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AUTH. NAME AUTHOR AFFILIATION
TOY, T. M. Mudge, Rose, Guthrie, Alexander & Ferden
TOY, T. M. Arizona Nuclear Power Project (formerly Arizona Public Serv
RECIP. NAME RECIPIENT AFFILIATION
Division of Pressurized Water Reactor Licensing - B (post 8

SUBJECT: Forwards seven vols of transaction documents re 860818 closing of sale & leaseback transaction w/five equity investors & 861106 issuance of lease obligation bonds. Index encl w/each vol.

S6B financial info

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(1) 42. 61. 57. 71

December 5, 1986

Director of Nuclear Reactor Regulation
Attention: Frank J. Miraglia, Director
Division of Pressurized Water Reactor
Licensing-B
Nuclear Regulatory Commission
Washington, D.C. 20555

Re: Supplemental Application in Respect of Sale and Leaseback Transactions by Arizona Public Service Company Dated October 15, 1986 -- Palo Verde Nuclear Verde Nuclear Generating Station Unit 2

(Docket No. STN 50-529)

Dear Mr. Miraglia:

As undertaken in the above-captioned Supplemental Application (the Supplemental Application), the undersigned, on behalf of Arizona Public Service Company (APS), provides the following information:

(i) Closing Date: APS proposes to consummate up to 5 sale and leaseback transactions on or after December 15, 1986 with respect to up to 100% of the Remaining Interest (as defined in the Supplemental Application). The proposed closing date is at least seven (7) days following December 5, 1986, the date specified for the expiration of the com-

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ment period in the Federal Register notice (51 F.R. 40275, November 5, 1986) relating to the Supplemental Application.

(ii) **Identity of Equity Investors:** The proposed Equity Investors are (1) The Chase Manhattan Corporation (Chase) or an affiliate thereof, (2) Drexel Burnham Lambert Group, Inc. (Drexel) or an affiliate thereof, (3) Ford Motor Credit Company (Ford) or an affiliate thereof, (4) Irving Bank Corporation (Irving) or an affiliate thereof and (5) Federal National Mortgage Association (Fannie Mae) or an affiliate thereof. An affiliate of Chase and an affiliate of Drexel are two of the equity investors which have consummated sale and leaseback transactions with Public Service Company of New Mexico (PNM). An affiliate of Drexel has also consummated a sale and leaseback transaction with El Paso Electric Company (El Paso). The then currently available interim and annual financial statements for Chase and annual financial statement for Drexel were forwarded to the Commission under cover of letters from the undersigned dated June 10, July 29 and November 26, 1986, respectively. Such financial statements are incorporated herein by reference.

(iii) **Equity Investment:** Chase, or an affiliate, may provide an equity investment of up to $40,000,000 (not less than 20% of the equipment cost relating to a 4.53% undivided interest in Unit 2 and a 1.51% undivided interest in certain related common facilities). Drexel, or an affiliate, may provide an equity investment of not less than $40,000,000 (not less than 20% of the equipment cost relating to a 4.53% undivided interest in Unit 2 and a 1.51% undivided interest in certain related common facilities. Ford, or an affiliate, may provide an equity investment of not less than $40,000,000 (not less than 20% of the equipment cost

relating to a 4.53% undivided interest in Unit 2 and a 1.51% undivided interest in certain related common facilities). Irving, or an affiliate thereof, may provide an equity investment of not less than $40,000,000 (not less than 20% of the equipment cost relating to a 4.53% to undivided interest in Unit 2 and a 1.51% undivided undivided interest in certain related common facilities). Fannie Mae, or an affiliate thereof, may provide an equity investment of not less than $100,000,000 (not less than 20% of the equipment cost relating to a 13.8% interest in Unit 2 and a 4.6% interest in certain related common facilities). The foregoing dollar amounts and percentages are approximate and will be adjusted downward prior to actual consummation of the proposed transaction to reflect (i) one or more of the prospective Equity Investors either withdrawing or participating at a reduced level of equity investment and/or (ii) the fact that the Remaining Interest aggregates only $891,500,000 of equipment cost (20.17%) of Unit 2 and 6.72% of related common facilities).

(iv) **Debt Matters:** The debt portions (approximating 75% to 80% of the balance of the $891,500,000 equipment cost relating to such undivided interests) are expected to be funded with up to $713,000,000 of interim bank financing expected to be refunded through the issuance by PVNGS Funding Corp., Inc. (**Funding Corporation**), of its Secured Lease Obligation Bonds in one or more series. Enclosed herewith is the APS Prospectus dated November 6, 1986 relating to $273,000,000 of Secured Lease Obligation Bonds, Series 1986, the proceeds of which were used to refinance the interim bank financing with respect to the August 18, 1986 APS sale and leaseback transactions. The debt portion of one or more of the sale and leaseback transactions described in this letter may

be financed through the issuance by an entity other than Funding Corporation (either another funding corporation or directly by the Owner Trustee/Lessor) of Lease Obligation Bonds or non-recourse promissory notes, as the case may be. If the latter option is chosen, the debt instruments would differ from Secured Lease Obligation Bonds most significantly in the absence of a security interest in the undivided interest sold in the sale and leaseback transactions.

(v) Supporting Information: Pursuant to APS's undertakings under the caption "Supporting Information" in the Supplemental Application, enclosed herewith for APS is a Quarterly Report on Securities and Exchange Commission Form 10-Q for the quarter ended September 30, 1986. This report includes financial statements. The Quarterly Report on Form 10-Q for Bank of Boston Corporation (parent of The First National Bank of Boston, the Owner Trustee) was provided by the undersigned under cover of letters dated November 26, 1986 (relating to further sale and leaseback transactions by PNM and El Paso). Such Report is incorporated herein by reference. Enclosed also are (i) the Annual Report on Form 10-K for the year ended December 31, 1985 and the Quarterly Report on Form 10-Q for the quarter most recently ended for each of Ford and Irving and (ii) Fannie Mae's 1985 Annual Report.

APS respectfully requests that a further amendment to Facility Operating License NPF-51 be issued as requested in the Supplemental Application on or prior to December 15, 1986.

If I can be of further assistance, please do not hesitate to call at (212) 510-7750.

Sincerely,

Timothy Michael Toy

Timothy Michael Toy

Copies with enclosures to:

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411 North Central Avenue
Phoenix, Arizona 85072

ARIZONA PUBLIC SERVICE COMPANY

Sale and Leaseback Transactions

with respect to

Palo Verde Nuclear Generating Station Unit 2

(Docket No. STN-529)

Supplemental Financial Information

with respect to

Prospective Equity Investors and

Arizona Public Service Company

December 5, 1986

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1985 Annual Report

Irving Bank Corporation

Irving Bank Corporation

Irving Bank Corporation is a bank holding company with total assets of $21.7 billion. It is the 20th largest bank holding company in the United States, based on total assets at the end of 1985. The Corporation serves domestic and foreign businesses, correspondent banks, governments, official institutions and individuals through the following business segments:

- General Banking–Domestic
- Community Banking
- General Banking–International
- Investment Activities
- Fiduciary Services
- Service Products

Irving Trust is a major money center bank with large domestic and international operations. It is the Corporation's principal subsidiary, accounting for 86% of its total assets, and has 12 banking offices in New York City; 21 foreign branches and representative offices; investments in overseas affiliates; and Edge Act subsidiaries. Irving Trust also conducts factoring, accounts receivable management, commercial finance, equity financing and leasing activities. Irving Business Centers market the services of Irving Trust through offices in Atlanta, Chicago, Cincinnati, Dallas, Los Angeles, Miami and Minneapolis. Irving Bank Corporation's 13 community banking affiliates are located throughout New York State and provide a full range of commercial banking services at their 126 banking offices. The Corporation employs 9,700 people worldwide.

Cover

Irving Bank Corporation provides a window on Wall Street for our customers around the world.

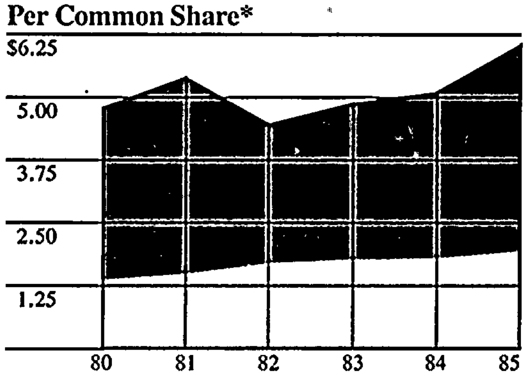
Contents

Financial Highlights

Irving Bank Corporation

For the Year	1985	1984	Percent Change
Net Interest Income	$511,972,000	$489,024,000	4.7%
Net Income	115,979,000	98,112,000	18.2
Dividends Declared on Common Stock	34,658,000	32,281,000	7.4
Per Common Share			
Net Income	$ 6.14	$ 5.11	20.2%
Dividends	1.96	1.84	6.5
Book Value at Year-End	49.56	45.56	8.8
Common Stock Price Range	44⅛-31⅝	34¼-23⅛	
Financial Ratios			
Rate of Return:			
On Average Interest-Earning Assets	0.66%	0.58%	
On Average Total Assets	0.55	0.48	
On Average Common Shareholders' Equity	12.96	11.66	
On Average Total Shareholders' Equity	12.64	11.55	
As a Percentage of Total Assets at Year-End:			
Primary Capital	6.4	5.9	
Total Capital	8.0	7.5	
At Year-End			
Total Assets	$21,650,661,000	$18,982,403,000	14.1%
Total Deposits	14,026,275,000	13,446,875,000	4.3
Total Loans	12,744,500,000	11,202,236,000	13.8
Total Investment Securities	1,432,079,000	1,195,330,000	19.8
Common Shareholders' Equity	880,369,000	802,825,000	9.7
Total Shareholders' Equity	955,926,000	878,429,000	8.8
Primary Capital	1,387,027,000	1,124,123,000	23.4
Total Capital	1,745,522,000	1,444,741,000	20.8
Common Shares Outstanding	17,763,978	17,620,851	
Common Shareholders of Record	25,825	27,488	
Full-Time Employees	9,700	9,500	
Worldwide Offices	202	188	

Net Income and Dividends Per Common Share*

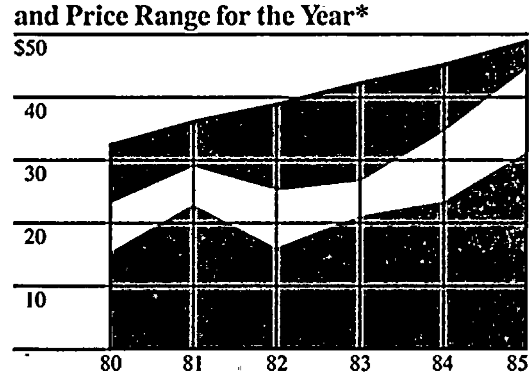


Net Income Per Common Share

Dividends Per Common Share

**Reflects a two-for-one split of the Corporation's common stock during 1984.*

Common Stock: Book Value at Year-End and Price Range for the Year*



Book Value of Common Stock at Year-End

Common Stock Price Range for the Year

**Reflects a two-for-one split of the Corporation's common stock during 1984.*

To Our Shareholders

Irving Bank Corporation made excellent progress in 1985 and achieved record levels of net income and earnings per share. Net income for the year improved by 18.2% to $116.0 million, and earnings per common share grew 20.2% to $6.14.

Our 1985 earnings performance was attributable in large part to continued improvement in three key indicators: net interest margin, noninterest income and expense control. Net interest income, on a fully taxable basis, increased 6.0% to $559.4 million, with the net interest rate spread increasing from 3.12% in 1984 to 3.16% in 1985. Noninterest income grew by 33.4% to $272.2 million, largely due to superior performance in fiduciary services and foreign exchange trading. Operating expenses increased by 8.0%, among the lowest rates of increase for any New York money center bank.

Joseph A. Rice,
Chairman

During 1985, we continued to pursue a strategy designed to improve returns on assets and equity: identifying selected businesses for growth based on their potential contribution to a higher return on assets; expanding those businesses; and reducing our lower-yielding assets. Specific actions to execute this strategy included the following:

- We extended our trading business into the mortgage-backed securities market; acquired the assets of an odd-lot U.S. Government securities dealer; acquired a 50% ownership interest in Trans City Holdings Limited, an Australian investment bank located in Sydney; and announced our intention to acquire Smith St. Aubyn & Co. Limited, a London securities dealer.
- We extended our community banking business into the New Jersey market through establishment of our Irving Financial Center in Morristown. We expect to open additional Financial Centers in other selected Northeastern cities during 1986.
- We opened Irving Trust Company Florida, located in Miami, in order to extend our private banking services into the Florida market.
- We reduced low-yielding interbank placements by $636 million.

During 1985, we also continued to maintain a strong balance sheet. Our net loan charge-offs were 0.33% of average loans, among the lowest of New York money center banks. In addition, we increased capital, largely

through the sale of $200 million of Floating Rate Subordinated Capital Notes, due 1997. At year-end, our primary capital was 6.4% of total assets, and total capital was 8.0% of total assets.

On February 18, 1986, the Board of Directors increased the quarterly Common Stock dividend to shareholders by 6.1% to 52¢ per share. This marks the 10th consecutive year of increases. Annualized dividends are now $2.08 per share, up from $1.96 per share in 1985.

Other Developments

Interstate Banking–During 1985, the most significant banking development was the U.S. Supreme Court decision upholding the constitutionality of regional interstate banking laws adopted by certain states. In the short term, this decision has enabled regional banks to grow by mergers and acquisitions behind protective barriers erected primarily against New York banks. In the longer term, these barriers will disappear, and we are confident Irving Bank Corporation will have ample opportunity to extend its statewide community banking network into selected markets in the Northeast, which we regard as an attractive and logical region for our future growth.

International Debt–During 1985, U.S. Treasury Secretary Baker outlined a new initiative for improving growth in the major debtor nations through local actions to stimulate investment, free markets and private enterprise, supported by additional lending from both multinational development agencies and the international banking community. While details of the Baker initiative need to be more fully developed, it is a welcome assumption by the U.S. Government of a more active role in achieving a long-term solution. And it is further recognition that the U.S. and other Western nations have a strong stake in the continued economic growth and political stability of the major debtor nations. As an international lender, we have always worked with our foreign customers in good times and bad, and we are confident that there will continue to be progress in resolving these difficult problems.

Tax Reform–During 1985, the Administration and Congress undertook a major overhaul of the tax laws. We have serious problems with this effort in several areas, including the threat to continued deductibility by our employees of their state and local taxes, the threat to continued existence of "401-K" plans, which have provided an effective incentive for our employees to save for their retirement, and the punitive approach taken toward the deductibility of loan loss reserves of large banks.

The treatment of loan loss reserves in the House-passed bill poses a particular problem. By not only eliminating current incentives for building loan loss reserves, but also requiring that banks pay over a major portion

of their reserves lawfully accumulated in prior years, the bill would have a negative impact on bank earnings, reserves and capital, thereby undermining other policies of the Administration calling for higher capital ratios and increased lending to debtor nations.

Directors

Irving Bank Corporation is fortunate to have an unusually capable and dedicated Board of Directors. During the year, Marvin A. Asnes, Harrington Drake and Robert Hellendale stepped down as Directors. These men deserve our thanks for their valuable service to the Corporation. We are pleased to have Messrs. Drake's and Hellendale's continuing wise counsel as Advisory Directors.

Left to right
Samuel F. Chevalier,
President–Irving Bank Corporation, Vice Chairman–Irving Trust Company
David M. Mace,
President–Irving Trust Company
Peter C. Palmieri,
Executive Vice President–Irving Bank Corporation, Vice Chairman–Irving Trust Company

We are also pleased to welcome as Board members William R. Laidig, G.G. Michelson and John M. Pietruski, Jr. Mr. Laidig is Chairman and Chief Executive Officer of Great Northern Nekoosa Corporation, Mrs. Michelson is Senior Vice President—External Affairs of R.H. Macy & Co., Inc. and Mr. Pietruski is Chairman and Chief Executive Officer of Sterling Drug Inc.

The Directors of our community banking affiliates deserve special recognition for their able and valuable assistance. These men and women provide insight into local markets and enable our community banks to serve their customers more effectively.

Our People

We are proud of the efforts of our employees around the world who made 1985 a record year. Achieving higher returns will require even greater skill and dedication from our employees in the future. Recognizing the essential contribution of our employees, we adopted an Employee Stock Purchase Plan in 1985 to encourage employee stock ownership and give more employees a personal stake in the success of the Corporation.

In the review that follows, we present a report on our major business segments.

Joseph A. Rice
Chairman

Samuel F. Chevalier
President

February 18, 1986

Business Segment Report

The discussion in this year's Annual Report is divided into the following business segments.

General Banking-Domestic

Community Banking

General Banking-International

Investment Activities

Fiduciary Services

Service Products

General Banking-Domestic

Irving Trust provides specialized credit and noncredit services to customers in carefully selected industries. At year-end 1985, loans in this business segment totaled $4.8 billion and represented approximately 38% of our total loan portfolio.

Middle Market–Like many financial institutions, we are placing increasing emphasis on serving companies with sales of $5 million to $100 million. Through Irving Trust, smaller business borrowers can gain efficient access to a full range of credit, investment banking, securities, information and other products designed to meet their needs. Irving Trust's advantage is that it is large enough to provide international money center services, yet small enough to ensure that our customers receive professional and personal attention.

In 1985, we established an Irving Business Center office in Miami, Florida, to extend our services to this market. This office complements our existing national network of Business Centers in Atlanta, Chicago, Cincinnati, Dallas, Los Angeles and Minneapolis. Last year, loans originated from these offices increased by over 50%.

Asset-Based Financial Services–Through Irving Commercial Corp. (ICC), we provide a full range of factoring, accounts receivable management and commercial finance services. ICC is fifth among U.S. factoring companies in volume of factored receivables. Irving Leasing Corporation offers leveraged leasing arrangements, including syndication and private placement, and other types of specialized financing on a wide range of fixed assets.

Financial Institutions Banking–Irving Trust is a leading provider of credit, securities clearing and custody services to major brokers and dealers. This business, which capitalizes on the Bank's strong automated data processing capacity, has grown consistently and profitably, reflecting the rapid growth of securities markets in recent years. We are currently expanding our business with major thrift institutions, insurance companies and finance companies. Our securities products for these customers are designed to guarantee the most efficient execution of securities transactions, combined with availability of funds and lower funding costs.

Multinational Corporations–Our ability to serve multinational corporations increasingly depends on our ability to sell technologically advanced products such as our microcomputer-based package of cash management, treasury and letter of credit services plus other fee-generating services,

The Irving Business Center in Minneapolis coordinates the delivery of a range of banking services to Datacard Corporation, a manufacturer of credit card embossing and encoding machinery. Through Irving Trust, we provide short- and medium-term financing, cash management, foreign exchange trading, short-term money management and financial advisory services. In addition, Irving Bank Canada provides credit services to Datacard's Toronto subsidiary.

General Banking-Domestic *(continued)*

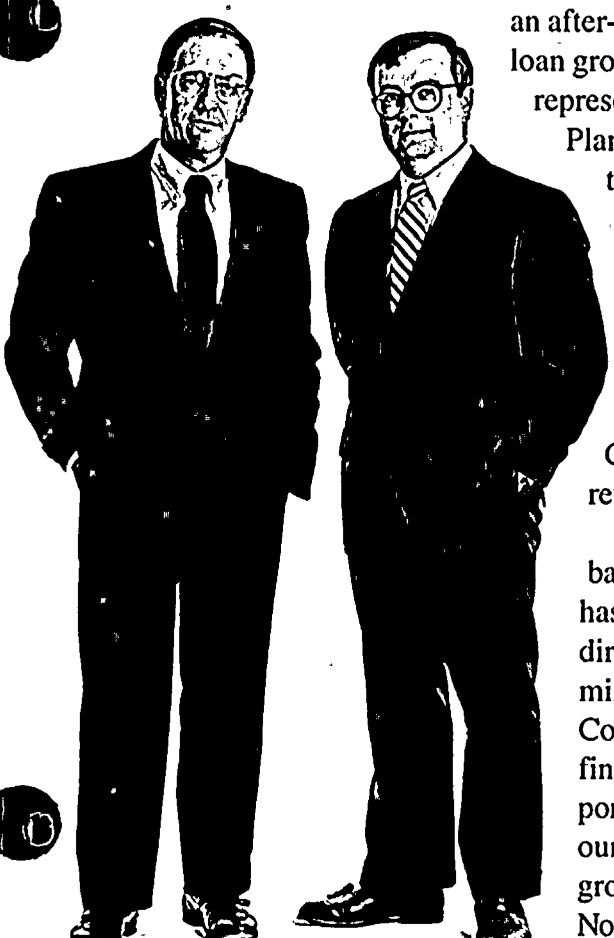
including trade finance, commercial paper issuance, securities and foreign exchange trading services and interest rate and currency swaps.

Industry Specialization–Irving Trust pioneered the concept of industry specialization with our early focus on the public utilities industry in the 1930's. As a result of the success of this approach, we developed additional specialization in the commodities, energy and minerals, real estate, transportation and securities industries. This industry specialization has allowed us to provide more responsive service to our customers, including customized financing techniques and operating services. As businesses become more complex, industry specialization will be an increasingly important means of identifying opportunity and limiting risk.

Community Banking

The Corporation's community banking business is conducted through 13 community bank subsidiaries and Irving Trust's Community Banking Division. We now have 138 banking offices in New York State, 12 of which are located in Manhattan. Through these offices, and through a shared electronic banking system with approximately 1,400 terminals in New York State, we provide commercial, consumer and residential mortgage credit, deposit, brokerage, insurance and other services primarily to individuals and small to medium-size businesses.

Charles R. Schmidt, Executive Vice President, Finance and Administration, of Datacard Corporation, left, and Russell A. Burr, Vice President and Center Manager of the Irving Business Center in Minneapolis.



Since 1981, the community banking network has consistently earned an after-tax return on assets of 1% or higher and has shown excellent loan growth. At year-end 1985, loans totaled $2.6 billion, which represented 20% of our total loan portfolio. Insured Money Market Plan accounts, which have proved to be very popular with customers since their introduction in 1982, continued to represent an important source of deposits and at year-end amounted to $980 million, or 29% of our total community banking deposits. Average net noninterest-bearing demand deposits, another important source of funds, grew by 9% in 1985 to $600 million. In 1986, we plan to expand substantially our real estate mortgage lending, especially in the New York City metropolitan area, as part of our strategy to improve our return on assets.

We attribute much of our continuing success in community banking to our management philosophy. Each community bank has retained its local identity, operates with its own board of directors and management, and bears the responsibility for determining its own strategy for serving the local market. Irving Bank Corporation provides system-wide management direction, legal, financial, marketing, product development and operational support. Community banking is an increasingly important part of our business, and we will continue to expand through internal growth and acquisitions in New York State and other states in the Northeast, as laws and regulations permit.

The Bank of Babylon provides Apoca Industries with both short- and long-term financing for the manufacture and sale of electronic equipment used by the aerospace and defense industries. Our 13 community banking affiliates provide credit, deposit, discount brokerage, insurance and other services to individuals and small to medium-size businesses through 126 offices in New York State.

General Banking–International

International correspondent banking has long been a recognized strength of Irving Bank Corporation. We conduct business in 120 countries and have active account relationships with over 2,200 foreign commercial and central banks as well as with foreign-owned corporations and local subsidiaries of U.S. multinational corporations. We operate this business from our main office in New York City and through branch offices, subsidiaries and affiliates, where we conduct business in both local currency and U.S. dollars, and representative offices that are responsible for marketing Irving Trust's financial services. In 1985, we extended this network by opening a branch office in Osaka, Japan and a representative office in Istanbul, Turkey, acquiring a 40% interest in Tütünbank, a commercial bank located in Izmir, Turkey, and increasing our ownership of Banco Irving Austral in Buenos Aires, Argentina, to 100%.

At the end of 1985, international loans totaled $5.5 billion, representing approximately 42% of the Corporation's total. Loans to the public sector (governments and official institutions), banks and other financial institutions amounted to approximately 63% of the international total.

The Bank's international business has been an important source of non-interest-bearing deposits, which represent compensation for our funds transfer and other services.

C. R. Merolla, President of Bank of Babylon, left, and Santos Abrilz, President of Apoca Industries.

During 1985, we undertook a major effort to increase our business in the insurance company segment of the international market. In all major countries the insurance industry plays an important financial role. Payment flows among international insurers are very large. We have developed a series of technologically advanced, microcomputer-based products designed to improve international insurance companies' cash management techniques by speeding these payments. In addition, we offer the international insurance industry U.S. Government securities trading, securities lending and other fiduciary services.

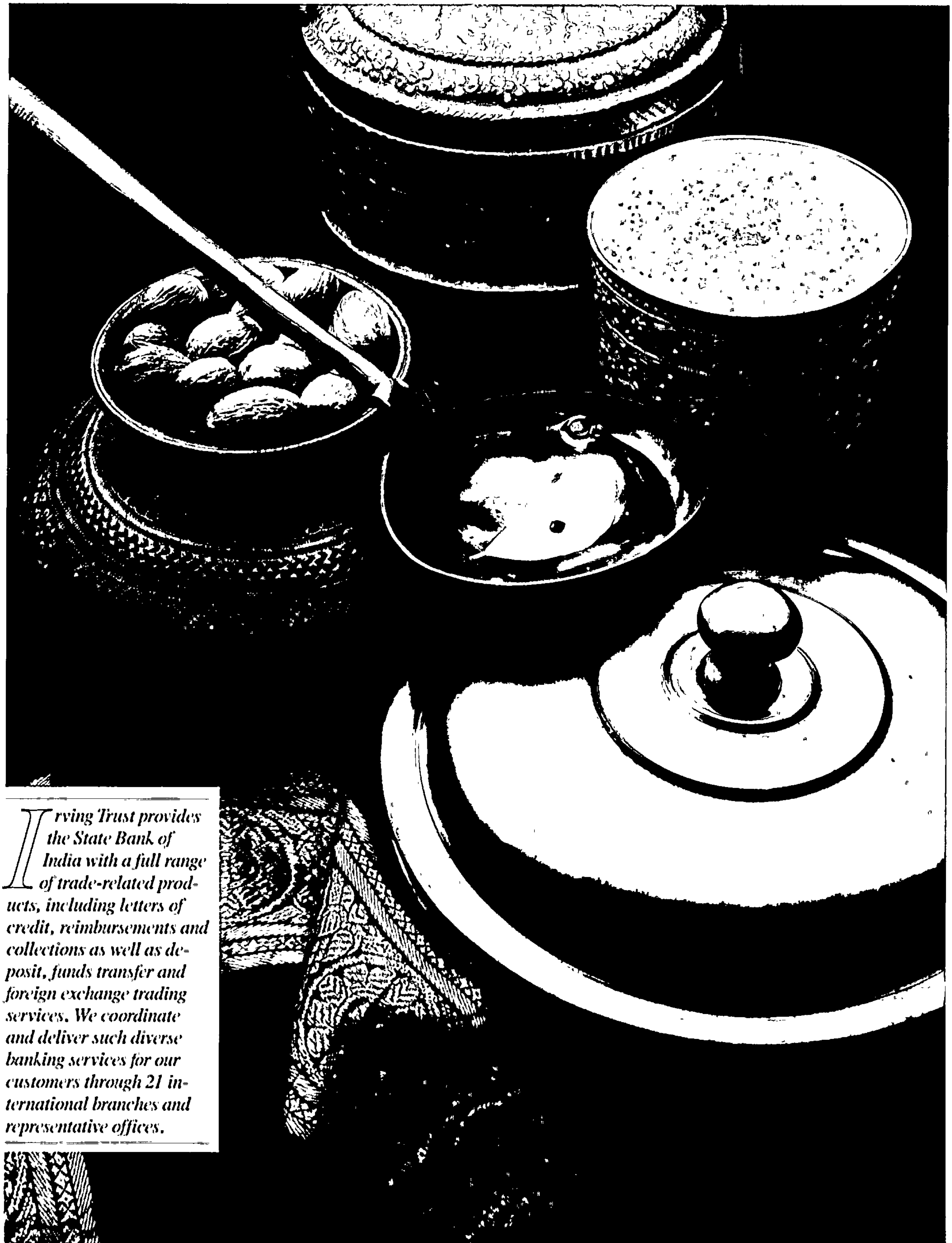
Investment Activities

Irving Trust's Investment Activities area funds our worldwide operations on a daily basis, manages the investment portfolio and engages in trading and investment banking.

Trading

Revenue from trading securities and foreign exchange has become more important to Irving Trust in relation to total net revenue, reflecting improved organization and personnel, significant investment in hardware and software, and better trading markets.

Growth trends and opportunities in trading businesses and disintermediation of traditional bank lending require that trading businesses become an even more important source of earnings for Irving Trust in the future. We are taking steps in 1986 to extend



Irving Trust provides the State Bank of India with a full range of trade-related products, including letters of credit, reimbursements and collections as well as deposit, funds transfer and foreign exchange trading services. We coordinate and deliver such diverse banking services for our customers through 21 international branches and representative offices.

Investment Activities *(continued)*

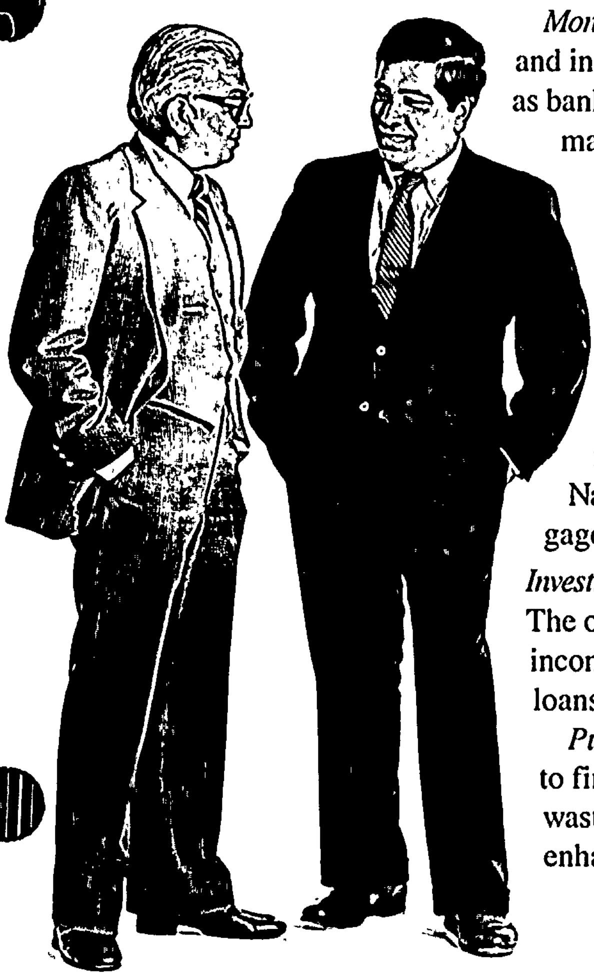
our securities trading business in selected international trading centers through acquisition of local securities firms.

Foreign Exchange–Irving Trust is a market maker in foreign exchange on behalf of customers worldwide, with active dealing facilities in New York, London, Frankfurt, Milan, Hong Kong, Tokyo and Singapore. In a recent survey of the most active foreign exchange customers, Irving Trust was again ranked among the top 20 foreign exchange dealers in the world.

U.S. Governments–We are also a primary dealer in U.S. Government securities through our 1984 acquisition of Briggs Schaedle, one of the 36 primary dealers recognized by the Federal Reserve. Briggs Schaedle is now part of Irving Securities, Inc. (ISI), formed in 1985 as a subsidiary of Irving Trust. Also in 1985, we acquired the assets of an odd-lot U.S. Government securities dealer, Kenney & Branisel. Our odd-lot business is now ISI's Retail Division.

Municipals–Our municipal bond underwriting and trading activity generates earnings by purchasing from issuers or from the secondary market tax-exempt securities for resale to individuals, other financial institutions and corporations. While we frequently participate in major underwriting syndicates, our principal strategy has been to carve out a profitable niche for ourselves in the underwriting and distribution of securities of small to medium-size municipal governments and their agencies in the New York, New Jersey and Connecticut area.

Bharatendu Gupta, Chief Manager of State Bank of India, left, and Rakesh Surie, Irving Trust's representative in Bombay.



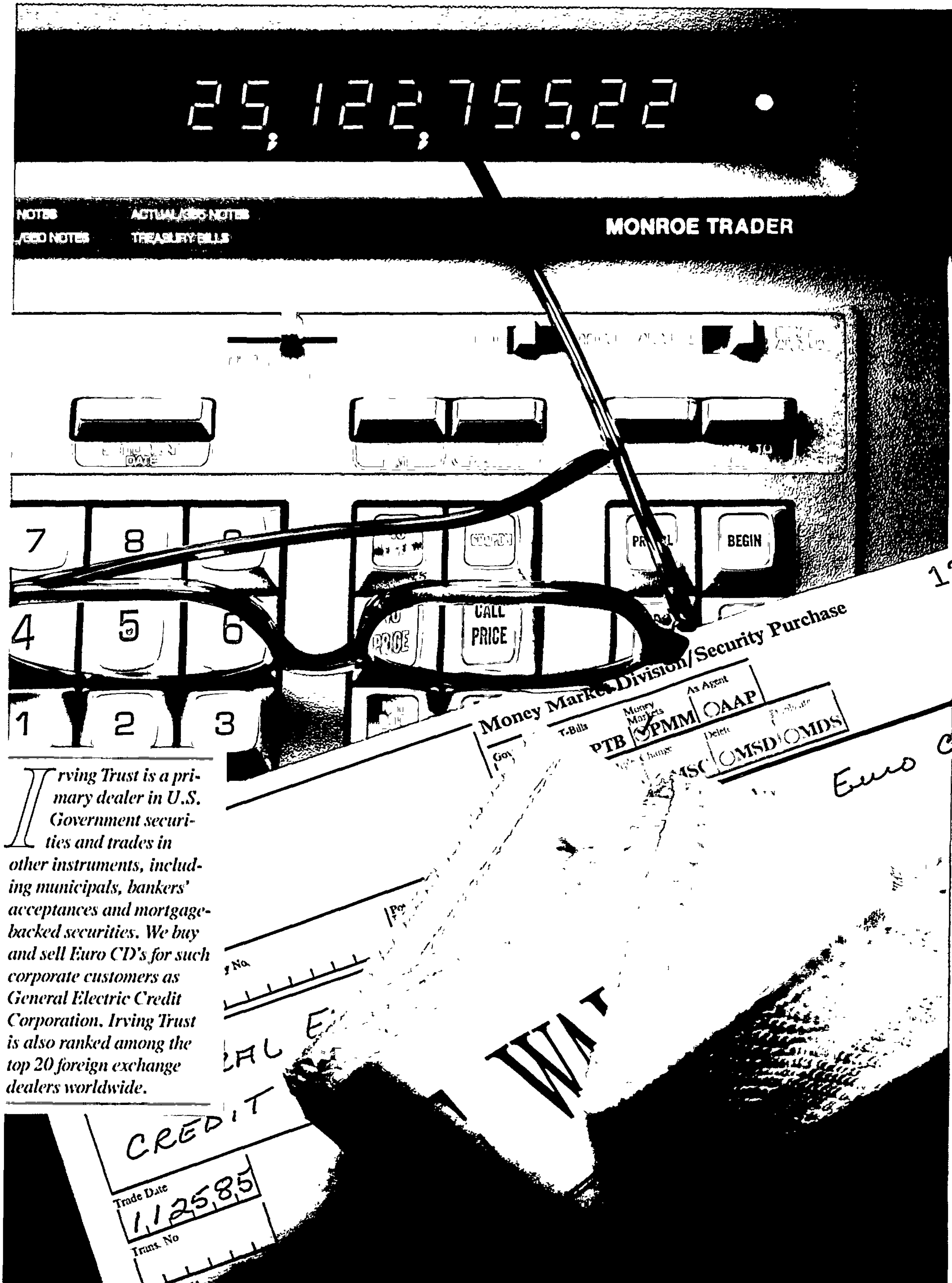
Money Market Instruments–We are a market maker for corporate and institutional customers in short-term financial instruments such as bankers' acceptances and domestic and Euro CD's. Our money market traders and salespeople buy and sell our trading inventory as well as Irving Trust CD's, acceptances and Irving Bank Corporation commercial paper. In this activity, we act as our own dealer and generate substantial savings for the Corporation.

Mortgage-Backed Securities–Trading in mortgage-backed securities has been a very profitable activity for those engaged in it over the past several years, reflecting the securitization of residential mortgages. We trade and deal in mortgage paper issued by such agencies as the Government National Mortgage Association and the Federal National Mortgage Association.

Investment Banking

The objective of our investment banking activities is to earn fee income from structuring and arranging transactions, syndicating loans, underwriting securities and selling assets and liabilities.

Public Finance–We assist customers in raising tax-exempt funds to finance projects ranging from hospitals to university housing to waste disposal plants. Our assistance includes credit and liquidity enhancement through Irving Trust standby letters of credit as well



Irving Trust is a primary dealer in U.S. Government securities and trades in other instruments, including municipals, bankers' acceptances and mortgage-backed securities. We buy and sell Euro CD's for such corporate customers as General Electric Credit Corporation. Irving Trust is also ranked among the top 20 foreign exchange dealers worldwide.

Investment Activities *(continued)*

as access to investors through underwriting and syndication of issues. Our correspondent banking network is both a source of public finance business and a source of investable funds.

Project Finance–We assist in structuring and arranging the financing for major projects in such fields as cogeneration and resource recovery, which require expert knowledge and involve specialized financing techniques.

Syndications–Our Syndications Division works with our commercial bankers to arrange and structure large financings that assist in acquisitions or other special corporate purposes. These financings can be sold in whole or in part to institutions with investable funds.

Loan Sales–Our loan portfolio management program is responsible for the sale of loans, enabling the Bank to earn incremental profits and better manage and control its portfolio.

Merchant Banking–Our merchant banking activities offer customers securities underwriting, syndication and distribution capabilities. Through Irving Trust International, Ltd., we offer these services to corporations, banks and government units in the London Eurodollar market. In early 1986, we acquired a 50% ownership interest in Trans City Holdings Limited, an Australian investment bank in Sydney, and we announced our intention to acquire Smith St. Aubyn & Co. Limited, a London securities dealer.

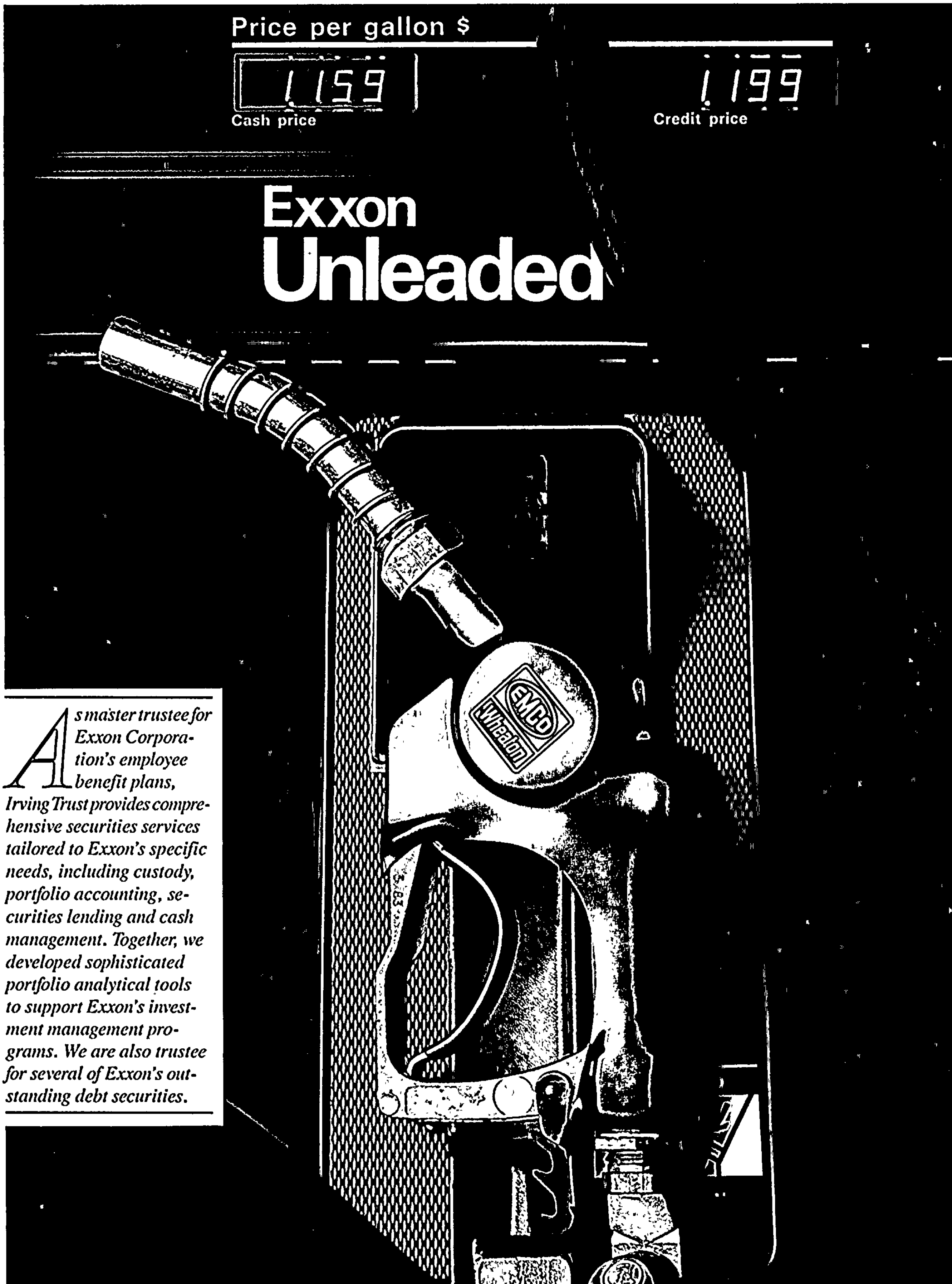
Frank Hlava, Assistant Treasurer of General Electric Credit Corporation, left, and Madeleine D. Robinson, Executive Vice President of Irving Trust's Securities Markets Group.

Fiduciary Services

Our fiduciary services business primarily generates fee income by selling a full range of integrated securities, estate and trust services to institutional and individual customers.

Master Trust and Custody Services–Irving Trust provides comprehensive and sophisticated custody, accounting and reporting for employee benefit plans sponsored by corporate employers, public pension funds and unions. Through our master trust service, customers are able to consolidate their employee benefit assets to achieve administrative and investment efficiencies. We also offer custody services to meet the clearance, servicing and reporting requirements of a wide variety of institutional investors. Our securities processing and flexible reporting capabilities contributed to the significant new business we secured during 1985, particularly in the public pension fund sector. Irving Trust currently ranks among the top 10 master trust and custody banks in the country.

We have been highly successful in recent years in selling securities lending services to trust and custody clients. By allowing the Bank to lend their securities to brokers and dealers needing them for daily settlement requirements, customers receive additional income beyond that produced through dividends, interest and appreciation. Our sizable base of trust and custody assets, together with our long-standing relationship with the broker and dealer community, has positioned Irving Trust as a market leader in securities lending.



As master trustee for Exxon Corporation's employee benefit plans, Irving Trust provides comprehensive securities services tailored to Exxon's specific needs, including custody, portfolio accounting, securities lending and cash management. Together, we developed sophisticated portfolio analytical tools to support Exxon's investment management programs. We are also trustee for several of Exxon's outstanding debt securities.

Fiduciary Services *(continued)*

Indenture Trusteeships–Irving Trust provides trustee and related services to customers that issue debt securities. An increase in complex and innovative corporate financings has provided new opportunity for growth and higher profitability in this business. The experience of our trust professionals, combined with the flexibility and high quality of our automated data processing systems, has enabled us to increase our share of the corporate trust market.

Investment Management Services–Our investment management services provide a disciplined and proven investment approach for employee benefit funds, endowments and foundations. Our professionals work closely with customers to formulate their investment objectives and risk tolerances, which are then integrated with Irving Trust's capital market forecasts to create a customized strategy designed to add value in each step of the investment process. Our disciplined investment style has resulted over the past five years in above average performance in the equity, fixed-income and short-term markets.

For Individuals–Irving Trust offers fiduciary and asset management services to high-income, high-net-worth individuals worldwide. These services are carefully integrated to satisfy individual goals: planning and creating an estate and preserving and managing existing assets. Our personal fiduciary services include estate and financial planning, estate administration, trust administration, investment management and custody.

In 1985, we opened Irving Trust Company Florida in Miami. This trust subsidiary will enhance service to our customers and develop new relationships in that market. We also offer personal trust services through various community banking affiliates, Irving Financial Centers and our foreign branches and representative offices.

Thomas W. Archibald, Executive Vice President of Irving Trust's Institutional Securities Services Group, left, and C.W. Williams, Assistant Treasurer of Exxon Corporation.

Service Products

Service products are basic transaction services, including funds transfer, securities transfer, documentary trade and various information services. Irving Trust has experience and skill in providing these services, and they will be an increasingly important business for us in the future for three main reasons:

- We are a leader in the markets for these products, with a reputation for high quality;
- We believe that investment in technology and skilled people, combined with aggressive marketing and sales, will enable us to expand revenue and net income by selling these products to existing customers and new customers;
- Service product revenues are not dependent on booking large volumes of assets and therefore are a prime means of improving our return on assets.

Service Products *(continued)*
Important current products include funds transfer, cash management, dealers clearance and American Depositary Receipts.

Funds Transfer–Irving Trust provides high-quality funds transfer services for our customers across the country and around the world. Our F.A.S.T. (Fully Automated Straight-Through) Processing System allows customers' payment instructions to be electronically processed within seconds of their receipt.

Cash Management–Irving Trust, like other banks, has long assisted customers in managing their cash. In 1978, we introduced CA$H-Register to assist customers in their electronic cash management needs. During 1984, micro/CA$H-Register was introduced, which allows customers to transfer funds through their IBM Personal Computers and Irving Trust's fully automated systems. With funds transfer via micro/CA$H-Register an established product (we have more than 250 users in 34 countries), the Bank in 1985 added letters of credit, reimbursements and broker/dealer clearance applications. These are the first of a broad range of microcomputer-based, transaction-oriented products. Other securities and cash management applications are under development.

Dealers Clearance–Irving Trust is a major clearing agent of U.S. Government securities for brokers and dealers, domestic and foreign banks, retail discount brokers and regional securities firms. We also clear money market instruments and mortgage-backed securities. We currently clear commercial paper and certificates of deposit for five of the six largest commercial paper dealers in the United States.

American Depositary Receipts–ADR's are one of the most widely used instruments for investment in the international securities markets. ADR's are securities of foreign corporations issued specifically for trading in the United States. Irving Trust is a leading ADR depositary bank with over 30% share of this market. We are taking steps to strengthen our leadership position in the business by offering a complete range of ADR and related services through ADR specialists in New York, London and Tokyo.

Irving Bank Corporation

Contents–Financial Section

Five-Year Summary of Selected Financial Data

Irving Bank Corporation

For the Year *In Millions*	1985	1984	1983	1982	[illegible]
Interest Income	$1,756.2	$1,938.4	$1,668.4	$2,145.2	$2,2[illegible]
Tax Equivalent Adjustment*	47.4	38.7	33.9	55.2	60.6
Interest Income (Fully Taxable Basis)	1,803.6	1,977.1	1,702.3	2,200.4	2,330.7
Interest Expense	1,244.2	1,449.4	1,216.8	1,695.4	1,813.9
Net Interest Income (Fully Taxable Basis)	559.4	527.7	485.5	505.0	516.8
Provision for Loan Losses	63.9	39.4	27.0	39.9	43.0
Other Operating Income	272.2	204.2	167.8	127.6	119.4
Other Operating Expenses	551.7	510.9	468.2	442.6	397.4
Net Income	116.0	98.1	92.5	81.0	97.0
Dividends Declared on Common Stock	34.7	32.3	30.7	29.3	26.4
Per Common Share** *In Dollars*					
Net Income	$6.14	$5.11	$4.86	$4.57	$5.51
Dividends	1.96	1.84	1.76	1.68	1.52
Financial Ratios					
Rate of Return:					
On Average Interest-Earning Assets	0.66%	0.58%	0.59%	0.51%	0.67%
On Average Total Assets	0.55	0.48	0.48	0.42	0.53
On Average Common Shareholders' Equity	12.96	11.66	11.92	11.95	15.92
On Average Total Shareholders' Equity	12.64	11.55	11.68	11.94	15.93
As a Percentage of Total Assets at Year-End:					
Primary Capital***	6.4	5.9	5.2	4.7	[illegible]
Total Capital***	8.0	7.5	6.9	6.3	[illegible]
At Year-End *In Millions*					
Total Assets	$21,651	$18,982	$18,586	$19,514	$18,227
Total Deposits	14,026	13,447	12,610	14,153	14,006
Total Loans	12,745	11,202	10,505	10,100	10,102
Total Investment Securities	1,432	1,195	1,067	1,025	1,354
Long-Term Debt	605	410	340	345	249
Common Shareholders' Equity	880	803	741	687	638
Total Shareholders' Equity	956	878	816	763	639

**The tax equivalent adjustment is calculated (by using a combined Federal, state and local income tax rate of approximately 56% in 1985, 60% in 1984 and 1983, and 59% in 1982 and 1981) to recognize the differential between interest income that is partially or wholly exempt from income taxes and interest income that is fully taxable.*

***During 1984, the Corporation effected a two-for-one split of the Corporation's common stock. Accordingly, per common share amounts for prior periods have been restated to reflect this event.*

****These computations are based upon definitions promulgated by the Federal Reserve Board. Accordingly, Total Assets are defined as Total Assets plus the Allowance for Loan Losses.*

1985 Earnings

Irving Bank Corporation achieved record earnings in 1985. Net income was $116.0 million in 1985, an increase of 18.2% over the $98.1 million achieved in 1984. Net income for 1984 represented a 6.1% increase over 1983 earnings of $92.5 million. On a per common share basis, earnings were $6.14, $5.11 and $4.86 in 1985, 1984 and 1983, respectively. The earnings increases for both periods were attributable to higher net interest income, on a fully taxable basis, and increased noninterest income. Partly offsetting these positive factors were increases in the provision for loan losses and noninterest expenses. A higher effective income tax rate also adversely affected 1984 earnings. Per common share amounts reflect the two-for-one split of the Corporation's common stock in 1984 and were computed using average common shares outstanding of 17,798,244 in 1985, 17,674,332 in 1984 and 17,601,918 in 1983, assuming full conversion of the Corporation's $4.00 Convertible Preferred Stock.

Net Interest Income (Fully Taxable Basis)

In Millions	1985	1984	1983
Interest Income	$1,756.2	$1,938.4	$1,668.4
Tax Equivalent Adjustment	47.4	38.7	33.9
Interest Income (Fully Taxable Basis)	1,803.6	1,977.1	1,702.3
Interest Expense	1,244.2	1,449.4	1,216.8
Net Interest Income (Fully Taxable Basis)	$ 559.4	$ 527.7	$ 485.5

Net interest income, on a fully taxable basis, amounted to $559.4 million in 1985, representing a 6.0% increase from $527.7 million in 1984. During 1984, net interest income, on a fully taxable basis, increased 8.7% from $485.5 million in 1983. The improvement in 1985 over 1984 was due to a four basis-point improvement in the net interest rate spread to 3.16% and higher average interest-earning assets. The increase in net interest income in 1984 from 1983 resulted from the same factors noted for 1985.

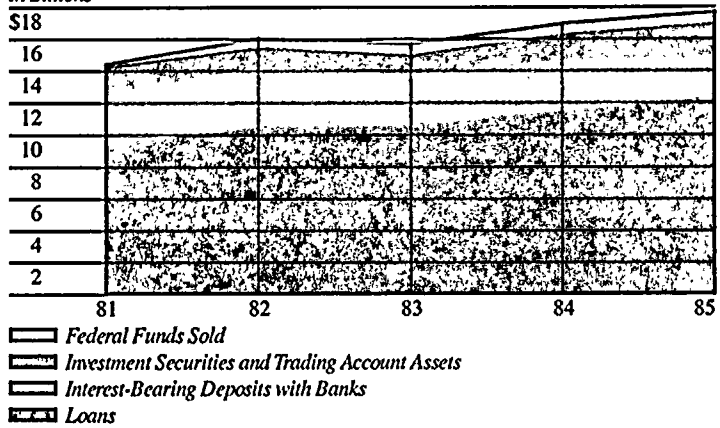
Average Volumes

In Billions	1985	1984	1983
Interest-Earning Assets	$17.7	$16.9	$15.8
Interest-Bearing Liabilities	$15.0	$14.5	$13.2
Net Noninterest-Bearing Funds	2.7	2.4	2.6
Total Sources of Funds	$17.7	$16.9	$15.8

The average volume of interest-earning assets continued to grow in 1985, with a 4.5% increase over 1984, following a 7.2% increase in 1984 when compared with 1983. The funding of these increases was accomplished principally through higher levels of interest-bearing liabilities and in 1985 through an increase in net noninterest-bearing funds. Average interest-bearing liabilities grew by 3.6% in 1985 over 1984 and 9.5% in 1984 over 1983. During 1985, net noninterest-bearing funds increased by 9.8% over 1984. Net noninterest-bearing funds declined 4.9% from 1983 to 1984.

Average Interest-Earning Assets

In Billions



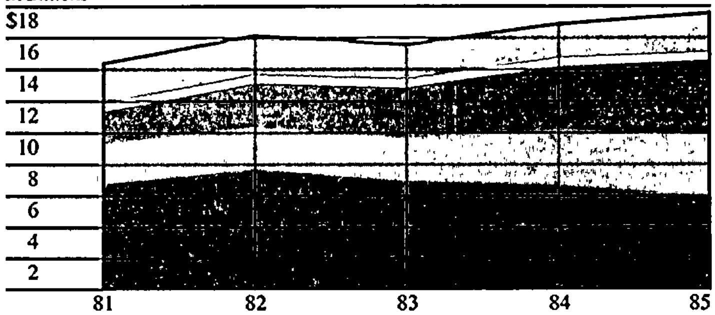
Higher domestic loan volume and a growth in investment securities were largely responsible for the increase in interest-earning assets in 1985. Earning asset growth in 1984 resulted primarily from increases in loans, both domestic and international, and trading account assets.

Average total loan volume advanced 5.9% to $12.1 billion in 1985 and 10.9% to $11.5 billion in 1984. Investment securities averaged $1.5 billion in 1985, an increase of 32.9%. In 1984, average trading account assets increased by $180 million, due mainly to the trading activities of Briggs Schaedle & Co., Inc., a primary dealer in U.S. Government securities. Reflecting the Corporation's efforts to reduce its volume of low-margin assets, interest-bearing deposits with banks (placements) declined by 12.0% to $2.8 billion in 1985, following an 8.6% reduction in 1984.

Average loan volume from international operations, which includes loans at Irving Trust's overseas branches and subsidiaries, international banking facilities and international business conducted at domestic offices, was $5.0 billion, $5.1 billion and $4.9 billion in 1985, 1984 and 1983, respectively. Loans attributable to domestic operations averaged $7.1 billion in 1985, $6.4 billion in 1984 and $5.4 billion in 1983, reflecting the continued expansion of the U.S. economy over the past two years.

Financial Review
Irving Bank Corporation

Average Sources of Funds
In Billions

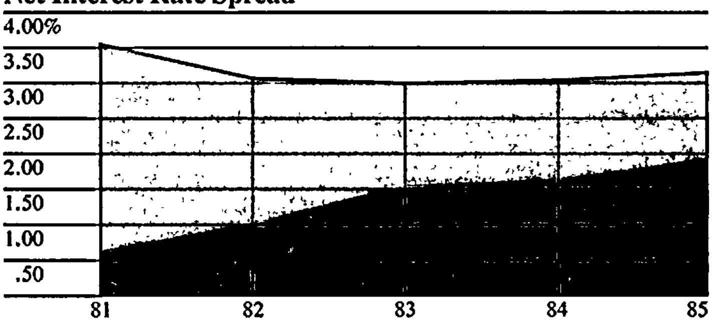


Net Noninterest-Bearing Funds
Long-Term Debt
Federal Funds Purchased and Other Borrowed Funds
Savings and Time Deposits
Interest-Bearing Foreign Office Deposits

Funding the growth in interest-earning assets in 1985 was accomplished through increases in interest-bearing liabilities and net noninterest-bearing funds. Increases in savings deposits, Federal funds purchased and securities sold under agreements to repurchase and long-term debt were responsible for the 3.6% growth in interest-bearing liabilities. Partially offsetting these increases were reductions in interest-bearing foreign office deposits and other borrowed funds. A 24.4% increase in savings deposits to $1.6 billion in 1985 from $1.3 billion in 1984 resulted from substantial increases in insured money market plan accounts. Federal funds purchased and securities sold under agreements to repurchase increased by $675 million to $3.2 billion in 1985, reflecting efforts to reduce funding costs in a declining interest rate environment. Average long-term debt increased by $138 million to $532 million in 1985, due to the issuance of $200 million of Floating Rate Subordinated Capital Notes in May 1985. The 8.3% reduction in other borrowed funds resulted mainly from a decrease in commercial paper borrowings by the Parent Corporation. Interest-bearing deposits at foreign offices declined $487 million to $6.0 billion in 1985, paralleling the decline in placement volume.

