

Even though the Federal Reserve System (FRS) was created by an act of Congress in 1913, it is owned by stockholders of its National Banks, which subscribe to the FRS. The Federal Reserve functions as the central bank for the U.S. with ownership in private, non-government hands, therefore, the Federal government of the U.S. does not own one share of its stock. The only involvement of the U.S. government is with the appointment by the President of the Federal Reserve Board and its Chairman, which must be confirmed by the U.S. Senate. As a result, the Federal Reserve has no legal authority outside of the U.S. and acts officially in the best interest of the U.S. financial community.

The above stated structure requires an explanation regarding authority relative to the Fed's influence beyond its borders. This international influence is exerted through the Bank for International Settlements (BIS). Basel Switzerland in which the Federal Reserve System is its largest shareholder along with the Bank of England, Bank of France, The Central Bank of Belgium, Central Bank of Germany, Central Bank of Japan, J.P. Morgan, The National Bank of New York, First National Bank of Chicago, the central banks of Sweden, Romania, Poland the Netherlands and Switzerland to name a few.

Approximately 16% of BIS is owned by private shareholders, with the BIS functioning as the central bank of all the world's central banks. As the largest shareholder in the central bank to the world's central banks, the Fed's influence is factually evident and offers an explanation of its involvement with private placement, off-ledger trading. As with the World Bank Organization and the International Monetary Fund, the Fed has no legal authority but exerts considerable influence.

The events leading to the creation of off ledger trading began in 1978 when the Federal Government was effectively bankrupt and subject to control by the New York banking community, in which it was indebted in excess of one-half trillion dollars. This debt required servicing at a cost of one billion dollars of additional borrowing each week to keep the government operational.

This in turn created the additional problem in that the banks were starting to run out of hard currency. It was concluded that the printing of additional money through the Federal Reserve would lead to runaway inflation in the U.S. with substantial effect on the world economy. The alternative solution -- to tap a new source of existing dollar currency savings on a large scale -- was available in the Middle East, as a result of the oil crisis of the 70's, which we all can substantiate as a factual occurrence. At that time the oil producing countries controlled US dollar notes in excess of one-

half trillion U.S. dollars. To put this into perspective, this almost represented an amount equal to the entire value of all shares issued by all corporations listed on the New York stock exchange at the end of 1978.

Adding to this dilemma was the fact that in early 1979, of the twenty largest banks in the world, only three were U.S. registered. Germany had six, Japan, five, France, four and Great Britain, two. The three U.S. banks were Citicorp, Bank of America and Chase Manhattan. Citicorp was one of the largest banks relative to world standing, and the largest player in the "Eurodollar" (jargon for U.S. dollar currency in circulation outside of the U.S.) interbank market. Factual data supports the statement that there was \$1.5 Trillion (\$1,500 billion) in Eurodollars in circulation outside U.S. borders during this time period.

As a result, it was further determined that a number of monetary mechanisms were necessary to attract investment and control of these dollars under contract, at free market rates above normal bank rates into the system. This in turn led to the development of both the "Shell Branch Bank" and the "Multinational Consortium Bank". A shell branch bank is not a physical bank, but a device used to get around U.S. Government regulations. Shell branches are actually run out of New York and London for the purpose of Eurodollar way stations. You may have wondered why Citibank

would have a branch office in the Bahamas, or why major banks around the world have opened branch offices in the Bahamas, Cayman Islands, Panama and other obscure islands where local populace deposits are not the main attraction.

Other dollars are controlled and brought under the U.S. roof by Multinational bank consortiums, such as the marriage of Manufacturers Hanover and N.M. Rothschild to form Manufacturers Hanover Ltd.

To attract and control Eurodollar currency, a facility was required to process off-balance-sheet underwriting commitments by banks, resulting in the creation of Note Issuance Facilities (NIF's) in 1984. Under this arrangement the banks simply act as a marketing agent for their own issue of Medium Term Notes (MTN's) which are mainly "Eurodollar" denominated, and constitute a legally binding commitment.

