Federal Home Loan Bank Board

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not public info

The Honorable William Proxmire
Chairman
Senate Committee on Banking,
Housing and Urban Affairs
Dirksen Senate Office Building
Washington, D. C. 20510

Dear Senator Proxmire:

Having gotten back to Washington from Georgia where I spent Christmas and New Year's with my family, I note carefully your concern about recent newspaper reports of proposals made by me at the December 18th open meeting of the Board. After some 35 years of professional, government and business life of unquestioned integrity, it is disturbing to find my motives being doubted and the suggestion being made that I would unfairly aid a former business associate. I am anxious that you have the facts -- clearly and fairly stated. The sources quoted in the Wall Street Journal article of December 24, 1986 are most unfair and grossly misleading. The grandfathered direct investment problem involves billions of dollars and not one but hundreds of institutions. I trust that my letter may obviate your concerns about the particular proposal in question.

Prior to my appointment to the Board, I had interests in businesses that dealt with a number of thrift institutions, including Lincoln Savings of Irvine, California. I fully disclosed these relationships to the Office of Government Ethics and at great effort and expense put all of my business assets having any thrift connection into a "qualified blind trust." In short, I did all I could do to insure that I would be free to exercise independent judgement at the Board.

The question of direct investment has caused perhaps as much controversy as any issue before the Board in recent years. Feelings are high. States' rights are in question. Economists disagree on the worth of allowing direct investments in the industry.

An open meeting of the Board was held in December 18, 1986, at which I made certain proposals with respect to direct investments. I suggested the proposals as a balanced regulatory approach to apply generally to the industry with no thought of some calculated effort to single out some past business associate for favorable treatment.

I would like to examine my proposal to test it for balance and general application.

1. My proposal continued virtually all of the old direct investment rule and only changed three areas-- two more strict and one somewhat more lenient.

(a) Instantaneous reporting of all direct investments was required for closer monitoring of the area. PSAs were directed to give priority attention from this "early warning system" to watch for unsafe and unsound investments. As a part of my staff briefing, I was surprised to find that information concerning direct investment are contained only in quarterly reports that are often filed months after such investments are made.

(b) Capital requirements for a proposed direct investment would be made as of the previous quarter rather than at some later date.

(c) Institutions meeting the greater of fully phased-in capital requirements or 6% of liabilities were permitted to make direct investments as allowed by state or federal law, after reporting such to the PSA and after complying with all capital requirements in advance.

I might point out that an attorney with the Washington firm of Miller and Chevalier (who represent Lincoln and other S&L clients) argued for a threshold of 1% over minimum regulatory capital (3% plus 1%) which I rejected in favor of the more stringent 6% level. Other industry people had argued for differing thresholds of, for example, 4% to 6% capital measured by either GAAP or tangible net worth. I settled on the greater of fully phased in capital or 6% level as being reasonable, particularly when coupled with the new capital requirements effective January 1, 1987 requiring additional capital infusion of up to 16% of any proposed direct investment.

The Grandfathering Confusion. I proposed to clear up what I understood to be general confusion over certain grandfathering provisions of the old regulation having to do with what was a "definitive plan" to complete a project. The Board has never, to my knowledge, defined "definitive plan," even though the regulation has been effective for two years. My proposal would have allowed the "continuation and/or completion" of real estate projects that were started or planned prior to 12/10/84. It had nothing to do with

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the question of investments in service corporations or the new capital regulations. Under the proposal, an institution seeking to complete such a real estate project was prohibited, (whatever level of capital it had) from making any new direct investments without prior PSA approval. The proposal used the term "inadvertent" so as to not require relief in the case of trumped up "plans."

I made the proposal in good faith, believing it to be a general industry problem.

(1) Perhaps my first introduction to the problem came from Mr. Gary Driggs of Western Savings, a respected member of this industry, who spoke to me at the U.S. League meeting in Kansas City, Missouri on December 2, 1986. He advised that the Board should not abandon its direct investment rule but should continue a reasonable rule in the future. He further stated that parts of the grandfathering rule were confusing both to his institution and to others in the industry and that some solution should be found. He argued that where an institution had begun a shopping center or subdivision, it productively should be completed without a technical dispute over what was or was not a "definitive plan."