During 1984, earning asset growth was funded primarily through a 9.5% increase in interest-bearing liabilities, primarily other borrowed funds, time and savings deposits and Federal funds purchased and securities sold under agreements to repurchase. Partially offsetting these increases were declines in net noninterest-bearing funds and foreign office interest-bearing deposits.

Purchased Funds Margin and Net Interest Rate Spread



Net Interest Rate Spread
Purchased Funds Margin

The net interest rate spread continued to widen in 1985, increasing by four basis points to 3.16% from 3.12% in 1984 and five basis points in 1984 from 3.07% in 1983. The improvement in the net interest rate spread in 1985 was attributable largely to a 24 basis-point widening in the purchased funds margin and an increase in the volume of net noninterest-bearing funds. Contributing to the widening of the purchased funds margin was a change in the earning asset mix from lower-yielding placements to higher-margin loans and investment securities. Partially offsetting these positive factors was a decline in the value of net noninterest-bearing funds, due to the lower interest rate environment in 1985. The widening of the net interest rate spread in 1984 from 1983 was attributable principally to the increased value of net noninterest-bearing funds due to the higher 1984 interest rate environment and a nine basis-point widening in the purchased funds margin. A lower volume of net noninterest-bearing funds partially offset these improvements.

Noninterest Income

In Millions	1985	1984	1983
Trust Income	$ 55.0	$ 44.7	$[illegible]
Trading Account Profits and Commissions	8.9	7.7	[illegible]
Foreign Exchange Trading Profits	30.4	15.9	12.6
Investment Securities Gains/(Losses)	3.6	1.1	(0.1)
Other Income:			
Factoring Commissions	14.6	15.2	14.3
Domestic Commission and Fee Income	64.8	45.4	34.7
Foreign Commission and Fee Income	48.7	40.0	31.5
Other	46.2	34.2	34.4
	174.3	134.8	114.9
Total Noninterest Income	$272.2	$204.2	$167.8

The Corporation continued to achieve substantial gains in noninterest income this past year. Total noninterest income increased 33.4% in 1985 over 1984, following a 21.7% increase in 1984 over 1983. All income statement categories contributed to the improvements in both 1985 and 1984. The 23.2% increase in trust income in 1985 was due primarily to fees generated from new account relationships and higher asset values of existing accounts. Income from trading bonds and other money market assets improved 16.9% to $8.9 million in 1985, due largely to municipal bond trading activities. Profits derived from foreign exchange trading increased 90.9% to $30.4 million in 1985 as a result of an increased customer base and expanded participation in global markets. Gains on the sales of investment securities amounted to $3.6 million in 1985, compared with $1.1 million in 1984. Other income increased

29.3% in 1985 to $174.3 million, due mainly to greater domestic and foreign commission and fee income. Domestic commissions and fees grew 42.7% to $64.8 million, due principally to increases in dealers clearance and other financial services fees. Foreign commissions and fees improved 21.9% to $48.7 million in 1985 from $40.0 million in 1984.

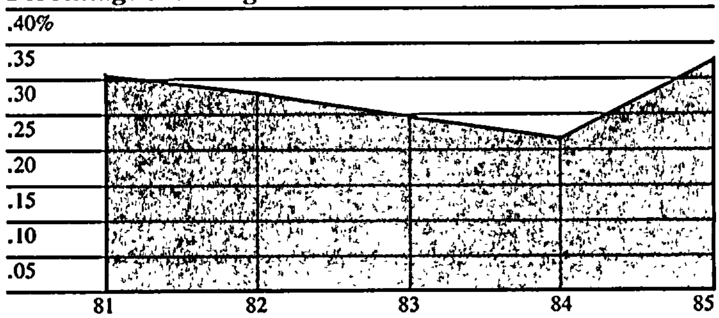
The improvement in noninterest income in 1984 over 1983 was attributable to the same factors mentioned for the 1985 increase. Partially offsetting these favorable factors was the effect of a $4.5 million loss in 1984 related to an investment in which Irving Trust has a minority interest.

Provision and Allowance for Loan Losses

In Millions	1985	1984	1983
Balance, January 1	$155.1	$141.1	$141.0
Loans Charged Off	(55.4)	(36.6)	(36.4)
Recoveries on Loans Previously Charged Off	15.5	11.2	10.1
Net Loan Charge-Offs	(39.9)	(25.4)	(26.3)
Provision Charged to Operations	63.9	39.4	27.0
Balance Related to Acquisition	0.6	—	—
Translation of Foreign Currency Allowance Balances	—	—	(0.6)
Balance, December 31	$179.7	$155.1	$141.1
Percentage of Loans	1.41%	1.38%	1.34%

The allowance for loan losses at December 31 amounted to $179.7 million in 1985, $155.1 million in 1984 and $141.1 million in 1983. The allowance as a percentage of loans was 1.41%, 1.38% and 1.34% at year-end 1985, 1984 and 1983, respectively. Net loan charge-offs were $39.9 million in 1985, $25.4 million in 1984 and $26.3 million in 1983. The ratio of net loan charge-offs to average loans was 0.33%, 0.22% and 0.25% in 1985, 1984 and 1983, respectively. The provision for loan losses amounted to $63.9 million in 1985, compared with $39.4 million in 1984 and $27.0 million in 1983. The provision reflects management's assessment of the appropriate level of the allowance in relation to the risks inherent in the loan portfolio and continuing uncertainties related to the liquidity problems of certain foreign countries. For further analysis of the provision and allowance for loan losses, see pages 51 through 53 of this Report.

Net Loan Charge-Offs as a Percentage of Average Loans



Noninterest Expenses

In Millions	1985	1984	1983
Salaries and Employee Benefits	$296.5	$282.4	$260.3
Net Occupancy Expense of Premises	67.2	64.7	60.0
Furniture and Equipment Expense	42.6	39.9	36.0
Other Expenses	145.4	123.9	111.9
Total Noninterest Expenses	$551.7	$510.9	$468.2

Noninterest expenses grew 8.0% in 1985, compared with a 9.1% increase in 1984. The growth in both 1985 and 1984 resulted from increases in all of the expense categories noted above. Principally responsible for the increases of 5.0% and 8.5% in salaries and employee benefits expense in 1985 and 1984, respectively, were normal salary adjustments and, to a lesser degree, the acquisition in July 1984 of Briggs Schaedle & Co., Inc. Net occupancy expense advanced 3.9% in 1985 and 7.8% in 1984, while furniture and equipment costs increased 6.6% and 11.1% in the same periods. These increases moderated somewhat in 1985 as the move to the new operations center was completed. The 1984 increase in net occupancy expense was attributable largely to higher utility, depreciation and other expenses. Higher depreciation expense resulting from the purchase of new data processing equipment accounted for the increase in furniture and equipment costs in 1985 and 1984. A continued increase in the general level of business accounted for the higher levels of other expenses in 1985 and 1984.

Applicable Income Taxes

Applicable income taxes totaled $52.6 million, $44.8 million and $31.7 million in 1985, 1984 and 1983, respectively. The increases in applicable income taxes in both 1985 and 1984 resulted principally from higher levels of pretax income. An increase in the effective income tax rate also contributed to the rise in income taxes during 1984. A decline in income from overseas affiliates and subsidiaries was largely responsible for this higher rate. The effective tax rates on income before income taxes were 31.2% for 1985, 31.3% for 1984 and 25.5% for 1983.

The Corporation's effective tax rate is primarily a reflection of its volume of tax-exempt securities, since interest on these securities is substantially exempt from Federal income taxes. The income foregone on tax-exempt securities, where the yield is lower than the yield on taxable securities with similar maturities and risks, represents a subsidy to state and local governments. This subsidy can be considered an implicit tax on the Corporation when analyzing the Corporation's overall effective income tax rate.

In addition, the income that is foregone by the Corporation's subsidiary banks on noninterest-bearing reserve balances that are maintained at a Federal Reserve Bank can also be considered a part of the Corporation's effective tax burden. The reserve balances at the Federal Reserve Bank are invested, and the income earned thereon is remitted to the U.S. Treasury. The Corporation's published effective tax rate for 1985 and its adjusted effective tax rate, which reflects the impact of the lower yield on tax-exempt securities and the income foregone on Federal Reserve balances, are presented in the table at the right.

1985 Effective Tax Rate

		Adjustments		
In Millions	Published	Tax-Exempt Securities	Reserve Account	Adjusted
Total Income before Income Taxes	$168.6	$46.2	$24.4	$239.2
Applicable Income Taxes	52.6	46.2	24.4	123.2
Effective Tax Rate	31.2%			51.5%

Nonaccrual and Reduced-Rate Loans

At December 31 *In Millions*	1985	1984	1983	1982	1981
Attributable to Domestic Operations:					
Nonaccrual	$ 95.8	$ 72.4	$ 52.0	$ 47.5	$ 40.6
Reduced-Rate	3.1	4.9	6.7	72.3	92.4
	98.9	77.3	58.7	119.8	133.0
Attributable to International Operations:					
Nonaccrual	159.7	198.5	143.6	79.9	49.8
Reduced-Rate	5.2	12.9	0.1	6.8	6.6
	164.9	211.4	143.7	86.7	56.4
Total Nonaccrual and Reduced-Rate Loans	$263.8	$288.7	$202.4	$206.5	$189.4
As a Percentage of Loans	2.07%	2.58%	1.93%	2.04%	1.87%

Nonaccrual loans are loans (other than consumer installment loans and residential mortgages) on which the accrual of interest ceases when the collection of principal or interest payments is determined to be doubtful by management. It is the general policy of the Corporation to cease the accrual of interest when principal or interest payments are delinquent 90 days or more. Any unpaid amounts previously accrued on these loans are reversed from income, and thereafter interest is recognized only to the extent payments are received. A nonaccrual loan can be returned to accrual status once all interest and principal payments are current and future payments are no longer considered doubtful.

Reduced-rate loans are loans that have been restructured to provide for a reduction of the originally contracted rate of interest as a result of a weakening in the financial position of the borrower. Interest income on these loans is accrued at the reduced rate.

The $38.8 million decrease in international nonaccrual loans at December 31, 1985 from the prior year-end was attributable largely to the return to accrual status of certain Argentine loans. The $54.9 million increase in international nonaccrual loans at year-end 1984 from year-end 1983 was principally caused by the placing of certain Argentine loans on nonaccrual status. Total Argentine nonaccrual loans at December 31 were $5 million in 1985, $66 million in 1984 and $3 million in 1983. Substantially all of these loans were to public-sector borrowers.

Interest income that would have been accrued at originally contracted interest rates during 1985 was $13.2 million for domestic nonaccrual and reduced-rate loans and $22.9 million for international nonaccrual and reduced-rate loans. The [illegible] tax amount of interest income included in 1985 earnings w[illegible] $2.8 million and $8.9 million on domestic and international nonaccrual and reduced-rate loans, respectively.

The preceding table excludes a relatively small amount of loans that are contractually delinquent 90 days or more as to principal or interest payments and continue to accrue interest. These past-due loans, which include consumer installment loans and residential mortgages, are well secured and in the process of collection. At year-end 1985, 1984 and 1983, past-due loans were $3.8 million, $2.8 million and $14.4 million, respectively. Past-due loans at year-end 1981 and 1982 were not significant.

Real estate assets acquired in partial or full satisfaction of loan obligations are classified as other assets and are not included in the above table. These assets are recorded at their fair market value at the time of acquisition, and any excess is charged to the allowance for loan losses. These assets amounted to $42.9 million in 1985, $25.5 million in 1984 and $29.6 million in 1983 at the respective year-ends. The increase in 1985 was due mainly to the acquisition of a U.S. real estate property in satisfaction of a loan obligation.

Cross-Border Outstandings

In Millions	Governments and Official Institutions*	Banks and Other Financial Institutions	Commercial and Industrial	Other	Total
At December 31, 1985					
Japan	$ —	$524	$188	$ 1	$713
Venezuela	402	35	34	—	471
Brazil	257	129	26	—	412
Mexico	310	—	47	—	357
France	8	317	4	—	329
Italy	17	255	26	—	298
United Kingdom	—	186	98	4	288
Greece	125	35	101	—	261
Hong Kong	—	181	65	3	249
Argentina	175	57	11	—	243
At December 31, 1984					
Japan	$ 66	$470	$165	$ 1	$702
United Kingdom	2	209	266	15	492
Venezuela	391	54	34	—	479
Brazil	241	148	19	—	408
Italy	10	360	31	—	401
Mexico	314	—	51	—	365
France	9	342	4	—	355
Argentina	167	41	6	—	214
Canada	23	162	26	—	211
South Korea	60	139	9	—	208
Switzerland	—	185	20	1	206
South Africa	—	205	—	—	205
At December 31, 1983					
Japan	$ 1	$571	$211	$ 3	$786
United Kingdom	1	275	201	26	503
Venezuela	395	55	40	—	490
France	14	430	10	—	454
Brazil	231	115	25	—	371
Italy	10	266	55	19	350
Mexico	301	—	48	—	349
Argentina	161	58	11	—	230
Canada	—	186	15	25	226
West Germany	1	148	44	3	196
Switzerland	—	190	3	—	193

**Includes government-owned corporations.*

The preceding tables summarize the Corporation's cross-border outstandings that were in excess of 1% of total assets at December 31, 1985, 1984 and 1983, respectively. Cross-border outstandings include loans (and accrued interest), acceptances, placements, other interest-bearing investments and any other monetary assets that are denominated in U.S. dollars or other nonlocal currency. These outstandings have been classified according to the domicile of the borrower or ultimate guarantor and have been reduced by any tangible, liquid collateral. At year-end, in addition to the above amounts, the Corporation had cross-border outstandings between 0.75% and 1% of total assets totaling $1,192 million in Canada, Kuwait, South Africa, South Korea, Switzerland and Turkey in 1985; $459 million in Greece, Hong Kong and Kuwait in 1984; and $670 million in Kuwait, Luxembourg, South Korea and Spain in 1983.

A continuation of the uncertain economic and political environments in Argentina, Brazil, Mexico and Venezuela during 1985 affected the ability of various public- and private-sector

borrowers in these countries to service their external currency debt on a timely basis. The more significant of these delays pertained to Argentine and Venezuelan borrowers. Negotiations with respect to restructuring arrangements between these four countries and their respective creditors continued throughout 1985. A number of factors, among them further deterioration in the economic or social conditions affecting these four countries, their inability to borrow sufficient funds to service such indebtedness or to effect necessary reschedulings, continuation of the reduced levels of the price of oil, or adverse internal political developments, could adversely affect the Corporation's earnings.

Certain information on the Corporation's cross-border outstandings to Argentina, Brazil, Mexico and Venezuela during 1985 is presented in the following table.

In Millions	Argentina	Brazil	Mexico	Venezuela
Cross-Border Outstandings at December 31, 1984	$214	$408	$365	$479
Increase in Outstandings	43	50	35	51
Decrease in Outstandings Due to:				
Principal Repayments	(2)	(7)	(8)	(12)
Interest Payments	(12)*	(39)	(35)	(47)
Cross-Border Outstandings at December 31, 1985	$243	$412	$357	$471
As a Percentage of Total Assets	1.1%	1.9%	1.6%	2.2%
Nonaccrual Loans at December 31, 1985	$ 5	$ 3	$ 9	$ 40
Revenue on Cross-Border Outstandings for 1985	$ 29	$ 43	$ 37	$ 50

**Excludes interest payments on nonaccrual loans of $15 million.*

Argentina–During the first half of 1985, a review of Argentina's economic performance by the IMF found that certain agreed upon targets were not being met. As a result, loan disbursements from the IMF were suspended, and the implementation of commercial bank agreements was delayed. In June 1985, the Argentine government implemented a broad anti-inflationary program that brought the country back into accord with the IMF targets and resulted in subsequent loan disbursements by the IMF and creditor banks. In November 1985, however, the IMF again suspended loan disbursements, which in turn caused disbursements by the international banking community to be delayed. The Argentine government and the IMF are currently conducting negotiations to resume these loan disbursements.

The Corporation's share of the new loans and trade and interbank credits under agreements signed in August 1985 between Argentina and its creditor banks is $37 million, of which $26 million was disbursed in 1985. Certain arrearages of Argentine borrowers were brought current by year-end 1985, which resulted in the recognition of $5.5 million of income relating to 1984 and the return to accrual status of $61 million of loans to Argentine borrowers.

During 1985, $40 million of the Corporation's Argentine loans were restructured. The interest rate on this debt prior to restructuring was 213 basis points above the London Interbank Offered Rate (LIBOR) for $30 million of loan principal and 200 basis points above a referenced prime rate for the remaining loan principal. After restructuring, the interest rate for the entire $40 million will be at 138 basis points above either a LIBOR or a referenced certificate of deposit rate. Currently, $9 million is the subject of restructuring negotiations. The current interest rate on the debt is approximately 200 basis points above a referenced prime rate. Once negotiations are complete, the interest rate is expected to be at 138 basis points above either a LIBOR or a referenced certificate of deposit rate. The Corporation recorded $5.3 million in revenue during 1985 on the $49 million of loans subject to restructuring. The Corporation would have recognized revenue of $5.5 million on such loans during 1985 based on rates prior to restructuring and $4.6 million based upon the restructured rates.

Brazil–During 1985, the Brazilian government and the IMF continued their attempts to establish mutually acceptable economic targets. Thus far they have not succeeded, and IMF disbursements are still being withheld. Negotiations between Brazil and the international banking community on a restructuring arrangement for existing loans also continue.

Mexico–During the third quarter of 1985, Mexico was unable to comply with the economic targets established by the IMF. Consequently, Mexico could not draw upon its next allotment of IMF funds, although earthquake assistance was made available. Due to these developments, a new letter of intent is currently being negotiated between the IMF and Mexico.

During 1985, Mexico and its creditor banks finalized an agreement, which is currently being implemented, to restructure much of its public-sector debt. This agreement calls for a 14-year extension on debt maturing between 1985 and 1990, a reduction in interest rates on such debt and a $950 million payment of principal in 1985. The principal payment was postponed by Mexico's creditor banks. At year-end 1985, a total of $199 million of the Corporation's loans to Mexico were subject to this restructuring agreement and were accounted for on an accrual status. The Corporation's spread on these restructured loans was 88 basis points above LIBOR at December 31, 1985. Prior to restructuring, the Corporation's spread was 160 basis points above a referenced prime rate on $148 million of these loans and 80 basis points above LIBOR on the remaining $51 million. Based upon the restructured rates, the Corporation recorded $18.5 million in pretax income during 1985 on these loans. The Corporation would have recognized revenue of $21.8 million on such loans during 1985 based on rates prior to restructuring.

Venezuela–Negotiations continued on the proposed restructuring with an agreement in principle being reached on the terms for Venezuela's public-sector debt. This agreement was endorsed by the Advisory Committee and distributed to Venezuela's creditor banks for their approval. In general, this restructuring calls for a reduction in interest rates and an extension of final maturities, as well as an initial $750 million principal payment.

At year-end 1985, $385 million of the Corporation's Venezuelan public-sector debt was subject to the proposed restructuring, all of which were on an accrual status. The Corporation's spread at December 31, 1985 was 100 basis points above a referenced prime rate on these loans. The Corporation expects the spread to be approximately 113 basis points over LIBOR on all of the restructured debt. During 1985, the Corporation recorded $42.9 million in revenue on those loans subject to restructuring. Based upon the expected restructured rates the Corporation would have recognized income of $36.7 million on these loans in 1985.

In addition to the foregoing, certain developments in South Africa have affected the repayment of indebtedness by borrowers in that country. In September 1985, the South African government imposed a four-month moratorium on repayment of principal of the foreign debt of South African borrowers. In December 1985, the moratorium was extended through March 1986. The Corporation anticipates the renewal or refinancing of short-term credits, which constitute the major portion of the Corporation's exposure in South Africa. Payment of interest is current. At December 31, 1985, the Corporation's outstandings to South African borrowers, which consisted exclusively of private banks, totaled $195 million. As a matter of policy, the Corporation makes no loans to the government of South Africa or its agencies.

Asset/Liability Management

The maintenance of adequate liquidity and the management of interest sensitivity are basic aspects of the Corporation's asset/liability management strategy. Adequate liquidity is maintained to match the cash flow needs of customers and other corporate financial requirements. The management of interest sensitivity involves the structuring of the maturity and repricing characteristics of interest-earning assets and interest-bearing liabilities in view of the current and forecasted interest rate environments.

Liquidity

Management's assessment of liquidity reflects a number of factors. Included among these factors are access to worldwide markets of readily available funds, the amount of core deposits and the degree of liquidity in the asset structure.

Irving Trust's major source of liquidity is its ability to obtain funds in domestic and international money markets for various maturities at market rates of interest. Irving Trust's reputation in these worldwide markets and its policy of diversifying its funding requirements allows it to avoid undue concentration in any single financial market and to avoid heavy needs for funding within short-term periods.

The sizable amount of core deposits, principally net demand deposits, maintained at Irving Trust has enhanced its overall financial flexibility; however, our customers have managed their demand balances more closely in recent years, resulting in an increased reliance by Irving Trust on purchased funds. Sources of purchased funds include overnight and term Federal funds purchased, securities sold under agreements to repurchase, foreign office deposits and large-denomination time certificates of deposit.

The Corporation's 13 community banking affiliates conduct their own liquidity management strategies, which are monitored by the Corporation's Regional Banking Group. The community banks maintain a significant amount of core deposits, mainly consumer demand deposits, insured money market plan accounts, savings deposits, negotiable order of withdrawal (NOW) accounts and individual retirement accounts. The community banks also draw upon certain Federal funds facilities to fulfill their liquidity needs.

The Corporation is also able to generate liquidity from maturing or readily marketable assets. The carrying value of investment securities maturing within one year amounted to $468 million at December 31, 1985, $486 million at December 31, 1984 and $284 million at December 31, 1983, representing 33%, 41% and 27%, respectively, of total investment securities. At year-end 1985, approximately 56% of total loans were scheduled to mature within one year as compared with approximately 59% and 56% at December 31, 1984 and 1983, respectively. Federal funds sold, securities purchased under agreements to resell and trading account assets provide other sources of asset liquidity to the Corporation.

The Parent Corporation's liquidity requirements, consisting mainly of the payment of interest to holders of its notes and debentures and dividend payments to holders of the Corporation's common and preferred stocks, are met largely by interest and dividend payments from its subsidiaries. Limitations on the payment of dividends by subsidiary banks are imposed by Federal and New York laws. These limitations are explained in note 18 to the financial statements on pages 40 and 41 of this Report. Subsidiary bank dividends paid to the Parent amounted to $57 million in 1985, $49 million in 1984 and $44 million in 1983. In addition, the Parent has access to the commercial paper market to satisfy its liquidity requirements and to supplement the liquidity of its affiliates. The Parent's commercial paper borrowings averaged $392 million in 1985 and $480 million in 1984.

Interest Sensitivity

The Corporation's interest sensitivity position reflects the sensitivity of its earnings to interest rate movements in the global financial markets. The Corporation's interest sensitivity position is monitored by Irving Trust's Asset and Liability Committee (ALCO).

Since the repricing dates of interest-earning assets typically do not coincide with the repricing dates of interest-bearing liabilities, an interest sensitivity gap (i.e., the difference between repriceable interest-earning assets and repriceable interest-bearing liabilities within a specific time span) will generally result. The ALCO is responsible for monitoring these gaps in light of the current interest rate environment and expected future trends.

The table at the bottom of this page presents the interest sensitivity of the Corporation at December 31, 1985. It should be noted that this table presents the Corporation's overall position for a single day, which may not be indicative of its position in the future. As shown in this table, the Corporation's cumulative interest sensitivity gap within one year is $505 million. This indicates that the Corporation is asset sensitive at the one-year interval and will generally benefit from rising interest rates within a one-year time frame. The primary reason for this interest sensitivity gap is the large volume of noninterest-bearing deposits that Irving Trust receives in connection with its services as a major worldwide correspondent bank.

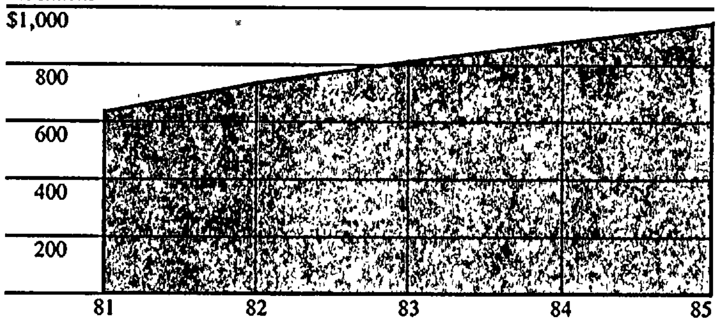
Interest Sensitivity By Repricing Date

At December 31, 1985 *In Millions*	Within Three Months	After Three Months But Within Six Months	After Six Months But Within One Year	After One Year But Within Five Years	After Five Years	Noninterest-Sensitive Funds	Total
Interest-Earning Assets:							
Interest-Bearing Deposits with Banks	$ 1,682	$ 433	$ 83	$ —	$ —	$ —	$ 2,198
Investment Securities	169	197	145	541	337	43	1,432
Trading Account Assets	503	—	—	—	—	—	503
Federal Funds Sold and Securities Purchased Under Agreements to Resell	253	—	—	—	—	—	253
Loans	9,122	1,049	493	969	856	256	12,745
Total	$11,729	$1,679	$721	$1,510	$1,193	$ 299	$17,131
Sources of Funds:							
Interest-Bearing Deposits	$ 7,370	$1,014	$183	$ 133	$ 462	$ —	$ 9,162
Federal Funds Purchased and Securities Sold Under Agreements to Repurchase	1,829	2	—	—	—	—	1,831
Other Borrowed Funds	2,029	127	1	—	—	—	2,157
Long-Term Debt	275	91	1	40	198	—	605
Other	702	—	—	—	—	2,674	3,376
Total	$12,205	$1,234	$185	$ 173	$ 660	$ 2,674	$17,131
Interest Sensitivity Gap	$ (476)	$ 445	$536	$1,337	$ 533	$(2,375)	$ —
Cumulative Interest Sensitivity Gap	$ (476)	$ (31)	$505	$1,842	$2,375	$ —	$ —

Shareholders' Equity and Long-Term Debt

Capital adequacy continues to be an important issue for bank regulators, investors and lenders. During 1985, the Federal Reserve Board revised the guidelines established in 1981 for assessing the capital adequacy of banks and bank holding companies. Computed as a percentage of total assets plus the allowance for loan losses, minimum primary and total capital ratios of 5.5% and 6.0%, respectively, were adopted as guidelines for state member-banks and bank holding companies. Primary capital, as defined by the Federal Reserve Board, includes common shareholders' equity, perpetual preferred stock, allowance for loan losses, equity commitment and contract notes net of amounts dedicated to note funds, and minority interest in consolidated subsidiaries. Total capital consists of primary capital and qualifying notes and debentures. The Corporation's ratio of primary capital to total assets at December 31 was 6.4% and 5.9% for 1985 and 1984, respectively, while the ratio of total capital to total assets was 8.0% and 7.5% for the same periods. Although specific guidelines pertaining to capital adequacy may serve to provide direction to large banking organizations in their strategic planning process, no single ratio can completely portray an organization's capital adequacy. Management maintains that an evaluation of capital adequacy should also consider such factors as the organization's mix of business, risk characteristics and asset quality, access to funding sources and capital markets, and an assessment of future needs. In January 1986, the Federal Reserve Board proposed for comment supplemental guidelines for capital adequacy which take some of these factors into account.

Total Shareholders' Equity at Year-End
In Millions



As indicated in the preceding chart, total shareholders' equity has grown consistently over the past five years. At year-end 1985, total shareholders' equity amounted to $956 million. Earnings retention is the Corporation's fundamental source of capital growth. During the 1981 through 1985 period, $308 million was added to the Corporation's capital base through retained earnings. The rate of internal capital generation on beginning total shareholders' equity was 8.5% for 1985 and 7.1% for 1984 and 1983.

Since the amount of dividends paid directly affects the rate of internal capital generation, dividend policy is an integral part of the Corporation's capital planning process. The Corporation has increased its dividend in each of the last nine years. During that period, the common dividend payout ratio has ranged between 28% and 41%. Future dividend policy will not be related to any particular percentage of earnings, but rather management will continue to consider the needs of the Corporation and its shareholders.

Another source of new equity capital is the Corporation's Dividend Reinvestment and Stock Purchase Plan (the Plan). Under the Plan, common shareholders may invest all or part of their dividends in newly issued Irving Bank Corporation common shares at a 5% discount from the current market price and make additional cash payments of between $25 and $5,000 per quarter towards the purchase of newly issued common shares at the current market price. Total equity was increased by $4,645,000 in 1985 due to 133,068 shares issued under the Plan and by $3,163,000 in 1984 due to the issuance of 101,067 shares.

In July 1985, the Corporation adopted an Employee Stock Purchase Plan, which management anticipates will augment the Corporation's equity capital base. Under the terms of the plan, all eligible employees were granted the opportunity to buy shares of common stock over a two-year period at a price equal to book value or market value at the grant date. At year-end 1985, outstanding subscriptions amounting to $16 million may be used to purchase book value shares at $47.66 per share, or market value shares at $38.81 per share, or any combination thereof, or may be withdrawn in cash from the plan.

The Corporation utilizes debt as a source of long-term funds. At year-end 1985, 1984 and 1983, long-term debt amounted to $605 million, $410 million and $340 million, respectively. As a percentage of shareholders' equity and long-term debt at year-end, long-term debt represented 39% in 1985, 32% in 1984 and 29% in 1983. In accordance with the Corporation's objective of maintaining a strong capital position, $200 million of Floating Rate Subordinated Capital Notes, due 1997, were sold to the public in May 1985. At December 31, $164 million of these notes qualified as primary capital for Federal bank regulatory purposes. The interest rate on these notes is determined quarterly by a formula based upon the arithmetic mean of the London interbank offered quotations for three-month Eurodollar deposits plus 0.125%, subject to a minimum rate of 5¼% per annum. At December 31, 1985, the rate on the notes was 8.3125%. In 1984, the Corporation issued $75 million of Floating Rate Subordinated Notes, due 1996, which also qualified as primary capital for Federal bank regulatory purposes. At year-end 1985 and 1984, the rates on these notes were 8.125% and 8.8125%, respectively.

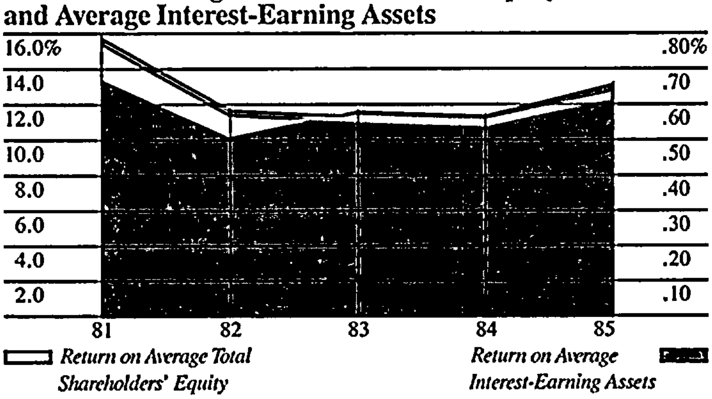
Funds are provided to the subsidiary banks of the Corporation through the purchase of additional shares of their capital stock and capital notes. The terms of the capital notes, such as interest rates, sinking fund provisions and maturity dates, are similar to the Corporation's underlying securities that finance their

purchase, thereby providing scheduled principal and interest payments to meet the Corporation's debt obligations. In 1985 and 1984, the Corporation purchased from Irving Trust $150 million and $75 million of capital notes with terms paralleling those of the Corporation's equity contract notes and equity commitment notes, respectively.

The Corporation continually evaluates its requirements for equity capital and long-term debt and believes that its financial position allows it the flexibility to meet future needs. Many factors are considered by management when making such a review. The capital markets, leverage ratios, potential dilution of shareholders' equity and existing indenture covenants are among the most important of these factors. Certain debentures issued by the Corporation contain terms as to the maximum amount of additional funded debt that can be created or guaranteed by the Corporation. At December 31, 1985, this amounted to $296 million.

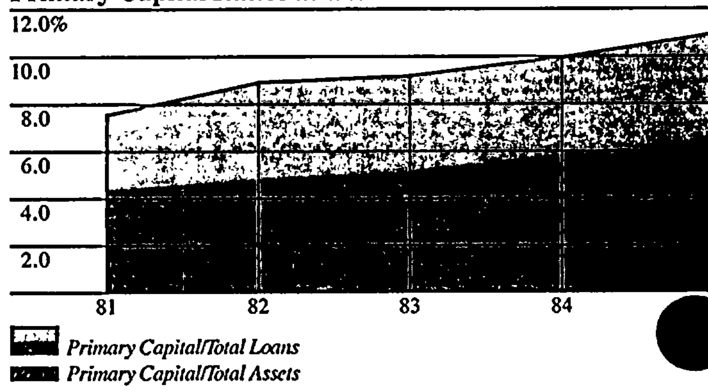
The Corporation utilizes various ratios to monitor its performance. The returns on average interest-earning assets, average common shareholders' equity, average total shareholders' equity and average total assets are some of the ratios used. These ratios for 1985 were 0.66% for the return on average interest-earning assets, 12.96% for the return on average common shareholders' equity, 12.64% for the return on average total shareholders' equity and 0.55% for the return on average total assets.

Returns on Average Total Shareholders' Equity and Average Interest-Earning Assets



The Corporation's asset mix, which is different from those of many other New York money center bank holding companies, is taken into consideration in management's evaluation of the aforementioned ratios. Irving Trust's position as a worldwide leader in the correspondent banking business generates a substantial volume of international placements that are low-margin and low-risk in nature. Another by-product of the correspondent banking business is deposit float, which is reflected in both balances due from other banks and demand deposits, resulting from the bank's clearing activities. Both of these businesses enlarge the Corporation's asset base and, therefore, result in a lower return on total average assets. The low-risk nature of these assets is considered in management's evaluation of the appropriate level of capital for the organization. Therefore, management considers the ratio of primary capital to total loans a better reflection of the low-risk nature of the Corporation's asset structure. At December 31, 1985 and 1984, the Corporation's primary capital amounted to $1,387 million and $1,124 million, respectively. Primary capital as a percentage of total loans at year-end was 10.9% in 1985 and 10.0% in 1984.

Primary Capital Ratios at Year-End



Acquisitions and New Subsidiaries

In March 1985, Irving Trust Company purchased 40% of the shares of Tütünbank, a commercial bank located in Izmir, Turkey. Tütünbank, the 10th largest private bank in Turkey, has its headquarters in Izmir and maintains 34 branches in the Aegean region and throughout Turkey.

Effective October 1, 1985, Irving Securities, Inc. (ISI) was established as a subsidiary of Irving Trust Company to perform certain of its securities trading activities. Its Retail Division functions as a dealer in U.S. Government securities in odd-lot denominations and its Mortgage-Backed Securities Division operates as a dealer in mortgage-backed securities eligible for underwriting by banks. In January 1986, Irving Trust's money market trading activity and its wholly owned subsidiary, Briggs Schaedle & Co., Inc., were combined and became the Briggs Schaedle Division of ISI.

In December 1985, Irving Trust Company Florida, a subsidiary of Irving Bank Corporation, was opened in Miami. Irving Trust Company Florida provides personal asset management, financial planning and trust services to residents of Florida and overseas investors.

In December 1985, Irving Trust Company purchased the remaining 50% ownership in Banco Irving Austral, a commercial bank located in Buenos Aires, Argentina. Irving Trust purchased its initial 50% ownership position in 1981.

In January 1986, Irving Trust Company purchased 50% of the shares of Trans City Holdings Limited, an Australian investment bank located in Sydney. Trans City, a leading authorized dealer and merchant bank in Australia, also maintains a representative office in London.

In January 1986, Irving Financial Centers, Inc., a subsidiary of Irving Bank Corporation, was established to expand the base of community banking business in locations outside New York State. Irving Financial Centers will engage in residential and light commercial construction and mortgage lending, consumer finance and lending to local business.

In February 1986, Irving Trust Company announced a tender offer for all of the outstanding common shares of Smith St. Aubyn (Holdings) P.L.C., a United Kingdom holding company. Its principal subsidiary is Smith St. Aubyn & Co. Limited, a London discount house that deals in bankers' acceptances, U.K. Government securities and other money market instruments. The proposed acquisition is expected to be consummated in April 1986.

Fourth Quarter Operating Results

Net income for the fourth quarter of 1985 totaled $28.2 million, representing an increase of 33.2% from $21.1 million in the prior year. Fourth quarter earnings per common share were $1.49 in 1985 and $1.08 in 1984.

The fourth quarter earnings improvement was due principally to higher net interest income, on a fully taxable basis, and increased noninterest income. Partly offsetting these positive factors were increases in the loan loss provision and noninterest expenses. Fourth quarter 1984 earnings were negatively impacted by a $4.5 million loss related to an investment in which Irving Trust has a minority interest.

Net interest income, on a fully taxable basis, for the fourth quarter of 1985 increased 6.8% to $147.9 million from $138.5 million in 1984. A 6.0% increase in earning assets, primarily loans and investment securities, a higher volume of net noninterest-bearing funds and a 19 basis-point widening in the purchased funds margin accounted for this increase. The reduced value of net noninterest-bearing funds, due to the lower interest rate environment in 1985, partially offset these favorable factors. The fourth quarter net interest rate spread was 3.24% in 1985 and 3.23% in 1984.

The growth in noninterest income during the fourth quarter resulted from significantly increased levels of trust income, foreign exchange trading profits, gains on the sales of investment securities, and other income, which were offset partly by lower trading account profits and commissions. Trust income advanced 37.5% in the fourth quarter of 1985 to $15.6 million from $11.4 million in the corresponding 1984 period, due primarily to fees generated from new account relationships and higher asset values of existing accounts. Profits derived from foreign exchange trading totaled $8.5 million in 1985, compared with $6.2 million in 1984. Sales of investment securities resulted in gains of $3.5 million in 1985 and $733,000 in 1984. Other income increased 66.4% to $47.4 million in 1985 from $28.5 million in 1984, due principally to greater domestic and foreign commission and fee income and the effect of the previously mentioned $4.5 million loss in 1984. Income derived from trading bonds and other money market assets amounted to $2.8 million in 1985 and $8.2 million in 1984.

The 9.2% increase in noninterest expenses in the fourth quarter of 1985 over the corresponding 1984 period was mainly attributable to increased staff and other expenses. During the fourth quarter of 1985, salaries and employee benefits expense increased 3.8% to $76.2 million from $73.5 million in 1984, due primarily to normal salary adjustments. Other expenses increased 21.9% to $44.4 million in 1985 from $36.4 million in the prior year, due to general business expansion.

The provision for loan losses amounted to $21.3 million in the fourth quarter of 1985 and $11.4 million in the comparable 1984 period. Fourth quarter net loan charge-offs totaled $18.4 million in 1985 and $7.8 million in 1984.

Five-Year Analysis of the Effects of Changing Prices

The supplemental information on the effects of changing prices required by the Financial Accounting Standards Board is set forth on page 60 of this Report under "Five-Year Analysis of the Effects of Changing Prices."

Consolidated Statement of Income
Irving Bank Corporation

In Thousands (Except Share Amounts)	Year Ended Decemb[illegible]		
	1985	1984	[illegible]
Interest Income:			
Interest and Fees on Loans	$1,250,618	$1,367,060	$1,137,965
Interest on Investment Securities:			
Taxable	90,201	66,818	62,218
Exempt from Federal Income Taxes	37,634	30,396	27,165
Interest on Trading Account Assets	47,651	31,243	11,572
Interest on Federal Funds Sold and Securities Purchased Under Agreements to Resell	56,853	87,716	73,365
Interest on Deposits with Banks	273,181	355,166	356,139
Total Interest Income	1,756,138	1,938,399	1,668,424
Interest Expense:			
Interest on Domestic Office Deposits	295,724	322,107	244,771
Interest on Foreign Office Deposits	529,937	675,479	656,641
Interest on Federal Funds Purchased and Securities Sold Under Agreements to Repurchase	249,291	252,444	191,003
Interest on Other Borrowed Funds (Note 9)	120,795	159,717	92,311
Interest on Long-Term Debt	48,419	39,628	32,095
Total Interest Expense	1,244,166	1,449,375	1,216,821
Net Interest Income	511,972	489,024	451,603
Provision for Loan Losses (Note 5)	63,933	39,363	27,042
Net Interest Income after Provision for Loan Losses	448,039	449,661	424,561
Other Operating Income:			
Trust Income	55,014	44,667	38[illegible]
Trading Account Profits and Commissions	8,926	7,638	1,818
Foreign Exchange Trading Profits	30,378	15,915	12,556
Investment Securities Gains/(Losses)	3,570	1,120	(87)
Other Income (Notes 8 and 14)	174,356	134,808	114,923
Total Other Operating Income	272,244	204,148	167,797
Other Operating Expenses:			
Salaries and Employee Benefits (Note 15)	296,545	282,384	260,317
Net Occupancy Expense of Premises	67,220	64,695	60,002
Furniture and Equipment Expense	42,562	39,942	35,938
Other Expenses	145,375	123,891	111,925
Total Other Operating Expenses	551,702	510,912	468,182
Income before Income Taxes	168,581	142,897	124,176
Applicable Income Taxes (Note 16)	52,602	44,785	31,712
Net Income	$ 115,979	$ 98,112	$ 92,464
Net Income Available to Common Shareholders	$ 109,210	$ 90,322	$ 85,536
Net Income Per Common Share (Note 12)	$6.14	$5.11	$4.86
Average Common Shares Outstanding (Note 12)	17,798,244	17,674,332	17,601,918

See Accompanying Notes to Consolidated Financial Statements.

Consolidated Balance Sheet

Irving Bank Corporation

In Thousands	1985	December 31 1984
Assets		
Cash and Due from Banks (Note 2)	$ 1,624,180	$ 984,721
Interest-Bearing Deposits with Banks	2,197,925	2,833,825
Investment Securities (Note 3):		
U.S. Government and Federal Agency Obligations	609,921	527,696
Obligations of States and Political Subdivisions	682,752	563,278
Other Securities	139,406	104,356
Total Investment Securities (Approximate Market Value of $1,417,885 and $1,134,744)	1,432,079	1,195,330
Trading Account Assets	503,265	363,824
Federal Funds Sold and Securities Purchased Under Agreements to Resell	252,887	376,294
Loans (Less Unearned Discount of $176,961 and $179,391) (Note 4)	12,744,500	11,202,236
Less: Allowance for Loan Losses (Note 5)	179,697	155,106
Net Loans	12,564,803	11,047,130
Premises and Equipment (Note 6)	396,588	399,168
Customers' Acceptance Liability	1,403,156	989,881
Accrued Interest Receivable	236,629	255,257
Other Assets (Note 8)	1,039,149	536,973
Total Assets	**$21,650,661**	**$18,982,403**
Liabilities and Shareholders' Equity		
Deposits:		
Domestic Office Noninterest-Bearing	$ 4,703,342	$ 3,332,633
Foreign Office Noninterest-Bearing	161,160	144,327
Domestic Office Interest-Bearing	3,988,257	4,126,590
Foreign Office Interest-Bearing	5,173,516	5,843,325
Total Deposits	14,026,275	13,446,875
Federal Funds Purchased and Securities Sold Under Agreements to Repurchase	1,831,017	1,078,452
Other Borrowed Funds (Note 9)	2,156,517	1,599,706
Acceptances Outstanding	1,414,660	1,000,548
Accrued Interest Payable	109,923	142,100
Accrued Taxes and Other Expenses	84,259	91,504
Other Liabilities	466,910	334,826
Total Liabilities Excluding Long-Term Debt	20,089,561	17,694,011
Long-Term Debt (Note 10)	605,174	409,963
Shareholders' Equity:		
Preferred Stock, Authorized 10,000,000 Shares (Note 11)		
Cumulative Adjustable Rate Outstanding 1,500,000 Shares	75,000	75,000
$4 Convertible, Cumulative Outstanding 27,870 and 30,218 Shares	557	604
Common Stock, $10 Par Value, Authorized 40,000,000 Shares (Note 12) Outstanding 17,763,978 and 17,620,851 Shares	177,640	176,209
Surplus	107,017	103,725
Retained Earnings	595,712	522,891
Total Shareholders' Equity	955,926	878,429
Total Liabilities and Shareholders' Equity	**$21,650,661**	**$18,982,403**

See Accompanying Notes to Consolidated Financial Statements.

Consolidated Statement of Changes in Shareholders' Equity

Irving Bank Corporation

In Thousands	Year Ended December 31 1985	1984	[illegible]
Cumulative Adjustable Rate Preferred Stock (Note 11):			
Balance at Beginning and End of Year	$ 75,000	$ 75,000	$ 75,000
$4 Convertible, Cumulative Preferred Stock (Note 11):			
Balance at Beginning of Year	$ 604	$ 705	$ 896
Conversion of Preferred Stock	(47)	(101)	(191)
Balance at End of Year	$ 557	$ 604	$ 705
Common Stock (Notes 11 and 12):			
Balance at Beginning of Year	$176,209	$ 87,421	$ 87,112
Conversion of $4 Convertible, Cumulative Preferred Stock	94	179	191
Issued Pursuant to Dividend Reinvestment and Stock Purchase Plan and Employee Stock Purchase Plan	1,337	1,011	118
Issued Pursuant to Two-for-One Stock Split	—	87,598	—
Balance at End of Year	$177,640	$176,209	$ 87,421
Surplus (Notes 11 and 12):			
Balance at Beginning of Year	$103,725	$101,651	$101,264
Issuance Costs of Cumulative Adjustable Rate Preferred Stock	—	—	(94)
Conversion of $4 Convertible, Cumulative Preferred Stock	(47)	(78)	—
Dividend Reinvestment and Stock Purchase Plan and Employee Stock Purchase Plan	3,339	2,152	481
Transfer for Two-for-One Stock Split	—	(87,598)	—
Transfer from Retained Earnings	—	87,598	—
Balance at End of Year	$107,017	$103,725	$10[illegible]
Retained Earnings:			
Balance at Beginning of Year	$522,891	$551,614	$498,471
Net Income for the Year	115,979	98,112	92,464
Cash Dividends Declared	(41,542)	(40,202)	(38,432)
Transfer to Surplus	—	(87,598)	—
Change in Accumulated Translation Adjustment* (Notes 14 and 16)	(1,593)	965	(889)
Purchase of Treasury Stock, at Cost	(23)	—	—
Balance at End of Year	$595,712	$522,891	$551,614

**The accumulated translation adjustment balance included in retained earnings was $(2,610), $(1,017) and $(1,982) at December 31, 1985, 1984 and 1983, respectively.*

See Accompanying Notes to Consolidated Financial Statements.

Consolidated Statement of Changes in Financial Position

Irving Bank Corporation

In Thousands	1985	1984	1983
			Year Ended December 31
Financial Resources were Provided by (Applied to):			
Operations:			
Net Income	$ 115,979	$ 98,112	$ 92,464
Noncash Charges (Credits) Included in Net Income: Depreciation, Amortization, Provision for Loan Losses and Deferred Income Taxes	114,684	74,494	52,700
Less: Cash Dividends Declared	(41,542)	(40,202)	(38,432)
Net Financial Resources Provided by Operations	189,121	132,404	106,732
Deposits and Other Financing Activities:			
Deposits	579,400	836,951	(1,542,700)
Federal Funds Purchased and Securities Sold Under Agreements to Repurchase	752,565	(730,404)	(194,882)
Other Borrowed Funds	556,811	425,119	647,878
Long-Term Debt	195,211	70,002	(4,798)
Issuance of Common Stock under Dividend Reinvestment and Stock Purchase Plan and Employee Stock Purchase Plan	4,676	3,163	599
Total Financial Resources Provided by (Applied to) Deposits and Other Financing Activities	2,088,663	604,831	(1,093,903)
Other Activities—(Increase) Decrease in Net Nonearning Assets	(1,118,637)	109,889	(126,518)
Increase (Decrease) in Financial Resources Invested in Earning Assets	$ 1,159,147	$ 847,124	$(1,113,689)
Increase (Decrease) in Earning Assets:			
Interest-Bearing Deposits with Banks	$ (635,900)	$(108,707)	$(1,030,975)
Investment Securities	236,749	128,448	42,301
Trading Account Assets	139,441	247,815	(90,290)
Federal Funds Sold and Securities Purchased Under Agreements to Resell	(123,407)	(118,001)	(439,786)
Loans	1,542,264	697,569	405,061
Increase (Decrease) in Earning Assets	$ 1,159,147	$ 847,124	$(1,113,689)

See Accompanying Notes to Consolidated Financial Statements.

1. Accounting Policies

The accounting and reporting policies of Irving Bank Corporation (the Corporation) and its subsidiaries are in accordance with generally accepted accounting principles and conform to general practices within the banking industry. The following is a description of the more significant of these policies.

Consolidation—The consolidated financial statements include the accounts of the Corporation and all of its subsidiaries. All significant intercompany accounts and transactions have been eliminated. Investments in companies that are less than majority-owned but in which there is at least a 20% ownership are accounted for by the equity method and classified as other assets.

Foreign Currency Transactions—Foreign currency assets and liabilities have been translated at rates of exchange prevailing at the respective year-end. Translation gains and losses on foreign currency investments whose functional currency is not the U.S. dollar are included in accumulated translation adjustment, along with the related tax effect, which is included in retained earnings. For foreign currency investments whose functional currency is the U.S. dollar, transaction gains and losses are included in other income. Gains and losses from hedging such investments are included in the same categories as the related translation or transaction gains and losses. Income and expenses of foreign offices have been translated at rates of exchange prevailing at the time the income was earned or the expense incurred. Foreign exchange transactions, including spot and futures contracts and forward commitments, are valued monthly at current market rates. Gains and losses resulting from these valuations are included in foreign exchange trading profits.

Investment Securities—Investment securities are stated at cost, adjusted for amortization of premium to call date and accretion of discount to maturity. Gains and losses on sales of investment securities (calculated under the identified certificate method) are shown separately in the consolidated statement of income.

Trading Account Assets—Trading account assets are carried at market value. Both realized and unrealized gains and losses from trading account activities are included in trading account profits and commissions.

Loans—Loans are reported at the principal amount outstanding, net of unearned discount.

Nonaccrual loans are loans (other than consumer installment loans and residential mortgages) on which the accrual of interest ceases when the collection of principal or interest payments is determined to be doubtful by management. It is the general policy of the Corporation to cease the accrual of interest when principal or interest payments are delinquent 90 days or more. Any unpaid amounts previously accrued on these loans are reversed from income, and thereafter interest is recognized only to the extent payments are received. A nonaccrual loan can be returned to accrual status once all interest and principal payments are current and future payments are no longer considered doubtful.

Reduced-rate loans are loans that have been restructured to provide for a reduction of the originally contracted rate of interest as a result of a weakening in the financial position of the borrower. Interest income on these loans is accrued at the reduced rate.

Allowance for Loan Losses—The Corporation and its subsidiaries provide for loan losses on the reserve method. The allowance is increased by provisions charged to operations and decreased by loans charged off, net of recoveries. The charge to operations and the level of the allowance are based on management's evaluation of the loan portfolio, including such factors as the volume and character of loans outstanding, past loan loss experience and general economic conditions.

Premises and Equipment—Premises and equipment are carried at cost less accumulated depreciation and amortization. Depreciation and amortization are computed on a straight-line basis over the estimated useful lives of the assets. Maintenance and repairs are charged to expense as incurred.

Income Taxes—Certain income and expense items are recognized in different periods for income tax purposes than for financial reporting purposes. Provisions for deferred taxes are made in recognition of these timing differences. Investment tax credits relating to assets acquired for use by the Corporation and its subsidiaries are recognized in the year in which the asset is placed in service. Investment tax credits relating to lease financing are deferred and amortized over the terms of the respective leases.

Earnings Per Share—Earnings per share calculations are based on the weighted average number of common equivalent shares outstanding and on earnings available to common shareholders after deducting dividends on Cumulative Adjustable Rate Preferred Stock.

Common equivalent shares consist of Common Stock and $4 Convertible Preferred Stock. Common shares issuable pursuant to the Employee Stock Purchase Plan are not included in common equivalent shares as they do not have a material dilutive effect upon earnings per share.

2. Cash and Due from Banks

The Corporation and its subsidiaries maintain various deposit balances in banks in the United States and abroad. During 1985 and 1984, average balances of $338,717,000 and $323,456,000, respectively, were maintained by subsidiaries of the Corporation in satisfaction of statutory reserve requirements of the Federal Reserve System.

3. Investment Securities

The carrying value and approximate market value of investment securities at December 31, 1985 and 1984 follow:

In Thousands	Carrying Value	Approximate Market Value
December 31, 1985		
U.S. Government and Federal Agency obligations	$ 609,921	$ 625,223
Obligations of states and political subdivisions	682,752	651,607
Other securities	139,406	141,055
Total	$1,432,079	$1,417,885
December 31, 1984		
U.S. Government and Federal Agency obligations	$ 527,696	$ 532,180
Obligations of states and political subdivisions	563,278	494,566
Other securities	104,356	107,998
Total	$1,195,330	$1,134,744

4. Loans

A distribution of loans at December 31, 1985 and 1984 follows:

In Thousands	1985	1984
[illegible]tate:		
[illegible]ruction and land development	$ 285,759	$ 295,554
[illegible]ured by 1-4 family residential properties	492,673	369,881
Other	412,752	386,154
Financial institutions:		
Real estate investment trusts and mortgage companies	81,127	48,392
Domestic commercial banks	100,216	113,678
Other	448,494	335,796
Purchasing or carrying securities	953,344	742,348
Commercial and industrial	3,361,208	2,935,878
Individuals	1,261,470	1,121,974
Other loans attributable to domestic operations	72,197	55,671
Attributable to international operations	5,452,221	4,976,301
	12,921,461	11,381,627
Less unearned discount	176,961	179,391
Total	$12,744,500	$11,202,236

The outstanding principal amount of nonaccrual, reduced-rate and past-due loans at December 31, 1985 and 1984 follows:

In Thousands	1985	1984
Nonaccrual	$255,504	$270,872
Reduced-rate	8,328	17,818
Past-due	3,773	2,812
Total	$267,605	$291,502

Past-due loans are loans on which interest or principal payments are 90 days or more contractually delinquent and interest is still being accrued.

At December 31, 1985 and 1984, there were no unused commitments to extend credit to any of the borrowers included in the preceding table.

The effect on income of nonaccrual and reduced-rate loans for the years ended December 31, 1985, 1984 and 1983 follows:

In Thousands	1985	1984	1983
Interest income that would have been accrued at originally contracted rates	$36,135	$38,593	$30,174
Less interest actually recorded as income	24,884	14,027	18,390
Reduction of income before taxes	$11,251	$24,566	$11,784
Reduction of income after taxes	$ 5,434	$11,244	$ 6,083

5. Allowance for Loan Losses

Transactions in the allowance for loan losses follow:

In Thousands	1985	1984	1983
Balance, January 1	$155,106	$141,141	$140,956
Loans charged off	(55,425)	(36,593)	(36,364)
Recoveries on loans previously charged off	15,529	11,222	10,064
Net loan charge-offs	(39,896)	(25,371)	(26,300)
Provision charged to operations	63,933	39,363	27,042
Balance related to acquisition	568	—	—
Translation of foreign currency allowance balances	(14)	(27)	(557)
Balance, December 31	$179,697	$155,106	$141,141

6. Premises and Equipment

A summary of the accounts at December 31, 1985 and 1984 follows:

In Thousands	1985	1984
Land	$ 26,808	$ 26,820
Buildings	284,847	278,192
Furniture, equipment and leasehold improvements	246,219	235,598
	557,874	540,610
Less accumulated depreciation and amortization	161,286	141,442
Total	$396,588	$399,168

Depreciation and amortization expense amounted to $36,395,000 for 1985, $33,331,000 for 1984 and $25,487,000 for 1983.

7. Lease Commitments

The Corporation and its subsidiaries are parties to various lease agreements for both premises and equipment. Real estate leases typically contain renewal options ranging from five to 20 years and rent escalation clauses based on increases in specified categories of operating expenses incurred by the lessor. Equipment leases contain renewal options generally ranging from one month to five years.

Net rental expense incurred under all lease agreements during 1985, 1984 and 1983 amounted to:

In Thousands	1985	1984	1983
Gross rental expense	$34,640	$39,365	$46,107
Less rentals from subleases	1,196	1,968	2,020
Net rental expense	$33,444	$37,397	$44,087

At December 31, 1985, the aggregate minimum commitments under noncancelable lease agreements with initial or remaining terms of one year or more were as follows:

In Thousands	Aggregate Minimum Lease Commitments
1986	$ 19,169
1987	14,743
1988	12,756
1989	12,003
1990	10,421
After 1990	92,802
Total	$161,894

Aggregate future minimum sublease rental income under noncancelable subleases related to noncancelable leases at December 31, 1985 amounted to $2,550,000.

8. Investments in Less Than Majority-Owned Affiliates

At December 31, the Corporation had aggregate investments in less than majority-owned affiliates, accounted for by the equity method, amounting to $193,821,000 in 1985 and $154,842,000 in 1984, which exceeded its share of such affiliates' combined shareholders' equity by $22,300,000 and $12,430,000, respectively. In 1985, 1984 and 1983, the Corporation recorded $9,902,000, $10,039,000 and $16,071,000 of equity income attributable to affiliates in other income.

