does.

Insofar as the accounting problems are concerned, the FDIC, as distinguished from the FSLIC, has taken a different view on the subject of deferral of losses and the ability to transfer assets for the losses. As a result, our own institution, for example, would be hobbled by the same accounting difficulty to which Bill and former Chairman McKinney have referred. That may be changed if the FDIC were to change its views. It may develop that the combination of regulatory support, of State supervisory support, which is already being developed in New York, and tax certainty, it may be that the combination of those three things would allow the accounting profession to see the subject somewhat differently. That remains to be seen.

But, in the meantime, if this program were to go forward even with regulatory approval, you would have a distinction between regulatory accounting principles and generally accepted accounting principles that might have to give rise to a qualification on a financial statement, which every institution would have to evaluate as to whether they wanted it or not.

Senator LUGAR. The testimony earlier on between Treasury and Coopers & Lybrand got into the fact that this proposal offers a differential in rates which would be very advantageous to those seek-

ing shelters. That is, I recall that Treasury representative led us to believe it would be an abnormally successful shift; thus, leading to a great loss of revenue.

As you have analyzed the proposal, are there sufficient incentives for people to want to seek shelter in this particular area as opposed to, as one of the witnesses suggested, energy investments or other shelters that are available in the economy? Granted, it takes an educational lead-up time and some notification, but is this an attractive situation to which it is likely that persons would be drawn?

Mr. O'CONNELL. In our statement we did raise two reservations about the proposal. One dealt with the question of whether the changes in the Tax Code regarding unearned income would have some depressing effect on this.

The other reservation that we raised was the question of the ability of the secondary market, to absorb these subpar loans. I might say in that connection that, in spite of the Federal Home Loan Bank Board's, I would say, forward looking rule last year in connection with the treatment of losses on the sale of loans, there has not been an overwhelming response in the secondary market so far on the program for swapping low-yielding loans for more marketable participation certificates. We have proceeded quite slowly on that similar opportunity. There have been some institutions which have taken advantage of it. But these are important questions so far as we were concerned.

And yet I think, with this program on the books, you would begin to see more interest build up over a period of time. From our point of view, the Thrift Partnership Act is one approach to quite a difficult situation, and we are trying to develop a series of solutions to that situation.

Senator LUGAR. Well, I would certainly agree with that. And obviously the purpose of our hearing today is simply to try to explore one part of that. Other of my colleagues have advanced additional ideas, and I have advanced some in other forums. Unhappily, none of them are making startling progress, and this is one reason why we are deeply indebted to Chairman Dole of this committee, and my colleague Senator Packwood, specifically, for giving us this kind of forum, given the jurisdictional problems in which housing runs into taxes and financial situations.

Unless you have additional comments, I will conclude the formal part of our hearing presently.

Mr. O'CONNELL. I'd like to make one final comment. I really appreciate former Chairman McKinney's statement, and I would associate myself with the bulk of that statement. We have not had an opportunity to discuss or review his all-American mortgage proposal, but the facts that he stated with respect to, I would say, the dire straits of the thrift industry, I think were fairly close to our own estimates, and I hope will eventually and hopefully very soon produce some appropriate congressional response.

Senator LUGAR. Mr. Root.

Mr. ROOT. I would only add, Senator, that I thought Commissioner Yang touched on a point that deserves emphasis. That is, all too often in the financial press and in the commentary made by astute observers of what the capital needs are in this country, a distinc-

tion is made between plant and equipment and housing. And I thought that her peroration is noteworthy because it demonstrates that housing and plant and equipment are not severable sectors. I call it to your attention and underscore it, because I think it is something that others who will comment on this bill will seek to comment on adversely, based on a presumed distinction which I don't believe exists.

Senator LUGAR. I join your commendation and, indeed, am very grateful, as I'm certain my colleagues are, for the quality of the testimony and your willingness to appear today. We look forward to additional hearings, either on this legislation or on others, that may be of benefit to the housing industry and to the thrifts.