(2) I was under the general impression that the dollar volume of grandfathered direct investments was extremely large. There were Staff discussions of whether or not the Board could schedule public hearings (which Board Member White and I were calling for) in early January and let the current rule lapse, with whatever new rule that was agreed upon being effective as of the hearing date. We were told that this could cause serious new grandfathering problems which the Board should avoid. This again led me to believe the problem was general in nature and not isolated.

(3) I was extensively briefed by Staff and they indicted that there was a great deal of confusion in the industry over what were loans and what were direct investments. Obviously, if an ADC (acquisition, development, construction) loan was on the books of an institution before the grandfathering date (12/10/84), its reclassification as a direct investment would aggrevate the confusion and make the grandfather provisions more critical to the industry member.

(4) The proposal, informal in nature, was made at an open meeting in the presence of the Staff, the Board, the press and the public. Isn't it ludicrous to even suggest that a "favor for a friend" would be made in a setting of this type by a seasoned former Chief Counsel of the IRS, presumably highly sensitive to the need for "evenhandedness" in applying tax rules. The informal proposal was subject to being formally drafted by Staff at the Board prior to publication during which process its fairness of application would have been thoroughly reviewed.

(5) The Board in its notice of the public hearings in the Federal Register specifically called for comments on the question of grandfathering indicating that the matter was worth general discussion.

(6) When newspaper articles appeared suggesting that the proposal might help only a limited few institutions, I asked Staff to report to me the extent of the grandfathered direct investment problem to see if my mpression of a general industry problem was incorrect. Unfortunately, not all of the facts were reported to the press at the time the original articles were written, even though Board records were then available from which Staff has now reported the following general information:

(a) Over 1800 institutions reported actual or prospective grandfathered direct investments totaling approximately $40 billion at 6/30/85 and $34 billion at 6/30/86.

(b) At 6/30/85 some 648 institutions reported prospective grandfathered direct investments of about $12.9 billion out of $28.7 billion of total grandfathered direct investments.

(c) At 6/30/85 186 thrifts and at 6/30/86 108 thrifts reported prospective grandfathered direct investments of about $8.7 and $6.3 billion respectively above their "excess" threshold. Each of these would or will have to rely on grandfathering to complete such direct investments and, obviously, all could be affected by any grandfathering proposal.

(d) The Board has before it a proposal concerning the reclassification of certain so-called ADC loans as direct investments. Depending upon how the Board handles this question, the grandfathering problem could become acute for scores of additional institutions not now affected. An institution with a direct investment level of 2% below its net worth threshold would not concern itself with what may or may not be grandfathered. However, if certain of its loans are reclassified as direct investments so that their threshold is exceeded by 25%, the question of grandfathering becomes real.

How many more institutions could be affected? The Notice of Proposed Rulemaking on Direct Investments from the Board dated 9/11/86 (12 C.F.R. Section 563, No. 86-962) points out that in Texas, California and Florida alone, at 3/31/86, the average level of land and construction loans in institutions was about three times the average level of aggregate direct investments in such institutions. Suffice it to say that reclassification will make the grandfathering dispute even more widespread and more general.

In summary, my impression of a generalized problem from industry arguments and extensive staff briefing at the time I made the proposal is backed up by the facts. The matter will be further commented upon at the January 29 and 30 hearings. I will listen carefully. If confusion over the term "definitive plan" is widespread, the Board can discuss possible remedies. If not, I will propose to drop the suggestion.

Please be assured, Senator, that I will have no part in rule making for the benefit of a select group, but only where such is sound as having widespread application.

I am not philosophically committed to deregulation as a guiding principle. As you know, I previously served at the U.S. Treasury as ranking Assistant General Counsel and as Chief Counsel for the Internal Revenue Service where I supervised some 750 lawyers charged with drafting regulations both in the tax and Phase II wage and price control areas. In that position, I worked closely with former Secretaries George Shultz, William Simon and John Connally, as well as then General Counsel Sam Pierce, current Secretary of Housing and Urban Development. I am not afraid to regulate and deem myself to be a "sensible regulator." Our regulations must be as clear and free from confusion to the industry as possible. It was in this spirit that I suggested my approach.

I share your concern about any appearance of conflict of interest. I hope this letter helps to clear some of your concerns. I stand ready to meet with you if you so desire to discuss the matter further.

Sincerely yours,

Lee H. Henkel, Jr.
Board Member

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