Summary combined financial information available at December 31, 1985 and 1984 and for the years 1985, 1984 and 1983 with respect to less than majority-owned affiliates is presented below.

In Thousands	1985	1984
Total assets	$5,749,280	$5,021,916
Total deposits	4,879,335	4,155,685
Total loans	3,242,062	2,878,836
Total interest-bearing deposits with banks	1,519,870	1,193,892
Total shareholders' equity	428,305	357,453

In Thousands	1985	1984	1983
Net interest income	$95,051	$107,599	$115,801
Other operating income	88,062	86,198	80,715
Net income	33,654	19,719	43,264

Prior year data presented in the preceding tables have been reclassified to reflect the most current financial information available.

9. Other Borrowed Funds

The following information relates to other borrowed funds:

	At December 31	
In Thousands	1985	1984
Commercial paper	$ 261,705	$ 572,754
Other short-term borrowings	1,894,812	1,026,952
Total	$2,156,517	$1,599,706

	Average Balance for the Year		
	1985	1984	1983
Commercial paper	$ 392,023	$ 479,976	$ 33,061
Other short-term borrowings	1,028,860	1,069,351	949,494
Total	$1,420,883	$1,549,327	$982,555

	Average Rate for the Year		
	1985	1984	[illegible]
Commercial paper	8.52%	10.69%	[illegible]%
Other short-term borrowings	8.49	10.14	9.39
Total	8.50	10.31	9.39

10. Long-Term Debt

The following is a summary of long-term debt at December 31, 1985 and 1984:

In Thousands	1985	1984
Irving Bank Corporation: 5¾% Debentures, due 1991	$ 22,053	$ 23,433
6⅛% Debentures, due 1992	26,545	27,832
Floating Rate Subordinated Notes, due 1996	74,613	74,578
Floating Rate Subordinated Capital Notes, due 1997	200,000	—
8½% Debentures, due 2002	75,000	75,000
Floating Rate Notes, due 2004	90,000	90,000
12⅜% Debentures, due 2007	99,268	99,262
	587,479	390,105
Irving Trust Company and Subsidiaries: 4½% Notes, due 1993	15,508	17,468
Other Subsidiaries of Irving Bank Corporation: Various debt issues with maturity dates in 1989 and 1990 having interest rates of 4⅞% and 5%	2,187	2,390
Total	$605,174	$[illegible]

The interest rates on the Floating Rate Subordinated Notes, due 1996 and the Floating Rate Subordinated Capital Notes, due 1997 are determined quarterly by a formula based upon the arithmetic mean of the London interbank offered quotations for three-month Eurodollar deposits, and each issue is subject to a minimum rate of 5¼% per annum. Each issue is subordinated to senior indebtedness of the Corporation (as defined in the indentures).

At December 31, 1985, the unamortized discount on the Floating Rate Subordinated Notes, due 1996 amounted to $387,000. The interest rate on such notes was 8.125% at December 31, 1985 and 8.8125% at December 31, 1984. The Corporation has agreed that, prior to the maturity of the notes in 1996, it will issue shares of Common Stock, perpetual preferred stock or certain other securities of the Corporation (collectively "Capital Securities") in an amount not less than the original aggregate principal amount of the notes. The net proceeds raised from the issuance of Capital Securities shall be deposited in a segregated note fund in amounts equal to one-third of the principal amount of the notes by March 1988, two-thirds by March 1992 and 100% by March 1996. The note fund is expected to provide a source of funds for the payment of the notes, but does not constitute security for the notes.

The interest rate on the Floating Rate Subordinated Capital Notes, due 1997 was 8.3125% at December 31, 1985. The Corporation has agreed that at their maturity it will exchange for the outstanding notes, Capital Securities with a market value equal to the principal amount of such notes, or will under certain conditions redeem them for cash.

The interest rate on the Floating Rate Notes, due 2004 is determined semi-annually by a formula based upon the then-current rate for six-month U.S. Treasury bills and is subject to certain minimum per annum interest rates as specified in the agreement governing the issue. The interest rates on the notes were 8.65% and 11.75% at December 31, 1985 and 1984, respectively.

The 12⅜% Debentures were sold at a discount to yield 12.47%. At December 31, 1985, the unamortized discount amounted to $732,000.

During 1985, 1984 and 1983, the Corporation reduced the outstanding balances of its 5¾% and 6⅛% Debentures as follows:

In Thousands	1985	1984	1983
Par value of debentures purchased at a discount:			
5¾% Debentures	$1,380	$1,136	$1,433
6⅛% Debentures	1,287	1,369	1,374

The above purchases resulted in gains of $593,000 in 1985, $790,000 in 1984 and $782,000 in 1983, which were recorded in other income.

Sinking fund requirements for 1985, amounting to $2,650,000, were satisfied through the retirement of debentures purchased in 1983, 1984 and 1985. The aggregate amounts of long-term debt maturing and net sinking fund requirements remaining to be satisfied for the five years subsequent to December 31, 1985 are $2,350,000 for 1986, $9,495,000 for 1987, $9,593,000 for 1988, $10,995,000 for 1989 and $15,673,000 for 1990.

Pursuant to the terms of the indentures under which certain debentures issued by the Corporation are outstanding, the maximum amount of additional funded debt that could be created or guaranteed by the Corporation was $296 million at December 31, 1985.

11. Preferred Stock

The dividend rate on the Cumulative Adjustable Rate Preferred Stock is determined quarterly and will be 2.25% below the highest of the per annum three-month U.S. Treasury bill rate, the U.S. Treasury note ten-year constant maturity rate and the U.S. Treasury bond twenty-year constant maturity rate. In no event will the quarterly dividend rate be less than 6.50% per annum or greater than 14.00% per annum. The dividend rates were 8.55% and 10.40% at December 31, 1985 and 1984, respectively. The stock has a liquidation preference of $50 per share, plus cumulative and unpaid dividends. It may be redeemed at the option of the Corporation on or after January 1, 1988 through December 31, 1992 at $51.50 per share and thereafter at $50 per share, plus in each case cumulative and unpaid dividends to the redemption date.

The $4.00 Convertible Preferred Stock may be redeemed by the Corporation at $87 per share; its aggregate involuntary liquidation preference at December 31, 1985 amounted to $2,425,000. Each outstanding share, which entitles the holder to one vote, is convertible at the option of the holder into four shares of Common Stock. Prior to the two-for-one Common Stock split during the second quarter of 1984, each outstanding share was convertible into two shares of Common Stock. During 1985 and 1984, 2,348 and 5,051 shares were converted into 9,392 and 17,630 shares of Common Stock, respectively.

12. Common Stock

During 1984, the Corporation declared a two-for-one common stock split. Accordingly, 1983 per share amounts and average common shares outstanding have been restated.

Under the Corporation's Dividend Reinvestment and Stock Purchase Plan (the Plan), shareholders may elect to reinvest all or part of their dividends in newly issued shares of Irving Bank Corporation Common Stock at a 5% discount from the market price. In addition, shareholders may make quarterly purchases of between $25 and $5,000 of newly issued shares at the market price. The administrative costs associated with the Plan are paid by the Corporation. At December 31, the Corporation had issued 133,068 and 101,067 shares of Common Stock under the Plan in 1985 and 1984, respectively.

On July 1, 1985, the Corporation adopted an Employee Stock Purchase Plan, granting all eligible employees the opportunity to buy common shares over a two-year period at a price equal to book value or market value at the grant date. At December 31, 1985, outstanding subscriptions amounting to $16 million may be used to purchase book value shares at $47.66 per share, or market value shares at $38.81 per share, or any combination thereof, or may be withdrawn in cash from the plan. Under the plan, market value shares are freely tradable and transferable shares of the Corporation's Common Stock, and book value shares are shares of the Corporation's Common Stock that are not transferable except to the Corporation.

13. Pledged Assets

At December 31, 1985, securities, loans and premises amounting to $1,652,926,000, which are included in the consolidated balance sheet, were pledged as collateral for borrowings to secure public deposits and for other purposes.

14. Other Income

A summary of other income for the years ended December 31, 1985, 1984 and 1983 follows:

In Thousands	1985	1984	1983
Factoring commissions	$ 14,595	$ 15,210	$ 14,265
Domestic commission and fee income	64,771	45,388	34,748
Foreign commission and fee income	48,722	39,963	31,464
Foreign currency transaction gains/(losses)	(1,346)	(4,188)	(2,862)
Other income	47,614	38,435	37,308
Total	$174,356	$134,808	$114,923

Foreign currency translation gains/(losses) of $38,792,000 for 1985, $(23,337,000) for 1984 and $(20,879,000) for 1983 and related foreign currency hedging gains/(losses) of $(40,825,000) for 1985, $23,889,000 for 1984 and $18,892,000 for 1983 were recorded directly in accumulated translation adjustment.

15. Employee Benefits

The Corporation and its subsidiaries have noncontributory retirement plans that offer uniform benefits to substantially all full-time employees. The total pension cost, which includes amortization of prior service costs, was $2,305,000, $8,727,000, and $11,552,000 for 1985, 1984 and 1983, respectively.

Effective January 1, 1985, the cost method used to calculate actuarially determined pension cost and funding was changed to the Projected Unit Credit Cost Method. The net actuarial surplus that resulted from the change in the cost method used and the assumed rate of return for calculating pension cost is being amortized over 10 years. These changes reduced the 1985 pension cost by approximately $6,200,000. Due to changes in actuarial assumptions, which included changes in the assumed rate of return and projected salary increases, the pension cost was reduced by $2,400,000 in 1984. The assumed rate of return for calculating pension cost was 8.5% in 1985, 8% in 1984 and 7% in 1983. It is the policy of the Corporation and its subsidiaries to fund in accordance with the requirements of ERISA.

A comparison of accumulated retirement plan benefits and plan net assets at January 1, 1985 and 1984, the most recent actuarial valuation dates, is presented below:

In Thousands	1985	1984
Actuarial present value of accumulated plan benefits:		
Vested	$141,990	$129,246
Nonvested	9,348	7,951
Total	$151,338	$137,197
Net assets available for benefits	$241,539	$226,285

The assumed rate of return used in determining the actuarial present value of accumulated plan benefits was 8% for 1985 and 1984.

The Corporation provides certain health care and life insurance benefits for retired United States employees. Retired foreign office employees are generally covered by local government-sponsored programs. All of the Corporation's employees, excluding those employed by foreign branches and subsidiaries, become eligible for these benefits if they reach retirement age while still working for the Corporation. Benefits for retired and active employees are provided through insurance companies, whose premiums are based on the benefits paid during the year. The Corporation expenses the cost of providing these benefits, which amounted to $14,396,000 in 1985 and $11,680,000 in 1984. The cost of providing these benefits for 2,000 retirees is not readily separable from the cost of providing benefits for the 9,700 active employees.

16. Income Taxes

A summary of the provisions for income taxes for 1985, 1984 and 1983 follows:

In Thousands	1985	1984	1983
Taxes applicable to income before taxes	$52,602	$44,785	$31,712
Taxes applicable to accumulated translation adjustment*	(440)	(413)	(1,098)
Total	$52,162	$44,372	$30,614

**The accumulated translation adjustment includes translation gains/(losses) on foreign currency investments and the related gains/(losses) from hedging such investments.*

The current and deferred tax provisions for the years ended December 31, 1985, 1984 and 1983 follow:

In Thousands	Federal	State & Local	Foreign	Total
1985				
Current	$(4,996)	$(3,345)	$23,667	$ 15,326
Deferred	30,933	5,903	—	36,836
Total	$25,937	$ 2,558	$23,667	$ 52,162
1984				
Current	$25,354	$19,228	$12,736	$ 57,318
Deferred	(4,757)	(8,189)	—	(12,946)
Total	$20,597	$11,039	$12,736	$ 44,372
1983				
Current	$13,502	$14,647	$14,727	$ 42,876
Deferred	(5,506)	(6,756)	—	(12,262)
Total	$ 7,996	$ 7,891	$14,727	$ 30,614

The sources of timing differences resulting in deferred tax provisions in 1985, 1984 and 1983 and their tax effect for each year follow:

In Thousands	1985	1984	1983
Provision for loan losses	$(14,073)	$(12,113)	$ (2,606)
State and local income taxes	6,277	2,604	2,408
[illegible]nancing transactions	17,106	1,578	835
[illegible]ation	10,246	14,870	11,541
Foreign currency translation	20,894	(19,680)	(17,505)
Other—net	(3,614)	(205)	(6,935)
Total	$ 36,836	$(12,946)	$(12,262)

For the purpose of computing the Corporation's effective tax rate, income before income taxes includes the before-tax amount of the accumulated translation adjustment. The effective tax rate for each year is lower than the statutory Federal income tax rate of 46.0%. The reasons for these differences in the tax rates follow:

	As a Percentage of Income before Income Taxes		
	1985	1984	1983
Statutory Federal income tax rate	46.0 %	46.0 %	46.0 %
Increase (decrease) in tax rates resulting from:			
State and local income taxes, net of Federal income tax benefit	0.8	4.2	3.5
Tax-exempt income	(11.6)	(11.2)	(11.5)
Overseas affiliates' and subsidiaries' income	(2.8)	(3.1)	(7.2)
Investment tax credits	(1.0)	(2.6)	(4.0)
Other—net	(0.1)	(2.4)	(1.7)
Effective tax rate*	31.3 %	30.9 %	25.1 %

**Fo[illegible]rther analysis of the effective tax rate, see the discussion of Applicable I[illegible]xes on pages 21 and 22 of this Report.*

Investment tax credits amounted to $22,700,000 for 1985, $4,338,000 for 1984 and $5,124,000 for 1983 and are utilized in the Federal income tax return as a reduction of taxes payable.

A summary of income before income taxes, including the effect of the accumulated translation adjustment, from foreign activities (consisting of Irving Trust's branches, investments and subsidiaries located outside the United States and its international banking facilities) and domestic activities for 1985, 1984 and 1983 follows:

In Thousands	1985	1984	1983
Foreign activities	$129,086	$ 99,736	$ 80,941
Domestic activities	37,462	43,713	41,248
Total	$166,548	$143,449	$122,189

17. Parent Corporation Unconsolidated Summary Financial Information

The unconsolidated summary balance sheet of the Parent Corporation at December 31, 1985 and 1984 follows:

In Thousands	1985	1984
Assets:		
Interest-bearing deposits with subsidiary bank	$ 259,197	$ 570,393
Interest-bearing deposits with other banks	39,985	—
Participations in loans of subsidiary bank	26,365	11,700
Receivables from subsidiaries	375,450	234,846
Investments in subsidiaries, at underlying equity in net assets	1,104,649	1,025,054
Other assets	6,189	5,098
Total assets	$1,811,835	$1,847,091
Liabilities and shareholders' equity:		
Commercial paper (Note 9)	$ 261,705	$ 572,754
Other liabilities	6,725	5,803
Long-term debt (Note 10)	587,479	390,105
Total liabilities	855,909	968,662
Total shareholders' equity	955,926	878,429
Total liabilities and shareholders' equity	$1,811,835	$1,847,091

The unconsolidated summary statement of income of the Parent Corporation for the years ended December 31, 1985, 1984 and 1983 follows:

In Thousands	1985	1984	1983
Income:			
Dividends from subsidiaries	$ 45,411	$ 61,027	$44,114
Interest on deposits with subsidiary bank	34,180	51,169	2,865
Interest on deposits with other banks	1,897	—	—
Interest on participations in loans of subsidiary bank	1,982	1,805	1,037
Interest on receivables from subsidiaries	29,397	22,290	16,605
Other income	2,357	1,987	1,966
Total Income	115,224	138,278	66,587
Expenses:			
Interest on commercial paper	33,418	51,325	3,060
Interest on long-term debt	47,551	38,657	31,033
Salaries and employee benefits	3,298	3,009	2,429
Other expenses	4,422	3,699	3,223
Total expenses	88,689	96,690	39,745
Income before income taxes and equity in undistributed net income of subsidiaries	26,535	41,588	26,842
Applicable income tax benefits	10,256	9,761	8,977
Income before equity in undistributed net income of subsidiaries	36,791	51,349	35,819
Equity in undistributed net income of subsidiaries	79,188	46,763	56,645
Net income	$115,979	$ 98,112	$92,464

The unconsolidated summary statement of changes in financial position of the Parent Corporation for the years ended December 31, 1985, 1984 and 1983 follows:

In Thousands	1985	1984	1983
Sources of funds:			
Net Income	$ 115,979	$ 98,112	$ 92,464
Equity in undistributed net income of subsidiaries	(79,188)	(46,763)	(56,645)
Funds derived from operations	36,791	51,349	35,819
Increase in commercial paper	—	417,987	148,584
Increase in long-term debt	197,374	72,079	—
Issuance of common stock under dividend reinvestment and stock purchase plan and employee stock purchase plan	4,676	3,163	599
Decrease in interest-bearing deposits with subsidiary bank	311,196	—	—
Decrease in interest-bearing deposits with other banks	—	—	10,000
All other–net	—	538	—
Total sources of funds	$ 550,037	$545,116	$195,002
Disposition of funds:			
Cash dividends declared	$ 41,542	$ 40,202	$ 38,432
Increase in participations in loans of subsidiary bank	14,665	1,600	3,895
Increase in interest-bearing deposits with subsidiary bank	—	417,744	1[illegible]
Increase in interest-bearing deposits with other banks	39,985	—	—
Increase in receivables from subsidiaries	140,604	85,570	—
Decrease in commercial paper	311,049	—	—
Funds invested in capital stock of subsidiary	2,000	—	165
All other–net	192	—	2,847
Total disposition of funds	$ 550,037	$545,116	$195,002

18. Restrictions on Subsidiary Bank Dividends and Loans to Parent Company

Federal and New York laws impose restrictions upon the amount of dividends that the Corporation's subsidiary banks may declare. The most restrictive of these provisions requires approval by the appropriate bank regulatory agency in the event that a subsidiary bank declares dividends in any calendar year in excess of that year's net profits, plus the retained net profits of the two preceding years. Based upon this formula, the Corporation's subsidiary banks could, without seeking regulatory approval, declare dividends in 1986 of approximately $134,183,000 (retained net profits for 1985 and 1984), plus an additional amount equal to their net profits for 1986 up to the date of any such dividend declaration.

Federal law also imposes a restriction upon the amount of loans or advances that a bank holding company's subsidiary banks may extend to that company. This provision prohibits the Corporation from borrowing from its subsidiary banks unless such borrowings are secured by specific collateral. These secured loans are generally limited to 10% of a subsidiary bank's capital and surplus; and the aggregate amount of such loans to the Corporation and all of its nonbank subsidiaries is limited to 20% of that subsidiary bank's capital and surplus. Based upon these provisions, the Corporation's subsidiary banks could have advanced prior to the declaration of the maximum amount of dividends mentioned in the preceding paragraph, and assuming adequate qualifying collateral was available, up to $113,455,000 to the Corporation at December 31, 1985.

The effect of the preceding two restrictions, assuming they had occurred simultaneously, was to limit the Corporation's subsidiary banks to providing funds to the Corporation in the form of dividends and loans to a maximum of $234,220,000 at December 31, 1985.

19. Commitments and Contingent Liabilities

In the normal course of business, various commitments and contingent liabilities are outstanding, such as guarantees and commitments to extend credit, commitments to purchase and sell foreign currencies, and commercial and similar letters of credit, that are not reflected in the financial statements. Management does not anticipate losses as a result of these transactions. Standby letters of credit are issued primarily to secure certain borrowings of the Corporation's major customers. At December 31, 1985, standby letters of credit and guarantees amounted to $2,759,379,000 (including participations sold of $532,519,000), substantially all of which are scheduled to mature within five years.

The subsidiaries are defendants in various legal proceedings arising in connection with their business. It is the best judgment of management that the financial position of the Corporation and its subsidiaries will not be materially affected by the final outcome of these legal proceedings and that adequate provision has been made therefor in the accompanying consolidated financial statements.

20. International Operations

Certain information with respect to international operations for the years ended December 31, 1985, 1984 and 1983 is set forth under International Operations—"Basis of Presentation" and "Geographic Distribution of Selected Statement of Income Categories" on page 54 of this Report and under "Geographic Distribution of Selected Assets Attributable to International Operations" on page 55 of this Report.

Report of Independent Certified Public Accountants

PEAT
MARWICK

Peat, Marwick, Mitchell & Co.
Certified Public Accountants
345 Park Avenue
New York, NY 10154

To the Shareholders and Board of Directors of
Irving Bank Corporation:

We have examined the consolidated balance sheet of Irving Bank Corporation as of December 31, 1985 and 1984 and the related consolidated statements of income, changes in shareholders' equity and changes in financial position for each of the years in the three-year period ended December 31, 1985. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the aforementioned consolidated financial statements present fairly the financial position of Irving Bank Corporation and subsidiaries as of December 31, 1985 and 1984 and the results of their operations, changes in their shareholders' equity and changes in their financial position for each of the years in the three-year period ended December 31, 1985, in conformity with generally accepted accounting principles applied on a consistent basis.

January 13, 1986

Peat, Marwick, Mitchell & Co.

Management Report

Irving Bank Corporation

The accompanying consolidated balance sheet of Irving Bank Corporation at December 31, 1985 and 1984 and the consolidated statements of income, changes in shareholders' equity and changes in financial position for the years ended December 31, 1985, 1984 and 1983 have been prepared by management in accordance with generally accepted accounting principles appropriate in the circumstances and include some amounts that are necessarily based on management's best estimates and judgments. Management is responsible for the integrity, objectivity, consistency and fair presentation of the financial statements and all financial information contained in this Report.

Management fulfills these responsibilities through an internal accounting control system that has been designed to safeguard the Corporation's assets from material loss or misuse and assure that transactions are properly authorized and recorded in its financial records. The corporate-wide system emphasizes an organizational structure that provides proper delegation of authority and segregation of duties, the development and dissemination of policies and procedures, and a comprehensive system of internal audits and appropriate management follow-up. Because of inherent limitations on any system of controls, there can be no absolute assurance that errors or irregularities will not occur. Nevertheless, management believes that the system of internal accounting control provides reasonable assurance that the Corporation's assets are safeguarded and that its financial records, which are the basis for the preparation of all financial statements, are reliable.

Through its Committee on Examinations and Audits, which is composed of directors who are not officers or employees of the Corporation, the Board of Directors fulfills its responsibility for ascertaining that the accounting policies employed by management in preparing the Corporation's financial statements are reasonable and that the system of internal accounting control is adequately reviewed and maintained. This Committee reviews periodically, with management and the Auditor, accounting policies and control procedures and audit and regulatory examination reports of the Corporation and its subsidiaries. In addition, the Corporation's independent certified public accountants, Peat, Marwick, Mitchell & Co., meet periodically with and have full and free access to the Committee, privately and with management being present, to discuss the results of their examinations as well as other auditing and financial reporting matters.

Peat, Marwick, Mitchell & Co. have examined the accompanying consolidated financial statements of the Corporation, and their report thereon is presented on page 41. Such report represents an informed judgment as to whether the Corporation's financial statements, considered in their entirety, present fairly its financial position and results of operations in conformity with generally accepted accounting principles. Their examinations were conducted in accordance with generally accepted auditing standards, which included a review of the Corporation's internal accounting control system for the purpose of determining the reliance they placed thereon in designing their examination procedures, and appropriate tests of transactions to the extent they considered necessary in the circumstances.

Common and Preferred Stock

The principal market in which Irving Bank Corporation's Common Stock and Cumulative Adjustable Rate Preferred Stock are traded is the New York Stock Exchange. The $4.00 Convertible Preferred Stock is traded only in the Over-the-Counter Market. Cash dividends declared for the $4.00 Convertible Preferred Stock were $1.00 per share in each quarter of 1985 and 1984. There were no bid or asked prices for the $4.00 Convertible Preferred Stock in 1985 or 1984.

The following table sets forth the high and low sale prices on the New York Stock Exchange for the Common Stock and the Cumulative Adjustable Rate Preferred Stock and the cash dividends declared per share for the Common Stock and the Cumulative Adjustable Rate Preferred Stock.

	1985				1984			
	Fourth Quarter	Third Quarter	Second Quarter	First Quarter	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
Common Stock*								
Sale Prices:								
High	$ 44⅛	$ 40⅜	$ 40⅝	$ 35	$ 32½	$ 29⅞	$ 30¼	$ 34¼
Low	33	32½	34	31⅝	27⅛	23⅛	25	26⅜
Dividends Per Share	0.49	0.49	0.49	0.49	0.46	0.46	0.46	0.46
Cumulative Adjustable Rate Preferred Stock								
Sale Prices:								
High	$ 54¾	$ 52⅞	$ 53	$ 51	$ 46¾	$ 51¼	$ 54	$ 52⅝
Low	51⅝	50¼	49	44½	42¾	46	49	[illegible]
Dividends Per Share	1.0688	1.0313	1.2313	1.1813	1.3000	1.4000	1.2688	[illegible]

**During 1984, the Corporation effected a two-for-one split of the Corporation's common stock. Accordingly, the common stock ranges and dividends have been restated to reflect this event.*

Six-Year Consolidated Balance Sheet

Irving Bank Corporation

...ions	1985	1984	1983	1982	1981	December 31 1980
Assets						
Cash and Due from Banks	$ 1,624	$ 985	$ 1,266	$ 1,460	$ 1,607	$ 3,487
Interest-Bearing Deposits with Banks	2,198	2,834	2,942	3,974	3,558	2,649
Investment Securities:						
U.S. Government and Federal Agency Obligations	610	528	527	489	551	607
Obligations of States and Political Subdivisions	683	563	466	465	744	802
Other Bonds, Notes and Debentures	96	74	44	44	32	31
Corporate Stock	43	30	30	27	27	20
Total Investment Securities	1,432	1,195	1,067	1,025	1,354	1,460
Trading Account Assets	503	364	116	206	235	91
Federal Funds Sold and Securities Purchased Under Agreements to Resell	253	376	494	934	175	622
Loans:						
Domestic Offices	7,995	6,712	6,515	5,573	5,769	5,757
Foreign Offices	4,750	4,490	3,990	4,527	4,333	2,950
Less: Allowance for Loan Losses	180	155	141	141	130	116
Net Loans	12,565	11,047	10,364	9,959	9,972	8,591
Premises and Equipment	397	399	367	283	193	145
Customers' Acceptance Liability	1,403	990	1,287	1,129	641	559
Accrued Interest Receivable	237	255	237	270	318	258
Other Assets	1,039	537	446	274	174	228
Total Assets	$21,651	$18,982	$18,586	$19,514	$18,227	$18,090
Liabilities and Shareholders' Equity						
Deposits:						
Domestic Office Noninterest-Bearing	$ 4,703	$ 3,333	$ 3,122	$ 3,436	$ 3,998	$ 5,934
Foreign Office Noninterest-Bearing	161	144	143	114	194	130
Domestic Office Interest-Bearing	3,988	4,127	3,269	2,878	2,592	2,609
Foreign Office Interest-Bearing	5,174	5,843	6,076	7,725	7,222	5,490
Total Deposits	14,026	13,447	12,610	14,153	14,006	14,163
Federal Funds Purchased and Securities Sold Under Agreements to Repurchase	1,831	1,078	1,809	2,004	1,358	1,179
Other Borrowed Funds	2,157	1,600	1,175	527	694	870
Acceptances Outstanding	1,415	1,001	1,306	1,139	649	568
Accrued Interest Payable	110	142	159	201	256	177
Accrued Taxes and Other Expenses	84	91	98	93	98	95
Other Liabilities	467	335	273	289	278	218
Total Liabilities Excluding Long-Term Debt	20,090	17,694	17,430	18,406	17,339	17,270
Long-Term Debt	605	410	340	345	249	251
Shareholders' Equity:						
Preferred Stock	76	76	76	76	1	2
Common Stock	177	176	87	87	87	86
Surplus	107	103	102	101	103	103
Retained Earnings	596	523	551	499	448	378
Total Shareholders' Equity	956	878	816	763	639	569
Total Liabilities and Shareholders' Equity	$21,651	$18,982	$18,586	$19,514	$18,227	$18,090

Six-Year Consolidated Statement of Income

Irving Bank Corporation

In Millions (Except Share Amounts)	1985	1984	1983	1982	Year Ended Decem 1981	[illegible]
Interest Income:						
Interest and Fees on Loans	$1,250.6	$1,367.1	$1,138.0	$1,401.0	$1,495.1	$1,077.3
Interest on Investment Securities:						
Taxable	90.2	66.8	62.2	63.9	71.7	51.5
Exempt from Federal Income Taxes	37.6	30.4	27.1	40.9	46.5	42.0
Interest on Trading Account Assets	47.7	31.2	11.6	16.4	17.7	9.8
Interest on Federal Funds Sold and Securities Purchased Under Agreements to Resell	56.9	87.7	73.4	68.2	51.0	47.3
Interest on Deposits with Banks	273.2	355.2	356.1	554.8	588.1	404.2
Total Interest Income	1,756.2	1,938.4	1,668.4	2,145.2	2,270.1	1,632.1
Interest Expense:						
Interest on Domestic Office Deposits	295.7	322.1	244.8	293.9	345.3	208.5
Interest on Foreign Office Deposits	530.0	675.5	656.6	1,049.0	1,090.4	695.6
Interest on Federal Funds Purchased and Securities Sold Under Agreements to Repurchase	249.3	252.5	191.0	240.6	256.9	191.5
Interest on Other Borrowed Funds	120.8	159.7	92.3	86.9	96.9	93.3
Interest on Long-Term Debt	48.4	39.6	32.1	25.0	24.4	24.7
Total Interest Expense	1,244.2	1,449.4	1,216.8	1,695.4	1,813.9	1,213.6
Net Interest Income	512.0	489.0	451.6	449.8	456.2	418.5
Provision for Loan Losses	63.9	39.4	27.0	39.9	43.0	[illegible]
Net Interest Income after Provision for Loan Losses	448.1	449.6	424.6	409.9	413.2	367.5
Other Operating Income:						
Trust Income	55.0	44.7	38.6	30.2	26.3	24.8
Trading Account Profits and Commissions	8.9	7.7	1.8	8.3	2.6	0.9
Foreign Exchange Trading Profits	30.4	15.9	12.6	16.1	11.6	14.5
Investment Securities Gains/(Losses)	3.6	1.1	(0.1)	(4.0)	(0.2)	(1.2)
Other Income	174.3	134.8	114.9	77.0	79.1	68.1
Total Other Operating Income	272.2	204.2	167.8	127.6	119.4	107.1
Other Operating Expenses:						
Salaries and Employee Benefits	296.5	282.4	260.3	246.2	219.0	195.2
Net Occupancy Expense of Premises	67.2	64.7	60.0	53.9	44.1	40.4
Furniture and Equipment Expense	42.6	39.9	36.0	34.0	27.8	24.5
Other Expenses	145.4	123.9	111.9	108.5	106.5	91.8
Total Other Operating Expenses	551.7	510.9	468.2	442.6	397.4	351.9
Income before Income Taxes	168.6	142.9	124.2	94.9	135.2	122.7
Applicable Income Taxes	52.6	44.8	31.7	13.9	38.2	37.4
Net Income	$ 116.0	$ 98.1	$ 92.5	$ 81.0	$ 97.0	$ 85.3
Net Income Available to Common Shareholders	$ 109.2	$ 90.3	$ 85.5	$ 80.4	$ 97.0	$ 85.3
Net Income Per Common Share*	$6.14	$5.11	$4.86	$4.57	$5.51	$4.85
Dividends Per Common Share*	1.96	1.84	1.76	1.68	1.52	1.36

**During 1984, the Corporation effected a two-for-one split of the Corporation's common stock. Accordingly, per common share amounts have been restated to reflect thi*

Quarterly Consolidated Statement of Income

Irving Bank Corporation

	1985				1984			
In Millions (Except Share Amounts)	Fourth Quarter	Third Quarter	Second Quarter	First Quarter	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
Interest Income:								
Interest and Fees on Loans	$319.8	$310.9	$316.2	$303.7	$349.2	$365.3	$339.9	$312.7
Interest on Investment Securities:								
Taxable	22.6	24.4	23.1	20.1	17.7	16.6	16.6	15.9
Exempt from Federal Income Taxes	9.7	9.1	9.5	9.3	9.1	7.4	7.0	6.9
Interest on Trading Account Assets	13.6	9.5	11.9	12.7	12.3	10.9	3.6	4.4
Interest on Federal Funds Sold and Securities Purchased Under Agreements to Resell	13.9	12.6	14.7	15.7	20.9	23.8	25.0	18.0
Interest on Deposits with Banks	58.8	68.3	71.3	74.8	83.4	90.2	95.7	85.9
Total Interest Income	438.4	434.8	446.7	436.3	492.6	514.2	487.8	443.8
Interest Expense:								
Interest on Domestic Office Deposits	69.6	68.7	77.0	80.4	88.4	87.5	75.3	70.9
Interest on Foreign Office Deposits	124.5	131.6	135.5	138.4	162.8	180.3	171.4	161.0
Interest on Federal Funds Purchased and Securities Sold Under Agreements to Repurchase	61.9	64.7	68.3	54.4	61.3	67.4	67.3	56.5
Interest on Other Borrowed Funds	34.3	28.2	27.4	30.9	43.1	45.0	39.9	31.7
Interest on Long-Term Debt	13.5	13.6	11.3	10.0	10.6	10.6	10.3	8.1
Total Interest Expense	303.8	306.8	319.5	314.1	366.2	390.8	364.2	328.2
Net Interest Income	134.6	128.0	127.2	122.2	126.4	123.4	123.6	115.6
Provision for Loan Losses	21.3	17.2	14.6	10.8	11.4	9.8	7.6	10.6
Net Interest Income after Provision for Loan Losses	113.3	110.8	112.6	111.4	115.0	113.6	116.0	105.0
Other Operating Income:								
Trust Income	15.6	14.3	13.1	12.0	11.4	11.8	11.1	10.4
Trading Account Profits and Commissions	2.8	0.3	5.4	0.4	8.2	—	(1.2)	0.7
Foreign Exchange Trading Profits	8.5	8.5	8.4	5.0	6.2	4.1	2.0	3.6
Investment Securities Gains/(Losses)	3.5	(0.1)	0.2	—	0.7	—	0.2	0.2
Other Income	47.4	44.4	40.6	41.9	28.5	35.2	34.3	36.8
Total Other Operating Income	77.8	67.4	67.7	59.3	55.0	51.1	46.4	51.7
Other Operating Expenses:								
Salaries and Employee Benefits	76.2	73.6	72.9	73.8	73.5	72.0	68.8	68.1
Net Occupancy Expense of Premises	17.4	18.0	15.6	16.2	16.5	16.1	16.4	15.7
Furniture and Equipment Expense	11.3	11.1	9.9	10.3	10.4	10.4	10.0	9.1
Other Expenses	44.4	33.8	35.6	31.6	36.4	31.8	29.2	26.5
Total Other Operating Expenses	149.3	136.5	134.0	131.9	136.8	130.3	124.4	119.4
Income before Income Taxes	41.8	41.7	46.3	38.8	33.2	34.4	38.0	37.3
Applicable Income Taxes	13.6	12.6	14.9	11.5	12.1	10.4	11.7	10.6
Net Income	$ 28.2	$ 29.1	$ 31.4	$ 27.3	$ 21.1	$ 24.0	$ 26.3	$ 26.7
Net Income Available to Common Shareholders	$ 26.5	$ 27.6	$ 29.5	$ 25.6	$ 19.2	$ 21.9	$ 24.4	$ 24.8
Net Income Per Common Share*	$1.49	$1.55	$1.66	$1.44	$1.08	$1.24	$1.38	$1.41
Dividends Per Common Share*	0.49	0.49	0.49	0.49	0.46	0.46	0.46	0.46

**In 1984, the Corporation effected a two-for-one split of the Corporation's common stock. Accordingly, per common share amounts have been restated to reflect this event.*

Consolidated Average Balance Sheet and Summary of Net Interest Income (Fully Taxable Basis)

Irving Bank Corporation

In Thousands	Year Ended December 31, 1985 Average Balance	Interest	Average Rate	Year Ended December 31, 1984 Average Balance	Interest	A[illegible]
Assets						
Interest-Bearing Deposits with Banks	$ 2,799,790	$ 273,181	9.76%	$ 3,183,103	$ 355,166	11.16%
U.S. Government and Federal Agency Obligations	734,834	81,077	11.03	557,294	60,653	10.88
Obligations of States and Political Subdivisions	605,430	70,654	11.67	487,805	60,163	12.33
Other Securities	156,903	14,379	9.16	81,751	7,346	8.99
Total Investment Securities	1,497,167	166,110	11.09	1,126,850	128,162	11.37
Trading Account Assets	557,600	53,259	9.55	330,716	37,730	11.41
Federal Funds Sold and Securities Purchased Under Agreements to Resell	703,825	56,853	8.08	833,938	87,716	10.52
Loans at Domestic Offices	7,535,781	785,010	10.42	6,996,924	840,495	12.01
Loans at Foreign Offices	4,601,239	469,196	10.20	4,459,123	527,762	11.84
Total Loans	12,137,020	1,254,206	10.33	11,456,047	1,368,257	11.94
Total Interest-Earning Assets	17,695,402	1,803,609	10.19	16,930,654	1,977,031	11.68
Allowance for Loan Losses	(172,058)			(151,416)		
Cash and Due from Banks	1,177,072			1,246,514		
Premises and Equipment	398,427			385,219		
Customers' Acceptance Liability	1,219,866			1,284,026		
Other Assets	856,896			732,697		
Total Assets	$21,175,605			$20,427,694		
Liabilities and Shareholders' Equity						
Savings Deposits	$ 1,647,437	105,756	6.42	$ 1,323,791	96,742	7.31
Time Deposits	2,229,242	189,968	8.52	2,228,391	225,365	10.11
Foreign Office Deposits	5,993,545	529,937	8.84	6,480,363	675,479	[illegible]
Total Interest-Bearing Deposits	9,870,224	825,661	8.37	10,032,545	997,586	[illegible]
Federal Funds Purchased and Securities Sold Under Agreements to Repurchase	3,160,388	249,291	7.89	2,485,502	252,444	10.16
Other Borrowed Funds	1,420,883	120,795	8.50	1,549,327	159,717	10.31
Long-Term Debt	531,992	48,419	9.10	393,823	39,628	10.06
Total Interest-Bearing Liabilities	14,983,487	1,244,166	8.30	14,461,197	1,449,375	10.03
Noninterest-Bearing Deposits—Domestic Offices	3,306,861			3,140,147		
Noninterest-Bearing Deposits—Foreign Offices	151,863			128,822		
Acceptances Outstanding	1,229,522			1,292,772		
Other Liabilities	586,270			555,576		
Total Liabilities	20,258,003			19,578,514		
Shareholders' Equity	917,602			849,180		
Total Liabilities and Shareholders' Equity	$21,175,605			$20,427,694		
Net Interest Income		$ 559,443			$ 527,656	
Purchased Funds Margin			1.89			1.65
Average Rate on Total Sources of Funds			7.03			8.56
Net Interest Rate Spread			3.16			3.12
Total Interest-Earning Assets						
Domestic Operations	$ 9,586,643	$ 990,700	10.33%	$ 8,524,542	$1,006,080	11.80%
International Operations	8,108,759	812,909	10.03	8,406,112	970,951	11.55
Net Interest Income/Rate Spread						
Domestic Operations		372,538	3.89		335,555	3.94
International Operations		186,905	2.30		192,101	2.29

Notes: Interest-bearing deposits with banks are substantially attributable to international operations.
Nonaccrual and reduced-rate loans have been included in the above summary. See "Notes to Consolidated Financial Statements–Accounting Policies–Loans" for description of the Corporation's income recognition policy for such loans.
Fees on loans have been included in interest on loans in the above summary.

Year Ended December 31, 1983			Quarter Ended December 31, 1985			Quarter Ended December 31, 1984		
Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
$ 3,481,317	$ 356,139	10.23%	$ 2,584,743	$ 58,770	9.02%	$ 2,831,796	$ 83,409	11.72%
512,380	55,811	10.89	736,645	20,133	10.85	577,401	16,025	11.05
453,476	55,208	12.17	645,448	18,173	11.26	534,010	18,100	13.56
75,909	7,209	9.50	172,681	3,926	9.09	95,213	2,145	9.01
1,041,765	118,228	11.35	1,554,774	42,232	10.83	1,206,624	36,270	12.00
150,521	14,946	9.93	675,379	15,500	9.11	515,055	14,555	11.24
796,831	73,365	9.21	709,602	13,907	7.78	850,041	20,869	9.77
6,210,819	687,792	11.07	7,764,463	202,905	10.37	7,141,105	209,048	11.65
4,118,479	451,858	10.97	4,813,176	118,513	9.77	4,538,217	140,476	12.31
10,329,298	1,139,650	11.03	12,577,639	321,418	10.14	11,679,322	349,524	11.91
15,799,732	1,702,328	10.77	18,102,137	451,827	9.90	17,082,838	504,627	11.75
(145,179)			(180,876)			(155,702)		
1,430,873			1,392,693			1,147,314		
318,736			394,652			395,318		
1,166,771			1,121,038			1,116,844		
656,269			921,351			775,864		
$19,227,202			$21,750,995			$20,362,476		
$ 1,130,631	72,645	6.43	$ 1,759,219	27,384	6.18	$ 1,392,857	25,936	7.41
1,789,908	172,126	9.62	2,109,389	42,308	7.96	2,372,548	62,433	10.47
6,817,309	656,641	9.63	6,017,641	124,468	8.21	6,180,964	162,809	10.48
9,737,848	901,412	9.26	9,886,249	194,160	7.79	9,946,369	251,178	10.05
2,140,090	191,003	8.92	3,134,863	61,916	7.84	2,625,462	61,258	9.28
982,555	92,311	9.39	1,571,021	34,302	8.66	1,641,367	43,147	10.46
342,569	32,095	9.37	632,268	13,526	8.56	406,847	10,549	10.37
13,203,062	1,216,821	9.21	15,224,401	303,904	7.92	14,620,045	366,132	9.96
3,339,421			3,673,074			3,066,402		
129,469			170,694			119,911		
1,177,144			1,136,931			1,125,236		
586,187			598,667			558,430		
18,435,283			20,803,767			19,490,024		
791,919			947,228			872,452		
$19,227,202			$21,750,995			$20,362,476		
	$ 485,507			$147,923			$138,495	
		1.56			1.98			1.79
		7.70			6.66			8.52
		3.07			3.24			3.23
$ 7,277,119	$ 811,292	11.15%	$ 9,946,751	$256,048	10.22%	$ 9,136,403	$267,651	11.66%
8,522,613	891,036	10.45	8,155,386	195,779	9.53	7,946,435	236,976	11.86
	312,767	4.30		97,441	3.89		89,742	3.91
	172,740	2.03		50,482	2.46		48,753	2.44

Two-Year Volume/Rate Analysis

Irving Bank Corporation

The following table presents, on a fully taxable basis, a comparative analysis of the increases (decreases) in the categories of interest income and expense resulting from changes in volume or rate for the periods indicated. For purposes of this table, changes that are not due solely to volume or rate have been allocated equally to both.

	Increases (Decreases)					
	Year 1985 vs. Year 1984			Year 1984 vs. Year 1983		
In Thousands	Volume	Rate	Total	Volume	Rate	Total
Interest Income:						
Interest-Bearing Deposits with Banks*	$(40,085)	$ (41,900)	$ (81,985)	$ (31,891)	$ 30,918	$ (973)
U.S. Government and Federal Agency Obligations	19,456	968	20,424	5,028	(186)	4,842
Obligations of States and Political Subdivisions	14,117	(3,626)	10,491	4,207	748	4,955
Other Securities	6,820	213	7,033	540	(403)	137
Total Investment Securities	40,393	(2,445)	37,948	9,775	159	9,934
Trading Account Assets	23,778	(8,249)	15,529	19,225	3,559	22,784
Federal Funds Sold and Securities Purchased Under Agreements to Resell	(12,098)	(18,765)	(30,863)	3,660	10,691	14,351
Loans at Domestic Offices	60,431	(115,916)	(55,485)	90,742	61,961	152,703
Loans at Foreign Offices	15,656	(74,222)	(58,566)	38,845	37,059	75,904
Total Loans	76,087	(190,138)	(114,051)	129,587	99,020	228,607
Total Interest Income	88,075	(261,497)	(173,422)	130,356	144,347	274,[illegible]
Interest Expense:						
Savings Deposits	22,214	(13,200)	9,014	13,263	10,834	24,[illegible]
Time Deposits	79	(35,476)	(35,397)	43,256	9,983	53,239
Foreign Office Deposits	(46,893)	(98,649)	(145,542)	(33,788)	52,626	18,838
Total Interest-Bearing Deposits	(24,600)	(147,325)	(171,925)	22,731	73,443	96,174
Federal Funds Purchased and Securities Sold Under Agreements to Repurchase	60,890	(64,043)	(3,153)	32,955	28,486	61,441
Other Borrowed Funds	(12,080)	(26,842)	(38,922)	55,838	11,568	67,406
Long-Term Debt	13,239	(4,448)	8,791	4,980	2,553	7,533
Total Interest Expense	37,449	(242,658)	(205,209)	116,504	116,050	232,554
Net Interest Income	$ 50,626	$ (18,839)	$ 31,787	$ 13,852	$ 28,297	$ 42,149

**Substantially attributable to international operations.*

Statistical Summary

Irving Bank Corporation

	1985	1984	1983	1982	1981
Composition of Loans at December 31 *In Millions*					
Real Estate:					
Construction and Land Development	$ 286	$ 295	$ 280	$ 312	$ 222
Secured by 1-4 Family Residential Properties	493	370	339	340	340
Other	412	387	325	353	366
Financial Institutions:					
Real Estate Investment Trusts and Mortgage Companies	81	48	60	34	27
Domestic Commercial Banks	100	114	72	45	14
Other	449	336	332	399	355
Purchasing or Carrying Securities	953	742	517	314	425
Commercial and Industrial	3,361	2,936	2,592	2,334	2,371
Individuals	1,262	1,122	1,034	926	837
Other Loans Attributable to Domestic Operations	73	56	39	55	66
Attributable to International Operations	5,452	4,976	5,122	5,234	5,317
	12,922	11,382	10,712	10,346	10,340
Less Unearned Discount	177	180	207	246	238
Total Loans	$12,745	$11,202	$10,505	$10,100	$10,102
Short-Term Borrowings *In Millions*					
Federal Funds Purchased and Securities Sold Under Agreements to Repurchase:					
Maximum Amount Outstanding at Any Month-End	$4,192	$3,227	$3,199	$2,271	$1,878
Average Interest Rate on Year-End Balance	8.87%	7.15%	9.47%	10.66%	12.43%
Commercial Paper:					
Maximum Amount Outstanding at Any Month-End	$ 474	$ 589	$ 170	$ 6	$ 4
Average Interest Rate on Year-End Balance	8.01%	10.08%	9.57%	8.21%	10.00%
Other Short-Term Borrowings:					
Maximum Amount Outstanding at Any Month-End	$1,895	$1,232	$1,209	$ 778	$ 843
Average Interest Rate on Year-End Balance	7.81%	9.64%	9.24%	9.79%	12.62%
Shareholder Data					
Average Common Shares Outstanding*	17,798,244	17,674,332	17,601,918	17,601,658	17,601,658
Common Shares Outstanding at Year-End*	17,763,978	17,620,851	17,484,280	17,422,362	17,393,478
Common Shareholders of Record at Year-End	25,825	27,488	29,296	31,632	33,743
Common Stock Price Range*	$44⅛-31⅝	$34¼-23⅛	$26⅝-20⅝	$25½-16⅜	$29-23¼
Book Value at Year-End*	49.56	45.56	42.36	39.43	36.69
Financial Ratios					
Rate of Return:					
On Average Interest-Earning Assets	0.66%	0.58%	0.59%	0.51%	0.67%
On Average Total Assets	0.55	0.48	0.48	0.42	0.53
On Average Common Shareholders' Equity	12.96	11.66	11.92	11.95	15.92
On Average Total Shareholders' Equity	12.64	11.55	11.68	11.94	15.93
Average Total Shareholders' Equity as a Percentage of Average Total Assets	4.3	4.2	4.1	3.6	3.3
Primary Capital at Year-End as a Percentage of:					
Total Assets	6.4	5.9	5.2	4.7	4.3
Total Loans	10.9	10.0	9.3	9.1	7.8
Total Capital at Year-End as a Percentage of Total Assets	8.0	7.5	6.9	6.3	5.5
Common Dividend Payout Ratio	31.92	36.01	36.21	36.80	27.59

** During 1984, the Corporation effected a two-for-one split of the Corporation's common stock. Accordingly, per common share amounts and common shares outstanding have been restated to reflect this event.*

Statistical Summary

Irving Bank Corporation

Maturity Distribution and Weighted Average Yield to Maturity of Investment Securities at December 31, 1985 *In Millions*

	Within 1 Year	1-5 Years	5-10 Years	Over 10 Years	Total
*Maturity Distribution Based on Carrying Value**					
U.S. Government and Federal Agency Obligations	$145	$411	$ 41	$ 13	$ 610
Obligations of States and Political Subdivisions	262	122	141	158	683
Other Bonds, Notes and Debentures	61	25	8	2	96
Total	$468	$558	$190	$173	$1,389

**Excludes $43 million of corporate stock.*

	Within 1 Year	1-5 Years	5-10 Years	Over 10 Years	Total
*Weighted Average Yield to Maturity***					
U.S. Government and Federal Agency Obligations	10.44%	10.08%	9.01%	8.46%	10.06%
Obligations of States and Political Subdivisions	10.43	11.20	12.97	14.28	11.98
Other Bonds, Notes and Debentures	5.79	7.32	9.83	9.05	6.60
Total	9.83	10.20	11.99	13.77	10.76

***Yields have been computed by dividing interest income to maturity (adjusted for amortization of premium and accretion of discount) by the carrying values of the respective securities during the periods presented. Yields are stated on a fully taxable basis, using a combined Federal, state and local income tax rate of approximately 56%.*

Maturity Distribution of Selected Loans at December 31, 1985 *In Millions*

	Within 1 Year	1-5 Years	Over 5 Years	Total
Real Estate:				
Construction and Land Development	$ 183	$ 103	$ —	$ 286
Other (Excluding Loans Secured by 1-4 Family Residential Properties)	61	96	255	412
Financial Institutions	446	170	14	[illegible]
Purchasing or Carrying Securities	953	—	—	[illegible]
Commercial and Industrial Loans	2,177	773	411	3,361
Other Loans Attributable to Domestic Operations (Excluding Loans to Individuals)	35	18	20	73
Attributable to International Operations	3,432	1,420	600	5,452
Total***	$7,287	$2,580	$1,300	$11,167

Interest Sensitivity of Selected Loans at December 31, 1985 *In Millions*

	Within 1 Year	1-5 Years	Over 5 Years	Total
Loans with Predetermined Interest Rates	$4,367	$ 466	$ 346	$ 5,179
Loans with Floating Interest Rates	2,920	2,114	954	5,988
Total***	$7,287	$2,580	$1,300	$11,167

****Loan amounts are presented gross of unearned discount.*

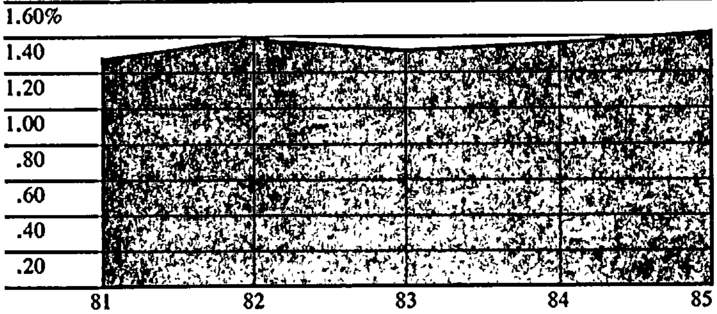
Maturity Distribution of Domestic Office Time Deposits of $100,000 or More at December 31, 1985 *In Millions*

	Time Certificates	Other Time	Total
Time Remaining to Maturity:			
Less than Three Months	$631	$ 980	$1,611
Three to Six Months	41	54	95
Six to Twelve Months	8	7	15
Over Twelve Months	12	1	13
Total	$692	$1,042	$1,734

Allowance for Loan Losses

At December 31, 1985, the Corporation's allowance for loan losses amounted to $179.7 million, or 1.41% of total loans. The following chart shows the allowance as a percentage of loans outstanding at year-end for the last five years.

Allowance for Loan Losses as a Percentage of Loans at Year-End



Another ratio to be considered when assessing the level of the allowance is the Corporation's earnings coverage of net loan charge-offs. In 1985, the sum of income before taxes and the provision for loan losses equaled 5.8 times net loan charge-offs. This earnings coverage compares with 5.9 times for the period 1981 through 1985.

The provision for loan losses represents management's determination as to the amount necessary to be transferred to the allowance for loan losses to bring it to a level that is considered adequate in relation to the risk of future losses inherent in the loan portfolio. Management seeks to minimize risk by diversification of the loan portfolio in terms of industry, geography and size and type of loan. While it is the Corporation's policy to write off in the current period those loans or portions of loans on which a loss is considered probable, nevertheless, in any large and diversified loan portfolio there exists the risk of future losses that cannot be quantified precisely or attributed to particular loans or classes of loans. Moreover, this risk is continually changing in response to the characteristics of the portfolio as well as to factors beyond the control of the lender, such as the state of the economy. Because of the nature of the risk to which the allowance relates, management's judgment as to its adequacy is necessarily an approximate one.

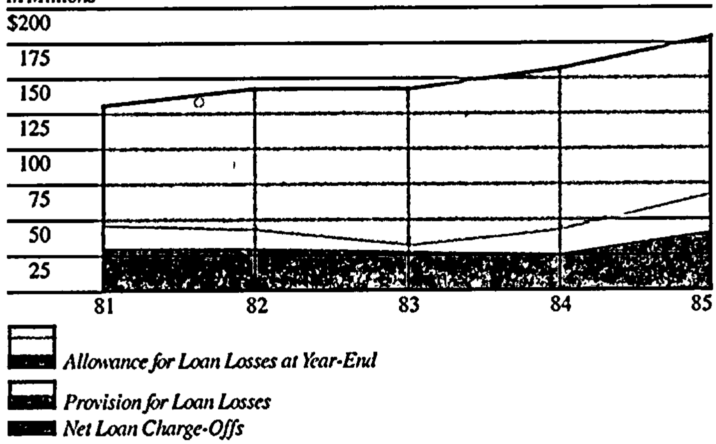
In assessing adequacy, management relies predominantly on its ongoing review of the loan portfolio, which is undertaken both to ascertain whether there are probable losses that must be written off and to assess the risk characteristics of the portfolio in the aggregate. Since losses on consumer loans tend to occur within reasonably predictable ranges, these loans are reviewed by senior management on an aggregate basis. Commercial loans, however, are reviewed on an individual basis both by the responsible officers in the various lending units and by a specialized loan review group that reports to senior management. All large commercial loans that are deemed to present significantly greater than normal risk of collectibility are reviewed independently at the senior management level. This review takes into consideration the judgments not only of the responsible loaning officers and the specialized loan review group, but also those of independent auditors and bank regulatory agencies that review the loan portfolio as a part of the regular bank examination process.

In addition, the Corporation's potential exposure and outstandings in countries outside of the United States are regularly reviewed by Irving Trust's Country Exposure and Credit Policy Committees, the latter of which approves limits with respect to such exposure on a country-by-country basis. Extensions of credit are monitored by senior officers of the international banking activities as well as the Senior Loan Officer of Irving Trust. In situations where a country is experiencing economic or political difficulties, the exposure to such country is reviewed on an ongoing basis at the senior management level.

In evaluating the allowance, management also considers current and projected loan volumes, historical net loan loss experience, the level and composition of nonaccrual, past-due and reduced-rate loans, the condition of industries experiencing particular financial pressures, international developments and current and anticipated economic conditions. Finally, management compares the level of the allowance to the Corporation's historical allowance-to-total loan ratios as well as to those of other banking institutions considered comparable.

The process of determining adequacy is, however, judgmental and is validated only to the extent that the level of the allowance proves adequate to absorb future losses. In this connection, over the past five years, the Corporation's cumulative loan loss provision amounted to $213.2 million, or $64.8 million more than the $148.4 million in net loan charge-offs during this period.