Mr. ROOT. Thank you very much.

Senator LUGAR. Thank you very much.

The meeting is adjourned.

[Whereupon, at 10:47 a.m., the meeting was adjourned.]

[By direction of the chairman, the following communications were made a part of the hearing record:]

## STATEMENT OF BASKIN AND SEARS, ATTORNEYS AT LAW

THRIFT PARTNERSHIP TAX ACT OF 1981

This memorandum discusses certain provisions of the proposed "Thrift Partnership Tax Act of 1981", introduced by Senator Richard G. Lugar (R.-Ind.) as S. 1828 on November 9, 1981 (the "Act"), in the context of the current Internal Revenue Code of 1954, as amended (the "Code").

Background

The partnerships contemplated by the Act would offer thrift institutions a mechanism for converting below current market-rate mortgages in their portfolios into an interest in a limited partnership with private investors. Under the proposal, thrift institutions would contribute low-yield mortgages in their existing portfolios to one of the new qualified thrift partnerships as capital and would be credited with a capital account at the book (face) value of the contributed mortgages. Private investors would contribute to the partnership as their capital contribution an amount of cash approximately equal to the difference between the book and market value of the mortgages contributed by the thrift institutions. The partnership then would sell the contributed mortgages in the secondary mortgage market, realize a loss (from book value) on the sale of the low-yield mortgages and invest the cash realized from the sale plus the cash contributed

by the private investors in mortgages carrying current market interest rates.

The proposed thrift partnership agreement would allocate the loss realized on the sale of the contributed mortgages first to the private investor participants to the extent of their original capital contribution, then to the thrift institution participants to the extent of their original capital contribution. It is expected that income earned by the partnership would be distributed as follows:

> First, an annual cash payment of approximately 150 basis points greater than the average book value yield of the contributed mortgages would be made to the thrift institution partners. The payment would be computed as a percentage of the institution's original capital account.
>
> Second, a similar annual cash payment would be made to the private investor partners. The payment would be computed as a percentage of the investor's original capital account.
>
> Third, any partnership income in excess of the annual cash payments would be allocated to any capital account showing a deficit from the amount of the original capital contribution.

Fourth, any remaining partnership income would be allocated between the thrift institution participants and the private investor participants.

The proposed qualified thrift partnership would be limited to investments legally available to thrift institutions. It is contemplated that the partnerships would actively trade their portfolios and may engage in servicing the mortgage contracts that they initiated or acquired.

Thus, proposed qualified thrift partnerships would combine the capital contributions of the two classes of partnership participants and convert the capital contributions into investments that yield a return at the current market interest rate. Participation in a thrift partnership potentially would provide thrift institutions with a mechanism both to liquidate low-yield mortgage assets and to increase their earnings.

## Discussion

1. Allocation of gain or loss (amendment to Code § 704 by Act Sec. 2(b)).

The Act would amend Code § 704 to add a new subsection (f). Under the proposed new subsection, a partner's share of the gain or loss realized by a qualified thrift partnership on mortgages contributed to the partnership by qualified thrift institutions would be determined in accordance with the terms of the partnership agreement.

For the reasons discussed below, the proposed allocation of gain or loss in new Code § 704(f), as applied to the contemplated operation of a qualified thrift partnership, is intended to be consistent with current law and has been introduced solely as a clarifying amendment.

Code § 704(b) currently provides that the net income or loss of a partnership for Federal income tax purposes shall be allocated among the partners as provided in the partnership agreement, so long as the provisions of the partnership agreement with respect to such allocations are considered to have "substantial economic effect" independent of tax consequences. Any allocation which does not have such "substantial economic effect" is ignored, in which case the allocation is "determined in accordance with the partner's interest in the partnership (determined by taking into account all the facts and circumstances)".