MTN instruments are issued in face values of 10, 25, 50 and 100 million USD in essentially three types of guarantee: as (1) ten year term with a coupon of seven and one half percent per annum, payable in arrears, (2) one year term with an eight percent annual coupon payable in arrears, and (3) zero-coupon one year instruments. The European banks that issue the MTN's guarantees are Pre-approved by the Federal Reserve and BIS and are rotated into and out of the system as the market dictates. The instruments

are brought into existence as "fresh cut", which indicates that the instruments do not yet have an I.S.I.N or CUSIP number and are therefore not screenable.

These instruments are commonly referred to and defined as "collateral" in the vernacular. The only authorized buyers for fresh cut paper are persons entitled "Master Commitment Holders", who are granted this authority by the Federal Reserve on an annual basis. The granting and or renewal of Master commitments are based on acceptable performance, subject to fulfillment of an annual quota by the Master Commitment Holder.

As of 1995 there were ten Master Commitments issued in the United States under control of three entities. There were ten Master Commitments issued in Great Britain in that same year. Master Commitment Holders have the right and authority to appoint "Collateral Commitment Holders" who have an exclusive right to purchase the instruments from the MCH at favorable discounted prices.

Below this level are entities who are granted "Fed Numbers" (commonly referred to as a license) which provide them with priority rights of purchase, as issued by the Collateral Commitment Holder. The Collateral Commitment or Fed number holders may sell the instruments onward as live (seasoned) instruments. Once sold, the MTN instrument is assigned an I.S.I.N. or CUSIP

identification number, making the instrument suitable for screening on either Bloomberg or Reuters. These instruments have an active secondary market which is dominated by institutional buyers who wish to buy and hold the instruments until maturity, while collecting their annual coupon interest.

With respect to the private investor market, all participants in private placement investment programs CANNOT trade for profit only. A substantial percentage of the earnings derived from trading must be applied to project financing under this scenario. All elements of these transactions are accomplished by arm's length transaction and not directly involving the Federal Reserve, which prefers to remain as an advisor. Additionally, the minimum entry for private placement begins at \$100MM dollars, with all other amounts beginning at \$10MM placed under syndication to make up the \$100MM minimum.

A \$100MM deposit supported by humanitarian project funding will gross 40.5% per day and net 30.0% per day to the account after invoicing and clearing. If this is allowed to ramp up each day (no draw down of profit) the compounding effect over a 10 day contract would yield a net of \$6,364,676,332, with a transaction fee cost of \$2,121,559,777.

In reality, the Fed limits or caps the amount of profit allowed to be earned by the investor on any one occurrence, subject to a number

of factors. The above limit may be allowed in the case of project funding for a government's hydro-electric dam costing 4.0 billion dollars along with a water filtration system, hospitals, etc. You should also note that the Fed requires an accounting of those project funds such that they are released only against certified invoice by the accounting entity. The approval for a private investor to receive those level of funds as profit would never be granted.

The need for private capital investment is justified on the basis that under BIS regulation, banks cannot sell their authorized issues to each other. Certain institutional investors such as U.S. pension funds are prohibited under ERISA from purchasing other than live MTN's or registered securities which are screenable.

A fresh cut note can only become live, or seasoned, after its title changes and it is registered. The only catalyst available to trigger the purchase of fresh-cut collateral is private investor funds in which the sale of fresh cut collateral at 58% of face is electronically invoiced and resold as live notes at 98.5% of face, and as a function of title change.

Considering the 10MM investor whose funds are placed under a syndicated contract, if 9 other investors make up the 100MM minimum, the 30% net earnings per day would allocate a percentage for project funding and a percentage share to each

investor. This would depend on the projects being funded under the program. Assuming a 50% allocation for the project, each investor would be pro-rated and may receive an average yield of from 0.74% to 1.66% per day as a simplified example. This yield may be stated as a minimum but is usually based on a best efforts basis. The investor is rewarded handsomely for participation, with the majority of profits going to non-recourse project funding.

These notes have a way to go before they reach your substantial purchases, for the following reasons. (1) They are issued by approved banks under a master commitment (written document) and can only be purchased by one entity entitled a Master Commitment Holder. (2) They can only be purchased for cash currency in US bank notes and (3) they must be purchased on a funds first basis.