Allowance for Loan Losses, Provision for Loan Losses and Net Loan Charge-Offs
In Millions



Statistical Summary
Irving Bank Corporation

In Millions	1985	1984	1983	1982	[illegible]
Analysis of the Allowance for Loan Losses					
Balance, January 1	$ 155.1	$ 141.1	$ 141.0	$ 129.9	$ 115.7
Loans Charged Off	(55.4)	(36.6)	(36.4)	(40.5)	(43.4)
Recoveries on Loans Previously Charged Off	15.5	11.2	10.1	12.2	14.9
Net Loan Charge-Offs	(39.9)	(25.4)	(26.3)	(28.3)	(28.5)
Provision Charged to Operations	63.9	39.4	27.0	39.9	43.0
Balance Related to Acquisition	0.6	—	—	—	—
Translation of Foreign Currency Allowance Balances	—	—	(0.6)	(0.5)	(0.3)
Balance, December 31	$ 179.7	$ 155.1	$ 141.1	$ 141.0	$ 129.9
Composition of Loan Charge-Offs and Recoveries					
Composition of Charge-Offs					
Real Estate	$ (0.2)	$ (0.2)	$ (1.0)	$ (0.5)	$ (0.7)
Financial Institutions	(2.3)	(4.6)	(0.4)	—	—
Purchasing or Carrying Securities	—	—	—	—	—
Commercial and Industrial	(26.4)	(10.8)	(12.7)	(27.6)	(32.6)
Individuals	(8.1)	(5.8)	(6.3)	(6.7)	(8.7)
Other Loans Attributable to Domestic Operations	(0.7)	(0.1)	(0.1)	(0.2)	—
Attributable to International Operations	(17.7)	(15.1)	(15.9)	(5.5)	(1.4)
Total Charge-Offs	(55.4)	(36.6)	(36.4)	(40.5)	[illegible]
Composition of Recoveries					
Real Estate	0.2	0.3	1.5	0.1	2.0
Financial Institutions	0.5	0.9	—	1.3	0.3
Purchasing or Carrying Securities	—	—	—	—	—
Commercial and Industrial	6.8	6.0	5.1	7.1	9.2
Individuals	3.3	3.4	3.2	3.1	3.3
Other Loans Attributable to Domestic Operations	0.1	—	—	0.1	—
Attributable to International Operations	4.6	0.6	0.3	0.5	0.1
Total Recoveries	15.5	11.2	10.1	12.2	14.9
Net Charge-Offs	$ (39.9)	$ (25.4)	$ (26.3)	$ (28.3)	$ (28.5)
Loan Statistics					
Average Loans	$12,137	$11,456	$10,329	$10,310	$ 9,239
Loans at Year-End	12,745	11,202	10,505	10,100	10,102
Allowance for Loan Losses at Year-End as a Percentage of:					
Average Loans	1.48%	1.35%	1.37%	1.37%	1.41%
Loans at Year-End	1.41	1.38	1.34	1.40	1.29
Net Charge-Offs as a Percentage of Average Loans	0.33	0.22	0.25	0.28	0.31

Allocation of the Allowance for Loan Losses

As set forth in "Statistical Summary—Allowance for Loan Losses," management assesses the adequacy of the allowance for loan losses in terms of the risk of future losses inherent in the loan portfolio as a whole, a risk that is not precisely quantifiable or attributable to particular loans or categories of loans. Management, however, has reviewed the allowance at December 31 for the past five years and, based primarily on its review of material loans deemed to present significantly greater than normal risks of collectibility, has estimated those portions of the allowance that could be attributable to major categories of loans at those dates, as set forth below. Allocations estimated for the indicated categories do not represent a specific judgment that loan write-offs of that magnitude will necessarily be required. Additionally, such an allocation does not restrict future loan losses attributable to a particular category of loans from being absorbed either by the portion of the allowance attributable to other categories or by the unallocated portion of the allowance.

Loans at

	December 31, 1985		December 31, 1984		December 31, 1983		December 31, 1982		December 31, 1981	
In Millions	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
Loans Attributable to Domestic Operations:										
Real Estate	$ 1,191	9.2%	$ 1,052	9.2%	$ 944	8.8%	$ 1,005	9.7%	$ 928	9.0%
Financial Institutions	630	4.9	498	4.4	464	4.3	478	4.6	396	3.8
Purchasing or Carrying Securities	953	7.4	742	6.5	517	4.8	314	3.0	425	4.1
Commercial and Industrial	3,361	26.0	2,936	25.8	2,592	24.2	2,334	22.6	2,371	23.0
Individuals	1,262	9.8	1,122	9.9	1,034	9.7	926	9.0	837	8.1
Other Loans Attributable to Domestic Operations	73	0.5	56	0.5	39	0.4	55	0.5	66	0.6
	7,470	57.8	6,406	56.3	5,590	52.2	5,112	49.4	5,023	48.6
Loans Attributable to International Operations	5,452	42.2	4,976	43.7	5,122	47.8	5,234	50.6	5,317	51.4
Total*	$12,922	100.0%	$11,382	100.0%	$10,712	100.0%	$10,346	100.0%	$10,340	100.0%

**Loan amounts are presented gross of unearned discount.*

Allowance for Loan Losses at

	December 31, 1985		December 31, 1984		December 31, 1983		December 31, 1982		December 31, 1981	
In Millions	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
Attributable to Domestic Operations:										
Real Estate	$ 3.1	1.8%	$ 8.3	5.4%	$ 7.3	5.2%	$ 8.1	5.7%	$ 4.0	3.0%
Financial Institutions	6.5	3.6	8.4	5.4	8.0	5.7	8.2	5.8	10.2	7.9
Purchasing or Carrying Securities	—	—	—	—	—	—	—	—	—	—
Commercial and Industrial	39.0	21.7	15.9	10.3	11.6	8.2	14.1	10.0	16.5	12.7
Individuals	11.0	6.1	10.0	6.4	9.9	7.0	8.9	6.3	8.1	6.3
Other Loans Attributable to Domestic Operations	—	—	—	—	—	—	—	—	—	—
	59.6	33.2	42.6	27.5	36.8	26.1	39.3	27.8	38.8	29.9
Attributable to International Operations	59.8	33.3	58.1	37.5	51.9	36.8	46.5	33.0	36.1	27.8
Unallocated	60.3	33.5	54.4	35.0	52.4	37.1	55.2	39.2	55.0	42.3
Total	$179.7	100.0%	$155.1	100.0%	$141.1	100.0%	$141.0	100.0%	$129.9	100.0%

Basis of Presentation

Substantially all of the Corporation's international business is conducted by Irving Trust. As a result of the close integration of international and domestic activities, it is not possible to characterize definitively the business of most operating activities as entirely domestic or international. However, for the purpose of presenting the information set forth below, the Corporation's international operations are deemed to consist of Irving Trust's international banking activities in New York City (including foreign financial institutions in which Irving Trust has a direct equity investment), the international components of its Worldwide Corporations Group and its foreign branches and subsidiaries (excluding certain loans to domestic domiciled customers), Edge Act subsidiaries and international banking facilities. Additionally, all foreign exchange transactions and transactions with foreign-domiciled customers generated by Irving Trust's domestic banking activities have been isolated and included as part of international operations, where appropriate, in the information set forth below.

Geographic Distribution of Selected Statement of Income Categories

As discussed above, the close integration of its international and domestic activities prevents a definitive distribution of the Corporation's earnings between these activities. As a result, estimates of the attribution of income and allocation of costs between domestic and international operations are based on certain discretionary and subjective assumptions, including: an earnings credit or charge (based upon Irving Trust's average incremental cost of funds for the respective year) to international operations based on the funding needs of Irving Trust's international banking activities in New York; an allocation of shareholders' equity to international and domestic operations (based on the level of average total assets); an allocation of expenses incurred by one department on behalf of another; adjustments for differences in applicable income tax rates between foreign countries and the United States; and an allocation of the provision for loan losses based upon actual charge-offs for the current year, adjusted as deemed necessary to reflect the current risks inherent in the respective international and domestic loan portfolios.

The following tables present allocations of selected statement of income categories between the Corporation's domestic and international operations based upon the domicile of the customer. The portions of these categories attributable to international operations are distributed by major geographic area.

	Total Operating Income						Total Operating [illegible]s					
	1985		1984		1983		1985		1984		1983	
In Millions	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
International Operations:												
Europe	$ 298	15%	$ 346	16%	$ 387	21%	$ 267	14%	$ 313	16%	$ 351	20%
Latin America & Caribbean	236	12	255	12	216	12	196	11	233	12	186	11
Asia	198	10	190	9	193	11	189	10	180	9	180	11
Middle East & Africa	107	5	127	6	95	5	91	5	106	5	76	4
North America	67	3	110	5	60	3	55	3	100	5	53	3
Total	906	45	1,028	48	951	52	798	43	932	47	846	49
Domestic Operations	1,122	55	1,115	52	885	48	1,061	57	1,068	53	866	51
Consolidated	$2,028	100%	$2,143	100%	$1,836	100%	$1,859	100%	$2,000	100%	$1,712	100%

	Income before Taxes						Net Income					
	1985		1984		1983		1985		1984		1983	
In Millions	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
International Operations:												
Europe	$ 31	19%	$ 33	23%	$ 36	29%	$ 21	18%	$17	17%	$23	25%
Latin America & Caribbean	40	24	21	15	30	25	22	19	11	11	16	17
Asia	9	5	10	7	13	10	6	5	6	6	9	10
Middle East & Africa	16	9	22	15	19	15	8	7	9	10	8	9
North America	12	7	10	7	7	6	7	6	5	5	4	4
Total	108	64	96	67	105	85	64	55	48	49	60	[illegible]
Domestic Operations	61	36	47	33	19	15	52	45	50	51	32	35
Consolidated	$169	100%	$143	100%	$124	100%	$116	100%	$98	100%	$92	100%

Geographic Distribution of Selected Assets Attributable to International Operations

It is estimated that the Corporation's international operations accounted for approximately 43%, 49% and 51% of its consolidated assets at December 31, 1985, 1984 and 1983, respectively, and 46%, 52% and 52% of its consolidated liabilities at December 31, 1985, 1984 and 1983, respectively.

The following table presents an allocation of certain of the Corporation's principal assets between international and domestic operations at December 31, 1985, 1984 and 1983, based upon the domicile of the customer. The portions of these assets attributable to international operations are distributed by major geographic area.

	1985			1984			1983		
In Millions	Interest-Bearing Deposits with Banks	Loans*	Customers' Acceptance Liability	Interest-Bearing Deposits with Banks	Loans*	Customers' Acceptance Liability	Interest-Bearing Deposits with Banks	Loans*	Customers' Acceptance Liability
International Operations:									
Europe	$1,110	$ 1,254	$ 199	$1,347	$ 1,204	$121	$1,725	$ 1,263	$ 319
Latin America & Caribbean	170	1,737	82	226	1,859	137	248	1,712	161
Asia	440	1,357	515	550	1,084	366	428	1,341	248
Middle East & Africa	169	811	197	320	628	156	283	582	135
North America	263	293	121	368	201	46	237	224	181
Total	2,152	5,452	1,114	2,811	4,976	826	2,921	5,122	1,044
Domestic Operations	46	7,470	289	23	6,406	164	21	5,590	243
Consolidated	$2,198	$12,922	$1,403	$2,834	$11,382	$990	$2,942	$10,712	$1,287

**Amounts are presented gross of unearned discount.*

International Loans

Based Upon Borrowers' Business Classifications

The accompanying table presents a distribution of loans (gross of unearned discount) attributable to the Corporation's international operations at year-end for the last five years, based upon the borrowers' business classifications.

In Millions	1985	1984	1983	1982	1981
Loans to:					
Banks and Other Financial Institutions	$2,468	$2,096	$2,080	$2,387	$2,530
Governments and Official Institutions	979	1,198	937	608	426
Commercial and Industrial*	1,807	1,538	1,900	2,026	2,191
Other	198	144	205	213	170
Total	$5,452	$4,976	$5,122	$5,234	$5,317

**Includes government-owned corporations.*

Summary of Changes in the Allowance for Loan Losses Attributable to International Operations

The accompanying table presents a reconciliation of the portion of the allowance for loan losses attributable to the Corporation's international operations for 1985, 1984 and 1983.

In Millions	1985	1984	1983
Balance, January 1	$ 58.1	$ 51.9	$ 46.5
Loans Charged Off	(17.7)	(15.1)	(15.9)
Recoveries on Loans Previously Charged Off	4.6	0.6	0.3
Net Loan Charge-Offs	(13.1)	(14.5)	(15.6)
Provision Charged to Operations	14.2	20.7	21.6
Balance Related to Acquisition	0.6	—	—
Translation of Foreign Currency Allowance Balances	—	—	(0.6)
Balance, December 31	$ 59.8	$ 58.1	$ 51.9

International Interest-Bearing Deposits

The accompanying tables present a distribution of interest-bearing deposit liabilities attributable to the Corporation's international operations for the last three years. Deposits are distributed based upon the depositors' business classifications.

A majority of the foreign office interest-bearing deposits at December 31, 1985, 1984 and 1983 are denominated in amounts of $100,000 or more.

At December 31 *In Millions*	1985	1984	1983
Foreign Office Interest-Bearing Deposits:			
Banks in Foreign Countries	$2,772	$2,633	$2,558
Foreign Governments and Official Institutions	339	506	206
Other	2,063	2,704	3,312
Total Foreign Office Interest-Bearing Deposits	5,174	5,843	6,076
Domestic Office Interest-Bearing Deposits Attributable to International Operations	530	355	318
Total International Interest-Bearing Deposits	$5,704	$6,198	$6,394

Average Balance *In Millions*	1985	1984	1983
Foreign Office Interest-Bearing Deposits:			
Banks in Foreign Countries	$3,145	$3,022	$3,024
Foreign Governments and Official Institutions	376	183	287
Other	2,473	3,275	3,506
Total Foreign Office Interest-Bearing Deposits	5,994	6,480	6[illegible]
Domestic Office Interest-Bearing Deposits Attributable to International Operations	515	329	[illegible]
Total International Interest-Bearing Deposits	$6,509	$6,809	$7,051

Average Rate for the Year	1985	1984	1983
Foreign Office Interest-Bearing Deposits:			
Banks in Foreign Countries	9.04%	10.15%	9.46%
Foreign Governments and Official Institutions	8.45	9.69	8.93
Other	8.65	10.72	9.84
Total Foreign Office Interest-Bearing Deposits	8.84	10.42	9.63
Domestic Office Interest-Bearing Deposits Attributable to International Operations	7.93	9.32	9.29
Total International Interest-Bearing Deposits	8.77	10.37	9.62

Headquarters

Irving Trust Company
One Wall Street
New York, New York 10015

Branch Offices

Frankfurt
Niedenau 61–63
6000 Frankfurt a. Main 1
Federal Republic of Germany

Grand Cayman
c/o Operations Support Department
PO Box 12885
New York, New York 10015

Hong Kong
73 New Henry House
10 Ice House Street
Hong Kong

London
36-38 Cornhill
London EC3V 3NT, England

Milan
Largo Donegani, 1
20121 Milan, Italy

Osaka
Nomura Fodosan Osaka Building
uchimachi 2-chome
i-ku
541, Japan

Singapore
10 Collyer Quay
14-01 Ocean Building
Singapore 0104

Taipei
Tai Chi Building
10-12 Chungking South Road, Sec. One
Taipei, Taiwan, Republic of China

Tokyo
Fukoku Seimei Building
2-2-2 Uchisaiwai-cho
Chiyoda-ku, Tokyo 100, Japan

International Banking Facilities

Miami
The Alfred I. du Pont Building
169 East Flagler Street & 2nd Avenue
Miami, Florida 33131

New York
One Wall Street
New York, New York 10015

Representative Offices

Bahrain
66 Government Road
Manama 316
Manama, Bahrain

Bangkok
Asia Credit Building
320 RAMA IV Road
Bangkok, 10500, Thailand

Beirut
Avco Center
Autostrade Jdeideh
Beirut, Lebanon

Bombay
Express Towers
Nariman Point
Bombay 400 021, India

Buenos Aires
Reconquista 144
1003 Buenos Aires, Argentina

Caracas
Edificio Plaza El Venezolano
Chorro a Dr. Paul
Caracas 1010, Venezuela

Istanbul
Esentepe, Buyukdere Caddesi
Enka Han, No. 108 Kat 4
80280, Mecidiyekoy
Istanbul, Turkey

Madrid
Edificio "La Caixa"
Paseo de la Castellana, 51
28046 Madrid, Spain

Manila
Solidbank Building
777 Paseo de Roxas
Makati, Metro Manila, Philippines

Melbourne
B.H.P. House
140 William Street
Melbourne, 3000, Victoria, Australia

Paris
16 Place Vendome
75001 Paris, France

Rio de Janeiro
Avenida Rio Branco 125-16th
20040 Rio de Janeiro, Brazil

Subsidiaries

Banco Irving Austral
Cangallo 300
1038 Buenos Aires, Argentina

Irving Bank Canada
Commerce Court East
Toronto, Ontario, Canada M5L IE8

Irving International Financing Corporation
One Wall Street
New York, New York 10015

Irving Trust Company (Cayman) Limited
PO Box 694
Georgetown, Grand Cayman, BWI

Irving Trust Finanziaria S.p.A.
Largo Donegani, 1
20121 Milan, Italy

Irving Trust International Bank
The Alfred I. du Pont Building
169 East Flagler Street & 2nd Avenue
Miami, Florida 33131

Irving Trust International Limited
3 Birchin Lane
London EC3V 3NT, England

Wing Hang Bank Limited
161 Queen's Road Central
Hong Kong

Investments

Banca della Svizzera Italiana
Via Magatti 2
6901 Lugano, Switzerland

Banco de Investimento Credibanco S.A.
52-4 Avenida Almirante Barroso
20031 Rio de Janeiro, Brazil

China United Trust & Investment Corporation
China United Trust & Investment Building
136 Sung Kiang Road
Taipei, Taiwan, Republic of China

International Commercial Bank PLC
9-10 Angel Court
London EC2R 7HP, England

Sociedad Financiera Consolidada C.A.
Edificio Torre California
Avenida San Francisco
Urban Colinas de la California
Caracas 1070, Venezuela

Trans City Holdings Limited
15 Castlereagh Street
Sydney, 2000, New South Wales, Australia

Tütünbank
Ataturk Caddesi No. 136
Izmir, Turkey

Domestic Operations

Irving Bank Corporation

Headquarters

Irving Bank Corporation
One Wall Street
New York, New York 10005

Subsidiary Banks

Irving Trust Company
One Wall Street
New York, New York 10015

Bank of Babylon
48 Deer Park Avenue
Babylon, New York 11702

The Bank of Lake Placid
81 Main Street
Lake Placid, New York 12946

Central Trust Company
44 Exchange Street
Rochester, New York 14614

Dutchess Bank & Trust Company
285 Main Mall
Poughkeepsie, New York 12601

Endicott Trust Company
35-41 Washington Avenue
Endicott, New York 13760

The First National Bank of Hancock
East Main Street
Hancock, New York 13783

The First National Bank of Moravia
Main Street
Moravia, New York 13118

The Fulton County National Bank and Trust Company
2 North Main Street
Gloversville, New York 12078

Hayes National Bank
West Park Row
Clinton, New York 13323

The Merchants National Bank & Trust Company of Syracuse
216-220 South Warren Street
Syracuse, New York 13221

Nanuet National Bank
250 South Middletown Road
Nanuet, New York 10954

Scarsdale National Bank and Trust Company
8 East Parkway
Scarsdale, New York 10583

Union National Bank
80 State Street
Albany, New York 12207

Subsidiaries

Irving Capital Corporation
1290 Avenue of the Americas
New York, New York 10104

Irving Commercial Corporation
1290 Avenue of the Americas
New York, New York 10104

Irving Leasing Corporation
One Pennsylvania Plaza
New York, New York 10119

Irving Securities, Inc.
One Wall Street
New York, New York 10015

ITC Capital Corporation
1290 Avenue of the Americas
New York, New York 10104

Irving Trust Company Florida
The Alfred I. du Pont Building
169 East Flagler Street & 2nd Avenue
Miami, Florida 33131

Irving Business Centers

Atlanta
5901-A Peachtree-Dunwoody Road, NE
Atlanta, Georgia 30328

Chicago
Xerox Centre
55 West Monroe Street
Chicago, Illinois 60603

Cincinnati
4555 Lake Forest Drive
Cincinnati, Ohio 45242

Dallas
Plaza of the Americas
700 North Pearl Street
Dallas, Texas 75201

Los Angeles
800 West 6th Street
Los Angeles, California 90017

Miami
The Alfred I. du Pont Building
169 East Flagler Street & 2nd Avenue
Miami, Florida 33131

Minneapolis
7301 Ohms Lane
Minneapolis, Minnesota 55435

Irving Financial Centers

Burlington*
126 College Street
Burlington, Vermont 05401

Morristown
237 South Street
Morristown, New Jersey 07960

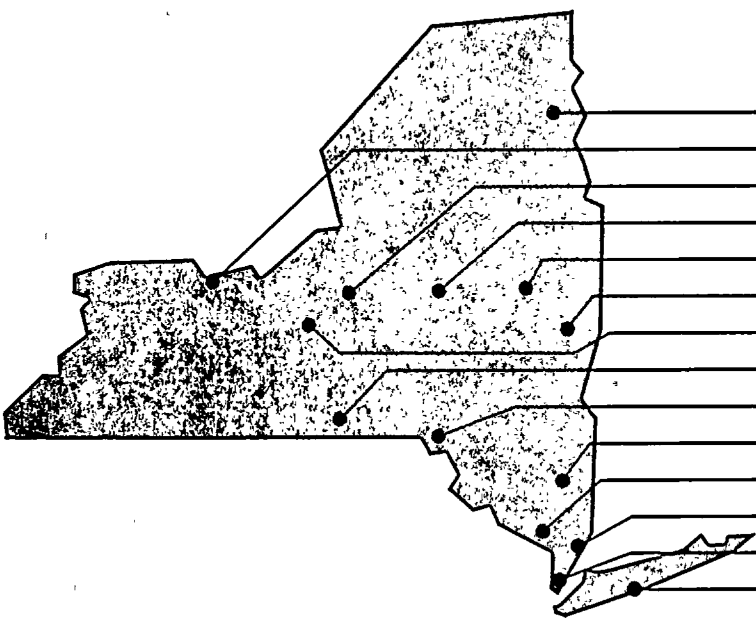
Nashua*
11 Trafalgar Square
Nashua, New Hampshire 03063

**Opened in 1986.*

Subsidiary Banks
Irving Bank Corporation

In millions	At December 31, 1985 Total Assets	Loans	Deposits	Equity	At December 31, 1984 Total Assets	Loans	Deposits	Equity
Irving Trust Company	$18,675.9	$10,622.1	$11,583.3	$898.1	$16,456.8	$9,372.4	$11,145.0	$837.8
Central Trust Company	728.2	496.2	651.7	50.8	637.2	457.3	551.5	50.3
The Merchants National Bank & Trust Company of Syracuse	535.4	380.1	496.6	33.1	490.6	313.7	440.2	29.4
Scarsdale National Bank and Trust Company	339.5	233.2	309.9	20.7	280.2	192.2	258.9	17.2
Nanuet National Bank	281.5	205.7	260.0	16.6	234.7	186.6	210.3	13.8
Bank of Babylon	219.0	153.9	205.6	11.7	177.9	119.8	163.0	11.2
Union National Bank	202.3	142.9	189.9	11.0	173.2	133.7	150.6	10.4
Dutchess Bank & Trust Company	206.1	143.2	187.0	12.1	192.7	125.7	174.0	11.8
Endicott Trust Company	210.5	165.5	184.9	12.8	188.5	140.3	166.8	11.7
Hayes National Bank	76.2	53.5	71.3	4.3	64.6	40.8	60.2	3.8
The Fulton County National Bank and Trust Company	74.9	54.8	68.3	6.4	72.1	53.8	65.7	6.4
The Bank of Lake Placid	45.9	31.8	42.0	3.7	42.0	28.7	36.9	3.4
The First National Bank of Moravia	31.4	21.4	28.1	3.2	29.0	21.3	25.8	3.1
The First National Bank of Hancock	25.9	15.7	23.9	1.8	23.4	13.2	21.5	1.7

New York State



Five-Year Analysis of the Effects of Changing Prices

Irving Bank Corporation

Although inflation in the United States has declined significantly in recent years, it continues to have some effect on the U.S. economy. Statement of Financial Accounting Standards No. 33, "Financial Reporting and Changing Prices," requires that large business enterprises measure and report the effects of general price level changes (inflation) and changing prices of specific assets.

The first schedule shows a five-year comparison of selected historical cost financial data. These data are based upon traditional accounting measurements, which have been used for many years and are generally referred to as historical cost. Historical cost represents the basis of measurement used in developing the financial data shown in all other sections of this Report.

The second schedule shows a five-year comparison of selected supplementary financial data adjusted for the effects of changing prices. These data were calculated by adjusting the historical cost data in the first schedule by the average Consumer Price Index for All Urban Consumers (CPI), issued by the U.S. Department of Labor, to reflect changes in the general purchasing power of the dollar. The resulting numbers are generally referred to as constant dollar amounts. Proponents of this method believe that a comparison of historical cost and constant dollar amounts will indicate the effects of general inflation on a business enterprise. There are, however, differences of opinion as to the value of this information.

A bank's asset and liability structure is substantially different from that of an industrial company in that virtually all assets and liabilities of a bank are monetary in nature. Accordingly, changes in interest rates may have a significant impact on a bank's performance. Interest rates, however, do not necessarily move in the same direction, or in the same magnitude, as the prices of other goods and services in general.

Analysis of the various supplementary schedules shown elsewhere in this Report will assist in understanding how well the Corporation is positioned to react to changing interest rates and inflationary trends. In particular, we direct attention to the average balance sheet and summary of net interest income, the maturity distributions and compositions of loans, investment securities and deposits, the data on the interest sensitivity of loans, and the asset/liability management discussion included in the Financial Review. We believe that this method of analysis is superior to the mechanical adjustment of long-accepted historical cost-based financial data by an index of the prices of all goods and services purchased by consumers or to the remeasurement of historical cost-based financial data at their estimated current cost or lower recoverable amounts.

Five-Year Comparison of Selected Historical Cost Financial Data

	Year Ended Decemb				
In Millions of Historical Dollars, Except Share Amounts	1985	1984	1983	1982	1981
Net Interest Income	$ 512.0	$ 489.0	$ 451.6	$ 449.8	$ 456.2
Net Income	116.0	98.1	92.5	81.0	97.0
Net Assets at Year-End	955.9	878.4	816.4	762.7	639.2
Average Total Assets	21,175.6	20,427.7	19,227.2	19,085.7	18,403.9
Net Income Per Common Share*	6.14	5.11	4.86	4.57	5.51
Dividends Per Common Share*	1.96	1.84	1.76	1.68	1.52
Market Price Per Common Share at Year-End*	44.13	32.13	26.44	20.56	25.56

Five-Year Comparison of Selected Supplementary Financial Data Adjusted for Effects of Changing Prices**

	Year Ended December 31				
In Millions of Average 1985 Dollars, Except Share Amounts	1985	1984	1983	1982	1981
Net Interest Income	$ 512.0	$ 506.5	$ 487.6	$ 501.3	$ 539.6
Net Income	116.0	101.6	99.8	90.3	114.7
Net Assets at Year-End	1,161.2	1,109.3	1,064.5	1,022.8	900.2
Purchasing Power (Gain)/Loss on Net Monetary Items	(4.0)	1.9	6.9	7.1	23.0
Average Total Assets	21,175.6	21,156.6	20,760.7	21,270.8	21,768.5
Net Income Per Common Share*	6.14	5.29	5.25	5.09	6.52
Dividends Per Common Share*	1.96	1.91	1.90	1.87	1.80
Market Price Per Common Share at Year-End*	43.42	32.81	28.07	22.66	29.26
Average Consumer Price Index	322.2	311.1	298.4	289.1	272.4

**During 1984, the Corporation effected a two-for-one split of the Corporation's common stock. Accordingly, per common share amounts for prior periods have been restated to reflect this event.*

***The data presented are based upon a historical cost/constant dollar method of accounting. This information has been substituted for the current cost/constant purchasing power information since constant dollar amounts do not differ materially from current cost amounts. Amounts related to foreign operations have been translated into U.S. dollars and then adjusted by the CPI. As the effect of applying constant dollar accounting to depreciation and amortization expense on premises and equipment is not material to net income, this expense has not been restated.*

In calculating net assets at year-end, the historical cost amount of shareholders' equity has been adjusted for the effects of general inflation and for the excess of the constant dollar amount over the historical cost amount of premises and equipment.

In calculating purchasing power (gain)/loss on net monetary items, historical cost shareholders' equity (i.e., net assets) has been reduced by the historical cost amount of nonmonetary items, primarily premises and equipment, trading account assets and investments in less than majority-owned affiliates.

Consolidated Statement of Condition

Irving Trust Company

In Thousands	December 31 1985	1984
Assets		
Cash and Due from Banks	$ 1,419,366	$ 805,977
Interest-Bearing Deposits with Banks	2,153,675	2,811,232
Investment Securities:		
U.S. Government and Federal Agency Obligations	406,670	334,530
Obligations of States and Political Subdivisions	331,601	282,958
Other Securities	126,176	95,896
Total Investment Securities (Approximate Market Value of $848,192 and $651,256)	864,447	713,384
Trading Account Assets	503,265	363,824
Federal Funds Sold and Securities Purchased Under Agreements to Resell	269,587	415,744
Loans (Less Unearned Discount of $112,457 and $105,067)	10,622,081	9,372,427
Less: Allowance for Loan Losses	151,767	132,967
Net Loans	10,470,314	9,239,460
Premises and Equipment	363,289	368,807
Customers' Acceptance Liability	1,403,156	990,920
Accrued Interest Receivable	206,142	227,101
Other Assets	1,022,662	520,324
Total Assets	**$18,675,903**	**$16,456,773**
Liabilities and Shareholder's Equity		
Deposits:		
Domestic Office Noninterest-Bearing	$ 4,098,384	$ 2,792,715
Foreign Office Noninterest-Bearing	161,160	144,327
Domestic Office Interest-Bearing	1,888,234	2,350,419
Foreign Office Interest-Bearing	5,435,513	5,857,574
Total Deposits	11,583,291	11,145,035
Federal Funds Purchased and Securities Sold Under Agreements to Repurchase	1,863,568	1,077,313
Other Borrowed Funds	1,894,439	1,610,871
Acceptances Outstanding	1,414,660	1,001,587
Accrued Interest Payable	100,472	131,880
Accrued Taxes and Other Expenses	79,842	85,063
Other Liabilities	461,042	334,731
Total Liabilities Excluding Long-Term Debt	17,397,314	15,386,480
Notes Payable, 4½%, Due 1993	15,508	17,468
Capital Notes	365,000	215,000
Shareholder's Equity:		
Preferred Stock, $50 Par Value Authorized and Outstanding 1,500,000 Shares	75,000	75,000
Common Stock, $28 Par Value Authorized and Outstanding 9,400,000 Shares	263,200	263,200
Surplus	220,750	220,750
Undivided Profits	339,131	278,875
Total Shareholder's Equity	898,081	837,825
Total Liabilities and Shareholder's Equity	**$18,675,903**	**$16,456,773**

Senior Officers

Irving Bank Corporation and Irving Trust Company

Irving Bank Corporation

Joseph A. Rice
Chairman

Samuel F. Chevalier
President

John J. Houseman
Executive Vice President

Peter C. Palmieri
Executive Vice President

William R. Hamcke
Treasurer

Eliot N. Vestner, Jr.
General Counsel and Secretary

William C. Bennett
Senior Vice President

Daniel J. Keane
Senior Vice President

John F. McIlwain
Senior Vice President

Joseph J. Tenicki
Senior Vice President
Irving Business Center, Inc.

Raymond G. Hollasch
Auditor

Robert E. Garber
Associate General Counsel

Paul E. Albert
Vice President

James T. Booth
Vice President

Anthony R. Burriesci
Vice President

Reynold H. Byrne, Jr.
Vice President

Ronald L. Cyr
Vice President

Alan J. Dalewitz
Vice President

Salim S. Dallal
Vice President

James T. Frost
Vice President

Thomas J. Mastro
Vice President

Richard A. Nelipowitz
Vice President

Edward A. Nolan, Jr.
Vice President

Michael M. Pascale
Vice President

Thomas A. Polucci
Vice President

Martin S. Silver
Vice President

Grace Sterrett
Vice President and Counsel

Stephen A. Swartz
Vice President

Louis P. Tietz
Deputy Auditor

Irving Trust Company

Joseph A. Rice
Chairman

David M. Mace
President

Samuel F. Chevalier
Vice Chairman

Peter C. Palmieri
Vice Chairman

Senior Executive Vice Presidents

James F. Ganley
William R. Hamcke
John A. Orr
Robert W. Stone

Executive Vice Presidents

Thomas W. Archibald
Phillip D. Barksdale, Jr.
N. Morgan Brassler
Pierre du Vair
Joseph A. Grimaldi
Adrian G. Kole
James P. Kuharski
John R. Mohr
Donald R. Monks
Anthony Rendino
Madeleine D. Robinson
L. Parks Shipley, Jr.
Ronald D. Upton
Eliot N. Vestner, Jr.
General Counsel and Secretary

Senior Vice Presidents

Kenneth J. Abere
Truett E. Allen
David A. Bartsch
Alvin L. Begleiter
Dennis D. Beuchler
Anthony R. Burriesci
Comptroller
Dominic K. C. Chang
Anthony G. Chappell
Helen L. Cunneen
Jean de Rochefort
Harold F. Dietz
Lawrence J. Gallaway
Robert E. Garber
Emanuel Genauer
Dominic G. Gilbert
Marquis H. Gilmore
Anthony T. Guasco
T. Carter Hagaman
G. Gordon Haw
Richard T. Henshaw, III
John H. Hicks
Raymond G. Hollasch
Auditor
Janet E. Hunt
Robert A. Hunt
Thomas D. Jacobs
William F. Klausing
Wolfgang W. Koenig
Daniel N. Leiter
Edith F. Lichota
Neal T. Maher
Richard T. McIntosh
Carlos Menendez
Irving Trust International Bank
Ronald L. Niper
Roy T. Ortman
Richard A. Pace
Frederick E. Palmerton
James Peale
Gordon B. Pye
Arnoldo A. Ramirez
Robert A. Sbarbaro
James W. Scanlan, Jr.
Robert D. Schumacher
Morrie A. Sigel
John A. Snyder
Martin C. Stearns
Donald A. Stephen
Witold S. Sulimirski
Clifford M. Svikhart
James E. Wellington
William R. White, Jr.
J. Perry Wootten
Gary N. Yalen
Bruno E. Ziolkowski

Directors

Irving Bank Corporation and Irving Trust Company

Board of Directors

Joseph A. Rice
Chairman

Samuel F. Chevalier
President
Irving Bank Corporation
Vice Chairman
Irving Trust Company

David M. Mace*
President
Irving Trust Company

Peter C. Palmieri*
Executive Vice President
Irving Bank Corporation
Vice Chairman
Irving Trust Company

John F. Bookout
President and
Chief Executive Officer
Shell Oil Company
(Integrated oil company)

Theodore F. Brophy
Chairman and
Chief Executive Officer
Corporation
unication services,
nics and lighting)

Cees Bruynes
Chairman, President and
Chief Executive Officer
North American Philips
Corporation
(Manufacturing organization with operations in consumer products and services, lighting products, electrical and electronic components and professional equipment)

William R. Chaney
Chairman and
Chief Executive Officer
Tiffany & Co.
(Fine jewelry, silver, china and crystal)

John C. Duncan
Chairman
Cyprus Minerals Company
(Natural resource company)

Ward S. Hagan
Former Chairman and
Chief Executive Officer
Warner-Lambert Company
(Diversified health care and specialized manufacturing company)

Robert P. Jensen
President and
Chief Executive Officer
Tiger International Inc.
(Transportation company)

William R. Laidig
Chairman and
Chief Executive Officer
Great Northern Nekoosa
Corporation
(Manufacturer of paper, board and forest products)

David L. Luke, III
Chairman and
Chief Executive Officer
Westvaco Corporation
(Producer of paper, packaging and chemicals)

G.G. Michelson
Senior Vice President
External Affairs
R.H. Macy & Co., Inc.
(Owner and operator of department stores)

Minot K. Milliken
Vice President and Treasurer
Milliken & Company
(Textile manufacturing and sales)

Martha T. Muse
Chairman and President
The Tinker Foundation
Incorporated
(Private foundation)

John M. Pietruski, Jr.
Chairman and
Chief Executive Officer
Sterling Drug Inc.
(Manufacturer of ethical and proprietary medicines and household and consumer products)

Gordon T. Wallis
Chairman of the Executive
Committees
Irving Bank Corporation
and Irving Trust Company

W. Clarke Wescoe, M.D.
Former Chairman and
Chief Executive Officer
Sterling Drug Inc.
(Manufacturer of ethical and proprietary medicines and household and consumer products)

W.S. White, Jr.
Chairman and
Chief Executive Officer
American Electric Power
Company, Inc.
(Public utility holding company)

Richard A. Zimmerman
Chairman and
Chief Executive Officer
Hershey Foods Corporation
(Chocolate and confectionery products, pasta and restaurant operations)

Advisory Directors

Harrington Drake
Former Chairman and
Chief Executive Officer
The Dun & Bradstreet
Corporation
(Business information, publishing and marketing)

Robert Hellendale
Chairman of the
Executive Committee
Great Northern Nekoosa
Corporation
(Manufacturer of paper, board and forest products)

Lelan F. Sillin, Jr.
Former Chairman and
Chief Executive Officer
Northeast Utilities
(Public utility holding company)

Donald B. Smiley
Former Chairman
R.H. Macy & Co., Inc.
(Owner and operator of department stores)

Pieter C. Vink
Former Chairman
North American Philips
Corporation
(Manufacturing organization with operations in consumer products and services, lighting products, electrical and electronic components and professional equipment)

Ralph A. Weller**
Former Vice President
United Technologies Corporation
(Diversified multi-market industrial organization, designer and builder of jet engines, elevators, air conditioning equipment, wire and cable products, electronic products and helicopters)

**Director of Irving Trust Company only.*
***Advisory Director of Irving Bank Corporation only.*

Shareholder Information

Irving Bank Corporation

Headquarters
One Wall Street
New York, New York 10005
212/635-1111

Annual Meeting
The Annual Meeting of Shareholders will be held at 101 Barclay Street, New York, NY on Thursday, April 17, 1986 at 2:00 pm

Telex Numbers
RCA-232241
ITT-420268
WUI-62832
TRT-177612

Cable Address
IRVINGBANK, New York

S.W.I.F.T. Address
IRVTUS3N

Dividend Disbursing Agent, Transfer Agent for Stock
Irving Trust Company
One Wall Street
New York, NY 10015
212/635-6927

Registrar for Stock
Morgan Guaranty Trust Company of New York
30 West Broadway
New York, NY 10015

Trustee for Floating Rate Subordinated Notes, due 1996
Morgan Guaranty Trust Company of New York
30 West Broadway
New York, NY 10015

Trustee for Floating Rate Subordinated Capital Notes, due 1997
National Westminster Bank USA
175 Water Street
New York, NY 10038

Trustee for all Other Notes and Debentures
The Bank of New York
48 Wall Street
New York, NY 10015

Paying Agent for Notes and Debentures
Irving Trust Company
One Wall Street
New York, NY 10015

Independent Certified Public Accountants
Peat, Marwick, Mitchell & Co.
345 Park Avenue
New York, NY 10154

Dividend Reinvestment and Stock Purchase Plan
Irving Bank Corporation offers a Dividend Reinvestment and Stock Purchase Plan to holders of its Common Stock. Common Shareholders may reinvest all or part of their dividends in newly issued shares of Common Stock at a 5% discount from the current market price and make optional cash payments of between $25 and $5,000 per quarter to purchase newly issued shares of Common Stock at the current market price.

The Corporation pays the administrative costs associated with the Plan.

Shareholders of Common Stock, as well as brokers and custodians who hold stock for clients, may receive a Plan prospectus and enrollment card by contacting:

Stephen A. Swartz
Vice President & Director of Investor Communications
Irving Bank Corporation
One Wall Street
New York, NY 10005
212/635-7942

Stockholder Inquiries
For information about Irving Bank Corporation, please contact:
Stephen A. Swartz
Vice President & Director of Investor Communications
Irving Bank Corporation
One Wall Street
New York, NY 10005
212/635-7942

Common Stock Listing
Irving Bank Corporation's Common Stock is traded on the New York Stock Exchange. Trading Symbol: V

SEC Form 10-K
For copies of the Annual Report to the Securities and Exchange Commission on Form 10-K, please write:

Eliot N. Vestner, Jr.
General Counsel & Secretary
Irving Bank Corporation
One Wall Street
New York, NY 10005

CONFORMED COPY

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT UNDER SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For Quarter Ended September 30, 1986

Commission file number 1-4473

ARIZONA PUBLIC SERVICE COMPANY
(Exact name of registrant as specified in its charter)

Arizona	86-0011170
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

411 North Central Avenue, P. O. Box 53999, Phoenix, Arizona 85072-3999
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code 602-250-1000

Former name, former address and former fiscal year, if changed since last report

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to the filing requirements for the past 90 days.

Yes X No ____

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Number of shares of common stock, $2.50 par value, outstanding as of November 6, 1986: 71,264,947

Deloitte Haskins+Sells

Suite 1000
First Interstate Bank Plaza
Phoenix, Arizona 85003
(602) 257-8333
Cable DEHANDS

Arizona Public Service Company:

We have made a review of the consolidated balance sheet of Arizona Public Service Company (the "Company") and its subsidiaries as of September 30, 1986 and the related consolidated statements of income for the three-month, nine-month and twelve-month periods ended September 30, 1986 and 1985 and of changes in financial position for the nine-month periods ended September 30, 1986 and 1985, included in the Company's quarterly report on Form 10-Q, in accordance with standards established by the American Institute of Certified Public Accountants.

A review of interim financial information consists principally of obtaining an understanding of the system for the preparation of interim financial information, applying analytical review procedures to financial data, and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an examination in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the above-mentioned consolidated financial statements in order for them to be in conformity with generally accepted accounting principles.

Deloitte Haskins & Sells

November 6, 1986

PART I - FINANCIAL INFORMATION

m 1. Financial Statements

ARIZONA PUBLIC SERVICE COMPANY
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

	Three Months Ended September 30, 1986	Three Months Ended September 30, 1985
	(Dollars in Thousands, Except Per Share Amounts)	
ELECTRIC OPERATING REVENUES	$ 391,738	$ 368,129
FUEL EXPENSES:		
Fuel for electric generation	52,935	67,893
Purchased power and interchange - net	52,714	3,523
Total	105,649	71,416
OPERATING REVENUES LESS FUEL EXPENSES	286,089	296,713
OTHER OPERATING EXPENSES:		
Operations excluding fuel expenses	39,688	31,242
Maintenance	23,179	16,711
Depreciation and amortization	37,911	25,466
Income taxes - current	30,076	608
Income taxes - deferred	23,002	75,122
Other taxes	36,652	29,278
Total	190,508	178,427
OPERATING INCOME	95,581	118,286
ER INCOME (DEDUCTIONS):		
Allowance for equity funds used during construction	19,986	30,332
Income taxes - current	(4,464)	(322)
Income taxes - deferred	4,446	16,219
Other - net	36,181	(5,648)
Total	56,149	40,581
INCOME BEFORE INTEREST DEDUCTIONS	151,730	158,867
INTEREST DEDUCTIONS:		
Interest on long-term debt	55,972	54,236
Interest on short-term borrowings	308	1,662
Debt discount, premium and expense	1,620	886
Allowance for borrowed funds used during construction	(8,393)	(12,390)
Total	49,507	44,394
NET INCOME	102,223	114,473
PREFERRED STOCK DIVIDEND REQUIREMENTS	9,349	10,832
EARNINGS FOR COMMON STOCK	$ 92,874	$ 103,641
AVERAGE COMMON SHARES OUTSTANDING	71,264,947	71,264,947
PER SHARE OF COMMON STOCK:		
Earnings (based on average common shares outstanding)	$ 1.30	$ 1.45
Dividends declared	$ 0.74	$ 0.69

Notes to Consolidated Financial Statements

ARIZONA PUBLIC SERVICE COMPANY
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

	Nine Months Ended September 30, 1986	1985
	(Dollars in Thousands, Except Per Share Amounts)	
ELECTRIC OPERATING REVENUES	$ 961,720	$ 888,378
FUEL EXPENSES:		
Fuel for electric generation	143,135	170,777
Purchased power and interchange - net	86,387	5,772
Total	229,522	176,549
OPERATING REVENUES LESS FUEL EXPENSES	732,198	711,829
OTHER OPERATING EXPENSES:		
Operations excluding fuel expenses	107,563	88,146
Maintenance	71,290	67,620
Depreciation and amortization	100,145	73,680
Income taxes - current	35,440	27,858
Income taxes - deferred	107,139	139,632
Other taxes	93,745	78,825
Total	515,322	475,761
OPERATING INCOME	216,876	236,068
OTHER INCOME (DEDUCTIONS):		
Allowance for equity funds used during construction	80,202	103,919
Income taxes - current	(5,288)	(1,824)
Income taxes - deferred	29,491	40,118
Other - net	38,092	(4,447)
Total	142,497	137,766
INCOME BEFORE INTEREST DEDUCTIONS	359,373	373,834
INTEREST DEDUCTIONS:		
Interest on long-term debt	165,916	154,129
Interest on short-term borrowings	5,937	5,748
Debt discount, premium and expense	4,384	2,490
Allowance for borrowed funds used during construction	(32,039)	(35,210)
Total	144,198	127,157
NET INCOME	215,175	246,677
PREFERRED STOCK DIVIDEND REQUIREMENTS	29,957	33,672
EARNINGS FOR COMMON STOCK	$ 185,218	$ 213,005
AVERAGE COMMON SHARES OUTSTANDING	71,264,947	70,952,465
PER SHARE OF COMMON STOCK:		
Earnings (based on average common shares outstanding)	$ 2.60	$ 3.00
Dividends declared	$ 2.18	$ 2.02

See Notes to Consolidated Financial Statements

ARIZONA PUBLIC SERVICE COMPANY
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

	Twelve Months Ended September 30, 1986	1985
	(Dollars in Thousands, Except Per Share Amounts)	
ELECTRIC OPERATING REVENUES	$ 1,247,844	$ 1,130,851
FUEL EXPENSES:		
Fuel for electric generation	191,933	210,416
Purchased power and interchange - net	97,404	4,760
Total	289,337	215,176
OPERATING REVENUES LESS FUEL EXPENSES	958,507	915,675
OTHER OPERATING EXPENSES:		
Operations excluding fuel expenses	142,168	114,111
Maintenance	92,540	83,488
Depreciation and amortization	125,686	96,167
Income taxes - current	28,547	41,925
Income taxes - deferred	162,578	176,857
Other taxes	119,196	101,614
Total	670,715	614,162
OPERATING INCOME	287,792	301,513
OTHER INCOME (DEDUCTIONS):		
Allowance for equity funds used during construction	119,895	140,251
Income taxes - current	(6,119)	2,163
Income taxes - deferred	42,785	54,619
Other - net	38,217	(5,567)
Total	194,778	191,466
INCOME BEFORE INTEREST DEDUCTIONS	482,570	492,979
INTEREST DEDUCTIONS:		
Interest on long-term debt	221,007	201,290
Interest on short-term borrowings	7,140	8,826
Debt discount, premium and expense	5,507	3,223
Allowance for borrowed funds used during construction	(45,005)	(48,276)
Total	188,649	165,063
INCOME FROM CONTINUING OPERATIONS	293,921	327,916
LOSS FROM DISPOSAL AND OPERATION OF DISCONTINUED GAS SYSTEM, NET OF TAXES	---	(26,687)
NET INCOME	293,921	301,229
PREFERRED STOCK DIVIDEND REQUIREMENTS	40,697	46,186
EARNINGS FOR COMMON STOCK	$ 253,224	$ 255,043
AVERAGE COMMON SHARES OUTSTANDING	71,264,947	70,619,687
PER SHARE OF COMMON STOCK:		
Earnings (loss) (based on average common shares outstanding):		
Continuing operations	$ 3.55	$ 3.99
Discontinued operations	---	(0.38)
Total	$ 3.55	$ 3.61
Dividends declared	$ 2.89	$ 2.67

See Notes to Consolidated Financial Statements

ARIZONA PUBLIC SERVICE COMPANY
CONSOLIDATED BALANCE SHEETS

ASSETS

	September 30, 1986 (Unaudited)	December 31, 1985
	(Thousands of Dollars)	
UTILITY PLANT:		
Electric utility plant in service and held for future use	$4,858,988	$2,970,368
Less accumulated depreciation and amortization	910,732	838,684
Total	3,948,256	2,131,684
Construction work in progress	907,472	2,742,139
Nuclear fuel, net of amortization	76,841	---
Utility Plant - net	4,932,569	4,873,823
INVESTMENTS AND OTHER ASSETS:		
Investments in and receivables from subsidiaries.	16,513	16,513
Other investments and notes receivable.	13,026	5,991
Total investments and other assets	29,539	22,504
RENT ASSETS:		
Cash and marketable securities	31,804	7,871
Special deposits and working funds.	247,801	3,342
Accounts receivable:		
Service customers.	94,171	84,533
Other.	52,295	43,415
Allowance for doubtful accounts.	(1,621)	(1,395)
Materials and supplies (at average cost).	63,133	41,525
Fuel (at average cost).	29,052	30,433
Deferred fuel (Note 6).	28,501	74,335
Other	8,385	3,873
Total current assets	553,521	287,932
DEFERRED DEBITS:		
Deferred income taxes	69,811	13,754
Unamortized gas exploration costs	9,050	10,417
Unamortized debt issue costs.	19,884	16,705
Other	86,173	26,192
Total deferred debits.	184,918	67,068
TOTAL.	$5,700,547	$5,251,327

See Notes to Consolidated Financial Statements

ARIZONA PUBLIC SERVICE COMPANY
CONSOLIDATED BALANCE SHEETS

LIABILITIES

	September 30, 1986 (Unaudited)	December 31, 1985
	(Thousands of Dollars)	
CAPITALIZATION:		
Common stock	$ 178,162	$ 178,162
Premiums and expenses - net	1,040,086	1,040,909
Retained earnings	621,939	592,334
Common stock equity	1,840,187	1,811,405
Non-redeemable preferred stock	218,561	218,561
Redeemable preferred stock	178,728	219,421
Long-term debt	2,186,268	2,205,940
Total capitalization	4,423,744	4,455,327
CURRENT LIABILITIES:		
Commercial paper	---	18,000
Current maturities of long-term debt	238,174	17,456
Accounts payable	67,392	87,113
Accrued taxes	120,861	52,976
Accrued interest	67,422	72,678
Accrued dividends	3,107	3,566
Other	35,731	26,069
Total current liabilities	532,687	277,858
DEFERRED CREDITS AND OTHER:		
Deferred income taxes	353,012	230,553
Deferred investment tax credit	184,252	174,503
Unamortized gain - sale of utility plant	101,952	---
Unamortized credit - sale of tax benefits	42,304	43,645
Customers' advances for construction	23,080	23,991
Other	39,516	45,450
Total deferred credits and other	744,116	518,142
TOTAL	$5,700,547	$5,251,327

See Notes to Consolidated Financial Statements

ARIZONA PUBLIC SERVICE COMPANY
CONSOLIDATED STATEMENTS OF CHANGES IN FINANCIAL POSITION
(Unaudited)

	Nine Months Ended September 30, 1986	1985
	(Thousands of Dollars)	
SOURCE OF FUNDS:		
Funds from operations:		
Net income	$ 215,175	$ 246,677
Principal non-fund charges (credits) to income:		
Depreciation and amortization	100,145	73,680
Allowance for equity funds used during construction	(80,202)	(103,919)
Deferred income taxes - net	66,222	73,265
Deferred investment tax credit - net	9,749	26,578
Other	8,322	14,667
Total funds from operations	319,411	330,948
Funds from external sources:		
Common stock	---	24,752
Funds from sale of utility plant	340,806	---
Long-term debt	481,274	642,973
Other items - net	(16,499)	12,292
Total funds from external sources	805,581	680,017
Total source of funds	$1,124,992	$1,010,965
APPLICATION OF FUNDS:		
Funds used for capital expenditures	$ 349,655	$ 354,782
Investments and other assets	7,035	(6,731)
Short-term borrowings - net	18,000	109,800
Repayment and reacquisition of long-term debt	309,738	276,144
Redemption of redeemable preferred stock	41,516	59,510
Dividends on preferred and common stock	185,570	177,503
Increase in working capital*	213,478	39,957
Total application of funds	$1,124,992	$1,010,965
INCREASE (DECREASE) IN WORKING CAPITAL*:		
Current assets	$ 265,589	$ 101,684
Current liabilities	(52,111)	(61,727)
Net increase	$ 213,478	$ 39,957

*Excluding short-term borrowings - net and current maturities of long-term debt.

See Notes to Consolidated Financial Statements

ARIZONA PUBLIC SERVICE COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. The consolidated financial statements include the accounts of Arizona Public Service Company (the "Company" or "APS") and those of two of its wholly-owned subsidiaries, APS Finance Company N.V., organized to serve as a financing corporation to raise funds outside the United States of America, and APS Fuels Company, organized to manage investments in certain fuel resources. All significant intercompany balances and transactions have been eliminated. Certain reclassifications in the prior period financial statements were made to conform with the current period presentation.

2. In the opinion of the Company, the accompanying unaudited consolidated financial statements contain all adjustments (comprising only normal recurring accruals) necessary to present fairly the financial position of the Company and its subsidiaries as of September 30, 1986, the results of their operations for the three months, nine months and twelve months ended September 30, 1986 and 1985 and the changes in their financial position for the nine months ended September 30, 1986 and 1985.

3. The Company's operations are subject to seasonal fluctuations with variations occurring in energy usage by customers from season to season and from month to month within a season, primarily as a result of changing weather conditions. For this and other reasons, the results of operations for interim periods are not necessarily indicative of the results to be expected for the full year.

4. The Company sold its gas distribution system effective November 1, 1984.

5. On April 18, 1985 the Company's shareholders approved a plan for corporate restructuring. Effective April 29, 1985, APS became a subsidiary of a holding company, AZP Group, Inc.

6. See "Legal Proceedings" in Part II, Item 1 of this report for a description of legal matters.

7. See "Construction and Financing Programs" in Part II, Item 5 of this report for changes in capitalization since December 31, 1985.

8. During the fiscal quarter ended September 30, 1986, the Company decided not to appeal an ACC order disallowing recovery of $24,400,000 of under-collected fuel and purchased power costs and charged such costs to fuel expenses. However, the Company also reversed the $6,000,000 reserve established in September 1985 in anticipation of the ACC's order.

9. In August 1986, the Company entered into two sale and leaseback transactions under which it sold 30.7% of its 29.1% share of Unit 2 of the Palo Verde Nuclear Generating Station for $341,250,000. The resulting gain of approximately $97,000,000 has been deferred and is being amortized to operations expense over the original lease term. The leases require semi-annual payments of $15,591,000 through June 1997 and $18,878,000 through December 2015 and include an option to renew the leases for two additional years. The leases are being accounted for as operating leases for both accounting and ratemaking purposes in accordance with an ACC order.

ARIZONA PUBLIC SERVICE COMPANY

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

Operating Results for the Three Months, Nine Months and Twelve Months Ended September 30, 1986, as Compared with Corresponding Periods Ended September 30, 1985.

Although the Company has experienced increases and decreases in unit costs of generating fuel and purchased power, nearly all of such charges are either recovered currently from wholesale customers or deferred pursuant to the Company's Purchased Power and Fuel Adjustment Mechanism (the "PPFAM") and accordingly, do not materially affect earnings. Recovery or refund of such deferred amounts is subject to an ACC review and approval process which requires a hearing. See "Retail Rates - Phase I Hearings" in Item 5 of the Company's Current Report on Form 8-K dated September 3, 1986 for a discussion of recent ACC hearings and other matters regarding the Company's PPFAM.

Electric operating revenues increased 6.4%, 8.3%, and 10.3% in the three-month, nine-month, and twelve-month periods, respectively. In all periods, the increases were largely due to (i) a temporary $.004 per kilowatt hour increase effective September 1, 1985 pursuant to operation of the Company's PPFAM and (ii) increased unit sales to commercial and residential customers. The temporary $.004 per kilowatt hour increase was subsequently reduced by the ACC to $.003099 per kilowatt hour effective August 1, 1986; however, this decrease was nearly correspondingly offset by a $.000898 per kilowatt hour retail rate increase also effective August 1, 1986. In the nine-month and twelve-month periods, revenues also increased due to an increase in the portion of a coal-fired plant's capacity that is being temporarily sold and to a retail rate increase of 4.98% effective February 1, 1985. For the three-month, nine-month, and twelve-month periods, the average number of electric customers increased by 4.2%, 4.5%, and 4.4%, respectively, with these increases occurring in the residential and commercial customer classes. Total unit sales increased by 1% in the three-month period and declined by 1.2% and 0.6% in the nine-month and twelve-month periods, respectively. Unit sales in the residential and commercial customer classes increased in all periods reflecting increased customers, but such sales were offset by lower sales to resale customers and lower retail irrigation sales.

Fuel for electric generation expense decreased by 22.0%, 16.2%, and 8.8% in the three-month, nine-month, and twelve-month periods, respectively. In all periods, the reductions were largely due to (i) lower unit fuel costs associated with the commercial operation of Units 1 and 2 of the Palo Verde Nuclear Generating Station ("Palo Verde"), (ii) lower gas fuel unit prices, and (iii) decreased generation requirements reflecting reduced sales to other utilities.

Purchased power and interchange-net expense increased in all three periods due to the operation of the Company's PPFAM and reduced interchange sales to other utilities. A portion of the increase associated with the PPFAM is due to the disallowance of certain under-collected fuel and purchased power costs ordered by the ACC. The increase was partially offset by reduced purchased power unit fuel costs in all three periods and reduced purchased power unit purchases in the three-month and nine-month periods.