Whether a particular partnership allocation has "substantial economic effect" is deemed to be a question of fact and, therefore, is an issue on which the Internal Revenue Service has indicated that it will not issue advance rulings. Rev. Proc. 81-10, 1981-13 I.R.B. 44 [Sec. 3.01(25)]. There is only a limited amount of authority construing the meaning of this phrase. However, it is generally felt that allocations which affect a partner's capital account, and thus the amount that the partner can receive on liquidation of the

partnership, are allocations that have substantial economic effect. See, e.g., General Explanation of the Tax Reform Act of 1976, at 95 n.6 (1976); Treas. Reg. § 1.704-1(b)(2) (Example 5); Jean V. Kresser, 54 T.C. 1621 (1970); Stanley C. Orrisch, 55 T.C. 395 (1971), aff'd per curiam, 31 AFTR 2d 1069 (9th Cir. 1973); Leon A. Harris, Jr., 61 T.C. 770 (1974); Martin Magaziner, 37 T.C.M. 873 (1978). Also see the following Technical Advice Memoranda, Private Letter Rulings 8139005 (June 1, 1981), 8133028 (May 19, 1981), and 8133021 (April 30, 1981).

All of the allocations of gain or loss contemplated to be provided under a qualified thrift partnership agreement would affect the respective capital accounts of the various partners, and would determine the amounts which each partner would be able to receive upon liquidation of the partnership. Consequently, the allocations should meet the existing requirements of Code § 704(b) of having "substantial economic effect" independent of tax consequences.

In addition, the allocation of losses on the disposition of contributed mortgages to the private investor participants should be respected, notwithstanding the fact that the losses had economically accrued to the thrift institutions prior to their contribution. Code § 704(c) contemplates that a partner may contribute property to a

partnership having a value that is different from its basis, and that this difference may be allocated between the partners as provided in the partnership agreement. It is clear that this rule applies whether the property has appreciated or depreciated in value. Treas. Reg. § 1.704-1(c)(2)(i). Although special allocations of the appreciation or diminution element inherent in contributed property are usually made to the partner who contributes the property, Code § 704(c) and the related regulations make clear that this is only the case where the parties have provided for such a special allocation. These provisions hold that, unless a special allocation of the appreciation or diminution in value is made, gain or loss from the sale of the property will be treated as if the property had been purchased by the partnership, with the result that gain or loss will be allocated in accordance with the regular provisions of the partnership agreement. Since the contemplated thrift partnership agreement will provide that all of the diminution in value is to be allocated to the private investors, and since this allocation should have substantial economic effect, this provision should be respected for Federal income tax purposes.

In the absence, however, of a favorable ruling from the Internal Revenue Service as to whether any allocation has "substantial economic effect" -- which as noted above is not

obtainable -- and in view of the limited authority interpreting the scope of Code § 704(b) and "substantial economic effect", prospective private investors likely would require that any uncertainty or ambiguity as to the contemplated allocation be resolved prior to their becoming investor participants in a thrift partnership. New Code § 704(f) is being introduced to provide the requisite certainty.

2. Characterization of gain or loss (amendment to Code § 703 by Act Sec. 2(a)).

The Act would amend Code § 703 by adding a new subsection (c). Under the proposed new subsection, gain or loss realized by a qualified thrift partnership on the disposition of mortgages contributed by a qualified thrift institution in exchange for a partnership interest would be treated in the same manner as if the qualified thrift institution had disposed of the mortgages, i.e., ordinary income or ordinary loss.

For the reasons discussed below, the proposed characterization of gain or loss in new Code § 703(c), as applied to the contemplated operation of a qualified thrift partnership, is intended to be consistent with current law and has been introduced solely as a clarifying amendment.

It is contemplated that qualified thrift partnerships would conduct themselves as dealers in mortgages and mortgage-related securities. Treas. Reg. § 1.471-5 currently

provides that a dealer in securities can inventory securities. A dealer, however, must be distinguished from an investor or a mere trader. The regulations provide that a dealer in securities is "a merchant of securities, ... with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom." In distinguishing an investor or trader, the regulation adds that "taxpayers who buy and sell or hold securities for investment or speculation, irrespective of whether such buying or selling constitutes the carrying on of a trade or business, ... are not dealers in securities ...".