This may seem selective and unfair, but the designers of this system have installed these policies to insure the integrity of the instruments and for compliance with a multitude of regulation. Banks and institutional buyers (sovereigns, trusts, pension funds, insurance groups, mutuals) are prohibited from purchasing this collateral, as they are prohibited from investing in unrated securities and/or from purchasing securities on a "funds first" contract. This requires that the collateral be converted into live or seasoned stature such that it becomes a registered (ISIN or

CUSIP), and therefore screenable, security.

As the MCH is the only authorized buyer for this classification of paper, and he must arrange advance payment in cash on a funds first basis, you may ask yourself what method the MCH uses to accumulate such a large number of dollars.

Pay attention here, as this is where your declined offer of \$10 MM comes in. Through your access to proper channels, your \$10MM, being of commercial and non-criminal origin, would be syndicated into a pool of other deposits for a minimum total of \$100MM. These funds would be protected for all investors under a non-depleting trust account, with buy/sell parameters in accordance with SEC regulation and conducted within full view and involvement of the U.S. Banking system, co-incidentally in New York City, if desired.

The MCH authority requires that he fulfill an annual quota. His quota requires the influx of many billions of dollar to make those purchases on a funds first basis. Private placement capital from private investors makes up a large part of these initial purchase funds in which the spoils are shared with the investor, and as a giveaway to charitable and humanitarian projects. With large private placement sums, the investor will eventually be required to donate up to 85% of his yield for this cause as a result of the extraordinary returns.

Returning to the paper trail, the original issue at 51% of face is sold to the MCH under the commitment at a price of 58% reflecting the issuing banks maximum issue profit of 7%. The MCH can resell these notes to a collateral commitment holder or Federal Number holder at a higher price, where they instantly become seasoned by title change and therefore qualify for registration and rating as A or better MTN instruments, depending on the nominated issuing bank. These notes are also sold into the secondary market to institutional buyers, who redeem the annual interest coupons and may hold to maturity.

Alternatively, the MCH can resale the notes by invoicing techniques such that the fresh-cut collateral instrument is deposited into the investor's account at 58% resulting in title change, registration and rating and resold as AA seasoned paper in the afternoon at 98.5%.

The reason an issuing bank will participate in the issue of its paper at such a deep discount, is due to the fact that this is how an issuing bank gets its paper into the market. I believe I have already adequately explained the process of this cycle above.

A primary motivation, as with all banks, is the very lucrative profit they make as a result of the sale. In simplified terms and equation, the bank is issuing a debit instrument that is legally allowed to be excluded from the debit side of their ledger or "off-balance sheet".

The sale proceeds on a \$10B issue would net the issuing bank \$5.8B in today's (1999) dollars, versus payment of the \$10B face value being made in year 2009 dollars which will not be considered here. The issuing bank will have to pay out an additional 7.5% per annum or 75% of face over the ten year term to maturity. The bank's simplified liability computes as \$10B plus \$7.5B or \$17.5B less \$5.8B for a resultant liability of \$11.7B.

As not many banks would participate in a transaction of this nature, it would be logical to assume that the issuing banks have a method whereby the resultant liability is not only recaptured, but earns a gross profit. The secret to this method of recapture is based on leverage of capital reserves. In simple terms, the bank deposits the net invoice proceeds of \$5.8B into the bank's asset or credit side of its ledger, without any offsetting debit. As banks have the ability to borrow funds on a leveraged ratio against their capital reserves (deposits) of from 8 to 22 dollars for each dollar on deposit, our US issuing bank can go into the overnight short term or long term market and borrow (ratio of 10) approximately \$58B against its increased capital reserve, again in today's (1999) dollars.

From this point onward, considering the average per annum yield curve earned by banks over only the past five years, it should not be difficult for you to determine how the issuing banks recapture their original net liability of \$11.7B. Using a spread of only three

percent net per annum over and above the cost of funds, the bank will gross 30% (simplified) on \$58B or \$17.4B for the issue period, thereby offsetting their original net liability of \$11.7B in excess of \$5.7B as profit.

This should satisfy the question regarding who makes up the spread, with the answer being the issuing bank itself.