Maintenance expenses increased in all three periods due to the start of commercial operation of Palo Verde Units 1 and 2 and to the timing of scheduled power plant maintenance overhauls.

Operations, excluding fuel expenses, increased in all three periods due to increased expenses resulting from the start of commercial operation of Palo Verde Units 1 and 2. The increase in the twelve-month period also reflects an addition to the reserve for uncollectibles resulting from an unpaid note.

Depreciation and amortization expenses increased in all three periods reflecting increases in the Company's utility plant in service, including Palo Verde Unit 1 which, based upon an ACC determination, attained commercial operation on January 1, 1986. Although the Company considers Palo Verde Unit 2 to have attained commercial operation on September 19, 1986, depreciation and amortization expenses were not affected in any of the periods by this development because such expenses are accounted for beginning in the month following the commercial operation date.

Ad valorem taxes, a function of the size of the Company's utility plant, and sales taxes, a function of operating revenues, also increased in all periods. Sales taxes and ad valorem taxes are the principal components of other taxes.

Income taxes-deferred decreased in all three periods primarily due to lower investment tax credit and decreased amounts associated with tax timing differences. Income taxes-current increased in the three-month and nine-month periods primarily due to the deduction for deferred fuel costs incurred in the 1985 periods. Income taxes-current decreased in the twelve-month period primarily due to decreased taxable income.

The aggregate amount of allowance for funds used during construction ("AFC"), shown as other income and a credit to interest deductions, decreased in all three periods. AFC is primarily a function of the amount of construction work in progress during any given period and ceases to accrue on those portions of construction work in progress that are included in rate base or on those generating facilities transferred to plant in service, including those portions associated with Palo Verde Units 1 and 2. See Note 1e of "Notes to Consolidated Financial Statements" in Part II, Item 8 of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 1985.

Interest on long-term debt increased in all three periods and interest on short-term borrowings increased in the nine-month period due primarily to large amounts of new borrowings, partially offset by lower interest rates. The decrease in interest on short-term borrowings in the three-month and twelve-month periods resulted primarily from the effects of lower interest rates and decreased borrowings.

Consolidated net income represents a composite of cash and non-cash items and reflects accounting practices unique to regulated public utilities. Consolidated net income was adversely affected in all periods by an increase in operating costs and the loss of AFC, primarily resulting from Palo Verde Unit 1 attaining commercial operation in January 1986 without an increase in rates. See "Retail Rates" Part II, Item 5 of this report. An additional factor adversely affecting consolidated net income was the charge to fuel expense resulting from the ACC's disallowance of certain under-collected fuel and purchased power costs.

For additional information regarding the Company's liquidity and commitments for capital expenditures, see "Retail Rates" and "Construction and Financing Programs" in Part II, Item 5 of this report, incorporated herein by reference.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Water Supply

On or about August 21, 1985, Arizona Public Service Company (the "Company") filed claims in the case of In Re the General Adjudication of All Rights to Use Water in the Little Colorado System and Source in the Superior Court of Apache County, Arizona. The case constitutes a general adjudication of all claims to water in the Little Colorado River Watershed. The Company's groundwater resource utilized at the Cholla Power Plant is within the geographic area subject to the adjudication and is therefore potentially at issue in the case. The Company's claims dispute the Court's jurisdiction over the Company's right to use water from this resource on the basis that groundwater is neither appropriable under state law nor subject to claims based upon federal law. Alternatively, the claims seek to confirm the Company's rights to utilize the water resource for all existing and planned units of the Cholla Power Plant. No trial date has been set in the matter. The Company is not yet able to predict the resolution of this matter.

Indian Matters

On October 27, 1986, the Office of Navajo Labor Relations (the "ONLR") filed a complaint with the Navajo Labor Relations Board alleging violations by the Company, as the operating agent of the Four Corners Plant, of the Navajo Preference in Employment Act (the "NPEA") and the predecessor employment law of the Navajo Nation. As previously reported, the Company and the Tribe disagree on whether the NPEA or a March 1985 letter agreement (the "Letter Agreement") between the Company and the Tribe govern employment relations at the Four Corners Plant. The NPEA, if binding on the Company, could seriously impair the Company's present ability to hire and promote the most qualified employees at the Four Corners Plant. See "Indian Matters" in Part I, Item 1 of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 1985 (the "1985 10-K").

The ONLR complaint alleges that the Company's anti-nepotism policy disproportionately affects Navajo Indians and seeks recovery of damages and injunctive, declaratory, and other relief. The Company expects to file a written response which will, among other things, argue that the Letter Agreement rather than the NPEA governs the dispute and deny the alleged violations of law. A hearing is scheduled on November 20 and 21, 1986, before the Board of Directors of the ONLR. The Company cannot currently predict the outcome of this matter.

Item 5. Other Information

Retail Rates

Phase II Hearings

As previously reported, on October 9, 1986, the Arizona Corporation Commission (the "ACC") issued an order (the "Order") in the "Phase II" hearings of the rate case in which the Company requested an increase in annual retail rates premised on Unit 1 of the Palo Verde Nuclear Generating Station ("Palo Verde") being fully included in the Company's rate base (the "Unit 1 Rate Case"). See "Retail Rates - Phase II Hearings" in Item 5 of the Company's Current Report on Form 8-K dated October 10, 1986 (the "October 8-K"). On October 29, 1986, the Company filed a motion seeking rehearing and reconsideration of certain aspects of the Order, including the $1,600,000 increase in annual retail rate revenues effective November 1, 1986, the designation of revenues attributable to approximately 25% of total Unit 1 costs being included in the Company's rate base as "interim", and the determination of the Unit 1 commercial operation date. If this request is denied, the Company will evaluate its legal options, including a possible appeal of the Order.

Unit 2 Rate Case

As previously reported, the Company has an application before the ACC for an increase in annual retail electric rates based upon Unit 2 being placed in commercial operation (the "Unit 2 Rate Case"). See "Retail Rates" in Part II, Item 5 of the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended June 30, 1986 (the "June 10-Q"). The Company, the staff of the ACC, and one of the intervenors have asked the ACC to modify the existing procedural schedule to permit the Company to refile its application in the Unit 2 Rate Case on or before December 19, 1986. This refiled application would reflect, among other things, the effect of the Order, recent changes in federal taxation laws, and the recent consummation of sale and leaseback transactions involving a portion of the Company's undivided ownership interest in Unit 2. See "Palo Verde Nuclear Generating Station - Sale and Leaseback of Unit 2 Interests" in Item 5 of the Company's Current Report on Form 8-K dated September 3, 1986 (the "September 8-K"). Pursuant to the joint request for modification of the procedural schedule, the Unit 2 Rate Case hearings would commence on March 19, 1987.

NRC Notice of Violation

As previously reported, on June 4, 1986, the Company, as the Palo Verde operating agent, filed a response to the May 1986 Nuclear Regulatory Commission ("NRC") Notice of Violation and Proposed Imposition of Civil Penalty (the "NRC Notice") requesting mitigation of the proposed imposition of a $100,000 civil penalty for violations categorized in the aggregate as a "Severity Level III" problem. See "Palo Verde Nuclear Generating Station" in Part II, Item 5 of the June 10-Q. On October 10, 1986, the NRC denied the Company's request for mitigation of the $100,000 civil penalty. The Company has decided it is prudent to pay the penalty rather than engage in a lengthy and costly appeal.

Construction and Financing Programs

For the nine months ended September 30, 1986, the Company incurred approximately $313,000,000 in construction expenditures, accounting for approximately 76% of the most recently estimated 1986 construction expenditures. The Company has estimated total construction expenditures for the years 1986, 1987, and 1988 at $411,000,000, $288,000,000, and $282,000,000, respectively.

In addition to funds required for capital expenditures, repayment or refunding obligations of senior securities and installment obligations (including certain anticipated early redemptions based upon current interest rates) are expected to total $545,000,000, $248,000,000, and $46,000,000 for the years 1986, 1987, and 1988, respectively. The Company refunded or otherwise paid approximately 59% ($321,000,000) of the expected 1986 total during the nine months ended September 30, 1986. Taking into account the October 1, 1986 redemptions discussed in the following paragraph, the Company has refunded or otherwise paid approximately 99.3% ($542,000,000) of the expected 1986 total.

On August 18, 1986, the Company consummated two sale and leaseback transactions relating to a total of approximately 31% of the Company's 29.1% undivided interest in Palo Verde Unit 2 (the "Sale and Leaseback Transactions"). See "Palo Verde Nuclear Generating Station - Sale and Leaseback of Unit 2 Interests" in Item 5 of the September 8-K. Of the total purchase price of $341,250,000, the Company deposited $241,250,000 of the proceeds with the trustee under the Company's first mortgage bond indenture to redeem on October 1, 1986, at par value plus accrued interest, $100,000,000 principal amount of the Company's First Mortgage Bonds, 12-3/4% Series due 2013, $100,000,000 principal amount of the Company's First Mortgage Bonds, 13-1/2% Series due 2013, and $20,620,000 principal amount of the Company's First Mortgage Bonds, 15% Series due 1994. The Company used a portion of the remaining $100,000,000 of the proceeds to retire all of the Company's short-term obligations as of August 19, 1986, equal to

approximately $45,000,000 principal amount. The remaining proceeds (including approximately $10,700,000 still held by the trustee under the Company's first mortgage bond indenture) are being invested on a short-term basis pending application to further redemptions of long-term debt and/or general corporate purposes, including the Company's construction program.

In the near future, PVNGS Funding Corp., Inc., a corporation created for the sole purpose of facilitating the Company's Palo Verde sale and leaseback financings, will issue up to $275,000,000 of secured lease obligation bonds (the "Bonds") to, among other things, refund certain indebtedness incurred by the purchasers involved in the Sale and Leaseback Transactions. The Bonds will not be direct obligations of, or guaranteed by, the Company. However, the Company will be required to make payments under the leases associated with the Sale and Leaseback Transactions in amounts sufficient to pay the principal of, and premium, if any, and interest on, the Bonds when due.

The Company may also consummate during 1986 one or more additional sale and leaseback transactions relating to a portion of its remaining interest in Palo Verde Unit 2. Consummation of any such sale and leaseback transaction is subject to further evaluation and general market conditions.

On August 14, 1986, the Company entered into a Eurocommercial paper program agreement among the Company and various financial institutions providing for the issuance by the Company, at the Company's request and subject to acceptance by such financial institutions, of short-term notes in an aggregate principal amount not to exceed $120,000,000 outstanding at any one time. Funds available to the Company under this agreement are intended to be used primarily to fund the Company's investment in nuclear fuel.

Provisions in the Company's Mortgage Bond Indenture and Articles of Incorporation restrict it from issuing additional first mortgage bonds or preferred stock, respectively, unless its earnings (as defined) cover by at least the prescribed number of times the amount of interest (as to bonds) and the amount of interest plus preferred stock dividend requirements (as to preferred stock) on the securities to be outstanding after completion of the new issue. Operation of the latter such provision has at times limited the Company's ability to issue preferred stock. As calculated in accordance with the applicable document, and assuming 10.5% as the rate of interest on new bonds or as the dividend requirement on new preferred stock that might have been issued on September 30, 1986, the coverage afforded by defined earnings for the twelve months ended on that date would have allowed the issuance of either $1,466,000,000 in aggregate principal amount of additional first mortgage bonds (as compared to approximately $813,000,000 in bonds issuable on the basis of net "property additions" to September 30, 1986), or $521,000,000 in aggregate

par value of additional preferred stock. Required coverages are 2.0 for bonds and 1.5 for preferred stock. Coverages afforded by defined earnings for the twelve-month period ended September 30, 1986, were 3.85 for bonds and 1.81 for preferred stock.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

Exhibit	Description	Page Number in Manually Signed Original on Which Which Exhibit May Be Found
10.1	Eurocommercial Paper Agreement, dated as of August 14, 1986, between Arizona Public Service Company, Credit Suisse First Boston Limited, and Certain Financial Institutions	20
10.2	Amendment dated June 4, 1986 to Agreement for the Sale and Purchase of Wastewater Effluent with City of Tolleson and Salt River Agricultural Improvement and Power District	120
15.1	Letter in Lieu of Consent Regarding Unaudited Interim Financial Information	125

(b) During the quarter ended September 30, 1986, the Company filed, on the dates indicated, the following reports on Form 8-K:

Report filed September 4, 1986, relating to (1) the Company's sale and leaseback of Palo Verde Unit 2 Interests; (2) extension of an ACC order regarding the Palo Verde Prudency Audit; and (3) the Palo Verde Unit 2 commercial operation schedule.

Report filed October 14, 1986, relating to (1) denial of the Company's motion seeking reconsideration and rehearing of the ACC order in the Phase I Hearings of the Unit 1 Rate Case; (2) the ACC's order in the Phase II Hearings of the Unit 1 Rate Case; (3) the ACC order which established a new format for the Palo Verde Prudency Audit; and (4) Palo Verde Unit 2 attaining commercial operation.

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the Company has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

ARIZONA PUBLIC SERVICE COMPANY
(Registrant)

Dated: November 7, 1986

By: /s/ Jaron B. Norberg
Jaron B. Norberg
Executive Vice President and
Chief Financial Officer
(Principal Financial Officer
and Officer Duly Authorized
to sign this Report)

PROSPECTUS SUPPLEMENT
(To Prospectus dated October 24, 1986)

$273,000,000

Secured Lease Obligation Bonds, Series 1986, Due 1998 and 2015

Interest Payable June 30 and December 30

The Secured Lease Obligation Bonds, Series 1986, Due 1998 and 2015 (the "Offered Bonds") will be indirectly secured, as described in the accompanying Prospectus, by a lien on, and security interest in, certain ownership interests in Unit 2 of the Palo Verde Nuclear Generating Station and the respective Leases relating to Unit 2, and will be payable from basic rentals and certain other amounts to be paid under such Leases by

Arizona Public Service Company

The Offered Bonds will be issued by PVNGS Funding Corp., Inc. ("Funding Corp."), a corporation created for the sole purpose of the financing described herein and other similar financings. Arizona Public Service Company (the "Company") will be unconditionally obligated to make rental payments in amounts which will be at least sufficient to pay in full, when due, all payments of principal of, and premium, if any, and interest on, the Offered Bonds, although the Offered Bonds will not be direct obligations of, or guaranteed by, the Company.

The Offered Bonds will mature on December 30, 1998 and June 30, 2015, and will be in the aggregate principal amounts and will bear interest at the rates shown in the table below. For optional, sinking fund and special mandatory redemption provisions and other terms, see "Certain Terms of the Offered Bonds".

THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION NOR HAS THE COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS SUPPLEMENT OR THE ACCOMPANYING PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

Series of Bonds	Principal Amount	Price to Public(1)	Underwriting Commissions(2)	Proceeds(2)(3)
9% Secured Lease Obligation Bonds, Series 1986, Due 1998	$ 35,184,000	100%*	.625%*	$ 35,184,000
10.45% Secured Lease Obligation Bonds, Series 1986, Due 2015	237,816,000	100%*	.875%*	237,816,000
Total	$273,000,000	$273,000,000	$2,300,790	$273,000,000

(1) *Plus accrued interest, if any.*
(2) *Underwriting commissions will be paid by the Company and not by Funding Corp.*
(3) *Does not reflect deduction of expenses payable by the Company, estimated at $550,000, in connection with the registration of $550,000,000 aggregate principal amount of Bonds, which amount includes the Offered Bonds offered hereby.*

* *Per Bond.*

The Offered Bonds are offered by the Underwriters when, as and if issued and accepted by the Underwriters and subject to their right to reject orders in whole or in part. It is expected that the Offered Bonds will be ready for delivery on or about November 19, 1986.

The First Boston Corporation

Kidder, Peabody & Co.
Incorporated

Salomon Brothers Inc

The date of this Prospectus Supplement is November 6, 1986.

IN CONNECTION WITH THIS OFFERING, THE UNDERWRITERS MAY OVER-ALLOT OR EFFECT TRANSACTIONS WHICH STABILIZE OR MAINTAIN THE MARKET PRICE OF THE SECURITIES OFFERED HEREBY AT A LEVEL ABOVE THAT WHICH MIGHT OTHERWISE PREVAIL IN THE OPEN MARKET. SUCH STABILIZING, IF COMMENCED, MAY BE DISCONTINUED AT ANY TIME.

CERTAIN TERMS OF THE OFFERED BONDS

The following information concerning the Offered Bonds supplements and should be read in conjunction with the statements under "DESCRIPTION OF THE BONDS" in the accompanying Prospectus. Capitalized terms used in this Prospectus Supplement have the same meanings as in the accompanying Prospectus.

Principal Amounts, Interest Rates, Maturities and Payment

The Offered Bonds are to be issued under a Collateral Trust Indenture dated as of November 1, 1986 (the "Indenture") among Funding Corp., the Company and Chemical Bank, as indenture trustee (the "Trustee"), as supplemented by a Series 1986 Bond Supplemental Indenture thereto to be dated as of November 15, 1986 among such parties (the "Supplemental Indenture").

The Offered Bonds will be limited to an aggregate principal amount of $273,000,000 consisting of $35,184,000 aggregate principal amount of Offered Bonds Due December 30, 1998 (the "Offered Bonds Due 1998") and $237,816,000 aggregate principal amount of Offered Bonds Due June 30, 2015 (the "Offered Bonds Due 2015") (the aggregate principal amount of Offered Bonds due on each maturity date being referred to as a "Maturity"). The Offered Bonds will bear interest at the rate per annum for each respective Maturity shown on the cover page hereof, payable semi-annually on June 30 and December 30 in each year, commencing December 30, 1986, to the registered owners thereof at the close of business on the December 15 or June 15, as the case may be, next preceding such interest payment date. If the scheduled payment date for the Offered Bonds is not a business day, payment may be made on the next succeeding business day with the same effect as though made on the date due. (Indenture, Sections 1.13, 2.03 and 2.10, Supplemental Indenture and form of Offered Bond)

The principal of, and premium, if any, and interest on, the Offered Bonds will be payable at the corporate trust office of Chemical Bank, registrar and paying agent, in The City of New York. Payment of interest may, however, be made at the option of Funding Corp. by check mailed to the address of the person entitled thereto, as shown in the bond register. (Indenture, Sections 2.03 and 2.10, and form of Offered Bond)

Sinking Fund Redemption

The Indenture provides for the redemption of the Offered Bonds through operation of a sinking fund on each of the dates set forth below (other than maturity dates), at the principal amount thereof, together with interest accrued to the redemption date. The principal amounts of Offered Bonds of the respective Maturities to be redeemed on such dates, as well as the principal amounts payable on the final maturity date of each Maturity, are set forth in the following table opposite such dates. Offered Bonds to be redeemed through operation of the sinking fund will be selected by lot by the Trustee. (Indenture, Section 7.01, Supplemental Indenture and form of Offered Bond)

	Offered Bonds Due 1998	Offered Bonds Due 2015
December 30, 1989	$ 65,000	—
June 30, 1990	495,000	—
December 30, 1990	978,000	—
June 30, 1991	1,022,000	—
December 30, 1991	1,068,000	—
June 30, 1992	1,116,000	—
December 30, 1992	1,166,000	—
June 30, 1993	1,218,000	—
December 30, 1993	1,273,000	—
June 30, 1994	1,330,000	—
December 30, 1994	1,391,000	—
June 30, 1995	1,454,000	—
December 30, 1995	1,518,000	—
June 30, 1996	1,587,000	—
December 30, 1996	1,658,000	—
June 30, 1997	1,733,000	—
December 30, 1997	5,136,000	—
June 30, 1998	5,367,000	—
December 30, 1998	5,609,000	—
June 30, 1999		$ 3,485,000
December 30, 1999		4,722,000
June 30, 2000		5,169,000
December 30, 2000		5,148,000
June 30, 2001		5,147,000
December 30, 2001		4,558,000
June 30, 2002		4,979,000
December 30, 2002		4,862,000
June 30, 2003		5,313,000
December 30, 2003		5,187,000
June 30, 2004		5,533,000
December 30, 2004		5,392,000
June 30, 2005		5,856,000
December 30, 2005		5,704,000
June 30, 2006		6,250,000
December 30, 2006		6,086,000
June 30, 2007		6,670,000
December 30, 2007		6,493,000
June 30, 2008		7,118,000
December 30, 2008		6,928,000
June 30, 2009		7,596,000
December 30, 2009		7,393,000
June 30, 2010		8,107,000
December 30, 2010		7,888,000
June 30, 2011		8,652,000
December 30, 2011		8,417,000
June 30, 2012		9,234,000
December 30, 2012		10,279,000
June 30, 2013		9,751,000
December 30, 2013		11,616,000
June 30, 2014		14,316,000
December 30, 2014		17,035,000
June 30, 2015		6,932,000

The principal amount of Offered Bonds of a particular Maturity to be redeemed through operation of the sinking fund for the Offered Bonds of such Maturity may be adjusted once (upward or downward) at the discretion of Funding Corp. (contemporaneously with similar adjustments for all

Maturities) on or before June 30, 1989; provided, however, that such adjustment shall not increase or reduce the average life of the Offered Bonds of such Maturity (calculated in accordance with generally accepted financial practice from the date of initial issuance) by more than 6 months; provided further, however, that such adjustment may only be made in connection with an adjustment to basic rent under one or more of the Leases. The Trustee shall, at the expense of the Company, send to each holder of Offered Bonds of the affected Maturity at least 20 days before the first sinking fund date to be affected thereby, by first class mail, a revised schedule of principal amounts of sinking fund payments applicable to such Offered Bonds.

In the event of any partial redemption of Offered Bonds of a particular Maturity (other than pursuant to the sinking fund), the principal amount of Offered Bonds of such Maturity thereafter to be redeemed pursuant to the sinking fund shall be adjusted proportionately as nearly as practicable. (Indenture, Section 7.01, and form of Offered Bond)

Optional Redemption

The Offered Bonds may not be redeemed at the option of Funding Corp. prior to December 30, 1991. On and after December 30, 1991 the Offered Bonds may be redeemed at the option of Funding Corp., which option is exercisable only at the direction of a Lessor whose Pledged Lessor Notes are then proposed to be prepaid, in whole or in part, at any time with monies deposited with the Trustee, on not less than 20 or more than 60 days' notice given by mail, as follows:

(a) The Offered Bonds Due 1998 may be redeemed at the following redemption prices (expressed as a percentage of principal amount), together with interest accrued to the redemption date:

If Redeemed During the Twelve Months Beginning December 30,	Redemption Price
1991	104.50%
1992	103.60
1993	102.70
1994	101.80
1995	100.90

and thereafter at the principal amount thereof, together with interest accrued to the redemption date. (Indenture, Section 2.03, and form of Offered Bond)

(b) The Offered Bonds Due 2015 may be redeemed at the following redemption prices (expressed as a percentage of principal amount), together with interest accrued to the redemption date:

If Redeemed During the Twelve Months Beginning December 30,	Redemption Price	If Redeemed During the Twelve Months Beginning December 30,	Redemption Price
1991	107.70%	1998	103.85%
1992	107.15	1999	103.30
1993	106.60	2000	102.75
1994	106.05	2001	102.20
1995	105.50	2002	101.65
1996	104.95	2003	101.10
1997	104.40	2004	100.55

and thereafter at the principal amount thereof, together with interest accrued to the redemption date. (Indenture, Section 2.03, and form of Offered Bond)

Special Mandatory Redemption

If a Lease or Leases shall be terminated by reason of the Company's Board of Directors having determined that Unit 2 is surplus to the Company or is economically obsolete, which may occur only

on or after December 30, 1996 (see "DESCRIPTION OF THE LEASES — Termination for Obsolescence" in the accompanying Prospectus), Offered Bonds Due 1998 and Offered Bonds Due 2015 will be redeemed in an aggregate principal amount equal to the aggregate principal amount of all Pledged Lessor Notes related to such Lease or Leases to be prepaid, at a redemption price of 100% of the principal amount thereof, together with interest accrued to the redemption date. (Supplemental Indenture and form of Offered Bond)

USE OF PROCEEDS

Proceeds from the issuance of the Offered Bonds will be (a) used to retire the Bank Indebtedness incurred in connection with the Initial Sale and Leaseback Transactions, which Bank Indebtedness matures on December 30, 2015 and currently bears interest at the reference rate of one of the Interim Lenders and (b) loaned by Funding Corp. to the Lessors in the Initial Sale and Leaseback Transactions and used to refund a portion of amounts provided by the Equity Participants in the Initial Sale and Leaseback Transactions. (See "INTRODUCTION" and "USE OF PROCEEDS" in the accompanying Prospectus.)

UNDERWRITING

The First Boston Corporation, Kidder, Peabody & Co. Incorporated and Salomon Brothers Inc have each severally agreed to purchase from Funding Corp. $11,728,000 principal amount of Offered Bonds Due 1998.

The Underwriters named below have severally agreed to purchase from Funding Corp. the following respective principal amounts of Offered Bonds Due 2015:

Underwriter	Principal Amount
The First Boston Corporation	$ 35,616,000
Kidder, Peabody & Co. Incorporated	35,600,000
Salomon Brothers Inc	35,600,000
Bear, Stearns & Co. Inc.	7,000,000
Alex. Brown & Sons, Incorporated	7,000,000
Dillon, Read & Co. Inc.	7,000,000
Drexel Burnham Lambert Incorporated	7,000,000
A. G. Edwards & Sons, Inc.	3,000,000
Goldman, Sachs & Co.	9,000,000
E. F. Hutton & Company Inc.	7,000,000
Lazard Frères & Co.	7,000,000
Merrill Lynch, Pierce, Fenner & Smith Incorporated	9,000,000
Morgan Stanley & Co. Incorporated	9,000,000
PaineWebber Incorporated	7,000,000
Prudential-Bache Securities Inc.	7,000,000
Rauscher Pierce Refsnes, Inc.	3,000,000
L. F. Rothschild, Unterberg, Towbin, Inc.	7,000,000
Shearson Lehman Brothers Inc.	9,000,000
Smith Barney, Harris Upham & Co. Incorporated	7,000,000
Wertheim & Co., Inc.	7,000,000
Dean Witter Reynolds Inc.	9,000,000
Young, Smith & Peacock, Inc.	3,000,000
Total	$237,816,000

Funding Corp. and the Company have been advised by The First Boston Corporation, Kidder, Peabody & Co. Incorporated and Salomon Brothers Inc, as the several Underwriters in respect of Offered Bonds Due 1998 and as the Representatives of the several Underwriters in respect of Offered Bonds Due 2015, that the Underwriters propose to offer the Offered Bonds to the public initially at the offering price set forth on the cover page of this Prospectus Supplement. The three firms have also advised Funding Corp. and the Company that (i) the Underwriters propose to initially offer the Offered Bonds Due 1998 to certain dealers at the proposed initial public offering price less a concession of .375% of the principal amount of the Offered Bonds Due 1998 and that the Underwriters and such dealers may allow a discount of .25% of such principal amount on sales to certain other dealers; and (ii) the Underwriters propose to initially offer the Offered Bonds Due 2015, through the Representatives, at the proposed initial public offering price less a concession of .50% of the principal amount of the Offered Bonds Due 2015 and that the Underwriters and such dealers may allow a discount of .25% of such principal amount on sales to certain other dealers. The public offering price and concessions and discounts to dealers may be changed by the Underwriters in respect of Offered Bonds Due 1998 and by the Representatives in respect of Offered Bonds Due 2015.

The Company has agreed to indemnify the several Underwriters against certain civil liabilities, including liabilities under the Securities Act of 1933.

PROSPECTUS

SECURED LEASE OBLIGATION BONDS

The Secured Lease Obligation Bonds (the "Bonds") will be indirectly secured, as described herein, by a lien on, and security interest in, certain ownership interests in Unit 2 of the Palo Verde Nuclear Generating Station ("Unit 2") and the respective Leases relating to Unit 2, and will be payable from rentals and certain other amounts to be paid under such Leases by

Arizona Public Service Company

The Bonds will be issued by PVNGS Funding Corp., Inc. ("Funding Corp."), a corporation created for the sole purpose of the financing described herein and other similar financings. Arizona Public Service Company (the "Company") will be unconditionally obligated to make rental payments in amounts which will be at least sufficient to pay in full, when due, all payments of principal of, and premium, if any, and interest on, the Bonds, although the Bonds will not be direct obligations of, or guaranteed by, the Company. For each series of Bonds for which this Prospectus is being delivered (the "Offered Bonds"), there is an accompanying Prospectus Supplement (the "Prospectus Supplement") that sets forth the series designation, aggregate principal amount of the issue, interest rates, maturities, redemption terms and other special terms of the Offered Bonds.

The Bonds will be secured by a pledge and assignment of certain nonrecourse Lessor Notes (the "Pledged Lessor Notes") issued by the Lessors under the Lease Indentures described herein. Such Pledged Lessor Notes will be secured by liens on and security interests in the respective undivided ownership interests of such Lessors in Unit 2 which are the subject of such Leases and substantially all the rights of such Lessors under their respective Leases with the Company, including the right to receive the basic rentals and certain other amounts payable by the Company thereunder. (See "INTRODUCTION", "SECURITY AND SOURCE OF PAYMENT FOR THE BONDS", "DESCRIPTION OF THE BONDS", "DESCRIPTION OF THE LEASE INDENTURES" *and* "DESCRIPTION OF THE LEASES".)

THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION NOR HAS THE COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

The Bonds will be sold through the underwriters named below or an underwriting syndicate including and represented by such firms. The net proceeds from the sale of the Offered Bonds, and any applicable commissions or discounts, are set forth in the Prospectus Supplement.

The First Boston Corporation

Kidder, Peabody & Co.
Incorporated

Salomon Brothers Inc

The date of this Prospectus is October 24, 1986.

AVAILABLE INFORMATION

The Company is subject to the information requirements of the Securities Exchange Act of 1934, as amended (the "1934 Act"), and in accordance therewith files reports, proxy statements and other information with the Securities and Exchange Commission (the "Commission"). Such reports, proxy statements and other information can be obtained at prescribed rates from the Public Reference Section of the Commission or may be inspected and copied at the public reference facilities maintained by the Commission at 450 Fifth Street, N.W., Room 1026, Washington, D.C. 20549 and at certain of its regional offices located at Room 1242, Everett McKinley Dirksen Building, 219 South Dearborn Street, Chicago, Illinois 60604; and Room 1032, Jacob K. Javits Federal Building, 26 Federal Plaza, New York, New York 10278. Certain securities of the Company are listed on the New York and Pacific Stock Exchanges. Reports, proxy material and other information concerning the Company and its parent, AZP Group, Inc., can be inspected at the respective offices of these exchanges at Room 401, 20 Broad Street, New York, New York 10005, and 115 Sansome Street, San Francisco, California 94104.

INCORPORATION OF CERTAIN DOCUMENTS BY REFERENCE

The following documents previously filed with the Commission by the Company (File No. 1-4473) are incorporated by reference in this Prospectus:

1. The Company's Form 10-K Report for the fiscal year ended December 31, 1985 filed on March 25, 1986 (the "1985 10-K Report").
2. The Company's Form 10-Q Report for the fiscal quarter ended March 31, 1986, as filed on May 14, 1986 (the "March 10-Q Report").
3. The Company's Form 10-Q Report for the fiscal quarter ended June 30, 1986, as filed on August 13, 1986.
4. The Company's Form 8-K Report, dated January 20, 1986, as filed on January 22, 1986.
5. The Company's Form 8-K Report, dated January 22, 1986, as filed on January 23, 1986.
6. The Company's Form 8-K Report, dated February 21, 1986, as filed on February 25, 1986.
7. The Company's Form 8-K Report, dated February 24, 1986, as filed on February 26, 1986.
8. The Company's Form 8-K Report, dated June 18, 1986, as filed on June 19, 1986.
9. The Company's Form 8-K Report, dated September 3, 1986, as filed on September 4, 1986 (the "September 8-K Report").
10. The Company's Form 8-K Report, dated October 10, 1986, as filed on October 14, 1986 (the "October 8-K Report").

All documents filed by the Company pursuant to Section 13(a), 13(c), 14 or 15(d) of the 1934 Act after the date of the October 8-K Report and prior to the termination of the offering of the Offered Bonds described in the accompanying Prospectus Supplement shall be deemed to be incorporated by reference in this Prospectus and to be part of this Prospectus from the date of filing of such documents.

Any statement contained in a document incorporated by reference herein shall be deemed to be modified or superseded for purposes of this Prospectus to the extent that a statement contained herein or in any other subsequently filed document which is also incorporated by reference herein modifies or supersedes such statement. Any statement so modified or superseded shall not be deemed, except as modified or superseded, to constitute a part of this Prospectus.

The Company will provide without charge to each person to whom a copy of this Prospectus is delivered, upon the oral or written request of such person, a copy of any or all of the documents referred to above which have been or may be incorporated in this Prospectus by reference, other than exhibits to such documents. Requests for such copies should be directed to Arizona Public Service Company, Office of the Secretary, Station 1898, P.O. Box 53999, Phoenix, Arizona 85072-3999 (602) 250-1896.

SUMMARY INFORMATION RELATING TO THE BONDS

The material set forth in the following summary is qualified in its entirety by the more detailed information included elsewhere or incorporated by reference in this Prospectus. Capitalized terms used in this Prospectus and in the accompanying Prospectus Supplement without definition are defined in the Glossary for this Prospectus beginning at page 32.

Securities Offered..........	Secured Lease Obligation Bonds. See the accompanying Prospectus Supplement.
Interest Payment Dates.....	See the accompanying Prospectus Supplement.
Sinking Fund..............	See the accompanying Prospectus Supplement.
Optional Redemption	See the accompanying Prospectus Supplement.
Special Mandatory Redemption	See the accompanying Prospectus Supplement.
Use of Proceeds	Unless the accompanying Prospectus Supplement provides otherwise, the proceeds of the sale of the Bonds will be used (i) to refund interim nonrecourse indebtedness incurred to pay a portion of the purchase price of undivided interests in Unit 2 as part of the Sale and Leaseback Transactions described herein, (ii) to make certain payments to the Equity Participants in partial repayment of their respective original investments in Unit 2 and/or (iii) to finance all or a portion of the cost of certain capital improvements to Unit 2. On August 18, 1986, the Company sold approximately 30.7% of its 29.1% undivided interest in Unit 2 in connection with the Initial Sale and Leaseback Transactions. The total consideration to the Company from the Initial Sale and Leaseback Transactions was $341,250,000. (See "USE OF PROCEEDS" and "INTRODUCTION".)
Security and Source of Payment	The Bonds will be secured by the Pledged Lessor Notes described herein. The payments due on all Pledged Lessor Notes will equal the payments due on the Bonds. Each Pledged Lessor Note will be secured by, among other things, a lien on and security interest in the respective undivided ownership interest in Unit 2 of the Lessor issuing such Pledged Lessor Note and substantially all the rights of such Lessor under its Lease with the Company, including the right to receive the basic rentals and certain other amounts payable by the Company thereunder. (See "SECURITY AND SOURCE OF PAYMENT FOR THE BONDS".) Debt incurred by Lessors in connection with Sale and Leaseback Transactions will be approximately 80% of the aggregate consideration paid by the Lessors for their respective interests in Unit 2, including transaction costs. Any additional amounts will be contributed by the Equity Participants. The Pledged Lessor Notes, which secure the Bonds, will be senior in respect of basic rental and certain other payments made under the related Leases to the interests of the respective Equity Participants. Prior to the closing of the Initial Sale and Leaseback Transactions, the related Equity Participants received an opinion from Ebasco Business Consulting Company, independent engineers and consultants, to the effect that the fair market value of the aggregate undivided interests in Unit 2 purchased by the Lessors in connection therewith was equal to not less than the aggregate

consideration paid for such interests. (See "SECURITY AND SOURCE OF PAYMENT FOR THE BONDS".)

The Company will be unconditionally obligated to make payments under the Leases in amounts that will be at least sufficient to provide for the payment of principal of, and premium, if any, and interest on, the Pledged Lessor Notes, which amounts, in turn, will be sufficient to pay the principal of, and premium, if any, and interest on, the Bonds when due. However, neither the Bonds nor the Pledged Lessor Notes will be direct obligations of, or guaranteed by, the Company. The holders of the Bonds will have no recourse against the general credit of any of the banks or trust companies acting as Lessors or the Equity Participants. (See "DESCRIPTION OF THE BONDS" and "DESCRIPTION OF THE LEASES".)

Upon the happening and continuance of any Lease Indenture Event of Default which results from a default or other action or inaction by the Company, except as described in this paragraph, the related Lessor will control the exercise of remedies against the Company under the related Lease, subject to the right of the Lease Indenture Trustee to cause such Lessor to forbear from any proposed action which would have a material adverse effect on the holders of Lessor Notes. There could be circumstances, therefore, in which the full amount due in respect of the Bonds may not be paid, but the Lease Indenture Trustee will not be able to direct the Lessor's pursuit of remedies against the Company under the Lease. The Lease Indenture Trustee would not be precluded, however, from selling the related undivided interest in Unit 2 and other components of the Lease Indenture Estate in a foreclosure or similar proceeding if such sale occurs prior to or simultaneously with the termination of the related Lease and the Lessor has been given an opportunity to purchase such Lease Indenture Estate at the proposed sale price. (See "DESCRIPTION OF THE LEASE INDENTURES — Acceleration and Remedies".)

Under certain circumstances, the Company will be required to assume all or a portion of the Pledged Lessor Notes and all obligations of the Lessors thereunder and under the related Lease Indentures. (See "DESCRIPTION OF THE LEASE INDENTURES — Assumption by the Company".)

Rationale for Sale and Leaseback Transactions and Certain Debt Related Matters .... The Company has chosen to enter into the Sale and Leaseback Transactions to levelize and to reduce, in the near-term and on a present value basis, the revenues required to pay operating and capital costs arising with respect to its interest in Unit 2 through the substitution of lease payments for depreciation and capital recovery requirements associated with ownership and thus to mitigate in the near-term and levelize the cost to ratepayers of energy generated and capacity provided by Unit 2. (See "INTRODUCTION — Rationale for Sale and Leaseback Transactions".) In order to preserve leveraged lease accounting treatment for any bank or trust company acting as Lessor and such Lessor's related Equity Participant, the Pledged Lessor Notes will be structured to be without recourse to the general credit of such Lessors or Equity Participants. In addition, because of

guidelines promulgated by the Internal Revenue Service relating to leveraged lease transactions generally, the Pledged Lessor Notes are not guaranteed by the Company although the Company's obligations to make rental payments under the Leases are unconditional. (See "INTRODUCTION — Rationale for Certain Debt Related Matters".)

Description of the Palo Verde Nuclear Generating Station . . . . The Palo Verde Nuclear Generating Station ("PVNGS"), located 55 miles west of Phoenix, Arizona, consists of three units, each with a nominal rating of 1,270 megawatts ("MW"), and each containing a pressurized water reactor. Unit 1 of PVNGS attained commercial operation during the first quarter of 1986, Unit 2 of PVNGS attained commercial operation during the third quarter of 1986 and Unit 3 of PVNGS is expected to attain commercial operation during the third quarter of 1987. (See "DESCRIPTION OF THE PALO VERDE NUCLEAR GENERATING STATION".)

PVNGS Funding Corp., Inc. Funding Corp. was incorporated in Delaware in May 1986 for the sole purpose of facilitating the long-term financing of the Company's interest in PVNGS. The assets of Funding Corp. will consist primarily of the Pledged Lessor Notes, which are payable from basic rentals and certain other payments which the Company is unconditionally obligated to make under the Leases. (See "PVNGS FUNDING CORP., INC.".)

SUMMARY INFORMATION RELATING TO ARIZONA PUBLIC SERVICE COMPANY

The following material is qualified in its entirety by reference to the detailed information and financial statements incorporated by reference in this Prospectus.

The Company

Relationship with AZP Group, Inc.	All of the outstanding shares of common stock of the Company are owned by AZP Group, Inc., which became the Company's corporate parent in April 1985 in connection with a corporate restructuring. The restructuring did not affect the Company's preferred stock or any of its outstanding debt securities, all of which remain obligations of the Company.
Business	Electric utility serving approximately 1,425,000 persons (approximately 43% of Arizona's population).
Generating Fuel (12 months ended September 30, 1986)	Coal — 82.0%; Gas — 9.1%; Nuclear — 8.3%; Oil — 0.3%; Hydroelectric and Solar — 0.3%.

Consolidated Financial Data For Arizona Public Service Company (dollars in thousands)

Statement of Income Data	Twelve Months Ended September 30, 1986 (Unaudited)	December 31, 1985	December 31, 1984	December 31, 1983
Revenues:				
Continuing Operations Electric	$1,247,844	$1,174,502	$ 994,967	$ 871,875
Discontinued Operations Gas(1)	-0-	-0-	174,729	202,134
Total Revenues	$1,247,844	$1,174,502	$1,169,696	$1,074,009
Income from Continuing Operations	$ 293,921	$ 325,423	$ 297,570	$ 269,052
Loss from Discontinued Operations, including loss on disposal(1)	-0-	-0-	(26,503)	(4,255)
Net Income	$ 293,921	$ 325,423	$ 271,067	$ 264,797
Ratio of Earnings to Fixed Charges — Continuing Operations(2)	2.90	3.22	3.09	2.94

Capitalization Data	As of September 30, 1986(3) (Unaudited)	Percentage
Long-Term Debt (excluding current maturities)	$2,186,268	49.4%
Redeemable Preferred Stock	178,728	4.1
Non-Redeemable Preferred Stock	218,561	4.9
Common Stock Equity	1,840,187	41.6
Total Capitalization	$4,423,744	100.0%

(1) Effective November 1, 1984, the Company sold its gas distribution system and is now no longer engaged in the purchase and sale of natural gas.

(2) For purposes of computing the ratio of earnings to fixed charges — continuing operations, "earnings" are defined as the sum of income from continuing operations plus related income taxes and fixed charges of the Company and its subsidiaries; "fixed charges" consist of interest on debt, amortization of debt discount, premium and expense and an estimated interest factor in rentals, for continuing operations.

(3) The Leases entered into in connection with the Initial Sale and Leaseback Transactions are operating leases (as defined under generally accepted accounting principles) and, accordingly, neither any lease obligations nor any lease obligation notes or bonds issued in connection therewith are reflected in the Company's capitalization.

INTRODUCTION

Arizona Public Service Company (the "Company") was incorporated in 1920 under the laws of Arizona and is principally engaged in providing electricity in the State of Arizona. All of the outstanding shares of common stock of the Company are owned by AZP Group, Inc., which became the Company's corporate parent, effective in April 1985, pursuant to a corporate restructuring. The principal executive offices of the Company are located at 411 North Central Avenue, Phoenix, Arizona 85004 and its telephone number is (602) 250-1000.

The Company is the project manager and operating agent for, and a participant in, PVNGS. For a description of PVNGS, see "DESCRIPTION OF THE PALO VERDE NUCLEAR GENERATING STATION".

On August 18, 1986, the Company sold approximately 30.7% of its 29.1% undivided interest in Unit 2 (the "Leased Unit 2 Interest") to The First National Bank of Boston, as owner trustee under two separate owner trust agreements with two Equity Participants, and then leased the Leased Unit 2 Interest back from such Lessors on a long-term net lease basis (the "Initial Sale and Leaseback Transactions"). The total consideration to the Company from the Initial Sale and Leaseback Transactions was $341,250,000. Of such total consideration, approximately $71,626,000 was provided by the Equity Participants which participated therein and approximately $269,624,000 (the "Bank Indebtedness") was loaned by certain banks (the "Interim Lenders") to the Lessors on a non-recourse basis.

Should the Company sell and lease back all or any part of its remaining ownership interest in Unit 2 (the "Remaining Unit 2 Interest"), the Company and the prospective Lessors may consummate additional Sale and Leaseback Transactions prior to the issuance of the related Bonds using funds borrowed by such Lessors or Funding Corp. from banks or other sources. In such case, it is expected that Bonds would subsequently be issued to retire such interim indebtedness. (See "USE OF PROCEEDS".) The actual sales prices of any portion of the Remaining Unit 2 Interest would be confirmed as fair market value by independent appraisal.

Rationale for Sale and Leaseback Transactions

A significant reason the Company has chosen to sell and lease back portions of its undivided ownership interest in PVNGS is to levelize and to reduce, in the near term and on a present value basis, the revenues required to pay operating and capital costs (the "Revenue Requirements") arising with respect to its interest in PVNGS. A sale and leaseback accomplishes this objective through the substitution of lease payments for depreciation and capital recovery requirements associated with ownership. Reducing near-term Revenue Requirements through the Sale and Leaseback Transactions enables the Company to mitigate in the near-term and levelize the cost to ratepayers of energy generated and capacity provided by PVNGS.

Rationale for Certain Debt Related Matters

The Pledged Lessor Notes will be structured to be without recourse to the general credit of any bank or trust company acting as Lessor or such Lessor's related Equity Participant because, in accordance with Financial Accounting Standards Board Statement No. 13, to do otherwise would not permit the required leveraged lease accounting treatment.

While not guaranteed by the Company, the Pledged Lessor Notes are structured to be secured by, among other things, sufficient rent from the Company to make all payments on the Pledged Lessor Notes. A guarantee of the Pledged Lessor Notes by the Company would violate advance ruling guidelines issued by the Internal Revenue Service which state that the lessee in a leveraged lease transaction may not guarantee any indebtedness created in connection with the acquisition of the leased property by the lessor (Revenue Procedure 75-21, 1975-1, Cum. Bull. 715, Section 4(5)).

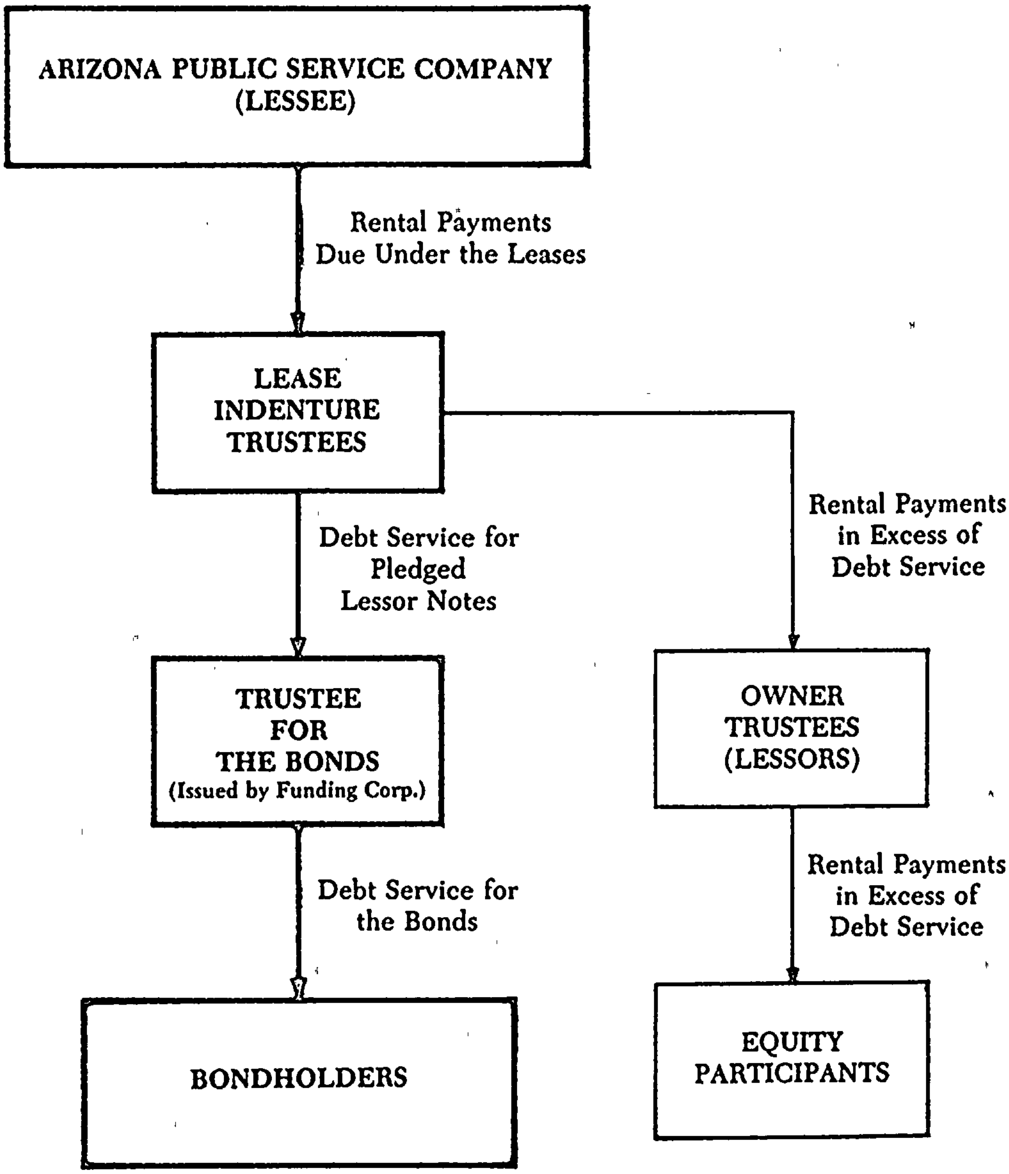
Capitalized terms used in this Prospectus and in the accompanying Prospectus Supplement without definition are defined in the Glossary for this Prospectus beginning at page 32.

USE OF PROCEEDS

Proceeds from the issuance of the Bonds will be (a) used to retire the Bank Indebtedness (including accrued interest thereon) incurred in connection with the Initial Sale and Leaseback Transactions, which Bank Indebtedness matures on December 30, 2015 and initially bears interest at the reference rate of one of the Interim Lenders, (b) used to refund interim nonrecourse indebtedness to be incurred to pay a portion of the purchase price of all or a portion of the Remaining Unit 2 Interest, (c) loaned by Funding Corp. to Lessors and used to refund a portion of amounts provided by certain Equity Participants in the Sale and Leaseback Transactions, and/or (d) used to finance all or a portion of the cost of certain capital improvements to Unit 2. See the accompanying Prospectus Supplement for the anticipated use of proceeds for a specified issue of Offered Bonds. To the extent the proceeds from the sale of the Bonds are to be used to retire the Bank Indebtedness, simultaneously with such retirement, the Initial Series Lessor Notes issued to the Interim Lenders evidencing such indebtedness will be cancelled and Lessor Notes will be issued to Funding Corp. and pledged as security for the Bonds. To the extent the proceeds from the sale of Bonds are to be used to retire interim indebtedness incurred in connection with future Sale and Leaseback Transactions, simultaneously with such retirement, the Lessor Notes evidencing such interim indebtedness will be cancelled and Lessor Notes will be issued to the Funding Corp. and pledged as security for the Bonds then issued.

The Company deposited $241.25 million of the proceeds of the Initial Sale and Leaseback transactions with the trustee under the Company's first mortgage bond indenture to redeem on October 1, 1986, at par value plus accrued interest, $100 million principal amount of the Company's First Mortgage Bonds, 12¾% Series due 2013, $100 million principal amount of the Company's First Mortgage Bonds, 13½% Series due 2013, and $20.62 million principal amount of the Company's First Mortgage Bonds, 15% Series due 1994. Approximately $10.7 million of this amount remains on deposit with such trustee. The Company used a portion of the remaining $100 million of the proceeds of the Initial Sale and Leaseback Transactions to retire all of the Company's outstanding short-term obligations as of August 19, 1986, equal to approximately $45 million principal amount. The remaining proceeds of the Initial Sale and Leaseback Transactions (including those held by the trustee under the Company's first mortgage bond indenture) are being invested on a short-term basis pending application to further redemptions of long-term debt and/or general corporate purposes, including the Company's construction program. (See "COMPANY CONSTRUCTION AND FINANCING PROGRAMS".)

FLOW OF FUNDS FOR DEBT SERVICE PAYMENTS ON THE BONDS



SECURITY AND SOURCE OF PAYMENT FOR THE BONDS

Funding Corp. has been formed for the exclusive purpose of facilitating the financing of the Company's interest in PVNGS and has only nominal equity capital. As such, the source of payments of principal of, and premium, if any, and interest on, the Bonds will be derived from payments made on the Pledged Lessor Notes. As described below, the source of payment for the Pledged Lessor Notes will be amounts payable by the Company under the related Leases. The aggregate principal amount of outstanding Pledged Lessor Notes will equal the aggregate principal amount of outstanding Bonds. The Pledged Lessor Notes will be payable on such dates and in such amounts as are required to pay in full the principal of, and premium, if any, and interest on, the Bonds when due.

Each Lease is or will be a net lease under which the Company is or will be unconditionally obligated to make rental payments at least sufficient to provide for the payment of the Lessor Notes of the Lessor which is a party to such Lease, without any right of counterclaim, setoff, deduction or defense on the part of the Company. Each Lease, by its terms, requires or will require that rent be paid by the Company in such amounts and at such times as will always provide for the payment of the principal of, and premium, if any, and interest on, all such Lessor Notes, including the Pledged Lessor Notes, when due. As such, the expected sources of payment for the Pledged Lessor Notes, and thus for the Bonds, are the payments to be made by the Company under the Leases.

The Pledged Lessor Notes will be issued under separate Lease Indentures by the Lessors without recourse to the general credit of the bank or trust company acting as Lessor or such Lessor's related Equity Participant. The Pledged Lessor Notes of each Lessor will be secured under a separate Lease Indenture by a lien on and security interest in the Lease Indenture Estate created thereby, which will include, among other things: (i) such Lessor's respective undivided ownership interest in Unit 2; (ii) such Lessor's rights under its Lease, including the right to receive all rents payable thereunder other than amounts which constitute Excepted Payments; and (iii) such Lessor's rights under the related Assignment and Assumption Agreement, which is designed to provide to such Lessor such additional resources, services and facilities as are necessary or desirable to enable it to obtain its proportionate share of energy generated by Unit 2 for a period from the expiration or earlier termination of such Lessor's Lease to the end of the estimated useful life of Unit 2. Excluded from the Lease Indenture Estate are any and all Excepted Payments, and certain other rights, including all rights and interests with respect to certain amounts to be set aside for the decommissioning of Unit 2 and rights to receive payments under any letter of credit which the Company shall cause to be issued in favor of an Equity Participant in support of payments of rent due under the relevant Lease.

Prior to the closing of the Initial Sale and Leaseback Transactions, the related Equity Participants received an opinion from Ebasco Business Consulting Company, independent engineers and consultants, to the effect that the fair market value of the interests in Unit 2 acquired by the Lessors in the Initial Sale and Leaseback Transactions (constituting, in the aggregate, approximately 8.928% of such unit) was equal to not less than the $341,250,000 of consideration paid for such interests. The opinion also was supportive of the conclusion that the expected fair market value of such undivided ownership interests on the maturity date of the Bonds will be equal to at least 20 percent of the consideration paid for such interests in Unit 2 in constant 1986 dollars. At the closing of any future Sale and Leaseback Transaction, each Equity Participant participating in such transaction will receive an opinion from independent engineers and consultants to the effect that the fair market value of the interest in Unit 2 acquired by the related Lessor in such Sale and Leaseback Transaction is at least equal to the purchase price paid for such interest.

Additional Lessor Notes may be issued under each Lease Indenture, subject to certain conditions as provided in the Lease Indentures, (i) for the purpose of refunding any previously issued series of Lessor Notes, (ii) to provide funds for all or any portion of certain capital improvements to Unit 2, and (iii) under certain circumstances, for the purpose of refunding a portion of the initial investment of the related Equity Participant in Unit 2. (See "Description of the Lease Indentures — Additional Lessor Notes".)

The Indenture under which the Bonds are to be issued provides that Securities in addition to the Bonds may be issued by Funding Corp. thereunder without limitation as to aggregate principal amount. Such additional Securities, if issued, could be issued in connection with future sale and leaseback transactions involving the Company's undivided interest in PVNGS. Payments due on Lessor Notes issued in connection with such future sale and leaseback transactions would equal the payments due on the related series of such additional Securities. However, all subsequently issued Securities and the Bonds will be secured equally by all Lessor Notes pledged by Funding Corp. to the Trustee. (See "DESCRIPTION OF THE BONDS — General" and "Security and Source of Payment for the Bonds".)

For further information with respect to the source of payment for the Bonds and the provisions of the Indenture and the Lease Indentures relating thereto, see "DESCRIPTION OF THE BONDS" and "DESCRIPTION OF THE LEASE INDENTURES".

PVNGS FUNDING CORP., INC.

Funding Corp. was incorporated under the laws of Delaware in May 1986 for the sole purpose of facilitating the long-term financing of the Company's interest in PVNGS. The only business of Funding Corp. will be the issuance and sale of the Bonds and other debt securities and the lending of the proceeds therefrom in connection with the Sale and Leaseback Transactions and similar activities in connection with possible future sale and leaseback transactions involving the Company's remaining undivided interest in PVNGS. (See "USE OF PROCEEDS".) In addition, Funding Corp. will be available to make loans in connection with any significant capital improvements which may be required to be installed at PVNGS from time to time. The assets of Funding Corp. will consist of any Lessor Notes issued by the Lessors from time to time and any lessor notes issued by any other lessors to evidence loans made by Funding Corp., any temporary investments of the proceeds of the offering of debt securities issued for the purpose of making such loans and $1,000 in cash, representing the equity capital contributed by its sole shareholder, Corporate Trinity Company, a Delaware corporation, which is 75% owned by The Corporation Trust Company, a Delaware corporation, and 25% owned by The Dutchess Day School of Millbrook, New York, a New York non-profit corporation. Neither the Company, nor any Lessor nor any Equity Participant holds any ownership interest in Funding Corp., Corporate Trinity Company, The Corporation Trust Company or The Dutchess Day School of Millbrook, New York and no person affiliated with the Company, any Lessor or any Equity Participant is an officer, director or employee of any such entity.