The Internal Revenue Service has recognized that an entity engaged in the business of buying and selling, and originating and selling, mortgages can be a "dealer" in "securities". It has held that mortgages are "securities" for both Code § 471 and Code § 1236 purposes; and that dealer status can apply not only with respect to mortgages purchased by the entity for resale, but to mortgages originated by the entity for purposes of servicing and resale. Rev. Rul. 72-523, 1972-2 C.B. 242.

Although the question of "dealer" status is a question of fact which must be determined after the event

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upon audit, it would appear that the proposed activities of qualified thrift partnerships are similar to those of the mortgage corporation referred to in Rev. Rul. 72-523 and, therefore, that such partnerships should be able to qualify as "dealers" in mortgages and mortgage-related securities.

Securities held in inventory or for sale to customers in the ordinary course of the business of the qualified thrift partnership would not be capital assets. Code § 1221(1) provides that the term "capital asset" does not include "stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business ...". As a result, any gain or loss realized by a qualified thrift partnership in the ordinary course of its business as a dealer in mortgages and mortgage-related securities should be considered ordinary gain or loss for Federal income tax purposes.

Since qualified thrift partnerships will engage in the business of originating mortgage loans, there is another reason why the gains and losses that they derive from mortgages should in general be treated as ordinary

income or loss. Code § 1221(4) provides that the term "capital asset" does not include indebtedness acquired in the ordinary course of a trade or business "for services rendered." Loans acquired by banking institutions engaged in the business of making loans have been held to constitute indebtedness acquired "for services rendered" within the meaning of this phrase and, thus, not to constitute capital assets. See Burbank Liquidating Corp., 39 T.C. 999 (1963), acq. sub nom., United Associates Inc., 1964-1 C.B. 5, modified on other grounds [64-2 U.S.T.C. ¶ 9676], 335 F.2d 125 (9th Cir. 1964); Rev. Rul. 73-558, 1973-2 C.B. 290. See also Rev. Rul. 80-56, 1980-1 C.B. 154; Rev. Rul. 80-57, 1980-1 C.B. 157; Rev. Rul. 72-238, 1972-1 C.B. 65.

A particularly important question is whether the anticipated loss from the sale of the initial mortgages contributed by qualified thrift institutions as their capital contributions to a qualified thrift partnership would qualify for ordinary loss rather than capital loss treatment. Although a sale of these mortgages by the qualified thrift institutions themselves should generate ordinary rather than capital losses, see Burbank Liquidating Corp., supra, the qualified thrift partnership would be a separate entity and the characterization of the losses from these sales by the qualified thrift partnership would depend on the status of

these assets in the hands of the partnership. Because these mortgages would not have been originated by the partnership, they could be distinguished from mortgages that later were originated by it. However, since these assets would have been acquired by the qualified thrift partnership for purposes of resale as part of the partnership's intended business as a dealer in mortgages, these assets should qualify as part of the partnership's dealer inventory as much as would mortgages purchased thereafter by the partnership for resale in the course of that business. In this regard, it might be noted that on August 30, 1979 the Internal Revenue Service issued a private letter ruling in a case in which a corporation proposed to form a new subsidiary which would purchase mortgage loans from a number of originators, and would then place these mortgages in a mortgage pool for resale. The subsidiary was to service the mortgages. The letter ruling held, *inter alia*, that the subsidiary would recognize ordinary income or loss upon the sale of its interest in each of the mortgages in the pool. Private Letter Ruling No. 7948086. Notwithstanding the existence of substantial authority supporting the ordinary gain or loss characterization, potential private investor participants may require greater certainty. New Code § 703(c) has been introduced to provide such certainty.

3. Contributions to the partnership (amendment to Code § 721 by Act Sec. 2(c)).

The Act would amend Code § 721 by adding a new subsection (c). Under the new subsection, sales by a qualified thrift partnership of mortgages contributed to the partnership by qualified thrift institutions would be treated for Federal income tax purposes as having been made by the thrift partnership.

For the reasons discussed below, the treatment of the partnership as the seller in new Code § 721(c), as applied to the contemplated operation of a qualified thrift partnership, is intended to be consistent with current law and has been introduced solely as a clarifying amendment.

Under current law, a sale by the partnership of the contributed mortgages ordinarily would be attributed to the partnership, absent a pre-arrangement to sell them entered into between a contributing thrift institution and a buyer prior to the contribution of such mortgages to the partnership. See Comm. v. Court Holding Co., 324 U.S. 331 (1945). However, Code § 482 permits the Internal Revenue Service to apportion or allocate income and deductions between two or more organizations "owned or controlled directly or indirectly by the same interests" if such apportionment or allocation "is necessary in order to prevent evasion of

taxes or clearly to reflect the income of any such organizations ...".

The predecessor of this Code section was applied in National Securities Corp. v. Commissioner, 137 F.2d 600 (3rd Cir. 1943), cert. denied, 320 U.S. 794 (1943), to a case where securities which had depreciated in value had been transferred in a tax-free transaction under the predecessor to Code § 351 from a parent corporation to its wholly-owned subsidiary. At the time of the transfer, the parent's basis in the securities was $140,000; the securities had a fair market value of $8,000; and the subsidiary issued $75,000 in value of its own stock to the parent as consideration for the transfer. Shortly thereafter, the subsidiary sold the securities for $7,000. The court held that the portion of the loss between $140,000 and $8,000 should be allocated to the parent rather than to the subsidiary, in order clearly to reflect the income of the parent and subsidiary. The Regulations under Code § 482 make clear that the purpose of Code § 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer. "The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's-length with another uncontrolled taxpayer." Treas. Reg. § 1.482-1(b).

Code § 482 and the National Securities Corp. case are distinguishable from the transactions contemplated for qualified thrift partnerships. The thrift institutions and the investor participants ordinarily would be dealing with each other at arm's-length. As a result of this arm's-length bargaining, the investor participants would bear the economic burden of the loss that may be realized on the sale of the mortgages. This was not the situation presented in the National Securities Corp. case, where the parties were a parent corporation and its wholly-owned subsidiary, the subsidiary simply issued additional shares of its stock to the parent which already owned all of its outstanding stock, and the subsidiary did not suffer any "economic loss". Moreover, the purpose of Code § 482 is to impose an arm's-length standard in cases where the parties are not dealing at arm's-length. It is not intended to apply to cases where unrelated parties are already dealing at arm's-length, as would be true for qualified thrift partnerships. Accordingly, under current law sales by such partner ships of contributed mortgages should be deemed made by them and, as in the case of the prior two amendments discussed herein, new Code § 721(c) has been introduced to confirm this conclusion.

February 12, 1982

RE: S. 1828

Mr. Chairman:

I express my strong support of S.1828, the Thrift Partnership Tax Act, and commend your efforts in initiating such legislation.

Act S.1828 would encourage the formation of partnerships between thrift institutions and individual investors who are in the highest marginal tax bracket. The thrifts would contribute low-rate mortgage loans at par, and the investors would contribute cash approximately equal to the difference between the book value and market value of the low-rate mortgage loans. This partnership would then sell the low-rate mortgage loans, and the loss on the sale would be allocated fully to the individual investors as an operating loss for tax purposes. The proceeds on the sale of low-rate mortgage loans together with the cash provided by individual investors would then be invested in mortgage loans at the then current market rate, the interest on which would be allocated proportionately to both the thrift institution and the individual investors.