DESCRIPTION OF THE PALO VERDE NUCLEAR GENERATING STATION

General

PVNGS, also known as the Arizona Nuclear Power Project ("ANPP"), consists of three units, each with a nominal rating of 1,270 MW. The Company, which owns or leases interests in PVNGS comprising 29.1% thereof, participates in PVNGS with three other investor-owned utilities (Southern California Edison Company (15.8%), El Paso Electric Company (15.8%) and Public Service Company of New Mexico (10.2%)) and three public power agencies (Salt River Project Agricultural Improvement and Power District (17.49%), Southern California Public Power Authority (5.91%) and The Los Angeles Department of Water and Power (5.7%)). The Company also serves as the project manager and operating agent of PVNGS. The NRC issued construction permits for PVNGS in May 1976. Construction of Units 1 and 2 is complete, and, as of September 30, 1986, construction of Unit 3 was 99% complete, based on construction man-hours expended and materials installed. Testing phases follow the completion of construction.

The Company's interest in PVNGS will amount to approximately 370 MW per unit (nominal), or a total of 1110 MW (nominal). Through September 30, 1986, the Company had expended approximately $2.6 billion (without giving effect to the Sale and Leaseback Transactions) for construction of its share of PVNGS, including allowance for funds used during construction ("AFUDC"), and approximately $177 million for nuclear fuel. Based on the Company's current construction budget estimates, the total estimated aggregate cost of the Company's share of PVNGS, excluding costs of related transmission facilities and nuclear fuel prior to commercial operation, but including AFUDC and costs of related

pollution control facilities, is expected to be approximately $2.76 billion (without giving effect to the Sale and Leaseback Transactions), resulting in an estimated cost for 1110 MW (nominal) of approximately $2,500 per kilowatt. However, the actual completion date of Unit 3, unexpected inflationary pressures and compliance with any additional governmental procedures and regulations could cause actual costs to vary from these and any later estimates.

Units 1 and 2 attained commercial operation during the first and third quarters of 1986, respectively. Unit 3 is scheduled for fuel loading in the first quarter of 1987 and for commercial operation in the third quarter of 1987. Between fuel loading and commercial operation, Unit 3 must undergo extensive testing. Commercial operation represents the time when power from the units can be reliably scheduled for service to customers, although electricity is produced prior to the commercial operation dates.

NRC Jurisdiction

PVNGS is subject to the jurisdiction of the NRC, which has authority to issue permits and licenses and to regulate nuclear facilities in order to protect the health and safety of the public from radiation hazards pursuant to the Atomic Energy Act of 1954, as amended, and the Energy Reorganization Act of 1974 and to conduct environmental reviews pursuant to the National Environmental Policy Act. Before any nuclear power plant can become operational, an operating license from the NRC is required.

The NRC granted a facility operating license for Unit 2 for a term of 40 years beginning December 9, 1985. The license authorizes the Company, as operating agent for PVNGS, to use and operate Unit 2. The Company obtained a license amendment from the NRC with respect to the Initial Sale and Leaseback Transactions. Any future Sale and Leaseback Transactions would require a further NRC license amendment.

The NRC has also granted a facility operating license for PVNGS Unit 1 for a term of 40 years beginning December 31, 1984.

Liability and Insurance Matters

The PVNGS participants have insurance against public liability claims resulting from nuclear energy hazards to the full limit ($680 million as of October 23, 1986) of liability under Federal law (such law being commonly referred to as the "Price-Anderson Act"). The maximum amount of insurance available from private carriers ($160 million) has been purchased and the remaining secondary coverage ($520 million as of October 23, 1986) is provided through a mandatory industry retrospective rating plan, under which the PVNGS participants could be assessed deferred premium charges of up to $5 million (the Company's share of which would be 29.1%) for each PVNGS reactor which has been licensed for operation by the NRC in the event the total liability arising from any nuclear incident involving any licensed facility in the nation participating in such rating plan exceeds $160 million. In the event of more than one incident, the potential $5 million assessment would apply to each incident, subject to a maximum annual assessment of $10 million (the Company's share of which would be 29.1%) for each licensed PVNGS reactor (currently Units 1 and 2) for all incidents. The insureds under the liability insurance discussed above include the PVNGS participants and "any other person or organization with respect to his legal responsibility for damage caused by the nuclear energy hazard". Such nuclear liability insurance coverage does not apply to damage to the plant facilities.

The Price-Anderson Act has also established an aggregate limitation of liability for all persons legally liable for any nuclear incident equal to the greater of $560 million or the amount of financial protection required, $680 million as of October 23, 1986.

To cover possible damage to the PVNGS facilities, the PVNGS participants maintain nuclear property damage and decontamination insurance in the aggregate amount of $1.160 billion, a substantial portion of which must first be applied to decontamination. The Company has also secured

insurance against the increased cost of generation or purchased power resulting from an accidental outage of Units 1 and 2 (and Unit 3 when it is placed in service), which, after a 26-week deductible period, will pay up to $692,706 per week for Unit 1 and $785,025 per week for Unit 2 for 52 weeks and up to 50% of the respective amounts for an additional 52 weeks. In the event that the incident affects more than one unit, the indemnity is reduced by 20% for each additionally affected unit (i.e., two units simultaneously out of service results in 80% of single unit recovery; three units simultaneously out of service results in 60% of single unit recovery).

In addition to the above-described policies of insurance, the PVNGS participants are parties to an indemnity agreement with the NRC containing an undertaking by the NRC to indemnify the PVNGS participants and any other person who may be legally liable from public liability arising from nuclear incidents. The maximum aggregate indemnity for each nuclear incident is $500 million less the amount by which the amount of required financial protection exceeds $60 million. The indemnity agreement is not currently operative and will remain inoperative unless or until the level of financial protection (i.e., the aggregate amount of primary and secondary levels of liability protection) required of the PVNGS participants falls below $560 million.

The authority of the NRC under the Price-Anderson Act to enter into indemnity agreements covering new nuclear facilities not then in operation or under construction will expire on August 1, 1987. This limited expiration of authority, if not modified by Congress, would have no effect upon the financial protection and indemnity agreements in effect for plants now in operation or under construction, such as PVNGS. Nonetheless, this expiration date has served as a catalyst for proposals to amend the Price-Anderson Act in a variety of ways. Some proposals would simply extend the indemnity authority for an additional ten years in order to preserve the viability of the nuclear option for future expansion of the nation's generating capacity. Bills to extend the expiring provisions and to amend or eliminate other provisions of the Price-Anderson Act have been offered in both the United States Senate and House of Representatives. Certain Senate and House Committees have reported out bills to amend the Price-Anderson Act which would increase the limit on liability to amounts as high as $6.6 billion per nuclear incident (or higher amounts in the future). Funding required to meet the increased limit on liability would be provided through a more than ten-fold increase in the deferred premium charges that could be assessed against licensees (including PVNGS participants) participating in the industry retrospective rating plan.

If, as a result of an amendment to the Price-Anderson Act (other than certain of the changes included in the current proposals) or other applicable law, independent counsel to an Equity Participant is of the opinion that the potential liability of such Equity Participant, the related Lessor or the Company for a single nuclear incident would be increased, such Lessor could declare a Deemed Loss Event, in which case the Company could be required (1) to assume the related Pledged Lessor Notes as described under "Description of the Lease Indentures — Assumption by the Company", and (2) to pay the Equity Participant an amount which, primarily because of certain tax consequences, could exceed such Equity Participant's original equity investment. At least one of the bills currently under consideration contains a provision exempting lessors from potential liabilities from nuclear incidents. If such a provision is enacted into law, the possibility that a Deemed Loss Event could be declared would be less likely. The ultimate response of Congress to the currently pending bills, or whether Congress will otherwise act to amend the Price-Anderson Act, cannot be predicted with certainty. In the event legislation permitting the Equity Participants to declare a Deemed Loss Event is enacted into law, the reaction of the Equity Participants to such enactment cannot be predicted by the Company.

DESCRIPTION OF THE ANPP PARTICIPATION AGREEMENT

The construction, operation and maintenance of PVNGS and the rights and duties of the joint owners of, or participants in, PVNGS are governed by the ANPP Participation Agreement. The ANPP Participation Agreement appoints the Company, as the agent for all of the participants, to act as the project manager responsible for the construction of PVNGS and as the operating agent responsible for the operation and maintenance of PVNGS. Such agreement provides the requisite delegations of

authority to the Company necessary to permit the Company to carry out such functions in a manner which complies with all laws, regulations, permits and licenses.

One of the primary obligations assumed by the participants under the ANPP Participation Agreement is the obligation to share the costs of construction, operation, maintenance, decommissioning and capital improvements of PVNGS in accordance with their respective generation entitlement shares. So long as a participant is not in default of its obligations under the agreement, such participant is entitled to schedule power based on its share of the generating capability available at the time of such scheduling.

Sales of power and energy generated by each unit through the utilization by each participant of its generation entitlement share of such unit can be made only by such participant. PVNGS, as a project, can make no sales of power or energy, and, except under certain circumstances relating to default under the ANPP Participation Agreement, no participant can utilize the generation entitlement share of any other participant.

In the event of a default by any participant in its obligations under the ANPP Participation Agreement, the non-defaulting participants are obligated to contribute pro rata an amount equal to that due from the defaulting participant. After a default continues for six months, and subject to certain conditions, the non-defaulting participants may suspend the right of the defaulting participant to be represented on and participate in the actions of all PVNGS committees and to receive all or any part of its generation entitlement share.

The ANPP Participation Agreement provides the participants with oversight of PVNGS and the actions of the Company as project manager and operating agent through participation in three standing committees: the Administrative Committee, the Engineering and Operating Committee and the Auditing Committee. Generally, all actions which each of the committees is authorized to take must be approved by the unanimous vote of all members entitled to vote on such committee. In the event any committee is unable or fails to agree on any matter (with certain limited exceptions) which the committee is authorized to determine, the Company, as the project manager and operating agent, is authorized and obligated to take such action and expend such funds as in its discretion are necessary for the proper construction, operation and maintenance of PVNGS, pending the resolution of such inability or failure to agree. Additionally, in the event of an operating emergency, the Company, as operating agent, is authorized and obligated to take such action as it, in its sole discretion, may deem prudent or necessary.

The ANPP Participation Agreement has been amended to permit participants' sale and leaseback financing transactions which meet specified criteria. The Initial Sale and Leaseback Transactions were structured, and future Sale and Leaseback Transactions, if any, with respect to the Company's Remaining Unit 2 Interest will be structured, to meet such criteria.

Certain other ANPP participants have also entered into sale and leaseback transactions with respect to portions of their respective undivided interests in PVNGS.

COMPANY CONSTRUCTION AND FINANCING PROGRAMS

Construction expenditures, including expenditures for environmental control facilities, for the years 1986 through 1989 have been estimated to be $413 million, $288 million, $282 million and $309 million, respectively. Of the total estimated construction expenditures during those four years of $1,292 million, it is estimated that $452 million will be applied to electric generation facilities, $156 million to electric transmission facilities, $486 million to electric distribution facilities and $198 million to general facilities.

The foregoing amounts include expenditures for nuclear fuel and start-up and preoperating costs, but omit all AFUDC and capitalized property taxes. They were derived in the course of the Company's ongoing review process and are subject to periodic revision to reflect further changes in

the Company's plans (which may result from extraneous developments, such as adverse rate orders or governmental regulations), updated scheduling, unanticipated inflation and other factors. For the nine months ended September 30, 1986, the Company incurred approximately $313 million in construction expenditures, accounting for approximately 76% of the Company's estimated 1986 construction expenditures.

In addition to funds required for capital expenditures in 1986, 1987, 1988 and 1989, refunding obligations of senior securities and installment obligations, including certain anticipated early redemptions, are expected to total up to $248 million, $46 million and $63 million for the years 1987, 1988 and 1989, respectively. The Company has satisfied substantially all of its refunding obligations, including anticipated early redemptions, for 1986. External financing was required for substantially all of the Company's total capital requirements in 1985 and is expected to be required for nearly 60% of such requirements in the 1986-1989 period assuming that internally generated funds remaining after dividend payments are augmented by adequate rate increases during the period.

Provisions in the Company's mortgage bond indenture and articles of incorporation restrict it from issuing additional first mortgage bonds or preferred stock, respectively, unless its earnings (as defined) cover, by at least the prescribed number of times, the amount of interest (as to bonds) and the amount of interest plus preferred stock dividend requirements (as to preferred stock) on the securities to be outstanding after completion of the new issue. Operation of the latter such provision has at times in the past limited the Company's ability to issue preferred stock. As calculated in accordance with the applicable document, assuming 10.5% as the rate of interest on new bonds or as the dividend requirement on new preferred stock that might have been issued on September 30, 1986, the coverage afforded by earnings (as defined) for the twelve months ended on that date would have allowed the issuance of either $1,466,000,000 in aggregate principal amount of additional first mortgage bonds (as compared to approximately $813,000,000 in bonds issuable on the basis of net "property additions") or $521,000,000 in aggregate par value of additional preferred stock. Minimum required coverages are 2.0 for bonds and 1.5 for preferred stock. Coverages afforded by defined earnings for the twelve-month period ended September 30, 1986, were 3.85 for bonds and 1.81 for preferred stock.

By statute, the Company's short-term borrowings may not exceed 7% of its total capitalization without the consent of the Arizona Corporation Commission (the "ACC"). Such borrowings are an important source of funds, particularly between permanent financings; and the statute could from time to time limit the Company's financing flexibility. However, the Company's own general policy relating to short-term borrowing is consistent with that of the statute.

EARNINGS RATIOS

The following table sets forth the Company's historical ratio of earnings to fixed charges — continuing operations for each of the indicated periods:

Twelve Months Ended					
	December 31,				
September 30, 1986	1985	1984	1983	1982	1981
2.90	3.22	3.09	2.94	2.77	2.34

For the purposes of these computations, "earnings" are defined as the sum of income from continuing operations plus related income taxes and fixed charges of the Company and its subsidiaries; "fixed charges" consist of interest on debt, amortization of debt discount, premium and expense and an estimated interest factor in rentals, from continuing operations.

REGULATORY MATTERS

The ACC has regulatory authority over the Company in matters relating to retail electric rates and the issuance of securities. On July 24, 1986, the ACC issued an order authorizing the Company to enter

into the Sale and Leaseback Transactions. The order provides that the Leases will be treated as operating leases for both accounting and rate-making purposes and that the aggregate amount of payments made pursuant to the Leases will be accounted for by the Company as an operating and maintenance expense. The order further provides that the rate-making treatment of the Lease payments will be determined in a pending rate case. See "Retail Rates" in Part II, Item 5 of the March 10-Q Report and "Palo Verde Nuclear Generating Station — Unit 2 Commercial Operation" in Item 5 of the October 8-K Report.

On October 9, 1986, the ACC issued an order granting the Company $1.6 million of its requested $54.6 million rate increase premised on PVNGS Unit 1 being fully included in the Company's rate base. The order further provides that those revenues attributable to the inclusion of $210 million of the cost of Unit 1 (representing approximately 25% of total Unit 1 costs) are to be deemed "interim or temporary until further order of the Commission." The order may thus deem as "interim or temporary" up to approximately $40 million per year of revenues attributable to Unit 1 costs included in the Company's rate base. The Company believes that the order is ambiguous as to the meaning of the phrase "interim or temporary" and intends to seek reconsideration or clarification of this aspect of the order.

Although the order purports to grant the Company a 14% return on equity, the Company believes that such a return on equity will be unattainable given the $1.6 million rate increase. As previously reported, the Company's earnings have declined as a result of Unit 1 having attained commercial operation without being fully included in the Company's rate base. See "Rates — State" in Part I, Item 1 of the 1985 10-K Report. Although the order includes Unit 1 and one-third of the facilities common to all three PVNGS units in the Company's rate base, the Company views the $1.6 million rate increase as inadequate and insufficient to halt its decline in earnings. The Company anticipates that it will file a motion seeking reconsideration and rehearing of certain aspects of the order, including the $1.6 million rate increase. If this request is denied, the Company will evaluate its legal options, including a possible appeal of the order. For additional information regarding the order, see "Retail Rates — Phase II Hearings" in Item 5 of the October 8-K Report.

DESCRIPTION OF THE BONDS

The statements under this caption are summaries and do not purport to be complete. The summaries are qualified in their entirety by reference to the Indenture, a copy of the form of which has been filed as an exhibit to the Registration Statement of which this Prospectus is a part.

General

The Bonds are to be issued under a Collateral Trust Indenture (the "Indenture") among Funding Corp., the Company and Chemical Bank, as indenture trustee (the "Trustee"), as supplemented by one or more supplemental indentures thereto (each a "Supplemental Indenture").

The Bonds are to be issued in fully registered form without coupons in denominations of $1,000 or any integral multiple thereof. Bonds may be surrendered for registration of transfer or exchange for Bonds of the same series and maturity at the corporate trust office of Chemical Bank, registrar and paying agent for the Bonds, in New York, New York. No service charge will be required of any Bondholder participating in any transfer or exchange of Bonds in respect of such transfer or exchange, but, with certain exceptions, payment may be required of any tax or other governmental charges that may be imposed in connection therewith. (Indenture, Sections 2.05 and 2.08)

The Indenture provides that the aggregate principal amount of Securities (including the Bonds) which may be issued thereunder is unlimited. In connection with the issuance of any series of Securities in connection with future transactions involving capital improvements at PVNGS or in connection with future Sale and Leaseback Transactions involving the Company's undivided interest in PVNGS, an equal aggregate principal amount of Lessor Notes must be pledged as security under the

Indenture in support of the payment of such Securities. A separate Supplemental Indenture will be entered into among Funding Corp., the Company and the Trustee establishing the title, interest rate, sinking fund and redemption provisions, if any, and other specific terms of any particular series of Securities. Any additional series of Securities will be secured pari passu with the Bonds by all Pledged Lessor Notes and the similar lessor notes issued in respect of such Securities.

Principal Amounts, Interest Rates, Maturities and Payment

See the accompanying Prospectus Supplement.

Sinking Fund Redemption

See the accompanying Prospectus Supplement.

Optional Redemption

See the accompanying Prospectus Supplement.

Special Mandatory Redemption

See the accompanying Prospectus Supplement.

Security and Source of Payment for the Bonds

Funding Corp. has been formed for the exclusive purpose of facilitating the financing of the Company's interest in PVNGS and has only nominal equity capital. As such, the source of payments of principal of, and premium, if any, and interest on, the Bonds will be derived from payments made on the Pledged Lessor Notes. As described below, the source of payment for the Pledged Lessor Notes will be amounts payable by the Company under the related Leases. The aggregate principal amount of outstanding Pledged Lessor Notes will equal the aggregate principal amount of outstanding Bonds. The Pledged Lessor Notes will be payable on such dates and in such amounts as are required to pay in full the principal of, and premium, if any, and interest on, the Bonds when due.

Each Lease is or will be a net lease under which the Company is or will be unconditionally obligated to make rental payments at least sufficient to provide for the payment of the Lessor Notes of the Lessor which is a party to such Lease, without any right of counterclaim, setoff, deduction or defense on the part of the Company. Each Lease, by its terms, requires or will require that rent be paid by the Company in such amounts and at such times as will always provide for the payment of the principal of, and premium, if any, and interest on, all such Lessor Notes, including the Pledged Lessor Notes, when due. As such, the expected sources of payment for the Pledged Lessor Notes, and thus for the Bonds, are the payments to be made by the Company under the Leases.

The Pledged Lessor Notes will be issued under separate Lease Indentures by the Lessors without recourse to the general credit of the bank or trust company acting as Lessor or such Lessor's related Equity Participant. The Pledged Lessor Notes of each Lessor will be secured under a separate Lease Indenture by a lien on and security interest in the Lease Indenture Estate created thereby, which will include, among other things: (i) such Lessor's respective undivided ownership interest in Unit 2; (ii) such Lessor's rights under its Lease, including the right to receive all rents payable thereunder other than amounts which constitute Excepted Payments; and (iii) such Lessor's rights under the related Assignment and Assumption Agreement, which is designed to provide to such Lessor such additional resources, services and facilities as are necessary or desirable to enable it to obtain its proportionate share of energy generated by Unit 2 for a period from the expiration or earlier termination of such Lessor's Lease to the end of the estimated useful life of Unit 2. Excluded from the Lease Indenture Estate are any and all Excepted Payments, and certain other rights, including all rights and interests with respect to certain amounts to be set aside for the decommissioning of Unit 2 and rights to receive

payments under any letter of credit which the Company shall cause to be issued in favor of an Equity Participant in support of payments of rent due under the relevant Lease.

Prior to the closing of the Initial Sale and Leaseback Transactions, the related Equity Participants received an opinion from Ebasco Business Consulting Company, independent engineers and consultants, to the effect that the fair market value of the interests in Unit 2 acquired by the Lessors in the Initial Sale and Leaseback Transactions (constituting, in the aggregate, approximately 8.928% of such unit) were equal to not less than the $341,250,000 of consideration paid for such interests. The opinion also was supportive of the conclusion that the expected fair market value of such undivided ownership interests at the date of termination of the related Leases will be equal to at least 20% of the consideration paid for such interests in Unit 2 in constant 1986 dollars. At the closing of any future Sale and Leaseback Transaction, each Equity Participant participating in such transaction will receive an opinion from independent engineers and consultants to the effect that the fair market value of the interest in Unit 2 acquired by the related Lessor in such Sale and Leaseback Transaction is at least equal to the purchase price paid for such interest.

Additional Lessor Notes may be issued under each Lease Indenture, subject to certain conditions as provided in the Lease Indentures, (i) for the purpose of refunding any previously issued series of Lessor Notes, (ii) to provide funds for all or any portion of certain capital improvements to Unit 2, and (iii) under certain circumstances, for the purpose of refunding a portion of the initial investment of the related Equity Participant in Unit 2. (See "DESCRIPTION OF THE LEASE INDENTURES — Additional Lessor Notes".)

Merger, Consolidation and Transfer of Assets

The certificate of incorporation of Funding Corp. provides that Funding Corp. shall not (i) dissolve or liquidate, in whole or in part, or (ii) merge into or consolidate with, or sell all or any part of its assets to, any person, firm, corporation, partnership or other entity unless, in the case of a sale of assets, the acquiring corporation shall have assumed all the liabilities and obligations of Funding Corp., and in the case of a sale of assets or a merger or consolidation, the acquiring corporation or the surviving corporation in such merger or the corporation resulting from such consolidation, as the case may be, shall have a certificate of incorporation containing provisions identical to those of Funding Corp.'s certificate of incorporation restricting the nature of its business and purposes and its ability to take certain action. In addition, Funding Corp. has agreed in the Indenture that it will not amend those provisions of its certificate of incorporation which restrict the nature of its business and its purposes or restrict its activities or which provide for its capitalization without the consent of the holders of not less than 66⅔% in aggregate principal amount of the Securities then outstanding. (Indenture, Section 5.08)

Events of Default and Notice

Events of Default under the Indenture include: (a) default in the payment of any principal of, or premium, if any, or interest on, any Security, including any sinking fund payment, when it becomes due and payable, and continuance of such default for a period of ten days; (b) default in the performance, or breach, of any covenant of the Company or Funding Corp. contained in the Indenture and continuance of such default or breach for a period of 30 days after there has been given, by registered or certified mail, to the Company and Funding Corp. by the Trustee, or to the Company, Funding Corp. and the Trustee by the holders of at least 25% in principal amount of outstanding Securities, a written notice specifying such failure and requiring it to be remedied and stating that such notice is a "Notice of Default" under the Indenture; (c) the occurrence of a Lease Indenture Event of Default under any Lease Indenture; and (d) the occurrence of certain bankruptcy or insolvency events with respect to Funding Corp. (Indenture, Section 8.01) Funding Corp. has agreed in the Indenture that it will not take any corporate action which would result in its being declared a bankrupt or insolvent. (Indenture, Section 5.08) The Company, the Lessors, the Equity Participants and the Lease Indenture Trustees have agreed, or will agree, in the respective Participation

Agreements that none of them will file, or participate in the filing of, a petition seeking reorganization, arrangement, adjustment or composition of or in respect of Funding Corp.

Upon the occurrence of an Event of Default under the Indenture, (i) if such Event of Default is of the type specified in any of clauses (a), (b) or (d) in the immediately preceding paragraph, the Trustee may, and upon the direction of the holders of not less than a majority in principal amount of the Securities outstanding, the Trustee is required to, or (ii) if such Event of Default is of the type specified in clause (c) in the immediately preceding paragraph (including a Lease Event of Default which has resulted in a default in payment of the Bonds) under circumstances in which there has been an acceleration of the maturity of the Lessor Notes, the Trustee is required to, declare all the Securities to be immediately due and payable, but no such declaration will be made in the case of a payment default of the type specified in clause (a) of the immediately preceding paragraph which results directly from a failure by the Company to make a payment of rent under a Lease until such time as the Lessor under such Lease has been given the opportunity to exercise its limited rights, if any, to cure such default under the related Lease Indenture. (See "DESCRIPTION OF THE LEASE INDENTURE — Rights of Lessors to Cure and Purchase Lessor Notes; Substitute Lessee".) In addition, upon the occurrence of a Lease Indenture Event of Default, Lease Indenture Default, Event of Loss or Deemed Loss Event, if the Trustee has actual knowledge thereof, the Trustee is required to give notice to all holders of Securities ("Securityholders") of such fact in accordance with the provisions of the Indenture and thereafter each Securityholder will have the right to direct the Trustee, as the holder of the Pledged Lessor Notes issued under such Lease Indenture, to vote the principal amount of such Pledged Lessor Notes in proportion to the principal amount of Securities owned by such Securityholder in favor of directing the Lease Indenture Trustee to take specific action or refrain from taking action, all as permitted under the terms of such Lease Indenture. (Indenture, Sections 3.03 and 8.02) Under each Lease Indenture, the Lease Indenture Trustee will be required to act with respect to such matters upon direction of the holders of a majority in principal amount of all Lessor Notes outstanding thereunder which, until such time, if any, that additional Lessor Notes are issued under such Lease Indenture, will mean a majority in aggregate principal amount of the Bonds outstanding as a result of the pass-through voting mechanism described above.

With certain exceptions, the request of the holders of not less than a majority in aggregate principal amount of Securities outstanding is necessary to require the Trustee to exercise any remedy under the Indenture. The Trustee is entitled to receive reasonable indemnity and under certain circumstances is not required to act. (Indenture, Section 9.03) Certificates of the Company and Funding Corp. as to absence or nature of default and compliance with the terms of the Indenture are required to be furnished to the Trustee annually. (Indenture, Section 5.10)

Voting of Lessor Notes

The Trustee, as holder of the Pledged Lessor Notes, has the right to vote and give consents and waivers in respect of such Pledged Lessor Notes and the Lease Indentures only as described below. The Indenture provides that the Trustee may not direct any action or cast any vote as the holder of the Pledged Lessor Notes except as directed by Securityholders and, upon receiving such directions, all such directions must be given to the Lease Indenture Trustees, as permitted by the Lease Indentures. The principal amount of the Pledged Lessor Notes directing any action or being voted for or against any proposal or not being voted will be in proportion to the principal amounts of Securities taking the corresponding position. (Indenture, Section 3.03)

Supplemental Indentures

Funding Corp., the Company and the Trustee may enter into indentures supplemental to the Indenture without the consent of the holders of the Securities for a number of purposes, subject to the conditions specified in the Indenture, including, among others, the issuance of additional Securities and the curing of any ambiguity, correcting of any defect or resolving of any questions, under the Indenture. (Indenture, Section 11.01)

With the consent of the holders of not less than a majority in aggregate principal amount of the Securities then outstanding, Funding Corp., the Company and the Trustee may enter into additional supplemental indentures, except that without the consent of the holders of all the Securities then outstanding affected thereby, no such supplemental indenture may (i) change the time of payment of the principal of, or any installment of interest on, or the dates or circumstances of payment of premium, if any, on, any Security or reduce the principal amount of, or the interest on, or any premium payable upon any redemption of, any Security or change the place of payment where, or the coin or currency in which, any Security or the premium, if any, or interest thereon is payable, or impair the right to institute suit for the enforcement of any such payment on or after the time for payment thereof (or, in the case of redemption, on or after the redemption date), or change the dates or amounts of payments to be made through the operation of the sinking fund in respect of any such Security, (ii) permit the creation of any lien prior or, except with respect to additional Securities issued in accordance with the Indenture, equal to the lien of the Indenture with respect to any of the Pledged Lessor Notes, or terminate the lien of the Indenture on the Pledged Lessor Notes (except as permitted by the Indenture) or deprive any Securityholder of the security afforded by the Indenture, (iii) reduce the percentage in principal amount of the Securities the consent of whose holders is required for any such supplemental indenture, or the consent of whose holders is required for any waiver provided for in the Indenture, or (iv) modify any of the above provisions or the provisions of the Indenture dealing with waivers of past defaults, except to increase such percentage or to provide that certain other provisions of the Indenture cannot be modified or waived without the consent of the Securityholders affected thereby. (Indenture, Section 11.02)

The Trustee

The Company maintains normal banking relationships with Chemical Bank, which will act as Trustee. In addition, Chemical Bank provided a portion of the bank financing to the Lessors in connection with the Initial Sale and Leaseback Transactions. Chemical Bank is also trustee under each of the Lease Indentures entered into in connection with the Initial Sale and Leaseback Transactions, and is expected to be the trustee under each of the Lease Indentures entered into in connection with future Sale and Leaseback Transactions.

DESCRIPTION OF THE LEASE INDENTURES

The statements under this caption are summaries and do not purport to be complete. The summaries describe the provisions of, and are qualified in their entirety by reference to, the Lease Indentures executed and delivered in connection with the Initial Sale and Leaseback Transactions, a copy of the form of which has been filed as an exhibit to the Registration Statement of which this Prospectus is a part. Any Lease Indenture executed and delivered in connection with any future Sale and Leaseback Transaction which involves the issuance of Bonds or Securities is expected to have substantially similar terms.

General

The Pledged Lessor Notes will be issued to Funding Corp. but will be pledged and assigned to the Trustee for the benefit of the holders of Bonds. In the future, additional Lessor Notes may be issued to Funding Corp. and pledged to the Trustee as security for subsequent issuances of Securities by Funding Corp., which subsequently issued Securities will be secured on a parity basis with the Bonds by all Lessor Notes then pledged to the Trustee. (See "Description of the Bonds — General".)

The aggregate principal amount of the Pledged Lessor Notes and other Lessor Notes which are issued in connection with the issuance of any Bonds or other Securities will equal the aggregate principal amount of the Bonds and other Securities the proceeds of which are loaned by Funding Corp. to the Lessors. The Pledged Lessor Notes or other Lessor Notes will bear interest at rates which are equal to the interest rates on the Bonds or Securities of corresponding principal amounts and maturities. Payments of the principal of, and premium, if any, and interest on, the Pledged Lessor Notes and other Lessor Notes will be due in such amounts and at such times as match the required

payment dates, including sinking fund payment dates, for the principal of, and premium, if any, and interest on, such Bonds and Securities.

Events of Default

Indenture Events of Default under each Lease Indenture include: (a) any Lease Event of Default arising from (A) the Company's failure to make a payment of basic rent under such Lease within five business days after the same has become due (other than the failure of the Company to make Excepted Payments and subject to the limited rights of each Lessor to cure defaults in the payment of basic rent and to purchase Lessor Notes upon the occurrence of a Lease Event of Default by the Company as described below), (B) the Company's failure to make a payment of Casualty Value, Extraordinary Casualty Value or Special Casualty Value when due or payment due pursuant to exercise of the Cure Option when due, except a failure of the Company to pay an amount which constitutes an Excepted Payment or except where the Lessor has not rescinded or terminated the Lease, (C) the occurrence of certain bankruptcy and insolvency events with respect to the Company, or (D) (i) the Company's failure to pay when due, after any applicable grace period, certain debt of the Company the principal amount (or equivalent) of which is greater than $20,000,000 and such failure shall continue after the applicable grace period, if any, or (ii) any other default of the Company relating to such debt which causes the acceleration of the maturity of such debt; (b) rescission or termination of, or the taking of action the effect of which would be to rescind or terminate, the related Lease by the Lessor or the Equity Participant; (c) prior to rescission or termination of, or the taking of action the effect of which would be to rescind or terminate, the related Lease by the Lessor or Equity Participant, the exercise by the Lessor or Equity Participant of certain remedies under such Lease as a result of which the Company would be obligated to pay liquidated damages; (d) any assignment, sublease or transfer by the Company in violation of the terms of the related Lease; (e) breach by the Company of the provisions of the related Participation Agreement relating to the maintenance of the Company's existence as a corporation organized under the laws of Arizona or the merger or sale of the Company (see "DESCRIPTION OF THE LEASES — Merger; Consolidation; Maintenance of Corporate Existence"); and (f) certain defaults by the Lessor or its related Equity Participant, including (A) any failure to make any payment in respect of the principal of, or premium, if any, or interest on, the Pledged Lessor Notes within five business days after the same having become due (except such payment defaults which result from a default under the Lease), (B) failure by the Lessor to perform its agreement in the Lease Indenture not to (i) create certain liens on the Lease Indenture Estate, (ii) purchase or agree to purchase any property or asset other than the related undivided interest in Unit 2, (iii) take any action which would result in an impairment of any Lessor Note or the obligation of the Company to pay any amount under the Lease which is part of the Lease Indenture Estate or any of the other rights or security created or effected thereby, except as otherwise permitted or contemplated by the related transaction documents and (iv) issue, or incur any obligation in respect of, indebtedness for borrowed money except for its obligations in respect of the Lessor Notes and the continuance of such failure for 30 days after notice, (C) failure by the Equity Participant to perform its agreement in the related Participation Agreement not to create or permit to exist certain liens on the Lease Indenture Estate and the continuance of such failure for 30 days after notice, (D) certain representations and warranties of the Lessor or the Equity Participant in the related Participation Agreement having been incorrect in any material respect when made, remaining material at the time of discovery and not being cured for 30 days after notice, and (E) occurrence of certain bankruptcy and insolvency events with respect to the Equity Participant or with respect to the trust for which the Lessor is owner trustee. (Lease Indenture, Section 6.2)

Rights of Lessors to Cure and Purchase Lessor Notes; Substitute Lessees

Each Lease Indenture provides that a Lease Indenture Event of Default thereunder is to be deemed cured if such Lease Indenture Event of Default results from a non-payment of rent under the related Lease and the Lessor or its related Equity Participant has paid all principal of, and premium, if any, and interest on, the Lessor Notes due (other than by acceleration) on the date such rent was payable, plus interest on such amount, within 15 days after receipt by the Lessor of notice of such non-

payment. However, the right of the Lessor or its related Equity Participant to cure the non-payment of basic rent or supplemental rent is limited to not more than four basic rent payment dates or two consecutive basic rent payment dates. (Lease Indenture, Section 6.8)

If a Lease Indenture Event of Default has occurred under any Lease Indenture and (i) the related Lessor Notes have been accelerated and (ii) the Lessor, within 30 days after receiving notice from the Lease Indenture Trustee of such Lease Indenture Event of Default, has given written notice to the Lease Indenture Trustee of its intention to purchase all of the related Lessor Notes, then, upon receipt within 10 business days after such notice from the Lessor of an amount equal to all of the unpaid principal of, and premium, if any, and interest on, all of the Lessor Notes issued by such Lessor (together with any interest on overdue principal and, to the extent permitted by law, interest), each holder of a Lessor Note issued by such Lessor, including the Trustee, as the holder of the Pledged Lessor Notes, will be required to sell such Lessor Notes and its right, title and interest in and to the Lease Indenture and the estate created thereunder to the Lessor. (Lease Indenture, Section 6.8)

In addition to the foregoing, if a Lease Event of Default has occurred, the Lessor may terminate such Lease and, in conjunction therewith, arrange for a substitute lessee under a new lease substantially similar to the terminated Lease. In connection with any such substitution, the Lessor must have cured any Lease Indenture Event of Default described in clause (f) under "Events of Default" above, such substitute lessee must assume the Company's obligations under the Lease and such substitute lessee must have a credit rating from Standard & Poor's Corporation and Moody's Investors Service, Inc. with respect to at least one series of its debt obligations or preferred stock equal to or better than that of comparable securities of the Company immediately prior to the substitution but in no event less than "investment grade". (Lease Indenture, Section 6.8)

Action by Trustee; Waiver

Subject to the terms of each Lease Indenture, the Lease Indenture Trustee is required to take such action (including the waiver of past defaults), or refrain from taking such action, with respect to any such Lease Indenture Event of Default, Lease Event of Default, Deemed Loss Event or Event of Loss, as it is directed to take by the holders of a majority in principal amount of all Lessor Notes. To the extent that a Lessor Note is pledged as collateral for one or more of the obligations of the registered holder thereof, or obligations with respect to which it is acting as trustee, such direction will be given in accordance with instructions received from the secured holders. If the Lease Indenture Trustee has not received such a Directive within 20 days after the mailing by the Lease Indenture Trustee of notice of such Lease Indenture Event of Default, Lease Event of Default, Deemed Loss Event or Event of Loss, the Lease Indenture Trustee may, subject to the receipt of a Directive after such 20 day period, but is not required to, take such action, or refrain from taking such action, as it deems advisable in the best interest of holders of Lessor Notes of all series. (Lease Indenture, Sections 6.11 and 7.1)

The Lease Indenture Trustee under any Lease Indenture may waive any past Lease Indenture Default or Lease Indenture Event of Default and its consequences except a Lease Indenture Default or a Lease Indenture Event of Default (i) in the payment of the principal of, or premium, if any, or interest on, any Lessor Note or (ii) in respect of a covenant or provision of such Lease Indenture which under the Lease Indenture cannot be modified or amended without the consent of each holder of a Lessor Note then outstanding. (Lease Indenture, Section 6.7)

Acceleration and Remedies

If a Lease Indenture Event of Default has occurred and is continuing, the Lease Indenture Trustee may, and upon receipt of a Directive must, declare the unpaid principal amount of all Lessor Notes issued and outstanding under such Lease Indenture, with accrued interest thereon, to be due and payable, subject to the right of the Lessor or its related Equity Participant to cure such default as described above. (Lease Indenture, Section 7.1)

Except in the case of the Lease Indenture Events of Default described in clause (f) under "Events of Default" above, and except as described in the next paragraph, the exercise of remedies against the Company under each Lease will be controlled by the related Lessor. In such circumstances, however, each such Lessor is required to consult with the Lease Indenture Trustee as to any proposed exercise or pursuit of remedies and the Lease Indenture Trustee has the right to cause the Lessor to forbear from such action if the Lease Indenture Trustee has determined that such action would have a material adverse effect on the holders of Lessor Notes. In addition, the Lessor has agreed that it will not pursue remedies in a manner which would unreasonably deprive the holders of the Pledged Lessor Notes of a material right or remedy unless the Lessor is commensurately adversely affected. There could be circumstances, therefore, in which the full amount due in respect of the Bonds may not be paid, but the Lease Indenture Trustee will not be able to direct the Lessor's pursuit of remedies against the Company under the Lease. (Lease Indenture, Sections 6.3 and 6.11)

Although the exercise of remedies is generally within the control of the Lessor, the Lease Indenture Trustee does have the right to sell the Lease Indenture Estate in foreclosure or similar proceedings if such sale occurs prior to or simultaneously with the termination of the related Lease and the Lessor has been given an opportunity to purchase the Lease Indenture Estate at the proposed foreclosure sale price. (Lease Indenture, Section 6.11)

If a Lease Indenture Event of Default occurs and is continuing, and the maturity of the Lessor Notes has been accelerated, any sums held or received by the Lease Indenture Trustee may be applied to reimburse the Lease Indenture Trustee for any expense or other loss incurred by it and to pay its fees and any other amounts due to the Lease Indenture Trustee prior to any payments to holders of Lessor Notes. (Lease Indenture, Section 5.3)

Under applicable law, it is possible that the Leases will be viewed as leases of real, rather than personal, property. To the extent the Leases are considered leases of real property in the event of a bankruptcy proceeding involving the Company, a claim for damages resulting from the termination of the Leases may be limited to an amount less than the amount then due and owing on the Bonds. The foregoing limitations may not apply, however, if the Leases were deemed to constitute "financing leases" within the meaning of the Bankruptcy Act. Although the issue has not been definitively addressed by the courts, a court reasonably could conclude that the Leases constitute "financing leases" for purposes of the Bankruptcy Act.

Assumption by the Company

The Company must assume the Pledged Lessor Notes under certain circumstances, including those listed in paragraphs (a) and (b) below. The Pledged Lessor Notes will be similarly assumed if any letters of credit issued in favor of the Equity Participants expire without renewal and the Company shall elect to exercise its option to purchase the Lessor's undivided interest in Unit 2 as a consequence thereof. Upon assumption by the Company, the Pledged Lessor Notes will become direct obligations of the Company and the interest of the related Lessor in Unit 2 will be transferred to the Company. Although certain changes will be made to the Lease Indenture to reflect the termination of the related Lease, the lien on the respective interest in Unit 2 created by the Lease Indenture will not be affected. The assumption by the Company of the Pledged Lessor Notes will not result in any changes to the terms of the Indenture or the Bonds.

(a) *Deemed Loss Event or Events of Loss Relating to PVNGS.* The Pledged Lessor Notes will be assumed upon the occurrence of any "Deemed Loss Event" or "Event of Loss" (as defined in the Lease Indenture).

(i) "Deemed Loss Events" include the following types of events:

(A) During the term of the related Lease, the Lessor or the related Equity Participant by reason of the acquisition or ownership of its undivided interest in Unit 2 or the real property interest purchased from the Company or other related transactions,

being deemed by a governmental authority having jurisdiction to be, or becoming subject to regulation as, an electric utility, a public utility or a holding company, and the effect thereof on such Lessor or Equity Participant would be, in the sole judgment of the Equity Participant, acting on the advice of counsel, adverse, except that if the Company is contesting certain of such actions and has complied with certain conditions with respect to such contest, such Deemed Loss Event shall be deemed not to have occurred;

(B) Any change in applicable law or the interpretation thereof, including the Price-Anderson Act (other than certain changes in law currently among the proposals in Congress), the Atomic Energy Act, the Nuclear Waste Act or the regulations of the NRC, or any other significant development, in each case as a result of which, in the opinion of independent counsel to the related Equity Participant, the potential liability of the Lessor, the related Equity Participant or the Company for a single nuclear incident is increased (including increases in the amounts payable by the Company under the retrospective rating plan with respect to incidents at other nuclear facilities in the nation). (See "DESCRIPTION OF THE PALO VERDE NUCLEAR GENERATING STATION — Liability and Insurance Matters");

(C) The Company's failure to comply with the insurance covenant in the Lease with such Lessor;

(D) Any action with respect to the Unit 2 License which requires or might require the Lessor or the related Equity Participant to become a licensee of the NRC, become subject to the obligations or liabilities of licensees under the Atomic Energy Act with respect to Unit 2, or become otherwise subject to significant regulation;

(E) The occurrence of two or more incidents at any nuclear facility or facilities in the world utilizing the type of reactor equipment used for Unit 2, or any three incidents within a five-year period at any nuclear facility or facilities in the world, each of which incidents result in certain minimum specified levels of radiation at the subject facilities or off-site property or certain minimum specified levels of damage to off-site property;

(F) Any governmental action or assertion or any change in applicable law the effect of which is or might be to make the related Sale and Leaseback Transaction illegal or which impedes the right of the Lessor or the related Equity Participant to assert any remedies currently available under the related Lease or Participation Agreement, or which causes the Lessor or such Equity Participant to become liable in any capacity with respect to the decommissioning of Unit 2;

(G) With respect to PVNGS, the NRC has issued within a two-year period certain final violation orders;

(H) The occurrence of an event at Unit 1 or Unit 3 which results in the happening of certain specified consequences, including radiation in the upper half of the containment vessel or primary coolant system exceeding certain specified levels, thermocouple temperatures exceeding certain specified levels or core damage exceeding certain specified levels or the cessation or expected cessation of operations for 36 months;

(I) The radiation levels in the spent fuel storage building for Unit 1 or Unit 3 exceeding certain specified levels; and

(J) Other than in consequence of a reduction in demand or a shutdown to repair damage to Unit 2, Unit 2 shall have operated below a specified net capacity factor for a specified period.

(ii) "Events of Loss" include the following types of events:

(A) Certain events of expiration, revocation or suspension regarding the Unit 2 License;

(B) Any order or direction of any governmental authority that Unit 2 suspend operations for reasons of radiological health and safety for a period in excess of 24 months or any cessation of operation of Unit 2 for a period of 24 months if the resumption of operations requires the concurrence of any governmental authority;

(C) A nuclear incident which causes operation of Unit 2 to cease for a period of 18 consecutive months;

(D) The occurrence of an event at Unit 2 which results in the happening of certain specified consequences, including radiation in the upper half of the containment vessel or the primary coolant system exceeding certain specified levels, thermocouple temperatures exceeding certain specified levels or core damage exceeding certain specified levels;

(E) The occurrence of an incident at Unit 2 which results in certain minimum specified levels of radiation at the subject facilities or off-site property or certain minimum specified levels of damage to off-site property;

(F) The occurrence at Unit 2 of a discharge or dispersal of radioactive material off-site exceeding certain specified limits or requiring decontamination costs in excess of $10,000,000;

(G) The declaration by the operating agent of PVNGS of a site area emergency set forth in the PVNGS emergency plan for any reason other than a drill or false alarm;

(H) Except as a result of controlled movement of spent fuel, the radiation level in the spent fuel storage building in Unit 2 exceeding certain specified levels;

(I) Damage to Unit 2 and the failure of the Company or the Company and the other ANPP participants to restore or reconstruct Unit 2 within certain specified time periods;

(J) Damage to Unit 2 and the failure by the Company within 18 months to agree to participate in the reconstruction of Unit 2;

(K) The cessation of operation of Unit 2 as a result of damage to Unit 2 for a period exceeding 3 years or ending after the expiration of the term of the Lease;

(L) The destruction of Unit 2; and

(M) A governmental requisition of title or use of Unit 2.

(b) *Exercise of the Cure Option.* The Pledged Lessor Notes will be assumed if a Lease Event of Default occurs as a result of the Company's breach of certain covenants concerning its activities as a PVNGS participant and the Company shall elect to exercise its option to cure such Lease Event of Default (the "Cure Option") by, among other things, paying a specified amount to the Lessor and assuming such related Pledged Lessor Notes.

Any assumption of the Pledged Lessor Notes is subject to receipt by the Lease Indenture Trustee of, among other things, (i) a duly executed Assumption Agreement from the Company, (ii) an opinion of counsel, (iii) copies of all necessary governmental actions relating to the assumption, (iv) an indenture supplemental to the Lease Indenture which will, among other things, confirm the release of the Lessor affected thereby and may contain provisions amending the Lease Indenture to reflect the termination of the related Leases while preserving the rights with respect to the Lessor Notes which the Company had, as lessee under such Leases, provided that the lien on the respective undivided interest in Unit 2 created by the Lease Indentures will not be affected and (v) a certificate of a responsible officer of the Company to the effect that (A) the conditions precedent to such assumption have been complied with, (B) such assumption has been authorized by the Company and (C) the

Company is not insolvent at the time of such assumption. If the Company is unable to assume the Pledged Lessor Notes because of its inability to satisfy the foregoing conditions, the Equity Participant may assign its beneficial interest in the owner trust to the Company or its assignee (a "Special Transfer"). In such case, the Lease will be amended to reduce the amount of basic rent payable thereafter to an amount equal to the principal of, and premium, if any, and interest payable from time to time on, the related Lessor Notes. (Lease Indenture, Section 3.9)

In the event that the Company fails to make the payments required to the Lessor and the Equity Participant under any Lease in connection with any assumption of Pledged Lessor Notes or any Special Transfer, if the Lessor nonetheless elects to transfer its undivided interest in Unit 2 or the beneficial interest in the trust estate to the Company, the Lessor and Equity Participant will retain a security interest in the property so transferred.

Amendments and Supplements

Each Lease Indenture Trustee may amend or supplement its Lease Indenture without the consent of the holders of any Lessor Notes (including the Trustee, as the holder of the Pledged Lessor Notes), to, among other things, evidence the assumption of the Lessor Notes by the Company as described under "Assumption by the Company" above, or to evidence the issuance of additional Lessor Notes in accordance with the terms of the Lease Indenture. (Lease Indenture, Section 10.1)

A Lease Indenture may also be amended or supplemented upon receipt of a Directive. However, without the consent of the holders of all of the Lessor Notes, the Lease Indenture Trustee may not consent to any supplement or amendment to its Lease Indenture or the related Lease, or to any waiver or modification of the terms of either thereof which has the effect of (i) modifying, waiving, discharging or terminating (A) any of the provisions of the Lease Indenture relating to (1) amendments and supplements to the Lease Indenture or the related Lease, (2) the terms and conditions relating to the issuance of additional Lessor Notes, or (3) the duties of the Trustee in respect of Lease Indenture Events of Default, Deemed Loss Events, Events of Loss and matters specified in a Directive, (B) the provisions of the related Lease relating to (1) the sufficiency of basic rent to pay the Lessor Notes, (2) the net lease provisions, (3) the Lease Event of Default relating to the failure of basic rent to be paid within 5 days after the same shall be due, or (4) insofar as it affects redemption of the Lessor Notes, termination of the Lease on the basis of the obsolescence of Unit 2, (C) the definition of "Directive" or the definition of "Indenture Event of Default", (ii) reducing, or otherwise modifying, amending or supplementing the related Lease so as to reduce the amount of basic rent or Casualty Value or any payment pursuant to the remedial provisions of such Lease below the amount required to pay the full principal of, and premium, if any, and interest on, the Lessor Notes or extend the time of payment thereof, (iii) except as provided in the Lease Indenture, depriving the holder of any Lessor Notes of the lien of the Lease Indenture, or (iv) materially adversely affecting the rights and remedies for the benefit of the holders of Lessor Notes under the default and remedy provisions of the Lease Indenture. (Lease Indenture, Section 10.2)

Limitation of Liability

The Pledged Lessor Notes which will secure the Bonds are not direct obligations of, or guaranteed by, the Company, any Equity Participant or any bank or trust company acting as Lessor, in its individual capacity. Except as specifically provided in the Lease Indentures, none of the Equity Participants, in their individual capacities, or Lease Indenture Trustees will be liable to any holder of a Pledged Lessor Note or a Bond or, in the case of the Equity Participants and the banks or trust companies acting as Lessors, in their individual capacities, to the Lease Indenture Trustees for any amounts payable under the Pledged Lessor Notes or, except as provided in the Lease Indentures in the case of the banks or trust companies acting as Lessors and the Lease Indenture Trustees, for any obligation under the Lease Indentures. (Lease Indenture, Section 3.7)

Additional Lessor Notes

Additional Lessor Notes may be issued under and secured by each Lease Indenture, at any time or from time to time, for cash at par for the purposes described under "SECURITY AND SOURCE OF PAYMENT FOR THE BONDS". (See "DESCRIPTION OF THE LEASES — Capital Improvements".) All Lessor Notes issued and outstanding under a Lease Indenture will rank on a parity with each other and will as to each other be secured equally and ratably thereunder, without preference, priority or distinction of any thereof over any other by reason of difference in time of issuance or otherwise. (Lease Indenture, Section 3.6)

DESCRIPTION OF THE LEASES

The statements under this caption are summaries and do not purport to be complete. The summaries describe the provisions of, and are qualified in their entirety by reference to, the Leases executed and delivered in connection with the Initial Sale and Leaseback Transactions, a copy of which has been filed as an exhibit to the Registration Statement of which this Prospectus is a part. Any Leases executed and delivered in connection with any future Sale and Leaseback Transactions are expected to have substantially similar terms.

Terms and Rentals

Each Lessor will have acquired separate undivided ownership interests in Unit 2 and will have leased such interests to the Company pursuant to separate Leases, each having a term expiring on December 31, 2015, unless earlier terminated or extended as described below. Basic rent is required to be paid by the Company under the Leases in immediately available funds on each June 30 and December 30. (Lease, Sections 3(a) and 3(c)) The basic rent payable under each Lease on each payment date is required to be at least equal to all principal of, and premium, if any, and interest on, the Lessor Notes of such Lessor then due and payable on such date. (Lease, Section 3(g)) Each payment of basic rent by the Company during such time as the related Lease Indenture is in effect will be made to the Lease Indenture Trustee and applied first to the payment of principal, and premium, if any, and interest due from a Lessor on its Lessor Notes. Except in the case of an acceleration of the Pledged Lessor Notes due to a continuing Lease Indenture Event of Default, the balance of any payments of basic rent under the Leases, after payment of the scheduled principal, and premium, if any, and interest on the Pledged Lessor Notes, will be distributed to the respective Equity Participants, as beneficial owners of the trusts which are the owners of the Leased Unit 2 Interest. (Lease Indenture, Sections 2.2 and 5.1)

Net Lease

The obligations of the Company under each Lease are those of a lessee under a "net lease". Payments of rent under the Leases by the Company are to be made without counterclaim, setoff, defense, abatement, suspension or reduction. (Lease, Section 4) The Company will be responsible under the Leases for paying all taxes, insurance premiums, operating and maintenance costs and all other similar costs associated with all undivided interests in Unit 2 sold and leased back in connection with the Sale and Leaseback Transactions.

Capital Improvements

The Company may incur additional costs from time to time in connection with capital improvements to Unit 2. Certain of such costs, based on a Lessor's proportionate interest in Unit 2, may be financed through the issuance of additional Lessor Notes (a "Supplemental Financing"). (See "DESCRIPTION OF THE LEASE INDENTURES — Additional Lessor Notes"). In the event of such a Supplemental Financing, the rent under the related Lease will be increased to cover the additional debt service. In addition, the Equity Participants may elect to make additional equity investments with respect to the cost of any capital improvement on terms to be agreed upon. (Lease, Section 8(f))

Possession, Sublease and Transfer

Except in connection with a merger, consolidation or sale, transfer, conveyance or lease of assets permitted by the Participation Agreements or a transaction required by the ANPP Participation Agreement, the Company is not permitted to assign, sublease or transfer any of its rights or interests under any Lease or surrender possession of Unit 2 without the prior consent of the Lessor. (Lease, Section 11)

Insurance

The Company is required under the Leases to cause the PVNGS operating agent to carry and maintain at least the insurance described below in the indicated amounts and is required to make all payments required of it under the ANPP Participation Agreement or otherwise in respect of such insurance.