The beleaguered thrift institutions could benefit immediately by selling their old low-rate mortgage loan portfolios and reinvesting the proceeds in new mortgage loans. This legislation addresses the most fundamental problem experienced by the thrift industry, namely, its low-rate mortgage loans. Faced with unprecedented operating losses of some $5 billion dollars in 1981 together with the resultant erosion of its capital base, the $650 billion savings and loan industry is undergoing radical transformation with consolidations occurring at an alarming rate. In the February 9, 1982 edition of the Wall Street Journal it was reported that the Federal Home Loan Bank Board expects some 40 mergers to occur during the current month. In effect, 1% of the nation's savings and loan associations will be merged in just one month, or 12% on an annualized basis. With interest rates heading higher, it seems reasonable to expect this trend to accelerate even further in the coming months. The question of how the nation's increasing housing needs of the eighties will be satisfied is indeed difficult to understand, given the very formidable problems facing the savings and loan industry, which has been the nation's leading supplier of funds for housing.

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**VALLEY FEDERAL SAVINGS**

President Reagan has stated on several occasions that the chronic economic problems, plaguing the nation over the past decade will not be reversed overnight. However, it is important to remember that all industries are not positioned equally to weather the financial storm during this turbulent period. In particular, those industries involved with housing, currently operating at depression-rate levels, cannot wait for a long-range recovery to occur. Thrift institutions, builders and realtors as well as lumber and other housing-related companies would all benefit from the enactment of this legislation. Additionally, unemployment in these industries, which is at double-digit levels, could be reduced materially.

This legislation could provide the necessary stimulus to allow thrift institutions to increase lending dramatically which, in turn, could stimulate the housing and other related industries. Greater lending could be accomplished because the burden of the old low-rate mortgage loans will finally be mitigated. As a result, housing could once again assume its customary role in leading our economy out of the current recession.

One major cause of concern, of course, would be the effect of such legislation on the already significant projected deficit of some $92 billion. Not unlike the rationale for reducing individual and corporate tax rates, the benefits associated with the enactment of this legislation would outweigh the costs to the Treasury specifically because of the number of housing-related industries benefitting and the type of individual investors participating in a tax-sheltered partnership as envisioned by this legislation.

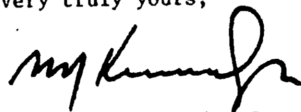
I have illustrated in Exhibit I the estimated net effect to the Treasury of enactment of this legislation. The illustration shows that there would be a net positive effect on the Treasury in that the national deficit would be reduced in both the initial and succeeding years.

The projected net revenue gain to the Treasury as illustrated in Exhibit I would amount to at least 1.8% (without considering any "multiplier effect") of the amount of contributed mortgages in the first year after enactment of the legislation.

It is important to note that very broad assumptions, by necessity, have to be made to project the estimated net effect to the Treasury of any new legislation. With respect to the assumptions made in Exhibit I those used are conservative in nature and, even if changes of a reasonable nature were to be made, a net positive effect would still result to the Treasury.

In summary, by enacting this legislation housing can begin to lead this country out of this recession at no expense to the taxpayer; the housing demands of the "baby-boom and post baby-boom" generations will begin to be satisfied; revenues to the Treasury will increase; and most critically, unemployment in housing-related industries will drop. I urge you to act on this legislation.

Very truly yours,



Matthew J. Kennedy, Jr.
Vice President

MJK/sg

Exhibit - I

ESTIMATED REVENUE GAIN TO THE TREASURY

ASSUMING ENACTMENT OF S.1828

A. Hypothetical example

A partnership is formed with "A" Savings and Loan contributing $100 million in mortgages with a weighted average coupon rate of 9% and with an estimated market value of $70 million. Individual investors in the highest marginal tax bracket (50%) contribute $30 million in cash. The partnership sells the 9% mortgage loans for $70 million, and the $30 million loss on the sale is allocated fully to the individual investors who treat such loss as an ordinary loss for tax purposes. The $70 million proceeds on the sale, together with the $30 million cash provided by the individual investors is then invested in mortgage loans with an average interest rate of 16½%, the interest on which is allocated to both the Savings and Loan and the individual investors.