Each Lease requires the following insurance coverage:

(i) Non-nuclear property insurance covering physical loss in amounts required by or in accordance with prudent utility practice, but not less than the estimated maximum probable loss in respect of such property;

(ii) Bodily injury and property damage liability insurance covering claims arising out of the ownership, operation, maintenance, condition or use of Unit 2 or the PVNGS Site in amounts in accordance with the higher of prudent utility practice and the ANPP Participation Agreement, but not less than $25 million per occurrence, with a deductible not exceeding $5 million;

(iii) Nuclear property insurance in amounts required by the highest of applicable law, the ANPP Participation Agreement and prudent utility practice; provided, however, that such insurance must at all times be maintained in amounts at least equal to the maximum nuclear property insurance available on commercially reasonable terms and must not be less than $750 million (except in certain limited circumstances) and with deductibles not exceeding $10 million; and

(iv) The maximum nuclear liability insurance in amounts as required by or in accordance with the highest of applicable law, the ANPP Participation Agreement, prudent utility practice and the maximum amount available on commercially reasonable terms, plus suppliers' and transporters' insurance in amounts consistent with prudent utility practice. (Lease, Section 10)

Purchase and Renewal Options at the End of the Lease Term

The Company has the option under each of the Leases to purchase at fair market value the Lessor's undivided interest in Unit 2 at the end of the Lease term or to renew the Lease for a specified period. (Lease, Sections 12 and 13) The initial term of each of the Leases ends on December 31, 2015. If the Company does not exercise its option to purchase or renew a Lease, the Lessor may, on at least one year's prior written notice, terminate such Lease at any time during the last two and one-half years of its term and elect to retain or sell its undivided interest in Unit 2, in which case the Lessor must pay in full the Lessor Notes of such Lessor, together with all accrued interest and any applicable premium. (Lease, Section 14(d))

Events of Loss, Deemed Loss Events, Cure Option and Special Purchase Option

If an Event of Loss or a Deemed Loss Event occurs with respect to Unit 2 or if the Company exercises the Cure Option or the option to purchase a Lessor's undivided interest in Unit 2 as a result of the failure to renew any letter of credit issued for the benefit of an Equity Participant, the Company will, if it is able to assume the obligations represented by the Lessor Notes, pay to each Lessor cash in the amount provided in such Lessor's Lease, and such Lessor will then transfer title to its undivided ownership interest in Unit 2 to the Company, subject to the lien of the Lease Indenture. (See

"DESCRIPTION OF LEASE INDENTURES — Assumption by the Company".) If the Company has not assumed the obligations represented by the Lessor Notes then the Equity Participant will assign its beneficial interest in the owner trust to the Company or its assignee. In the case of such an assignment, the Lease will be amended to reduce the amount of basic rent payable thereafter to an amount equal to the principal of, and premium, if any, and interest payable from time to time on, the Lessor Notes. (Lease Indenture, Section 3.9(b); Lease, Section 9(c), 9(d) and 16(e))

Termination for Obsolescence

If no default or Lease Event of Default shall have occurred and be continuing and no Event of Loss shall have occurred and no Deemed Loss Event shall have been declared, the Company has the option on any June 30 or December 30 on or after December 30, 1996 and prior to December 30, 2012 to terminate the Lease, on at least one year's prior written notice, if the Company's Board of Directors determines that Unit 2 is surplus to the Company or is economically obsolete and provided that the Company is making a good faith effort to sell any ownership interest which it may have in Unit 2. In such event, the Lessor may elect to retain or to sell its undivided interest in Unit 2. If the Lessor elects to retain such interest, as a condition to such retention, the Lessor must pay in full the Lessor Notes issued by it, together with all accrued interest and any applicable premium. If the Lessor elects to sell its undivided interest in Unit 2, it will be sold to the highest bidder (which may not be the Company or an affiliate of the Company), and the Company must pay to the Lessor that amount, if any, which when added to the net sale price therefor will be at least sufficient to prepay the Lessor Notes of such Lessor as of the termination date of the Lease and all accrued and unpaid rent, including any prepayment premium payable on the Lessor Notes then due. (Lease, Sections 14(a), 14(b) and 14(c)) In that case the Lessor Notes would be prepaid. (Lease Indenture, Section 3.9)

Events of Default

Lease Events of Default include, among other things: (a) failure by the Company to pay Casualty Value, Extraordinary Casualty Value or Special Casualty Value or payment due pursuant to exercise of the Cure Option when due or basic rent within five days after the same becomes due or any other rent within 20 days after the same becomes due or is demanded, as the case may be; (b) breach by the Company of certain provisions of the Participation Agreement relating to such Lease including those discussed under "Merger; Consolidation; Maintenance of Corporate Existence" below, or breach by the Company of certain other provisions of such Lease dealing with the removal of certain liens which may exist from time to time on such Lessor's interest in Unit 2 and subletting and assignment of such Lease; (c) except where the failure to do so would not have a material and adverse effect on the undivided interest and real property interest of the Lessor or Unit 2 or the respective rights of such Lessor, the related Equity Participant or any holder of a Lessor Note issued by such Lessor, failure by the Company to perform its obligations under, comply with the terms of and undertake certain actions in connection with, the ANPP Project Agreements for 15 days after notice by such Lessor or the related Equity Participant requiring that the same be remedied; (d) failure by the Company to perform other covenants in such Lease and related documents for 30 days after notice by such Lessor or the related Equity Participant requiring that the same be remedied; (e) material misrepresentations by the Company in connection with the related Sale and Leaseback Transaction; (f) occurrence of certain bankruptcy and insolvency events with respect to the Company; (g) a final judgment for the payment of money in excess of $10,000,000 not being paid or appropriately stayed by the Company within 60 days after entry of such judgment; (h) the expiration of 15 business days following receipt by the Company of a notice of default under the ANPP Participation Agreement, provided that no Lease Event of Default shall be deemed to have occurred if the Company is pursuing its rights under the ANPP Participation Agreement to contest the existence of such purported default; (i) a default by the Company under the ANPP Participation Agreement in consequence of which the Company's right to receive its generation entitlement share in PVNGS is suspended; (j) certain defaults with respect to other obligations of the Company which are in excess of $20,000,000; and (k) failure by the Company to maintain or renew a letter of credit or other financial support for the benefit of the related Equity

Participant pursuant to the terms of such Lease and the related Participation Agreement. (Lease, Section 15)

If a Lease Event of Default has occurred and is continuing, the Lessor may declare the Lease to be in default and may exercise one or more of the remedies provided in the Lease with respect to its undivided interest in Unit 2. These remedies include the right to repossess and use such interest (subject to compliance with applicable law), to sell or relet such interest free and clear of the rights of the Company and to retain the proceeds of such sale or lease and to require the Company to pay liquidated damages as specified in the Lease sufficient to pay the principal of, and premium, if any, and accrued interest on, the Lessor Notes and, as such, the Bonds. For a description of certain constraints on the ability of each Lessor and the Lease Indenture Trustee, as assignee of such Lessor, to exercise remedies, see "DESCRIPTION OF THE LEASE INDENTURES — Acceleration and Remedies".

Merger; Consolidation; Maintenance of Corporate Existence

Pursuant to each Participation Agreement, the Company has agreed that it will at all times maintain its existence as a corporation under the laws of the State of Arizona and will not, without the consent of the related Equity Participant and Lease Indenture Trustee, consolidate with or merge with or into, or convey or transfer more than 10% of its assets to, any person, unless immediately after giving effect to such transaction, a number of conditions are met, including the requirement that the surviving lessee under the related Lease (i) be a corporation organized under the laws of the United States of America, a State thereof or the District of Columbia, (ii) be a utility which is a principal supplier of electric service to residents of Phoenix, Arizona, (iii) if other than the Company, execute and deliver to the Equity Participant and the Lease Indenture Trustee, an agreement in form and substance reasonably satisfactory to the Equity Participant in which it assumes all of the Company's obligations pursuant to the Lease and other transaction documents, (iv) either (A) have a debt to equity ratio of not more than 3 to 1 or (B) have long-term unsecured debt securities rated at least "investment grade" as determined by Moody's Investors Service, Inc. and Standard & Poor's Corporation, if the Company has long-term unsecured debt securities rated by such rating organizations, or as determined by one of such rating organizations, if the surviving lessee has long-term unsecured debt securities rated by only one such organization, or, if neither of such rating organizations shall rate such debt securities of the surviving lessee at the time, by any nationally recognized rating organization in the United States of America and (v) have a net worth not less than $1.4 billion. Such requirement cannot be waived by the related Equity Participant without the consent of the holders of a majority in principal amount of the outstanding Lessor Notes.

Upon the consummation of any such permitted transaction, such corporation, if other than the Company, will succeed to, and be substituted for, and may exercise every right and power of, the Company under the Leases, the Participation Agreements and other related documents, with the same effect as if such corporation had been named therein.

PLAN OF DISTRIBUTION

Funding Corp. will sell the Bonds to The First Boston Corporation, Kidder, Peabody & Co. Incorporated and Salomon Brothers Inc or to an underwriting syndicate including and represented by such firms to be named in the Prospectus Supplement by which each series of Bonds is to be offered.

Each Prospectus Supplement with respect to the Offered Bonds will set forth the terms of the offering of the Offered Bonds and the proceeds to Funding Corp. from such sale, any underwriting discounts and other items constituting underwriters' compensation, any initial public offering price and any discounts or concessions allowed or reallowed or paid to dealers. Any initial public offering price and any discounts or concessions allowed or reallowed or paid to dealers may be changed from time to time.

The Bonds will be acquired by the underwriters for their own account and may be resold from time to time in one or more transactions, including negotiated transactions, at a fixed public offering price or at varying prices determined at the time of sale. The Company will agree to indemnify the

underwriters against certain civil liabilities, including liabilities under the Securities Act of 1933. The underwriting agreement will provide that the obligations of the underwriters are subject to certain conditions precedent and that the underwriters will be obligated to purchase all of the Offered Bonds if any are purchased.

LEGAL OPINIONS

Legal matters in connection with the issuance of the Bonds are being passed on for the Company by Snell & Wilmer, 3100 Valley Bank Center, Phoenix, Arizona 85073, for Funding Corp. by Mudge Rose Guthrie Alexander & Ferdon, 180 Maiden Lane, New York, New York 10038, and for the Underwriters by Sullivan & Cromwell, 125 Broad Street, New York, New York 10004. Certain legal matters in connection with the consummation of the Sale and Leaseback Transactions will be passed on for Funding Corp. by Mudge Rose Guthrie Alexander & Ferdon and for the Company by such firm and Snell & Wilmer.

As of September 25, 1986, attorneys in the firm of Snell & Wilmer beneficially owned, directly or indirectly, approximately 7,100 shares of the common stock of AZP Group, Inc., the Company's parent.

EXPERTS

The consolidated financial statements and related supplemental consolidated schedules incorporated in this Prospectus by reference from the Company's 1985 Annual Report on Form 10-K have been examined by Deloitte Haskins & Sells, independent certified public accountants, as stated in their opinion appearing therein, and have been so incorporated in reliance upon such opinion given upon the authority of that firm as experts in accounting and auditing.

With respect to the unaudited interim consolidated financial information for the periods ended March 31, 1986 and 1985 and June 30, 1986 and 1985, which are incorporated herein by reference, Deloitte Haskins & Sells have applied limited procedures in accordance with professional standards for a review of such information. However, as stated in their reports included in the Company's Quarterly Reports on Form 10-Q for the quarters ended March 31, 1986 and June 30, 1986, and incorporated by reference herein, they did not audit and they do not express an opinion on that interim financial information. Accordingly, the degree of reliance on their report on such information should be restricted in light of the limited nature of the review procedures applied. Deloitte Haskins & Sells are not subject to the liability provisions of Section 11 of the Securities Act of 1933 for their reports on the unaudited interim financial information because those reports are not "reports" or a "part" of the registration statements prepared or certified by an accountant within the meaning of Sections 7 and 11 of the Act.

The description of the opinion of Ebasco Business Consulting Company, independent engineers and consultants, as to the fair market value of Unit 2 at the closing of the Initial Sale and Leaseback Transactions has been included herein in reliance upon their opinion and upon the authority of said firm as a recognized consultant engaged in the design of electric generating facilities.

GLOSSARY

Certain capitalized terms used in this Prospectus have the following meanings:

"*ACC*" means the Arizona Corporation Commission.

"*Act*" means the Securities Act of 1933, as amended.

"*AFUDC*" means allowance for funds used during construction.

"*ANPP*" means Arizona Nuclear Power Project, also known as PVNGS. (See "DESCRIPTION OF THE PALO VERDE NUCLEAR GENERATING STATION".)

"*ANPP Participation Agreement*" means the Arizona Nuclear Power Project Participation Agreement, dated as of August 23, 1973, as heretofore and hereafter amended in accordance with its terms, which governs the rights and duties of the ANPP Participants. (See "DESCRIPTION OF THE ANPP PARTICIPATION AGREEMENT".)

"*ANPP Project Agreement*" means the ANPP Participation Agreement and any other agreement relating to PVNGS which is defined as a Project Agreement under the ANPP Participation Agreement.

"*Assignment and Assumption Agreement*" means a document titled "Assignment, Assumption and Further Agreement" between a Lessor and the Company. (See "DESCRIPTION OF THE BONDS — Security and Source of Payment for the Bonds".)

"*Assumption Agreement*" means a document titled "Assumption Agreement" executed by the Company in the form of Exhibit B to each Lease Indenture and pursuant to which the Company agrees to assume the Pledged Lessor Notes. (See "DESCRIPTION OF THE LEASE INDENTURES — Assumption by the Company".)

"*Bank Indebtedness*" means the loans from the Interim Lenders to the Lessors evidenced by the Initial Series Lessor Notes and made in connection with the Initial Sale and Leaseback Transactions.

"*Bankruptcy Act*" shall mean the Bankruptcy Reform Act of 1978, as amended.

"*Bonds*" means the Secured Lease Obligation Bonds to which this Prospectus relates.

"*Casualty Value*" means an amount specified in each Lease which the Lessee must pay to the Lessor under such Lease in certain circumstances, which amount is, in general, calculated to preserve the net economic return of the related Equity Participant.

"*Commission*" means the Securities and Exchange Commission.

"*Company*" means Arizona Public Service Company, an Arizona corporation, and in the appropriate context, its successors and assigns.

"*Cure Option*" means the option of the Company to cure certain specified Events of Default under a Lease upon the exercise of which the Company must (subject to certain specified conditions) assume Lessor Notes or acquire the beneficial interest of the Equity Participant. (See "DESCRIPTION OF THE LEASE INDENTURES — Assumption by the Company".)

"*Deemed Loss Event*" means any of the events described as a Deemed Loss Event in each Lease upon the occurrence of which the Company must (subject to certain conditions) assume Lessor Notes or acquire the beneficial interest of the Equity Participant. (See "DESCRIPTION OF THE LEASE INDENTURES — Assumption by the Company".)

"*Directive*" means, with respect to all Lessor Notes issued by a Lessor, an instrument in writing and executed by the holders of such Lessor Notes, representing a majority of the aggregate unpaid principal amount of such Lessor Notes directing such Lessor's Lease Indenture Trustee to take or refrain from taking the action specified therein or otherwise advising such Lease Indenture Trustee; provided, however, that each registered holder of a Lessor Note issued by such Lessor then

outstanding will be entitled to direct such Lessor's Lease Indenture Trustee only with respect to the proportionate aggregate unpaid principal amount of such Lessor Notes then outstanding which are registered in its name and which are (i) certified by the holder of such Lessor Notes to be held by it for its own account and not pledged as collateral for any of its obligations or (ii) pledged as collateral for one or more of its obligations, or obligations with respect to which it is acting as trustee under a related indenture, but in respect of which it has received a directive, satisfactory in form and substance to such Lease Indenture Trustee, given by the holder or holders of a proportionate interest in the obligations secured by such Lessor Notes in accordance with the instrument governing such obligations under the Lease Indenture.

"*Entire Unit 2 Interest*" means the Company's entire 29.1% undivided interest in Unit 2 without taking into account the sale of the Leased Unit 2 Interest or the future sale of any portion of the Remaining Unit 2 Interest.

"*Equity Participant*" means an institution which, in connection with a Sale and Leaseback Transaction, has acquired or will acquire an equity interest in the owner trust which is the owner and Lessor of an undivided interest in Unit 2.

"*Event of Default*" means an Event of Default under the Indenture. (See "DESCRIPTION OF THE BONDS — Events of Default and Notice".)

"*Event of Loss*" means any of the events described as an Event of Loss in each Lease upon the occurrence of which the Company must (subject to certain specified conditions) assume Pledged Lessor Notes or acquire the beneficial interest of the Equity Participant. (See "DESCRIPTION OF THE LEASE INDENTURES — Assumption by the Company".)

"*Excepted Payment*" means any indemnity or other amounts payable to a Lessor or Equity Participant by the Company under the general indemnity or general tax indemnity provisions of the Participation Agreement or under the Tax Indemnification Agreement to which such Equity Participant is a party, any amounts payable by the Company to a Lessor or Equity Participant under the documents relating to the related Sale and Leaseback Transaction to reimburse such Lessor or Equity Participant for performing or complying with any of the obligations of the Lessee under and as permitted by such documents, any insurance proceeds with respect to an Event of Loss in excess of amounts then due and owing in respect of the Pledged Lessor Notes, any insurance proceeds under liability policies, interest on the foregoing and, in certain circumstances, a portion of Casualty Value, Special Casualty Value or Extraordinary Casualty Value which is attributable to amounts due and owing to the Lessor.

"*Extraordinary Casualty Value*" means an amount specified in each Lease which the Lessee must pay to the Lessor under such Lease in certain circumstances which amount is, in general, calculated to preserve the net economic return of the related Equity Participant.

"*Funding Corp.*" means PVNGS Funding Corp., Inc., a Delaware corporation.

"*Indenture*" means the Collateral Trust Indenture among the Company, Funding Corp. and Chemical Bank, as indenture trustee, as supplemented and amended, pursuant to which the Bonds are issued.

"*Initial Sale and Leaseback Transactions*" means the Sale and Leaseback Transactions consummated on August 18, 1986 pursuant to which the Company sold undivided ownership interests in Unit 2 aggregating approximately 8.928% of the total ownership of Unit 2 to two separate Lessors and leased such interests back pursuant to two separate Leases. (See "INTRODUCTION".)

"*Initial Series Lessor Notes*" shall mean the Lessor Notes issued to the Interim Lenders.

"*Interim Lenders*" means the Banks listed on Schedule 1 to each of the Participation Agreements relating to the Initial Sale and Leaseback Transactions.

"*Lease*" means a net lease under which the Company leases an undivided interest in Unit 2 from a Lessor under circumstances in which the rent payable by the Company thereunder will always be at least sufficient to pay the principal of, and premium, if any, and interest on, such Lessor's Lessor Notes.

"Lease Event of Default" shall mean an Event of Default as such term is defined under a Lease.

"Lease Indenture" means a document titled "Trust Indenture, Mortgage, Security Agreement and Assignment of Facility Lease" between a Lessor and the Lease Indenture Trustee, pursuant to which Lessor Notes are issued.

"Lease Indenture Default" means an event or condition under a Lease Indenture which, with the giving of notice or lapse of time, or both, would constitute a Lease Indenture Event of Default.

"Lease Indenture Estate" means the trust estate assigned, transferred and pledged from a Lessor to the Lease Indenture Trustee under its Lease Indenture, for the ratable benefit of the holders of the Lessor Notes issued thereunder.

"Lease Indenture Event of Default" means a Lease Indenture Default which upon the giving of notice or lapse of time, or both, has become an "Event of Default" as defined in a Lease Indenture. (See "DESCRIPTION OF THE LEASE INDENTURES — Events of Default".)

"Lease Indenture Trustee" means, in connection with the Lease Indentures relating to the Initial Sale and Leaseback Transactions, Chemical Bank, as trustee thereunder, and its permitted successors and assigns and, in connection with any other Lease Indentures, the trustee thereunder and its permitted successors and assigns.

"Leased Unit 2 Interest" means the portion of the Entire Unit 2 Interest sold by the Company to the Equity Participants in connection with the Initial Sale and Leaseback Transactions.

"Lessor" means any bank or trust company, acting as owner trustee under a Trust Agreement with an Equity Participant and as Lessor under a Lease and which, in such capacity, has purchased or will purchase an undivided ownership interest in Unit 2 as part of a Sale and Leaseback Transaction, and "Lessors" means all of such Lessors.

"Lessor Notes" means the non-recourse promissory notes issued by a Lessor under its Lease Indenture.

"1934 Act" means the Securities Exchange Act of 1934, as amended.

"NRC" means the Nuclear Regulatory Commission.

"Offered Bonds" means the series of Bonds to which a particular Prospectus Supplement relates.

"Participation Agreement" means an agreement entered into among the Company, an Equity Participant, a Lessor, a Lease Indenture Trustee, and others, which relates to a Sale and Leaseback Transaction.

"Pledged Lessor Notes" means the Lessor Notes which are pledged by Funding Corp. to the Trustee as security for the Bonds. (See "SECURITY AND SOURCE OF PAYMENT FOR THE BONDS".)

"Price-Anderson Act" means the Price-Anderson Act, Pub. L. No. 85-256, 71 Stat. 576 (1957), as amended to August 18, 1986, including amendments to Section 170 of the Atomic Energy Act of 1954, as amended, and to any definition relevant to said Section 170.

"PVNGS" means the Palo Verde Nuclear Generating Station, also known as the Arizona Nuclear Power Project. (See "DESCRIPTION OF THE PALO VERDE NUCLEAR GENERATING STATION".)

"PVNGS Site" means the real property on which PVNGS is located.

"Remaining Unit 2 Interest" means, as of the time of determination thereof, the portion of the Entire Unit 2 Interest in which the Company has retained an ownership interest.

"*Sale and Leaseback Transaction*" means any transaction pursuant to which the Company sells and leases back an interest in Unit 2.

"*Securities*" means debentures, notes or other evidences of indebtedness which may be issued under the Indenture.

"*Securityholder*" means any holder of Securities.

"*Special Casualty Value*" means an amount specified in each Lease which the Lessee must pay to the Lessor under such Lease in certain circumstances, which amount is, in general, calculated to preserve the net economic return of the related Equity Participant.

"*Special Transfer*" shall mean the assignment by the Equity Participant of its beneficial interest in an owner trust to the Company or its assignee upon the Company's inability to assume the Pledged Lessor Notes.

"*Supplemental Financing*" means the issuance of additional Lessor Notes under a Lease Indenture to finance the related Lessor's proportionate share of capital improvements to Unit 2.

"*Supplemental Indenture*" means a supplemental indenture to the Indenture.

"*Trustee*" means Chemical Bank, trustee under the Indenture.

"*Unit 2*" means Unit 2 of PVNGS.

"*Unit 2 License*" means the facility operating license granted by the NRC for Unit 2.

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No person has been authorized to give any information or to make any representations in connection with this offering other than those contained in the Prospectus or the accompanying Prospectus Supplement, and, if given or made, such information and representations must not be relied upon as having been authorized by the Company or the Underwriters. Neither the delivery of this Prospectus nor any sale made hereunder shall, under any circumstances, create any implication that there has been no change in the affairs of the Company since the date hereof or that the information contained herein is correct as of anytime subsequent to its date. Neither this Prospectus nor the accompanying Prospectus Supplement constitutes an offer to sell or a solicitation of an offer to buy any securities other than the registered securities to which it relates. Neither this Prospectus nor the accompanying Prospectus Supplement constitutes an offer to sell or a solicitation of an offer to buy such securities in any circumstances in which such offer or solicitation is unlawful.

ARIZONA PUBLIC SERVICE COMPANY

SECURED LEASE OBLIGATION BONDS

APS.

PROSPECTUS

The First Boston Corporation

Kidder, Peabody & Co.
Incorporated

Salomon Brothers Inc

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D. C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13

OF THE

SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 1985 Commission file number 1-6368

FORD MOTOR CREDIT COMPANY

(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	38-1612444 (I.R.S. Employer Identification No.)
The American Road, Dearborn, Michigan (Address of principal executive offices)	48121 (Zip Code)

Registrant's telephone number, including area code: 313-322-3000

Securities registered pursuant to Section 12(b) of the Act: (See inside front cover)

As of February 28, 1986, the registrant had outstanding 250,000 shares of Common Stock.

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ✓ No ____

The registrant meets the conditions set forth in General Instruction J(1)(a) and (b) of Form 10-K and is therefore filing this Form with the reduced disclosure format.

Securities registered pursuant to Section 12(b) of the Act as of December 31, 1985:

Title of each class	Name of each exchange on which registered
8⅞% Notes due January 15, 1986	New York Stock Exchange
8⅝% Notes due June 1, 1986	
7.85% Notes due March 1, 1988	
8½% Notes due May 1, 1988	
8¼% Subordinated Notes due November 1, 1988	
9.55% Subordinated Notes due January 15, 1989	
7⅞% Subordinated Notes due July 1, 1989	
8⅞% Debentures due April 15, 1990	
8⅞% Subordinated Notes due August 15, 1990	
8⅞% Debentures due November 1, 1990	
8½% Subordinated Debentures due March 15, 1991	
7½% Debentures due November 15, 1991	
7½% Debentures due October 15, 1992	
7½% Debentures due May 1, 1993	
7⅞% Debentures due July 15, 1993	
10½% Debentures due October 1, 1994	
9½% Debentures due January 15, 1995	
4½% Convertible Subordinated Debentures due November 15, 1996	
4⅞% Convertible Subordinated Debentures due July 15, 1998	
8.70% Debentures due April 1, 1999	
9.70% Debentures due July 15, 2000	
9¾% Debentures due January 15, 2001	
9⅛% Debentures due June 1, 2001	
8⅜% Debentures due November 1, 2001	
8⅜% Debentures due December 1, 2002	
8½% Subordinated Debentures due December 1, 2002	

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* Not required under General Instruction J to Form 10-K.
** None to report.

PART I

ITEM 1. BUSINESS

The registrant, Ford Motor Credit Company, was incorporated in Delaware in 1959 and is a wholly owned unconsolidated subsidiary of Ford Motor Company ("Ford" or the "Company"). As used herein "Ford Credit" refers to Ford Motor Credit Company and its subsidiaries unless the context otherwise requires. Based on receivables outstanding, Ford Credit believes it is the second largest finance company in the world.

Ford Credit's financial services business is conducted in two operations—financing operations and insurance operations.

In its financing operations, Ford Credit provides wholesale financing and capital loans to franchised Ford vehicle dealers and purchases retail installment sale contracts and retail leases from them. Ford Credit also makes loans to vehicle leasing companies, the majority of which are affiliated with such dealers. Vehicle financing accounted for 97.9% of the dollar volume of financing done by Ford Credit in 1985 and 98.4% in 1984. Substantially all new vehicles financed by Ford Credit, consisting of cars, trucks, and tractors (including farm and industrial equipment), are manufactured by Ford or its subsidiaries. Ford Credit also finances at retail used vehicles built by Ford and other manufacturers, which accounted for 5.4% of the dollar volume of vehicle financing done by Ford Credit in 1985 and 5.9% in 1984. In addition to vehicle financing, Ford Credit offers diversified financing services, makes loans to affiliates of Ford, finances certain receivables of Ford and its subsidiaries, and engages in direct consumer loan operations.

In 1985 and 1984, United States operations, conducted in all 50 states, the District of Columbia and Puerto Rico, accounted for 92.5% and 92.8%, respectively, of the dollar volume of Ford Credit's financing business; Canadian operations accounted for 5.4% and 5%, respectively, of such volume in these periods. The balance primarily was in Australia. Vehicle financing operations in other foreign countries are conducted primarily by subsidiaries of Ford other than Ford Credit.

In its insurance operations, Ford Credit, through its wholly owned subsidiary, The American Road Insurance Company ("American Road") and its subsidiaries, issues liability insurance for Extended Service Plan contracts primarily originating from Ford vehicle dealers, credit life and credit disability insurance on retail purchasers of vehicles and equipment financed by Ford Credit and others and on consumer loan customers, and physical damage insurance principally covering vehicles and equipment financed by Ford Credit.

The business of Ford Credit is substantially dependent upon Ford Motor Company. See "Vehicle Financing" and "Borrowings and Other Sources of Funds" under the caption "Financing Operations". Also see Item 7—"Management's Discussion and Analysis of Financial Condition and Results of Operations". Any protracted reduction or suspension of Ford's production or sale of vehicles, resulting from a decline in demand, a work stoppage, governmental action, adverse publicity, or other event, could have a substantial adverse effect on Ford Credit. For additional information concerning Ford's results and operations, see Ford Motor Company's Annual Report on Form 10-K for the year ended December 31, 1985 filed with the Securities and Exchange Commission.

The mailing address of Ford Credit's executive offices is The American Road, Dearborn, Michigan 48121. The telephone number of such offices is (313) 322-3000.

SEGMENT INFORMATION

Segment information called for by Item 1 is set forth in Note 2 of Notes to Financial Statements at page FC-6 and is incorporated herein by reference.

FINANCING OPERATIONS

General

Ford Credit accounts for its financing business in four categories—retail (which consists of installment sale financing and lease financing), wholesale, diversified, and other. Total finance receivables outstanding in these four categories were as follows at the end of the years indicated:

	December 31				
	1985	1984	1983	1982	1981
			(in millions)		
Retail	$27,167.8	$18,713.5	$14,464.4	$12,007.1	$13,375.7
Wholesale	5,604.3	6,021.6	4,817.0	3,829.1	4,050.9
Diversified	1,113.1	704.9	704.3	829.5	1,110.3
Other	1,298.7	1,119.8	970.2	919.6	989.8
Total	$35,183.9	$26,559.8	$20,955.9	$17,585.3	$19,526.7

Vehicle Financing

Retail. Retail financing consists primarily of installment sale financing and lease financing of vehicles provided to franchised Ford vehicle dealers. The number of retail and lease vehicles financed by Ford Credit was as follows during the years indicated:

	Years Ended December 31				
	1985	1984	1983	1982	1981
			(in thousands)		
New	1,435	882	858	639	705
Used	325	320	294	335	394
Total	1,760	1,202	1,152	974	1,099

The levels of Ford Credit's retail financing volume and receivables are dependent on several factors, including vehicle sales, Ford Credit's retail market share, the average contract repayment obligation, and the amount of used car financing. See "Competition in Vehicle Financing". In addition, receivables levels will fluctuate depending on receivables sales, including the use of sale-of-receivables facilities. See "Borrowings and Other Sources of Funds".

Installment sale financing consists principally of purchasing and servicing installment sale contracts covering sales of new and used vehicles by franchised Ford vehicle dealers to retail customers. The purchase price paid by Ford Credit to the dealer generally is the total contract balance less the finance charge. A portion of the finance charge is paid or credited to the dealer. Ford Credit requires a retail customer to carry fire, theft, and collision insurance on the vehicle. For 1985 in the U.S., the average installment sale contract repayment obligation for new vehicles was $12,540. The corresponding monthly payment was $235 and the average original term was 51 months.

Various degrees of recourse to the dealer, in the event of a customer default, are available to Ford Credit under its installment sale financing plans. Of the dollar amount of retail installment sale contracts purchased by Ford Credit in 1985, approximately 29% provided for some recourse to the dealer. The dealer generally is obligated under these recourse plans for payment of the unpaid principal balance of a defaulted contract, unless Ford Credit fails to repossess the vehicle and deliver it to the dealer within 90 days after default. As a practical matter, Ford Credit's ability to collect on any such obligation depends to some extent on the financial condition of the dealer concerned. The dealer's obligation under these recourse plans applicable to cars and light trucks generally terminates after the first 24 monthly payments

are made under the contracts. These plans generally also provide for the dealer to maintain a reserve with Ford Credit to assist in protecting Ford Credit in the event the dealer fails to discharge its obligations to Ford Credit. At its option, the dealer may elect to limit its recourse liability to the amount of the reserve, provided that, at the time of its election, the amount of the reserve held by Ford Credit equals or is increased to an agreed percentage of the unpaid balance of outstanding contracts.

Lease financing consists principally of purchasing and servicing retail lease contracts covering vehicles leased to individuals by franchised Ford vehicle dealers and making loans to car and truck leasing companies, most of which are affiliated with franchised Ford vehicle dealers. Ford Credit's lease finance receivables (which are included in the retail receivables category) and the number of vehicles financed were as follows for the years indicated:

	Years Ended December 31		
	1985	1984	1983
		(In millions)	
Finance Receivables			
Red Carpet Lease	$5,331.9	$3,445.3	$1,349.8
Other	1,617.5	1,451.9	1,532.3
Total	$6,949.4	$4,897.2	$2,882.1
Vehicles			
Red Carpet Lease	440,000	281,000	120,000
Other	156,000	173,000	156,000
Total	596,000	454,000	276,000

In the U.S. and Canada, retail lease contracts are purchased by Ford Credit under its Red Carpet Lease Plan. The average monthly payment and the average original term of U.S. retail lease receivables purchased by Ford Credit in 1985 was $246 and 46 months. This business could be affected adversely if certain proposed tax legislation is enacted. It is uncertain when Congress will complete consideration of the proposed legislation, what changes may be made in it, or whether it will finally be adopted. Hence, the exact effect on Ford Credit cannot be predicted.

The average original term of the lease financing extended to leasing companies by Ford Credit in 1985 was 33 months for cars and light trucks and 51 months for medium and heavy trucks. Financing charges in connection with such lease financing generally are based on short-term interest rates in effect at the time the financing is extended. These rates generally are supplemented by payments from Ford whenever the rate payable by the borrower is less than the specified minimum rate agreed upon between Ford Credit and Ford. At December 31, 1985, 19 leasing companies each accounted for more than $10 million of such receivables, two of which accounted for $84.9 million and $77.6 million of such receivables, respectively.

Wholesale. Wholesale financing consists principally of loans, under approved lines of credit, to dealers to assist them in carrying inventories of new Ford-built vehicles. Ford Credit generally finances 100% of the wholesale price of cars and trucks and 95% of tractor and equipment wholesale prices. Vehicles are insured against fire, theft, and other risks under policies issued to Ford Credit by American Road. Ford Credit's United States car and truck wholesale receivables that liquidated in 1985 and 1984 were outstanding an average of 64 days and 60 days, respectively. Ford Credit also makes capital loans to franchised Ford vehicle dealers for facilities expansion and working capital and to enable them to purchase dealership real estate previously leased from an affiliate of Ford Credit. Such loans totaled $200.6 million at December 31, 1985.

The levels of Ford Credit's wholesale financing volume and receivables are dependent on several factors, including sales by Ford to dealers, the level of dealer inventories, Ford Credit's wholesale market share, and vehicle prices.

Competition in Vehicle Financing. The vehicle financing field is highly competitive, particularly in the case of retail financing. Ford Credit's principal competitors for retail installment sale financing have been banks and credit unions. Banks and other leasing companies are Ford Credit's principal competitors for lease financing and wholesale financing.

Ford Credit financed the following percentages of new Ford-built cars and trucks sold at retail and wholesale in the United States during each of the years indicated:

	Years Ended December 31				
	1985	1984	1983	1982	1981
Retail*	38.7%	24.8%	30.7%	26.8%	27.8%
Wholesale	64.6	65.8	66.8	67.6	67.2

* As a percentage of total sales, including cash sales

The increase in retail market share in 1985, compared with 1984, resulted from special-rate financing programs sponsored by Ford. Ford provides interest supplements to Ford Credit for vehicles financed by Ford Credit under these programs. The decrease in retail market share in 1984, compared with 1983, resulted from the absence of special-rate financing programs that were offered in 1983 and from increased competition from other consumer financing sources. The increase in retail market share in 1983, compared with 1982, resulted primarily from special-rate financing programs, partially offset by increased competition from other consumer financing sources in the latter part of 1983. See "Financing Volume".

Diversified Financing

Diversified financing receivables consist primarily of privately negotiated investments in preferred stock, leases of and loans secured by transportation equipment, energy related equipment and other equipment, and real estate loans secured by first and junior mortgages on improved property. Most of Ford Credit's diversified financing receivables represent transactions in an original amount in excess of $1 million each. Because of the relatively large size of individual diversified financing transactions, any individual loss arising out of such transactions could be substantial. Ford Credit's diversified financing receivables generally are intermediate-term; at December 31, 1985 approximately 70.6% of the outstanding receivables were scheduled to mature within five years. In its diversified financing, Ford Credit competes with banks, insurance companies, other finance companies, and others.

At December 31, 1985, outstanding diversified financing receivables totaled $1,113.1 million, compared with $704.9 million at December 31, 1984 and $704.3 million at December 31, 1983, representing 3.2%, 2.7% and 3.4%, respectively, of Ford Credit's total finance receivables outstanding at those dates. The increase in diversified financing receivables at year-end 1985 reflects higher levels of such financing in 1985.

Other Financing Activities

Ford Credit began making direct consumer loans in 1966; at December 31, 1985, Ford Credit had 81 consumer loan offices in 25 states and the Province of Ontario and held aggregate consumer loan receivables of $351.4 million. In making consumer loans, Ford Credit competes with banks, other finance companies, credit unions, and other consumer loan companies, and is not a significant factor in the field.

From time to time, Ford Credit purchases accounts receivable of certain divisions and affiliates of Ford. The amount of such receivables as of the end of each month during 1985 fluctuated between $603.6 million and $792.1 million. At December 31, 1985, such receivables totaled $792.1 million, all of which represents accounts receivable purchased by Ford Credit from Ford pursuant to agreements under which Ford Credit may purchase such receivables. In addition to the foregoing receivables, Ford Credit held $155.2 million of other finance receivables at December 31, 1985.

Financing Volume

Finance receivables acquired by Ford Credit (financing volume) were as follows during the years indicated:

	Years Ended December 31				
	1985	1984	1983	1982	1981
			(in millions)		
Retail	$21,330.7	$13,806.1	$11,639.1	$ 9,200.7	$ 9,503.2
Wholesale	27,932.2	27,395.9	21,397.9	16,005.9	15,358.9
Diversified	531.5	201.3	105.4	52.2	242.5
Other	923.8	890.4	767.4	702.5	820.2
Total	$50,718.2	$42,293.7	$33,909.8	$25,961.3	$25,924.8

Credit Loss Experience

The following table sets forth information concerning Ford Credit's credit loss experience with respect to the various categories of its finance receivables during the years indicated:

	Years Ended December 31				
	1985	1984	1983	1982	1981
			(dollar amounts in millions)		
Net losses					
Retail	$180.2	$ 78.4	$ 53.0	$ 61.2	$ 56.8
Wholesale	1.4	(1.2)	2.7	6.1	4.5
Diversified	12.2	15.5	11.3	4.9	3.5
Other	2.4	1.6	2.0	2.2	3.1
Total	$196.2	$ 94.3	$ 69.0	$ 74.4	$ 67.9
Net losses as a percent of liquidations					
Retail	1.49%	0.80%	0.59%	0.71%	0.73%
Total finance receivables	0.48	0.26	0.23	0.29	0.28
Net losses as a percent of average receivables					
Retail	0.79%	0.47%	0.40%	0.51%	0.45%
Total finance receivables	0.64	0.40	0.36	0.41	0.36
Provision for credit losses	$371.7	$178.2	$117.0	$ 81.7	$ 78.8
Allowance for credit losses	470.6	354.5	260.4	236.9	264.4
As percent of net receivables	1.53%	1.51%	1.39%	1.52%	1.53%

Allowances for estimated credit losses are established by direct charges (provision for credit losses) to expense at the time that retail installment sales contracts and retail leases are purchased; for other receivables, such allowances are established as required. The provision for credit losses generally varies with changes in the level of finance receivables. During periods of rapid growth in the level of finance receivables, such as during periods in which special-rate financing programs are offered, the provision for credit losses may increase substantially as shown, for example, in the table with respect to 1985. Ford Credit's retail loss experience is dependent upon the number of repossessions, the amount outstanding at the time of repossession, and the resale value of repossessed vehicles. In addition, the amount of retail credit losses varies depending on receivables levels. Wholesale losses generally reflect the financial condition of dealers. For additional information regarding credit losses, see Notes 1 and 6 of Notes to Financial Statements at pages FC-5 and FC-9, respectively.

Security

Ford Credit generally holds security interests in the vehicles which it finances to the extent that it is practical to do so, and generally is able to repossess a vehicle in the event of a default. The right to

repossess under a security interest securing wholesale obligations generally is ineffectual, as a matter of law, against a retail buyer of a vehicle from a dealer. Under a wholesale installment sale plan introduced by Ford and Ford Credit in 1984, dealers are permitted to delay payment of up to 10% of a vehicle's financed balance for up to 60 days after the dealer sells the vehicle. A portion of such delayed payments may, under certain circumstances, be unsecured. Lease financing is secured to the extent practicable by assignments of rentals under the related leases and, in almost all instances, by liens on the vehicles (which liens are not perfected against third parties in some cases). Diversified financing receivables generally are secured by liens on personal property or real estate.

Borrowings and Other Sources of Funds

Ford Credit relies heavily on its ability to raise substantial amounts of funds. These funds are obtained primarily by sales of commercial paper, issuance of term debt, and sales of receivables. Funds also are provided by retained earnings. The level of funds can be affected by certain transactions with Ford, such as capital contributions, the timing of payments for the financing of dealers' wholesale inventories and for income taxes, and dividend payments to Ford. Ford Credit's ability to obtain funds is affected by its debt ratings, which are closely related to the outlook for Ford, and the nature and availability of other financing facilities, such as revolving credit and receivables sales agreements. In addition, Ford Credit has developed the ability to sell receivables to other financial institutions by a competitive bid process. For additional information regarding Ford Credit's association with Ford, see "Certain Transactions with Ford and Affiliates".

Ford Credit's outstanding debt at the end of each of the last five years was as follows:

	December 31				
	1985	1984	1983	1982	1981
			(in millions)		
Commercial paper and STBAs(a)	$11,447	$ 8,896	$ 6,018	$ 4,031	$ 6,256(b)
Bank borrowings	8	39	86	742	1,031
Other short-term debt	766	1,468	1,491	1,374	277
Long-term debt (including current portion)	13,687	9,809	8,040	6,926	7,421(c)
Total debt	$25,908	$20,212	$15,635	$13,073	$14,985
Memo:					
Total support facilities (billions)	$9.2(d)	$9.1	$9.4	$8.6	$7.2
Use of sale of receivables facilities (billions)	0.2	0.7	1.3	1.4	0

(a) Borrowing agreements with bank trust departments
(b) Includes $500 million of commercial paper held by Ford at December 31, 1981
(c) Includes $400 million of bank borrowings classified as long-term debt
(d) As of January 1, 1986

In 1981 and 1982, Ford Credit's outstanding commercial paper and STBAs declined as a result of reductions in its debt ratings. This decline was more than offset by an increase in other publicly-offered, short-term notes and by proceeds from the sales of receivables. The reduction in debt ratings also resulted in an increase in Ford Credit's relative funding costs. During the 1983-1985 period, Ford Credit's debt ratings were raised, its relative funding costs improved signficantly and its funding sources and liquidity increased substantially. The long-term debt ratings of Ford and Ford Credit and the commercial paper ratings of Ford Credit as of December 31, 1985, were as follows:

	Ford and Ford Credit Long-Term Senior Debt	Ford Credit Commercial Paper
Moody's Investors Service	A1	Prime-1
Standard & Poor's Corporation	A	A-1
Fitch Investors Service	A+	F-1

Support facilities, which totaled $9.2 billion at January 1, 1986, represent additional sources of funds, if required. At that date, Ford Credit had $8.7 billion of these facilities for use in the United States, all of which were contractually committed. These facilities include approximately $5 billion of revolving credit agreements with banks (which are available at least through June 1990 and which include $1.8 billion of Ford bank lines that may be used by Ford or Ford Credit at Ford's option) and $3.7 billion of agreements to sell retail receivables ($3.3 billion of which expire in June 1990). In 1985, essentially all U.S. facilities were restructured and at January 1, 1986 had a contractual average term of 4.4 years, up from 3.3 years in 1984 and 1.5 years in 1983. At January 1, 1986, approximately $8.5 billion of these U.S. facilities were unused and available to support outstanding commercial paper and to finance growth in receivables. Outside the United States, Ford Credit had $450 million of credit facilities to support borrowing operations in Canada and Australia. Effective April 1, 1986, Ford Credit will have additional revolving credit agreements for use in the United States with various banks totaling approximately $1.4 billion available through March 1991.

INSURANCE OPERATIONS

Insurance operations are conducted through American Road and its principal subsidiaries, Ford Life Insurance Company ("Ford Life"), Vista Life Insurance Company ("Vista Life"), and Vista Life Insurance Company of Texas ("Vista Life of Texas"). Premiums written on policies issued by American Road and its subsidiaries were as follows during the years indicated:

	1985	1984	1983	1982	1981
			(in millions)		
Extended Service Plan	$144.8	$ —	$ —	$ —	$ —
Credit life and disability	116.3	84.0	70.7	57.7	77.0
Physical damage	60.2	48.7	38.3	40.5	49.7
Total	$321.3	$132.7	$109.0	$ 98.2	$126.7

The operations of American Road consist principally of the issuance of liability insurance relating to Extended Service Plan contracts sold by franchised Ford vehicle dealers and issuing and servicing physical damage insurance policies on vehicles and equipment financed primarily at wholesale by Ford Credit. In 1985, American Road, together with Ford, established the Extended Service Plan as an insurance product. Since 1975, American Road has written physical damage insurance on substantially all of the new cars and trucks financed at wholesale by Ford Credit in the United States and Canada. American Road wrote such insurance on less than 1% of the cars and trucks financed for retail customers by Ford Credit during the past three years. Ford Life, Vista Life, and Vista Life of Texas primarily write group credit life insurance and credit disability insurance on purchasers of vehicles and equipment financed at retail by Ford Credit and others and on consumer loan customers.

The insurance industry is highly regulated by the states with respect to premium rates, policy terms, investments, and many other aspects of the insurance business. American Road competes with many insurance companies and is not a significant factor in car and truck insurance underwriting. The principal competitors of Ford Life, Vista Life, and Vista Life of Texas are life insurance companies that specialize in credit life and credit disability insurance.

EMPLOYEE RELATIONS

At December 31, 1985, Ford Credit and its subsidiaries had 6,061 employees. All such employees are salaried, and none is represented by a union. Ford Credit considers its employee relations to be satisfactory.

GOVERNMENTAL REGULATIONS

Various aspects of Ford Credit's financing operations are regulated under both Federal and state law. Various states require licenses to conduct retail financing and to make consumer loans. Interest rates generally are limited by state law and, in periods of high interest rates, these limitations can have a substantial adverse effect on operations in certain states if Ford Credit is unable to pass on its increased interest costs to its customers.

During the past several years, legislative, judicial, and administrative authorities have evidenced a growing concern for the protection of the interests of consumers, especially in connection with consumer financing transactions. As a result, significant changes have been made in the methods by which Ford Credit and the financing industry conduct business, and many proposals have been made which would require further changes. None of the changes to date has had a substantial adverse effect on the operations of Ford Credit.

CERTAIN TRANSACTIONS WITH FORD AND AFFILIATES

Ford and its affiliates have taken actions from time to time resulting in the improvement of Ford Credit's income on an interim basis, particularly during periods of sharply rising interest rates. In this connection, Ford has made interest-free loans and contributions to capital and has taken other actions intended to reimburse Ford Credit for services provided for Ford's benefit such as continuing to make available financing accommodations to franchised Ford vehicle dealers and their retail customers.

For additional information, see Note 10 of Notes to Financial Statements on page FC-12, "Financing Operations—Other Financing Activities", "Financing Operations—Credit Loss Experience", "Financing Operations—Borrowings and Other Sources of Funds" and Item 6— "Selected Financial Data—Selected Income Statement Data".

SELECTED FINANCIAL DATA OF FORD

The following table sets forth selected financial data concerning Ford:

	Years Ended December 31				
	1985	1984	1983	1982	1981
	(in millions except a share amounts)				
Sales	$52,774	$52,366	$44,455	$37,067	$38,247
Operating income (loss)	2,730	3,422	1,804	(484)	(1,256)
Before-tax income (loss)	3,630	4,283	2,166	(408)	(1,138)
Net income (loss)	2,515	2,907	1,867	(658)	(1,060)
Net income (loss) a share	13.63	15.79	10.29	(3.64)	(5.87)
Net income a share assuming full dilution	13.22	14.92	9.64	—	—

FINANCIAL REVIEW OF FORD MOTOR COMPANY RESULTS

Ford's net income for 1985 totaled $2.5 billion or $13.63 a share—the second highest in Ford's history, exceeded only by net income of $2.9 billion or $15.79 a share in 1984.

Ford's capital expenditures for new and improved products and continued quality and productivity improvement were a record $3.7 billion in 1985. Ford also acquired First Nationwide Financial Corporation for $493 million and it purchased $449 million of Ford common stock. Further, cash dividends paid to stockholders during the year totaled $443 million—including a record 70¢ a share for the Fourth Quarter. Despite these actions, cash balances at year-end 1985 were $5.9 billion, about the same as

at year-end 1984. Total debt at the end of 1985 was reduced to $3.4 billion; at the same time, stockholders' equity increased to a record $12.3 billion. As a result, Ford's debt-to-equity ratio was reduced to 28%. (For a more complete discussion, see the section on "Liquidity and Capital Resources" that follows.)

Results of Operations

1985 Compared with 1984

Worldwide net income was $2,515 million in 1985, down $392 million or 13% from 1984. Dollar sales were $52.8 billion, an increase of $400 million or 1% from 1984. Factory unit sales of cars, trucks and tractors in 1985 were 5,634,000, down 33,000 units from 1984.

In the United States, net income was $1,988 million, compared with $2,391 million in 1984. Sales incentive programs and costs associated with new-model introductions more than accounted for the decline and were especially important during the latter part of the year. Manufacturing efficiencies provided a partial off-set, reflecting Ford's ongoing commitment to improve operating efficiency. Ford achieved a U.S. car market share of 19% in 1985, two-tenths of a point lower than in 1984, despite production losses from the changeover for the Taurus and Sable and an increased market share for Japanese producers. U.S. car industry sales in 1985 were 11 million units, compared with 10.3 million units in 1984; U.S. truck industry sales were a record 4.7 million units, compared with 4.2 million units in 1984.

Outside the United States, net income was $527 million, up $11 million from 1984. The improvement was more than accounted for by substantially higher earnings in Europe, reflecting primarily cost reductions and higher sales of more profitable vehicles and options. Earnings were lower in Canada, reflecting higher taxes, increased marketing costs, and unfavorable foreign exchange movements.

Worldwide net interest income was $303 million in 1985, compared with $382 million in 1984. The decrease reflected primarily lower interest rates on Ford's short-term investment portfolios.

Equity in net income of unconsolidated subsidiaries and affiliates was $598 million in 1985, $119 million higher than in 1984. The improvement was more than accounted for by the higher earnings of Ford Credit.

The provision for income taxes was $1,103 million in 1985, compared with $1,329 million in 1984. The reduction in taxes reflected primarily the effect of lower pre-tax profit.

1984 Compared with 1983

Worldwide net income was $2,907 million in 1984, an improvement of $1,040 million or 56% from 1983. Dollar sales were $52.4 billion, an increase of 18% from 1983. The increase in dollar sales was largely a result of higher unit sales and an increased mix of higher priced vehicles. Factory unit sales of cars, trucks and tractors in 1984 were 5,667,000, up 13% from 1983.

In the United States, net income was $2,391 million, compared with $1,516 million in 1983. The improvement reflected principally higher industry sales volumes, a higher car market share, and continued productivity improvements. Partial offsets to the improvements were higher costs for labor and materials (in excess of pricing) and higher product costs.

Ford's 1984 U.S. car market share improved to 19.2%—a two percentage point increase from 1983 and Ford's highest share of the U.S. car market since 1979. U.S. car industry sales in 1984 were 10.3 million units, up 1.2 million units from 1983; U.S. truck industry sales were 4.2 million units, compared with 3.2 million units in 1983.

Outside the United States, net income was $516 million, compared with $351 million in 1983. The improvement was more than accounted for by higher earnings in Canada and the Asia-Pacific region, reflecting primarily higher industry sales and continued productivity improvements and reduced losses in

Latin America. In Europe, profits declined in 1984, even though Ford was the car sales leader in that market for the first time. The decline in profits in Europe reflected primarily higher marketing costs and a less profitable mix of vehicle sales. Europe also was affected adversely by foreign-currency exchange-rate changes and the impact of labor interruptions.

Worldwide net interest income was $382 million in 1984, compared with $2 million in 1983. This improvement resulted mainly from higher levels of cash items and marketable securities in 1984.

Equity in net income of unconsolidated subsidiaries and affiliates was $479 million in 1984, an improvement of $118 million from 1983. This improvement was primarily a result of higher earnings of Ford's worldwide finance, insurance and real estate operations.

The provision for income taxes in 1984 was $1,329 million, an increase of $1,059 million from 1983, reflecting primarily higher earnings in the United States. In each of these years, investment tax credits, some of which were carried forward from prior years, reduced income taxes on earnings in the United States. At the end of 1984, these credits had been used fully.

Liquidity and Capital Resources

Despite capital expenditures of $3.7 billion during 1985, the acquisition of First Nationwide Financial Corporation for $493 million, the purchase of Ford common stock for $449 million, and cash dividends of $443 million, Ford's cash and marketable securities of $5.9 billion at December 31, 1985, were down only $39 million from December 31, 1984. Working capital (current assets less current liabilities) was $1.2 billion at year-end 1985, $126 million lower than last year. Total debt, at $3,432 million, was $27 million lower than at December 31, 1984, and stockholders' equity, at $12.3 billion, increased by $2.4 billion during the year. Total debt was equal to 28% of stockholders' equity at year-end 1985, compared with 35% a year earlier.

Historically, Ford's principal method of financing capital expenditures has been with funds provided by operations. In 1984 and 1985, funds provided by operations totaled $12.1 billion, reflecting improved operating results. The funds provided by operations enabled Ford to meet capital expenditure requirements of $7.3 billion, to increase cash and marketable securities balances by $2.8 billion, and to reduce debt by $223 million. These funds also have enabled Ford to acquire First Nationwide Financial Corporation and improve the value of the stockholders' investment through purchases of Ford's common stock.

At December 31, 1985, Ford had long-term credit agreements in the United States under which approximately $2.6 billion was available from various banks. Effective January 1, 1986, these facilities were terminated and replaced by agreements under which $3 billion is available from various banks at least through June 30, 1990. Of this amount, $1.8 billion may be used, at Ford's option, by either Ford or Ford Credit. These credit-line facilities were not utilized in 1985.

BUSINESS OF FORD

General

Ford was incorporated in Delaware in 1919 and acquired the business of a Michigan company, also known as Ford Motor Company, incorporated in 1903 to produce automobiles designed and engineered by Henry Ford.

Manufacture, assembly and sale of cars and trucks, and related parts and accessories, constitute the principal business of Ford and its consolidated subsidiaries, and accounted for 93% of sales in 1985, 93% in 1984 and 92% in 1983.

In the United States, Ford markets cars and trucks in various price classes and body styles. Ford also assembles and sells farm and industrial tractors and markets related farm, industrial and construction equipment.

Outside the United States, cars and trucks are manufactured or assembled by subsidiaries of Ford in Germany, Great Britain, Canada, Spain, Brazil, Australia, Argentina, Mexico and certain other countries. Tractors and construction equipment parts and components are manufactured in Great Britain, Belgium, Brazil and France for assembly in these and certain other countries. The automotive and tractor and equipment products of Ford and its subsidiaries are sold in most of the markets of the free world.

Estimated 1985 market shares of total worldwide retail sales of cars and trucks of Ford and its major competitors were: General Motors, 21.5%; Ford, 14.2%; Toyota, 9.4%; Nissan, 7.1%; Volkswagen, 5.7%; Chrysler, 5.4%; Renault, 4.5%; Fiat, 3.9%; Peugeot-Citroen, 3.7%; and all other, 24.6%.

Ford and its consolidated subsidiaries comprise a vertically integrated business consisting primarily of the manufacture, assembly and sale of cars and trucks and related parts and accessories.

Factory unit sales of cars and trucks since 1981 for Ford and its consolidated subsidiaries are shown in the following table (in thousands):

	Years Ended December 31									
	1985		1984		1983		1982		1981	
	Units	Pct.	Units	Pct.	Units	Pct.	Units	Pct.	Units	Pct.
Cars										
United States	1,941	35%	2,048	37%	1,672	34%	1,271	30%	1,385	32%
Outside United States	1,927	35	1,910	34	1,919	39	1,798	42	1,807	42
Total Cars	3,868	70%	3,958	71%	3,591	73%	3,069	72%	3,192	74%
Trucks(1)(2)										
United States	1,260	23%	1,239	22%	994	20%	803	19%	717	17%
Outside United States	423	7	388	7	349	7	396	9	404	9
Total Trucks	1,683	30%	1,627	29%	1,343	27%	1,199	28%	1,121	26%
Total Cars and Trucks										
United States	3,201	58%	3,287	59%	2,666	54%	2,074	49%	2,102	49%
Outside United States	2,350	42	2,298	41	2,268	46	2,194	51	2,211	51
Total Cars and Trucks	5,551	100%	5,585	100%	4,934	100%	4,267	100%	4,313	100%

(1) Includes buses

(2) Light trucks (generally those having a gross vehicle weight of 14,000 pounds or less) accounted for about 95% of total truck unit sales in 1985, about 95% in 1984, about 94% in 1983, about 93% in 1982, about 90% in 1981.

In 1985, 1984, 1983, 1982 and 1981, cars accounted for 63%, 65%, 68%, 67% and 69%, respectively, of consolidated car and truck sales revenue and trucks accounted for 37%, 35%, 32%, 33% and 31%, respectively.

In recent years, and continuing into the present, the automotive industry worldwide has been significantly affected by a number of factors over which the industry has had little control. One factor has been the substantial amount of government regulation. In the United States, government regulation has arisen primarily out of concern for the environment, for greater vehicle safety and for improved fuel economy. Many governments also regulate local content and impose export requirements as a means of creating jobs, protecting domestic producers or reducing balance of payments deficits.

Shortages of materials and components used by Ford occur from time to time and may affect production of certain model vehicles. Raw and semifinished materials, supplies and parts are purchased from a great many suppliers, many of whom employ special tools owned by Ford. Ford currently relies entirely on purchases from one or a limited number of suppliers for certain materials and a substantial number of major components.

Substantially all of Ford's products are marketed through retail dealers, most of which are privately owned and financed. At December 31, 1985, Ford had approximately 13,240 dealers worldwide, including approximately 6,770 dealers in the United States.

Automotive Operations in the United States

The United States automotive industry (including sales in the United States by foreign manufacturers) is highly competitive and is characterized by a wide variety of product offerings. It has been the practice in the industry to introduce some new models almost every year, usually requiring costly changes in design and engineering, for which substantial financial and other commitments must be made far in advance of production. Consumer demand is influenced by quality, price, styling, safety, reliability, economy and utility. A manufacturer's ability to satisfy changing consumer preferences with respect to type or size of vehicle and fuel economy can affect sales and earnings significantly.

Unit sales of Ford vehicles vary with the level of total industry demand and Ford's share of the industry. The level of industry demand is dependent to a large extent on general economic conditions, the cost of purchasing and operating cars and trucks, the availability and cost of credit, and the availability and cost of gasoline, and reflects the fact that cars and trucks are durable items, the replacement of which can be postponed. Within the constraints of Ford's and competitors' production capacities, Ford's market shares generally reflect the degree of consumer acceptance of its products relative to those produced by its competitors.

In 1985, U.S. industry retail deliveries of cars were 11.0 million units, 6% above the level of 1984. U.S. industry retail deliveries of trucks in 1985 were 4.7 million units, 14% above the level of 1984. Ford's retail car deliveries in 1985 were 5% above its deliveries in 1984. Ford's retail truck deliveries in 1985 were 9% above the level of 1984.