B. Itemized Beneficiaries

| | Amount | Marginal Tax Rate | First Year Effect on Treasury |
|---|---|---|---|
| 1. Individual Investors: | | | |
| a) Ordinary loss on sale of loans (note a) | $(10,000,000) | 50% | $(5,000,000) |
| b) Taxable interest income on new loans (note b) | 4,950,000 | 50% | 2,475,000 |
| 2. Savings and Loan: | | | |
| a) Additional interest income (note c) | 2,550,000 | 25% | 637,500 |
| b) Additional fee income (note d) | 2,000,000 | 25% | 500,000 |
| 3. Builders: | | | |
| a) Pre-tax profit on sale of new homes (note e) | 7,500,000 | 33% | 2,500,000 |
| 4. Realtors: | | | |
| a) Pre-tax profit on sale of additional real estate (note f) | 2,000,000 | 33% | 660,000 |
| Total - net benefit (without considering "multiplier effect') | | | $ 1,772,500 |
| | | Rounded to | $ 1,800,000 |

Exhibit I - continued

C. Other Beneficiaries

Among the other beneficiaries from this legislation would be the numerous housing suppliers such as appliance, carpet, door, window, and other manufacturers, as well as attorneys, title insurance and private mortgage insurance companies.

In addition to the benefits to the Treasury, State and local taxing authorities would also derive monetary benefit through real estate transfer taxes and corporate and individual income taxes.

Furthermore, workers in the industries listed in B above as well as those workers in the aforementioned industries who are currently unemployed, would now receive taxable wages while simultaneously relieving the Treasury of the financial burdens of unemployment compensation, food stamps, etc. Offsetting some of these benefits to the Treasury would be the additional interest expense incurred by purchasers of new homes that most likely would be deductible for tax purposes.

While it is extremely difficult to quantify with any degree of reasonable accuracy the multiplier effect of the benefits to the Treasury, it is rather obvious that such benefits would be significant.

D. Conclusion

The Treasury would receive a minimum net revenue gain of from $1,800,000 (rounded) for each $100 million of contributed mortgages without considering an obvious "multiplier effect" or, stated another way, at least 1.8% of the total amount of contributed mortgages.

E. Notes

a) Ordinary loss of $30,000,000 incurred by individual investors. Inasmuch as these individuals presumably would be in the highest marginal tax bracket (reduced in 1982 from 70% to 50% with respect to unearned income), it is highly likely that these individuals previously have participated in tax-sheltered or tax-exempt programs. To the extent that these individuals switch from investing in other tax-sheltered or exempt programs to the tax-sheltered programs encouraged by S.1828, there would be no gain or loss to the Treasury. For purposes of calculating the net effect to the Treasury in Exhibit I, it is conservatively projected that one out of three individual investors would be switching their investments out of taxable instruments into the tax-sheltered investments as envisioned by S.1828. As such, only $10,000,000 of the $30,000,000 would have an effect on the Treasury.

Exhibit I - continued

b) Taxable interest income realized by individual investors of new mortgage loans ($30,000,000 x 16½%). The $4,950,000 represents the annual taxable interest income on the individual investor's share.

c) Additional interest income realized by "A" Savings and Loan. The $2,550,000 represents the net additional taxable interest income on the savings and loan's share of new mortgage loans ($70,000,000 x 16½%) - ($100,000,000 x 9%).

d) Additional fee income realized by "A" Savings and Loan. The $2,000,000 represents the fee income on an additional $100,000,000 of mortgage loans granted - ($100,000,000 x 2%).

e) Pre-tax profit on sale of new homes realized by builder. It is assumed that $50,000,000 of the partnership's proceeds is funnelled into new housing starts creating $7,500,000 of pre-tax profits for the building industry, using an estimated pre-tax profit margin of 15%.

($100,000,000 x ½(new housing starts) x 15%)

f) Pre-tax profit on sale of additional real estate realized by realtor(s). The $2,000,000 represents the estimated pre-tax profit to realtor(s) resulting from the sale of $100,000,000 of real estate using an estimated pre-tax profit margin of 2%.