The profitability of vehicle sales is affected by many factors, including changes in unit sales volume, the mix of vehicles and options sold, and the ability of Ford to achieve cost efficiencies and to recover cost increases through higher pricing. Further, because the automotive industry is capital intensive, it operates from a relatively high fixed-cost base which can result in large changes in earnings with relatively small changes in unit volume.

The following tables show changes in car and truck market shares of United States and foreign manufacturers for the years indicated.

	U.S. Car Market Shares*				
	Years Ended December 31				
	1985	1984	1983	1982	1981
U.S. Manufacturers (Including Imports)					
General Motors	42.7%	44.5%	44.3%	44.2%	44.6%
Ford	19.0	19.2	17.2	16.9	16.6
Chrysler	11.4	10.4	10.3	10.0	9.9
American Motors	1.2	2.0	2.5	1.9	2.0
Total U.S. Manufacturers	74.3	76.1	74.3	73.0	73.1
Imports by Foreign Companies**					
Japanese	19.7	18.3	20.2	21.2	20.4
All Other	6.0	5.6	5.5	5.8	6.5
Total Imports by Foreign Companies	25.7	23.9	25.7	27.0	26.9
Total U.S. Car Retail Deliveries	100.0%	100.0%	100.0%	100.0%	100.0%
Memo:					
Total U.S. Car Retail Deliveries (in thousands of units)	10,979	10,327	9,147	7,956	8,514

	U.S. Truck Market Shares*				
	Years Ended December 31				
	1985	1984	1983	1982	1981
U.S. Manufacturers (Including Imports)					
General Motors	34.9%	34.5%	39.5%	40.2%	37.1%
Ford	26.8	28.0	31.3	30.6	31.4
Chrysler	12.8	12.6	8.7	9.5	8.2
American Motors	3.8	3.7	2.6	2.5	2.8
Navistar International	1.5	1.8	1.7	1.9	3.0
All Other	1.6	2.0	1.5	1.6	2.4
Total U.S. Manufacturers	81.4	82.6	85.3	86.3	84.9
Imports by Foreign Companies**					
Japanese	18.0	16.8	13.9	12.5	12.8
All Other	0.6	0.6	0.8	1.2	2.3
Total Imports by Foreign Companies	18.6	17.4	14.7	13.7	15.1
Total U.S. Truck Retail Deliveries	100.0%	100.0%	100.0%	100.0%	100.0%
Memo:					
Total U.S. Truck Retail Deliveries (in thousands of units)	4,747	4,164	3,165	2,585	2,281

* All U.S. retail sales data are based on publicly available information—data on U.S. manufacturers from the Motor Vehicle Manufacturers Association and data on foreign company imports from *Ward's Automotive Reports,* a trade publication.

** All references to "Imports by Foreign Companies" include Volkswagen, Honda and Nissan cars and trucks manufactured and sold in the United States.

The Japanese manufacturers increased their share of the U.S. car market from 3.7% in 1970 to a peak of 21.2% in 1982 and increased their share of the U.S. truck market from 3.7% in 1970 to 18.0% in 1985. These increases primarily reflected improvements in the Japanese manufacturers' shares of the small car and compact truck segments, respectively. The Japanese manufacturers' share of the U.S. car market declined in 1983 and 1984 because of a change in consumer preference in favor of larger cars and because of the limitations on exports of Japanese cars to the United States. In recent years, Honda Motor Company, Ltd., Mazda Motor Corporation ("Mazda"), Mitsubishi Motors Corporation, Nissan Motor Company, Ltd. and Toyota Motor Corporation, alone or in conjunction with others, have established or are establishing car or light truck assembly operations in the United States.

Ford's car market share declined from about 25% in the mid-1970s to a low of 16.6% in 1981, but improved thereafter. The increase to 19.2% in 1984 was attributable primarily to increased sales of Ford's middle, large and luxury cars and to reduced availability of competing products. The decrease in 1985 was attributable primarily to new model changeovers for the Taurus, Sable and Aerostar vehicles and an increased market share for Japanese producers. Except for 1983, Ford's truck market share declined from 1978 through 1985. The decline in 1985 was attributable primarily to a shift in consumer demand to the compact truck segment, Ford's share of which is lower than its share of other truck segments, and to the introduction timing of Ford's Aerostar vehicle.

Ford classifies cars by small, middle, large and luxury segments. Traditionally, the large car and luxury car segments include the industry's more profitable car lines. The percentage of Ford's sales in the middle segment declined from 1981 to 1982 but increased sharply in 1983 because of Ford's introduction of new models in the middle segment in that year. The percentage of Ford's sales in the large and luxury segments increased in 1982 but declined in 1983, reflecting the increase in the percentage of Ford's sales represented by the middle segment in that year. The percentage of Ford's sales in the middle, large and luxury segments increased in 1984 reflecting the full year effect of the new models introduced in the middle and luxury segments. The percentage of Ford's sales in the small segment increased in 1985 reflecting the impact of marketing programs.

The Japanese manufacturers have been able to compete aggressively in the U.S. in part because of lower manufacturing costs (including substantially lower labor costs). In addition, the competitive position of the Japanese manufacturers was aided by the undervaluation of the Japanese yen in relation to the U.S. dollar that existed from 1979 through 1985.

In the years beginning April 1, 1981, 1982 and 1983, the Japanese government voluntarily limited the number of car and passenger van exports to the United States to 1,680,000 units per year. During each of those periods, the Japanese manufacturers exported to the United States the maximum number of vehicles specified by the limitations. If the limitations had not been in effect, Japanese exports might have been greater during those periods. In November 1983, the Japanese government announced its intention to increase the number of such car and passenger van exports to 1,850,000 units for the year beginning April 1, 1984. In 1984, it became apparent that Japanese exports were constrained by these limitations. In March 1985, the Japanese government announced its intention to increase such car and passenger van exports during the year beginning April 1, 1985 to 2,300,000 units, up 24.3% from the year that began April 1, 1984. On February 13, 1986, the Japanese government announced its intention to continue such car and passenger van exports at the 2,300,000 unit level for another year, beginning April 1, 1986. Ford believes that this level of exports adversely affects Ford's sales and profits. See "Business of Ford—Governmental Standards—Fuel Economy" for a discussion of the effect of Japanese exports on Ford's ability to comply with Federal fuel economy standards.

Because of the low level of sales during the years 1980-1982, Ford took a number of actions to reduce capacity. During those years, Ford closed car assembly plants in Los Angeles, California, Mahwah, New Jersey and San Jose, California and subsequently sold them. Ford also closed four manufacturing facilities during the period.

Automotive Operations Outside the United States

Automotive operations outside the United States are conducted by a number of consolidated subsidiaries of Ford. The largest such subsidiaries are manufacturing companies in Germany ("Ford of

Germany"), Great Britain ("Ford of Britain"), Canada ("Ford of Canada") and Spain ("Ford of Spain"), in which Ford's capital stock interests at December 31, 1985 were substantially 100%, 100%, approximately 92% and 100%, respectively.

Ford and other automotive manufacturers have made major investments outside the United States primarily for the following reasons: first, industry car and truck sales in overseas markets are large; second, certain foreign governments do not permit participation in their markets without local investment; third, local sourcing for sales overseas typically has economic advantages over United States sourcing; and fourth, worldwide diversification of investments tends to make manufacturers less dependent on the economic conditions of a single market.

The automotive industry outside the United States is characterized by a large number of producers with no single producer accounting for a major percentage of total sales, but with some producers accounting for major percentages of total sales in particular countries, especially their respective countries of origin. Additionally, many manufacturers have been involved in acquisitions, joint venture agreements, co-production arrangements, cooperative efforts in basic research and development and intercompany sourcing of components. For example, Ford holds about a 25% equity interest in Mazda, a Japanese automaker.

Ford's operations outside the United States were profitable in the years 1981-1985. However, foreign operations involve a number of factors that could affect earnings in future periods. Changes in foreign currency exchange rates could affect the operating results of the foreign subsidiaries, particularly those that purchase or sell products for currencies other than their local currency. Rapid shifts in demand, high inflation, energy shortages, government regulations and competition from Japanese manufacturers also are factors that could affect future earnings.

Most of the factors that affect the U.S. automotive industry and its sales volumes and profitability, as discussed above under "Automotive Operations in the United States", are equally relevant outside the United States. This particularly applies to Ford's operations in Canada, which are closely integrated with those in the United States.

Retail sales of cars and trucks by all manufacturers outside the United States were an estimated 24.5 million units in 1985, compared with 23.4 million units in 1984, 23.4 million units in 1983, 23.1 million units in 1982, and 23.3 million units in 1981.

Factory unit sales of cars and trucks from plants of Ford's consolidated subsidiaries outside the United States since 1981 are shown in the table below. Factory unit sales represent vehicles produced in a country, but do not necessarily reflect the country where the vehicle is ultimately sold (except as noted below in footnote (1)). Units shown in the table are in thousands.

	Germany		Great Britain		Canada(1)		Spain		Other, principally Brazil, Australia, Argentina and Mexico(2)		Total	
	Cars	Trucks (3)	Cars	Trucks (3)	Cars	Trucks (3)(4)	Cars	Trucks (3)	Cars (4)	Trucks (3)(4)	Cars (4)	Trucks (3)(4)
1985	734	36	320	102	195	120	255	11	423	154	1,927	423
1984	750	40	277	94	167	95	259	10	457	149	1,910	388
1983	799	34	318	96	144	69	222	6	436	144	1,919	349
1982	752	46	307	116	119	70	222	8	398	156	1,798	396
1981	686	51	331	88	149	104	248	6	393	155	1,807	404

(1) Includes cars and trucks exported from the United States to Ford of Canada and excludes cars and trucks exported from Ford of Canada to the United States

(2) The manufacturing and sales subsidiaries in Australia are wholly owned by Ford of Canada.

(3) Includes buses

(4) Includes units manufactured by another company and imported and sold by Ford

The following table shows Ford's shares of car and truck retail sales in various locations outside the United States.

	Ford Car and Truck Market Shares Outside U.S.				
	Est. 1985	1984	1983	1982	1981
North America					
Canada	20.1%	19.7%	18.2%	18.2%	18.8%
Mexico	18.9	15.5	17.6	18.6	19.9
Europe					
Germany	10.5	12.0	11.6	11.1	11.4
Great Britain	26.9	28.3	29.4	31.3	30.9
Total Europe (Including Other)(1)	11.8	12.7	12.4	12.3	12.2
Latin America					
Total Latin America(2)	18.6	20.5	21.3	21.2	21.8
Asia-Pacific					
Total Asia-Pacific(2)(3)	14.2	13.9	14.5	14.8	13.4
Total Outside U.S.	9.6%	9.9%	9.7%	9.6%	9.6%

(1) Including France, Italy and Spain

(2) Excluding Columbia, Chile, Ecuador, Peru and Cuba in Latin America and India in Asia-Pacific, where Ford participation is limited by government restrictions

(3) Excluding Japan, where imports represent an insignificant percentage of the total market

Europe constitutes the largest market for the sale of Ford cars and trucks outside the United States. Within that region, Great Britain and Germany are the most important markets for Ford. In 1985, European industry sales were 10.4 million cars and 1.4 million trucks. Car sales were up 4% and truck sales were up 9% from the levels of 1984. Industry sales have remained relatively unchanged in recent years. Unit sales of Ford products in 1985 compared with 1984 increased in Great Britain and remained about the same in Germany.

The auto industry in Europe has excess capacity of more than two million cars, partly as a result of Japanese imports. This overcapacity has led to intense competition in the European market, resulting in a high level of marketing costs. Higher earnings in Europe reflect primarily cost reductions and higher sales of more profitable vehicles and options. See "Financial Review of Ford Motor Company Results—Results of Operations" for information concerning the effect of these and other factors on the profitability of Ford's European operations.

The operations of Ford's European subsidiaries are highly interdependent, with a substantial degree of integration of parts and components among subsidiaries. Labor difficulties have been a problem in the past and have resulted from time to time in a loss of production and sales throughout Europe.

In recent years, economic conditions have been depressed in Mexico and in most Latin American countries in which Ford does business. Argentina, Brazil, Mexico and Venezuela are experiencing severe economic difficulties primarily because of government efforts to reduce the shortage of foreign exchange required to service their large foreign debts. As a result, Ford sales of cars and trucks in the region have been depressed.

Australia constitutes the principal market for Ford products in the Asia-Pacific region. In the years 1985, 1984, 1983 and 1982, Ford achieved combined car and truck sales leadership in Australia. Ford's principal competition in the Asia-Pacific region has been the Japanese manufacturers and the General Motors subsidiary in Australia. About one-half of the vehicles sold by Ford in the Asia-Pacific region are Japanese-sourced, in whole or in part through Mazda.

Governmental Standards

A number of governmental standards in the United States and Canada relating to emission control, safety, damageability, noise control and fuel economy are now either proposed or applicable to new motor vehicles, engines and equipment. Progressively more stringent governmental standards applicable to future model vehicles also have been established. Further, stringent air and water pollution control and hazardous waste standards are applicable to certain manufacturing facilities. Some of these standards will present difficult problems if they remain in their present form.

Safety—Under the National Traffic and Motor Vehicle Safety Act (the "Safety Act"), the National Highway Traffic Safety Administration (the "Safety Administration") is empowered to determine on the basis of its investigation whether or not motor vehicles or equipment contain defects related to motor vehicle safety or fail to comply with applicable safety standards, and, generally, to require the manufacturer to remedy any such condition at its own expense. There currently are pending before the Safety Administration a number of major investigations relating to alleged safety defects or alleged noncompliance with safety standards in vehicles built or imported by Ford. The cost of recall programs to remedy safety defects or noncompliance, should any be determined to exist as a result of certain of such investigations, could be substantial.

In one investigation, the Safety Administration had announced in June 1980 that it had made an "Initial Determination" that defects existed in an estimated 22.8 million cars and trucks manufactured by Ford in the period 1969-1979. The Safety Administration alleged that transmissions in such vehicles had defects which could cause "inadvertent" rearward movement of a vehicle.

Ford strongly expressed its view that the Initial Determination was unjustified and that no such defects existed. In order to resolve the matter, however, Ford agreed in December 1980 that it would mail to the owners of all vehicles covered by the Initial Determination a letter and a label which would serve to remind drivers of the danger of unexpected vehicle movement and precautions to be followed. The Department of Transportation advised Ford that, without agreeing with Ford's interpretation of the merits of the controversy, it believed that Ford's letter and related actions would adequately address the Department's safety concerns at that time and that the matter was considered resolved. The Department further stated, however, that the Safety Administration reserves its right to take whatever action may be required under the Safety Act and warranted by the development of its knowledge in this matter based upon additional facts and that, if Ford should develop such facts, it would be expected that Ford would immediately bring them to the attention of the Safety Administration and take whatever remedial action those facts require under the Safety Act. Ford completed mailing the letters and the Safety Administration closed its investigation. Investigations by the Safety Administration are, however, subject to being reopened at any time. In connection with this matter, the Safety Administration from time to time requests information from Ford and Ford responds.

If, as a result of any additional facts of the kind referred to above or otherwise, Ford should be required to recall a significant number of vehicles, the cost of such a recall program would be substantial and could have a substantial adverse effect on Ford.

In March 1981, the Center for Auto Safety (a private organization) (the "CFAS"), together with four other consumer groups and four individuals, filed suit in the United States District Court for the District of Columbia against the Secretary of Transportation and the Acting Administrator of the Safety Administration, challenging the agreement of December 1980. The suit asked the Court to declare the agreement invalid or, in the alternative, to remand the matter to the Safety Administration for further explanation of the reasons for the December agreement. In May 1981, the United States filed a motion to dismiss the suit or, in the alternative, for summary judgment. In October 1981, the Court granted the motion for summary judgment and, in August 1982, the United States Court of Appeals for the District of Columbia affirmed that judgment.

In June 1981, an individual petitioned the Safety Administration to reopen its investigation and to order Ford to recall the vehicles. The Safety Administration denied the petition in October 1981. In February 1982, the CFAS filed a petition with the Safety Administration requesting it to reconsider the

order denying the petition filed by the individual in June 1981. The Safety Administration denied the petition to reconsider in June 1982. In March 1985, the CFAS and others filed another petition with the Safety Administration to reopen this investigation and to order Ford to recall the vehicles. In July 1985, the Safety Administration denied the petition. In September 1985, the CFAS and others filed suit in the United States District Court for the District of Columbia against the Secretary of Transportation and the Safety Administration challenging the denial of the petition to reopen. The United States filed a motion to dismiss the suit or, in the alternative, for summary judgment. The CFAS has also filed a motion for summary judgment. The Court has the motions under advisement.

Ford is unable to estimate the extent to which the Safety Administration's Initial Determination and subsequent actions have affected or may affect Ford's vehicle sales.

See "Business—Ford—Legal Proceedings" for information concerning pending lawsuits against Ford relating to certain of Ford's automatic transmissions.

In October 1983, the Safety Administration issued a notice of proposed rulemaking in which it proposed several alternatives that ranged from a proposal to promulgate an "airbag-only" standard to a proposal to again rescind all requirements that any vehicle be equipped with a passive restraint system. In July 1984, the Secretary of Transportation issued a new Final Rule that requires "passive restraints" for drivers and right-side front seat passengers, in cars manufactured for sale in the United States, to be phased in as follows: in not less than 10% of production during the 1987 model year (i.e., September 1, 1986-August 31, 1987), 25% during the 1988 model year and 40% during the 1989 model year. After September 1, 1989, 100% of the cars manufactured for sale in the United States would be required to provide passive restraints. The percentages of production for each manufacturer are based on its average annual production over the 36-month period next preceding each of the affected model years. If state mandatory usage laws covering at least two-thirds of the population of the 50 states and the District of Columbia and conforming to specified criteria are enacted by April 1, 1989, however, passive restraints will no longer be required. At the present time, Ford is unable to determine whether it can comply with all of the requirements of the Final Rule and its accompanying test procedure, by which compliance is adjudged, in their present form. Ford has filed a petition with the Safety Administration on a timely basis, as have other manufacturers, seeking reconsideration of certain technical aspects of the new Final Rule and accompanying test procedure.

Fuel Economy—Passenger cars and trucks weighing less than 8,500 pounds are required under the Energy Policy and Conservation Act to meet separate minimum corporate average fuel economy ("CAFE") standards. Failure to meet the CAFE standard in any model year, after taking into account all available credits, is deemed to be unlawful conduct and would subject a manufacturer to the imposition of a civil penalty equivalent to $5 for each one-tenth of a mile per gallon ("mpg") under the applicable standard multiplied by the number of vehicles in the class (e.g., domestic cars, domestic trucks, imported cars or imported trucks) produced in that year. Credits may be generated as a result of exceeding the standard in one or more of the preceding three model years ("carryforward credits") or pursuant to a plan, approved by the Safety Administration, under which a manufacturer expects to exceed the standard in one or more of the three succeeding model years ("carryback credits"). Ford expects to utilize all of its remaining carryforward credits in complying with 1985 model year requirements.

The fuel economy law established a passenger car CAFE standard of 27.5 mpg for 1985 and later model years but authorizes the Safety Administration to amend that standard under certain conditions. In response to petitions filed by Ford and General Motors, the Safety Administration reduced the fuel economy standard applicable to passenger cars for the 1986 model year from 27.5 mpg to 26.0 mpg and the CFAS filed suit challenging that action. The Safety Administration also published for public comment a proposal to reduce the standard applicable to the 1987 and 1988 model years to a level within the range of 26.0-27.5 mpg and decided to deny that part of the pending CFAS petition that sought increases in the passenger car CAFE standards to 31.5 and 34.5 mpg for model years 1987 and 1988, respectively. The CFAS also has filed suit challenging the Environmental Protection Agency's final rules which establish CAFE adjustments for changes in the test procedures for calculating fuel economy. Chrysler Corporation opposes the grant of any relief from the fuel economy standards as well as the test procedure adjustments.

Ford is unable to predict the outcome of the legal challenge to the revised 1986 standard or the test procedure adjustments or to predict whether, or to what extent, the Safety Administration will grant the relief requested with respect to the 1987 and 1988 standards.

There are several factors that could jeopardize Ford's ability to comply with passenger car CAFE requirements in the 1986 and later model years. These factors include the possibility of successful legal challenge to the 1986 model year standard and test procedure adjustments, changes in market conditions, including a shift in demand in favor of larger cars (affected in part by declining gasoline prices) and a decline in Ford's sales of small and middle size cars following a relaxation or termination of the Japanese government's voluntary restraints. For these reasons, Ford may find it necessary to take various costly actions to satisfy the applicable standard (whether 27.5 mpg or a lower mileage). Such actions could include curtailing or eliminating production of larger family-size and luxury cars, restricting its offerings of engines and undertaking marketing support programs for its most fuel-efficient car lines. If Ford should take such actions, there could be a substantial adverse impact on its volume and profits.

The truck CAFE standard for the 1986 model year is 20.0 mpg (on a combined two-wheel drive/four-wheel drive basis), rising to 20.5 mpg in 1987. The CFAS and the Environmental Policy Institute have filed suits challenging the 1985, 1986 and 1987 model year truck CAFE standards established by the Safety Administration. Ford expects to be able to comply with the standards currently applicable to 1986 and 1987 model year trucks, although it may be necessary to use carryforward and carryback credits to do so. The Safety Administration has proposed but not yet established truck standards for the 1988 and 1989 model years.

Imported passenger cars and trucks (cars and trucks with less than 75% United States/Canada content) are required to meet the same standards as those applicable to domestic cars and trucks. Ford expects its import fleet to comply with applicable CAFE requirements, in some cases through the use of carryforward and carryback credits.

The Energy Tax Act of 1978 imposes Federal excise taxes on 1980 and later model year automobiles which do not achieve prescribed fuel economy levels. Because of the uncertainties and variables inherent in testing for fuel economy and the uncertain effect on fuel economy of other government requirements, it is not possible to predict the amount of such excise taxes, if any, which may be imposed.

Legal Proceedings

Various legal actions, governmental investigations and proceedings, and claims are pending or may be instituted or asserted in the future against Ford and its subsidiaries, including those arising out of alleged defects in Ford's products, governmental regulations relating to safety, emissions and fuel economy, product warranties, and environmental matters. Certain of the pending legal actions are, or purport to be, class actions. The investigations include a number that are pending before or may be instituted by the Safety Administration relating to alleged safety defects or alleged noncompliance with safety standards with regard to motor vehicles made by Ford. Some of the foregoing matters involve or may involve compensatory, punitive or antitrust treble damage claims in very large amounts, or recall campaigns or other relief which, if granted, would require very large expenditures. See "Business of Ford—Governmental Standards." Included among the foregoing matters are the following:

In August 1981, a purported national class action was filed in the United States District Court for the District of Columbia by 104 named plaintiffs on behalf of themselves and all persons who, from July 5, 1975, through the entry of judgment, are or were purchasers or owners or were passengers in 1976 through 1979 model year vehicles equipped with certain automatic transmissions who claim to have incurred property damage, personal injury, economic losses or liability for such losses by reason of the alleged tendency of the vehicles to slip from park into reverse. The complaint alleged breach of express and implied warranty under the Magnuson-Moss Warranty Act, strict liability and negligence in the design, manufacture and use of materials in the transmission.

The District Court has on two occasions denied Ford's motions to dismiss.

In February 1983, plaintiffs filed a motion for class certification. The court heard argument on this motion in June 1984, and in May 1985, the court granted in part and denied in part plaintiffs' motion to certify a number of purported classes in this case. The court conditionally certified three separate classes of owners and purchasers alleging breach of written and implied warranties. Two of the conditionally certified classes consist of owners and purchasers seeking recovery of property damages and the third class consists of owners and purchasers seeking recovery of damages equal to an alleged difference between the value of the vehicles as warranted and as delivered. In November 1985, the United States Court of Appeals for the District of Columbia agreed to hear an immediate appeal from the District Court order conditionally certifying the classes described above and set a briefing schedule that will allow the case to be ready for oral argument during its May 1986 calendar.

Ford is a defendant in various actions for damages arising out of automobile accidents where the plaintiffs claim that the injuries resulted from (or were aggravated by) alleged deficiencies in the fuel systems in various car lines of several model years. The damages specified by the plaintiffs in the complaints in these actions, including both actual and punitive damages, aggregated approximately $1.5 billion at January 21, 1986. (In some of the foregoing actions no dollar amount of damages is specified or the specific amount referred to is only the jurisdictional minimum.) In addition to the pending actions, accidents have occurred and claims have arisen which also may result in lawsuits involving these vehicles.

In addition to the case involving allegedly defective automatic transmissions specifically described above Ford is a defendant in various other cases alleging that Ford's design of automatic transmissions and/or their shift selector mechanisms permit vehicles to move after being placed in park. The damages specified by the plaintiffs in the complaints in these additional actions, including both actual and punitive damages, aggregated approximately $1.2 billion at January 21, 1986. (In some of the foregoing actions no dollar amount of damages is specified or the specific amount referred to is only the jurisdictional minimum.) In addition to the pending actions, accidents have occurred and claims have arisen which also may result in lawsuits involving these vehicles.

Ford is a defendant in various cases in which the failure to provide an airbag or other passive restraint is alleged to have constituted a defect in the vehicle. The damages specified in these actions, including both actual and punitive damages, aggregated approximately $1.1 billion at January 21, 1986. (In some of the foregoing actions no dollar amount of damages is specified or the specific amount referred to is only the jurisdictional minimum.) In addition to the pending actions, accidents have occurred and claims have arisen which also may result in lawsuits in which such a defect may be alleged.

Ford, like many other manufacturers, has little or no product liability insurance for incidents that might occur in 1986 because of the limited availability of such insurance at reasonable premiums in the insurance market generally.

ITEM 2. PROPERTIES

All of Ford Credit's operations are conducted from leased properties. At December 31, 1985, Ford Credit's aggregate obligation under leases of real property (branch office leases) was $14.8 million.

ITEM 3. LEGAL PROCEEDINGS

Various legal actions, governmental proceedings, and other claims are pending or may be instituted or asserted in the future against Ford Credit and its subsidiaries.

Ford Credit is a defendant in actions asserting claims under the antitrust laws and the Automobile Dealers' Day in Court Act resulting from Ford Credit's termination of financing relationships with former automobile dealers, and actions alleging violations of various state and federal regulatory laws concerning financing and insurance, based upon technical interpretations of their requirements. Some of these matters involve or may involve class actions, compensatory, punitive or treble damage claims in very large amounts, or other requested relief which, if granted, would require very large expenditures.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

All shares of the registrant's Common Stock are owned by Ford and, accordingly, there is no market for such stock. Ford Credit paid cash dividends to Ford in 1984, 1983, 1981, 1980 and 1976. Ford Credit may pay additional dividends from time to time depending on Ford Credit's receivables growth, capital requirements, and profitability.

ITEM 6. SELECTED FINANCIAL DATA

FORD MOTOR CREDIT COMPANY AND CONSOLIDATED SUBSIDIARIES

FIVE YEAR SUMMARY OF SELECTED FINANCIAL DATA

	1985	1984	1983	1982	1981
SELECTED INCOME STATEMENT DATA (in millions)					
Financing revenue					
Retail	$2,929	$2,189	$1,862	$1,666	$1,616
Wholesale	594	638	437	578	714
Diversified	90	52	73	86	118
Other	126	125	109	138	177
Total financing revenue	3,739	3,004	2,481	2,468	2,625
Insurance premiums earned	145	108	102	110	124
Investment and other income	109	71	44	57	103
Total revenue	3,993	3,183	2,627	2,635	2,852
Interest expense	2,199	1,932	1,502	1,695	2,039
Provision for credit losses	372	178	117	81	79
Insurance losses and acquisition costs	120	88	83	92	99
Other expenses	530	450	380	355	325
Total expenses	3,221	2,648	2,082	2,223	2,542
Income before income taxes	772	535	545	412	310
Provision for income taxes	331	225	253	183	124
Net income	$ 441	$ 310	$ 292	$ 229	$ 186
Net income from financing	$ 400	$ 289	$ 277	$ 203	$ 144
Net income from insurance	41	21	15	26	42
Cash dividends	—	125	225	—	100
Return on equity	19.3%	15.1%	15.5%	13.3%	12.2%
Earnings-to-fixed charge ratio	1.35	1.28	1.36	1.24	1.15
SELECTED BALANCE SHEET DATA (in billions)					
Finance receivables					
Retail	$ 27.2	$ 18.7	$ 14.5	$ 12.0	$ 13.4
Wholesale	5.6	6.1	4.9	3.9	4.1
Diversified	1.1	0.7	0.7	0.8	1.1
Other	1.3	1.1	0.9	0.9	0.9
Total finance receivables	35.2	26.6	21.0	17.6	19.5
Deduct: Unearned income	(4.5)	(3.1)	(2.3)	(2.0)	(2.2)
Allowance for credit losses	(0.5)	(0.4)	(0.3)	(0.3)	(0.3)
Finance receivables, net	$ 30.2	$ 23.1	$ 18.4	$ 15.3	$ 17.0
Assets					
Financing	$ 30.6	$ 23.5	$ 18.7	$ 15.8	$ 17.3
Insurance	0.7	0.5	0.4	0.4	0.4
Total assets	$ 31.3	$ 24.0	$ 19.1	$ 16.2	$ 17.7
CAPITALIZATION (in billions)					
Short-term debt	$ 14.4	$ 11.8	$ 8.6	$ 7.1	$ 8.4
Long-term debt					
Senior	10.8	7.6	6.0	4.9	5.4
Subordinated	0.7	0.8	1.0	1.1	1.2
Total long-term debt	11.5	8.4	7.0	6.0	6.6
Stockholder's equity	2.6	2.1	1.9	1.8	1.6
Total capital	$ 28.5	$ 22.3	$ 17.5	$ 14.9	$ 16.6
Debt-to-equity ratio (to 1)	10.1	9.7	8.2	7.1	9.2
Short-term debt as percent of total capital	50.7%	53.0%	49.2%	47.7%	50.7%

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

The principal factors that influence the earnings of Ford Credit are interest margins and the level of finance receivables.

Interest margins reflect the difference between the interest rates earned on finance receivables ("yields") and the cost of borrowed funds. Yields on some receivables, primarily wholesale financing, vary with changes in short-term interest rates. Yields on retail and diversified receivables generally are fixed at the time the receivables are acquired. Borrowed funds include short-term debt, the cost of which varies with changes in short-term interest rates, and long-term debt, the cost of which generally is fixed at the time of placement. A portion of long-term debt placements has rates that are variable or that includes interest-rate exchange agreements that have the effect of converting fixed-rate obligations to variable-rate obligations.

The level of finance receivables depends primarily upon Ford's vehicle sales and the extent to which Ford Credit shares in the wholesale and retail financing of these sales. In the U.S., special-rate financing programs, sponsored by Ford, are presently available exclusively through Ford Credit; these programs can substantially increase Ford Credit's share of Ford's retail sales. Ford provides interest supplements to Ford Credit for vehicles financed by Ford Credit under these programs.

Results of Operations

1985 Compared with 1984

Ford Credit's consolidated net income in 1985 was $440.5 million, up $130.1 million from 1984. It was the 11th consecutive year of record earnings.

Ford Credit's results benefited from strong Ford vehicle sales during the past two years and from continued high levels of financing support for these sales. For the third consecutive year, Ford Credit provided retail financing for more than one million cars and trucks. Ford Credit's U.S. retail market share of sales of all new Ford-built cars and trucks was 38.7% in 1985. The increase from a 24.8% share in 1984 resulted from the special-rate financing programs that were sponsored by Ford in 1985 and from Ford Credit's marketing programs. Ford Credit's U.S. wholesale market share was 64.6%, compared with 65.8% in 1984.

Net income from financing operations was $399.9 million, an increase of $110.6 million from 1984. The improvement was principally the result of higher levels of receivables and higher net interest margins. These factors were offset partially by higher credit losses. During 1985, interest rates in the U.S. declined gradually throughout the year; Ford Credit's U.S. average borrowing rate declined from 11% in 1984 to 9.6% in 1985.

Net income from insurance operations was $40.6 million, up $19.5 million from 1984. The increase reflected higher income from investment activities and profits from the new Extended Service Plan insurance program.

Gross receivables at December 31, 1985 were $35.2 billion, compared with $26.6 billion at December 31, 1984. The increase was primarily the result of higher retail financing volume.

1984 Compared with 1983

Ford Credit's consolidated net income in 1984 was $310.4 million, up $18.6 million from 1983.

Ford Credit's U.S. retail market share of sales of all new Ford-built cars and trucks was 24.8% in 1984. The decrease from a 30.7% share in 1983 resulted from the absence of special-rate financing programs that were offered in 1983 and from increased competition from other consumer financing sources. Ford Credit's U.S. wholesale market share was 65.8%, compared with 66.8% in 1983.

Net income from financing operations was $289.3 million, an increase of $12.8 million from 1983. This improvement was principally the result of higher levels of receivables and a lower effective tax rate. These factors were offset partially by lower interest margins. Although interest rates declined sharply during the fourth quarter of 1984, interest rates in the U.S. generally were higher in 1984 than in 1983. Ford Credit's U.S. average borrowing rate increased from 10.6% in 1983 to 11% in 1984.

Net income from insurance operations was $21.1 million, up $5.8 million from 1983. The increase reflected higher income from investment activities.

Gross receivables at December 31, 1984 were $26.6 billion, compared with $21 billion at December 31, 1983. The increase was primarily the result of higher retail financing volume and higher year-end dealer inventories.

Additional information called for by Item 7 is incorporated herein by reference from Item 1—"Business—Financing Operations—Credit Loss Experience" and "Business—Financing Operations—Borrowings and Other Sources of Funds" and Item 8—"Financial Statements and Supplementary Data".

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The information called for by Item 8 is set forth at pages FC-1 through FC-14 of this Form 10-K Report, is incorporated herein by reference and is listed in the Index to Financial Statements as set forth in Item 14(a)(1).

PART IV

ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K

(a) 1. Financial Statements

Ford Motor Credit Company and Consolidated Subsidiaries

Consolidated statement of income and of earnings retained for use in the business for the years ended December 31, 1985, 1984, and 1983

Consolidated balance sheet, December 31, 1985 and 1984

Consolidated statement of changes in financial position for the years ended December 31, 1985, 1984, and 1983

Notes to financial statements

Auditors' Opinion

The financial statements and notes to financial statements listed above are incorporated by reference in Item 8 of this Report from pages FC-1 through FC-14 of this Form 10-K Report.

Information regarding significant restrictions on the ability of subsidiaries to transfer funds to the registrant, and condensed financial information of the registrant are omitted because the amounts related to such restrictions are not sufficient to require submission.

2. Financial Statement Schedules

Auditors' Opinion

Schedule VIII—Valuation and Qualifying Accounts

Schedule IX—Short-Term Borrowings

Schedules other than that indicated above have been omitted because the subject matter is disclosed elsewhere in the financial statements and notes thereto, is not required, is not present, or is not present in amounts sufficient to require submission.

3. Exhibits

Designation	Description	Method of Filing
Exhibit 3-A	Certificate of Incorporation of Ford Motor Credit Company.	Filed as Exhibit 3-A to Ford Motor Credit Company Report on Form 10-K for the year ended December 31, 1980 and incorporated herein by reference. File 1-6368
Exhibit 3-B	By-Laws of Ford Motor Credit Company.	Filed as Exhibit 3-B to Ford Motor Credit Company Report on Form 10-K for the year ended December 31, 1980 and incorporated herein by reference. File 1-6368
Exhibit 10-J-2	Copy of Agreement dated as of December 12, 1974 between Ford Motor Company and Ford Motor Credit Company.	Filed as Exhibit 13-J-2 to Ford Motor Credit Company Registration Statement No. 2-52561 and incorporated herein by reference.
Exhibit 10-J-3	Copy of Amendment dated as of April 14, 1978 between Ford Motor Credit Company and Ford Motor Company amending Agreement designated as Exhibit 10-J-2.	Filed as Exhibit 13-J-3 to Ford Motor Credit Company Registration Statement No. 2-61180 and incorporated herein by reference.
Exhibit 10-J-4	Copy of Amendment dated as of January 15, 1980 between Ford Motor Company and Ford Motor Credit Company amending Agreement designated as Exhibit 10-J-2.	Filed as Exhibit B to Ford Motor Credit Company Report on Form 10-K for the year ended December 31, 1979 and incorporated herein by reference. File 1-6368

Exhibit 10-N	Copy of Agreement dated November 15, 1971 between Ford Motor Credit Company and Ford Motor Company.	Filed as Exhibit 13-N to Ford Motor Credit Company Registration Statement No. 2-42132 and incorporated herein by reference.
Exhibit 10-O	Copy of Agreement dated November 15, 1971 between Ford Motor Credit Company and Ford Motor Company.	Filed as Exhibit 13-O to Ford Motor Credit Company Registration Statement No. 2-42132 and incorporated herein by reference.
Exhibit 10-R	Copy of Agreement dated July 15, 1972 between Ford Motor Credit Company and Ford Motor Company.	Filed as Exhibit 13-R to Ford Motor Credit Company Registration Statement No. 2-44675 and incorporated herein by reference
Exhibit 10-S	Copy of Agreement dated July 15, 1972 between Ford Motor Credit Company and Ford Motor Company.	Filed as Exhibit 13-S to Ford Motor Credit Company Registration Statement No. 2-44675 and incorporated herein by reference.
Exhibit 10-X	Copy of Agreement dated as of February 1, 1980 between Ford Motor Company and Ford Motor Credit Company.	Filed as Exhibit 10-X to Ford Motor Credit Company Report on Form 10-K for the year ended December 31, 1980 and incorporated herein by reference. File 1-6368.
Exhibit 12-A	Calculation of Ratio of Earnings to Fixed Charges of Ford Credit.	Filed with this Report.
Exhibit 12-B	Calculation of Ratio of Earnings to Fixed Charges of Ford.	Filed with this Report.
Exhibit 24	Consent of Experts.	Filed with this Report.
Exhibit 25	Powers of Attorney.	Filed with this Report.

Instruments defining the rights of holders of certain issues of long-term debt of the registrant have not been filed as exhibits to this Report because the authorized principal amount of any one of such issues does not exceed 10% of the total assets of the registrant. The registrant agrees to furnish a copy of each of such instruments to the Commission upon request.

(b) Reports on Form 8-K

Ford Credit filed the following Reports on Form 8-K during the quarter ended December 31, 1985, none of which contained financial statements:

Date of Report	Item
October 14, 1985	Item 5—Other Events
November 5, 1985	Item 5—Other Events
November 29, 1985	Item 5—Other Events
December 16, 1985	Item 5—Other Events
December 16, 1985	Item 5—Other Events

SIGNATURES

Pursuant to the requirements of Section 13 of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

FORD MOTOR CREDIT COMPANY

By JAMES W. FORD*

(JAMES W. FORD, *Chairman of the Board of Directors*)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the date indicated.

Signature	Title	Date
JAMES W. FORD* (James W. Ford)	Chairman of the Board of Directors and Director (principal executive officer)	March 27, 1986
RICHARD G. BENTLEY* (Richard G. Bentley)	Vice President—Finance (principal financial officer)	
FRANK H. MASON* (Frank H. Mason)	Controller (principal accounting officer)	
HAROLD A. POLING* (Harold A. Poling)	Director	
ALLAN D. GILMOUR* (Allan D. Gilmour)	Director	
DONALD E. PETERSEN* (Donald E. Petersen)	Director	
JAMES G. DUFF* (James G. Duff)	Director	
WILLIAM C. FORD* (William C. Ford)	Director	
DAVID N. MCCAMMON* (David N. McCammon)	Director	
WILLIAM E. ODOM* (William E. Odom)	Director	
JOHN SAGAN* (John Sagan)	Director	
STANLEY A. SENEKER* (Stanley A. Seneker)	Director	
ROBERT D. WARNER* (Robert D. Warner)	Director	

*By HURLEY D. SMITH

(Hurley D. Smith, *Attorney-in-Fact*)

INDEX TO FINANCIAL STATEMENTS

REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

FORD MOTOR CREDIT COMPANY
Dearborn, Michigan

We have examined the consolidated balance sheet of Ford Motor Credit Company and Consolidated Subsidiaries at December 31, 1985 and 1984, and the related consolidated statements of income and of earnings retained for use in the business and changes in financial position for each of the three years in the period ended December 31, 1985 and the financial statement schedules listed in Item 14(a) of this Form 10-K. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the consolidated financial position of Ford Motor Credit Company and Consolidated Subsidiaries at December 31, 1985 and 1984, and the consolidated results of operations and changes in financial position for each of the three years in the period ended December 31, 1985, in conformity with generally accepted accounting principles applied on a consistent basis. In addition, the financial statement schedules referred to above, when considered in relation to the basic financial statements taken as a whole, present fairly the information required to be included therein.

COOPERS & LYBRAND

Detroit, Michigan
February 7, 1986

FORD MOTOR CREDIT COMPANY AND CONSOLIDATED SUBSIDIARIES

CONSOLIDATED STATEMENT OF INCOME AND OF EARNINGS RETAINED FOR USE IN THE BUSINESS

(in millions)

	For the Years Ended December 31		
	1985	1984	1983
Financing revenue			
Retail	$2,929.0	$2,189.3	$1,862.0
Wholesale	593.9	638.3	436.5
Diversified	90.6	51.6	73.2
Other	125.7	124.6	109.5
Total financing revenue	3,739.2	3,003.8	2,481.2
Insurance premiums earned	145.5	108.2	101.7
Investment and other income (Note 1)	108.5	70.7	43.9
Total revenue	3,993.2	3,182.7	2,626.8
Expenses			
Interest expense	2,198.7	1,931.5	1,502.2
Operating expenses	418.6	375.2	349.6
Provision for credit losses	371.7	178.2	117.0
Depreciation (Note 4)	112.0	74.3	29.9
Insurance losses	83.9	59.4	55.0
Amortization of policy acquisition costs	36.2	28.7	27.9
Total expenses	3,221.1	2,647.3	2,081.6
Income before income taxes	772.1	535.4	545.2
Provision for income taxes (Note 9)	331.6	225.0	253.4
Net income	440.5	310.4	291.8
Earnings retained for use in the business			
Beginning of year	1,377.8	1,192.4	1,125.6
Cash dividends	—	(125.0)	(225.0)
End of year	$1,818.3	$1,377.8	$1,192.4

The accompanying notes are part of the financial statements.

FORD MOTOR CREDIT COMPANY AND CONSOLIDATED SUBSIDIARIES

CONSOLIDATED BALANCE SHEET

(in millions)

ASSETS

	December 31 1985	December 31 1984
Cash	$ 71.8	$ 142.7
Investments in securities		
Bonds, notes, and other securities, at amortized cost (market $479.7 in 1985 and $407.8 in 1984)	469.8	419.5
Marketable equity securities, at market (cost $127.3 in 1985 and $98.5 in 1984)	144.7	104.1
Total investments in securities	614.5	523.6
Finance receivables (Notes 4 and 5)		
Retail	27,167.8	18,713.5
Wholesale	5,604.3	6,021.6
Diversified	1,113.1	704.9
Other	1,298.7	1,119.8
Total finance receivables	35,183.9	26,559.8
Deduct		
Unearned income	(4,521.3)	(3,113.8)
Allowance for credit losses (Note 6)	(470.6)	(354.5)
Finance receivables, net	30,192.0	23,091.5
Amounts due and deferred from sales of receivables	44.9	35.9
Accounts receivable from affiliated companies	125.2	75.9
Repossessed vehicles, at estimated realizable value	71.1	49.8
Office equipment and company automobiles, at cost less accumulated depreciation of $19.5 in 1985 and $15.3 in 1984	26.8	16.2
Deferred charges and other assets	166.8	99.0
Total assets	$31,313.1	$24,034.6

LIABILITIES AND STOCKHOLDER'S EQUITY

	December 31 1985	December 31 1984
LIABILITIES		
Accounts payable		
Dealers (Note 6)	$ 152.1	$ 140.5
Affiliated companies	210.0	159.5
Trade and other	231.0	170.5
Total accounts payable	593.1	470.5
Income taxes currently payable	13.1	5.4
Debt		
Short-term debt, unsecured (Note 7)		
Commercial paper	11,160.4	8,601.8
Borrowing agreements with bank trust departments	286.6	294.8
Other short-term debt	773.7	1,506.8
Total short-term debt	12,220.7	10,403.4
Long-term debt payable within one year	2,205.2	1,405.9
Long-term debt (Note 8)	11,481.6	8,402.8
Total debt	25,907.5	20,212.1
Deferred income taxes including investment tax credits (Note 9)	879.6	592.9
Other liabilities and deferred income	1,005.3	512.6
Unpaid insurance losses	40.7	25.6
Unearned insurance premiums	309.3	133.7
Total liabilities	28,748.6	21,952.8
STOCKHOLDER'S EQUITY		
Capital stock, par value $100 a share, 250,000 shares authorized, issued, and outstanding	25.0	25.0
Paid-in surplus (contributions by stockholder) (Note 10)	751.5	701.5
Unrealized gain on marketable equity securities, net of taxes	9.2	3.0
Foreign currency translation adjustments (Note 1)	(39.5)	(25.5)
Earnings retained for use in the business	1,818.3	1,377.8
Total stockholder's equity	2,564.5	2,081.8
Total liabilities and stockholder's equity	$31,313.1	$24,034.6

Certain amounts for 1984 have been revised to conform with the presentation adopted in 1985.

The accompanying notes are part of the financial statements.

FORD MOTOR CREDIT COMPANY AND CONSOLIDATED SUBSIDIARIES

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION

(in millions)

	For the Years Ended December 31		
	1985	1984	1983
SOURCES OF FUNDS			
Operations			
Net income	$ 440.5	$ 310.4	$ 291.8
Depreciation	112.0	74.3	29.9
Amortization of debt issuance costs	49.7	40.8	39.9
Amortization of policy acquisition costs	36.2	28.7	27.9
Changes in other payables and other liabilities and deferred income	560.9	(1.2)	139.7
Changes in deferred taxes and investment tax credits	286.7	286.2	4.7
Changes in insurance liabilities and unearned premiums	190.7	27.6	5.0
Total from operations	1,676.7	766.8	538.9
Borrowing and other funding activities			
Additions of long-term debt	6,031.1	3,205.1	2,225.4
Additions of short-term debt, net	1,817.3	2,807.8	1,448.4
Proceeds from sales of receivables, net of repurchases	847.1	146.7	711.1
Other changes			
Capital contribution by stockholder	50.0	—	—
Accounts payable to dealers and affiliated companies	62.1	(142.0)	174.0
Receivables from affiliated companies	(49.3)	(55.2)	65.8
Cash and investments	(13.8)	(170.1)	(4.9)
Other	(213.1)	(122.2)	38.7
Total	$10,208.1	$6,436.9	$5,197.4
USES OF FUNDS			
Increase in finance receivables, net	$ 8,055.1	$4,875.9	$3,860.5
Reductions of long-term debt	2,153.0	1,436.0	1,111.9
Cash dividends	—	125.0	225.0
Total	$10,208.1	$6,436.9	$5,197.4

Certain amounts for 1984 and 1983 have been revised to conform with the presentation adopted in 1985.

The accompanying notes are part of the financial statements.

FORD MOTOR CREDIT COMPANY AND CONSOLIDATED SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS

NOTE 1. ACCOUNTING POLICIES

Principles of Consolidation

The consolidated financial statements include the accounts of Ford Motor Credit Company ("Ford Credit") and its majority owned domestic and foreign subsidiaries. Ford Credit is a wholly owned unconsolidated subsidiary of Ford Motor Company ("Ford").

Revenue Recognition

The majority of retail receivables, a portion of diversified receivables, and certain other finance receivables include total finance charges. These finance charges are recognized as income over the term of the receivables on the sum-of-the-digits basis. The amount of unearned income deducted from finance receivables in the accompanying balance sheet represents income allocable to future periods. The remaining finance receivables (primarily wholesale and simple interest lease financing) include only principal; interest on these receivables is accrued and recognized in income monthly. Accrued interest is included in other finance receivables. Acquisition and collection costs generally are expensed as incurred.

Allowance for Credit Losses

Allowances for estimated credit losses are established by direct charges to expense at the time that retail installment sales contracts and retail leases are purchased; for other receivables, such allowances are established as required. Finance receivables are charged to the allowance for credit losses when an account is deemed to be uncollectible, taking into consideration the financial condition of the borrower, the value of the collateral, recourse to guarantors, and other factors. Collateral repossessed or acquired by foreclosure or deed in lieu of foreclosure is carried at the lower of the recorded investment in the receivable or its estimated fair value at the date of repossession or acquisition. Any difference between the recorded investment in the receivable and the actual sales price of the underlying collateral is charged to the allowance for credit losses. Recoveries on finance receivables previously charged off as uncollectible are credited to the allowance for credit losses.

Insurance Operations

Insurance premiums are earned over the policy periods on bases related to amounts at risk. Premiums from extended service plan contracts are earned over the life of the policy based on historical loss experience. Physical damage insurance premiums covering vehicles and equipment financed at wholesale by Ford Credit and its finance subsidiaries are recognized as income on a monthly basis as billed; other physical damage, credit life, and credit disability premiums are earned over the lives of the related policies, primarily on the sum-of-the-digits basis. Certain costs of acquiring new business are deferred and amortized over the terms of the related policies on the same bases on which premiums are earned. The liability for unpaid insurance losses includes provisions for reported losses and an estimate of unreported losses based on past experience.

Foreign Currency Translation

Assets and liabilities of foreign subsidiaries are translated at current exchange rates, and the effects of these translation adjustments are accumulated in a separate component of stockholder's equity. The change in this account results from translation adjustments recorded during the year.

Investment and Other Income

Investment and other income consists primarily of interest income and dividends on investments in securities, gains and losses on sales of securities, gains on sales of receivables, and gains and losses resulting from acquisitions of Ford Credit's debt securities.

Note 2. Industry Segments and Foreign Operations

Ford Credit and its subsidiaries operate in two industries—financing and insurance. Financing operations primarily consist of: wholesale financing and capital loans to franchised Ford vehicle dealers and the purchase of retail installment sales contracts and retail leases from them; loans to vehicle leasing companies; diversified financing; and consumer loan financing. Insurance operations consist of the issuance of insurance relating to extended service plan contracts primarily originating from Ford dealers, credit life and credit disability insurance on retail purchasers of vehicles and equipment and on consumer loan customers, and physical damage insurance covering vehicles and equipment financed primarily at wholesale by Ford Credit and its finance subsidiaries. Total revenue, income before income taxes, and assets identifiable with financing and insurance operations were as follows:

	1985	1984	1983
		(in millions)	
Total revenue			
Financing operations	$ 3,797.8	$ 3,045.2	$ 2,499.2
Insurance operations	195.4	137.5	127.6
Income before income taxes			
Financing operations	720.0	509.3	520.4
Insurance operations	52.1	26.1	24.8
Assets at end of year			
Financing operations	30,576.7	23,554.7	18,685.8
Insurance operations	736.4	479.9	422.5

Included in the revenue of insurance operations are premiums related to physical damage insurance on vehicles and equipment financed at wholesale by Ford Credit and its finance subsidiaries. The amounts of such premiums, which were based on rates approved by insurance regulatory agencies, were as follows (in millions): 1985—$32.8; 1984—$30.6; 1983—$25. Ford Credit and its finance subsidiaries account for the cost of such premiums as a reduction of wholesale financing revenue.

Ford Credit and its subsidiaries conduct vehicle financing operations in several foreign countries, the most significant of which are in Canada and Australia. Total revenue, income before income taxes, and assets identifiable with United States and foreign operations were as follows:

	1985	1984	1983
		(in millions)	
Total revenue			
United States operations	$ 3,784.7	$ 3,005.6	$ 2,469.0
Foreign operations	208.5	177.1	157.8
Income before income taxes			
United States operations	746.6	513.7	519.6
Foreign operations	25.5	21.7	25.6
Assets at end of year			
United States operations	29,536.3	22,683.6	18,025.4
Foreign operations	1,776.8	1,351.0	1,082.9

NOTE 3. SUPPORT FACILITIES

At January 1, 1986, Ford Credit had approximately $5 billion of revolving credit agreements available in the United States, all of which were contractually committed and supported by fee arrangements and which are available at least through June 1990. Of this amount, up to $1.8 billion may be used, at Ford's option, by either Ford or Ford Credit. At January 1, 1986, Ford Credit also had agreements available that permit it to sell receivables at its option to other financial institutions. The agreements can provide proceeds to Ford Credit of up to $3.7 billion on a continuous basis during the terms of the agreements. Of these agreements, $185 million was utilized at December 31, 1985. No sales were made under these agreements during 1985.

NOTE 4. FINANCE RECEIVABLES

The maturities of finance receivables outstanding at December 31, 1985 were as follows:

	Due in Year Ending December 31			Due After 1988	Total
	1986	1987	1988		
	(in millions)				
Retail	$ 8,902.6	$7,379.5	$6,333.0	$4,552.7	$27,167.8
Wholesale	5,478.4	29.4	30:2	66.3	5,604.3
Diversified	143.0	97.2	383.9	489.0	1,113.1
Other	658.6	290.9	172.1	177.1	1,298.7
Total	$15,182.6	$7,797.0	$6,919.2	$5,285.1	$35,183.9

Wholesale receivables include capital loans to dealers.

Included in diversified receivables at December 31, 1985 and 1984 were investments, primarily in real estate, acquired through foreclosure or deed in lieu of foreclosure of $18.2 million and $22.8 million, respectively. These properties may require extended periods of time for disposition.

Other finance receivables primarily consist of accounts receivable purchased from Ford, consumer loans, and accrued interest receivable.

Installments, including interest, past due 60 days or more and the aggregate receivable balances related to such past due installments were as follows:

	December 31, 1985		December 31, 1984	
	Installments	Balances	Installments	Balances
	(in millions)			
Retail	$15.1	$213.1	$12.2	$134.7
Wholesale	2.0	3.4	12.6	13.6
Diversified	16.9	32.5	8.8	29.4
Other	4.1	18.8	6.0	9.7
Total	$38.1	$267.8	$39.6	$187.4

Installments past due less than 60 days included in retail finance receivables at December 31, 1985 and 1984 were $209.6 million and $162.5 million, respectively.

NOTE 4. FINANCE RECEIVABLES—Continued

The average yield on net earning finance receivables was as follows: 1985—14.8%; 1984—15.3%; 1983—15.7%.

Included in retail and diversified receivables are investments related to the leasing of motor vehicles and various types of transportation and other equipment.

	December 31	
	1985	1984
	(in millions)	
Investment in Direct Financing Leases		
Minimum lease rentals	$ 3,500.4	$2,385.8
Estimated residual values	2,285.8	1,117.3
Less		
Unearned income	(1,209.1)	(808.6)
Allowance for credit losses	(140.2)	(72.0)
Net investment in direct financing leases	$ 4,436.9	$2,622.5

Minimum direct financing lease rentals (including executory costs of $154.6 million) for each of the five succeeding years are as follows (in millions): 1986—$1,239.6; 1987—$1,103.4; 1988—$810.8; 1989—$289.9; 1990—$32.6.

The estimated residual values for direct financing leases represent estimates of proceeds to be received from the sale of assets, substantially all of which are motor vehicles for which there is a broad and active resale market.

	December 31	
	1985	1984
	(in millions)	
Investment in Operating Leases		
Vehicles and other equipment, at cost	$ 637.3	$ 583.3
Less accumulated depreciation	(202.1)	(156.5)
Net investment in operating leases	$ 435.2	$ 426.8

Rental payments on operating leases for 1985 and each succeeding year are as follows (in millions): 1985—$141.2; 1986—$144.3; 1987—$49.1; 1988—$24.2.

Depreciation expense on operating leases is provided for on a straight-line basis and was as follows (in millions): 1985—$107.5; 1984—$71.7; 1983—$27.8.

NOTE 5. SALES OF RECEIVABLES

Ford Credit periodically sells receivables to financial institutions. Proceeds from sales of receivables were as follows (in millions): 1985—$874.9; 1984—$181; 1983—$1,609.6. During 1985, Ford Credit realized a gain, net of applicable taxes, of $13.4 million from the sales of receivables. The unpaid balances of receivables sold, net of unearned income, were as follows at December 31 (in millions): 1985—$977.9; 1984—$690.

NOTE 6. ALLOWANCE FOR CREDIT LOSSES

Following is an analysis of the allowance for credit losses for the past three years:

	1985	1984	1983
		(in millions)	
Balance, beginning of year	$354.5	$260.4	$236.9
Additions	321.1	185.4	98.5
Deductions			
Losses	223.6	124.8	96.0
Recoveries	(27.4)	(30.5)	(27.0)
Net losses	196.2	94.3	69.0
Amounts related to receivables sold	8.8	(3.0)	6.0
Net deductions	205.0	91.3	75.0
Balance, end of year	$470.6	$354.5	$260.4

Various degrees of recourse to the dealer, in the event of a customer default, are available to Ford Credit under its retail financing plans. Of the dollar amount of retail installment sales contracts purchased by Ford Credit in 1985, approximately 29% provided for recourse to the dealer. Ford Credit's ability to collect on such obligations depends to some extent on the financial condition of the dealer concerned. These plans generally also provide for dealers to maintain reserves with Ford Credit. These reserves are included in accounts payable—dealers and assist in protecting Ford Credit in the event a dealer fails to discharge its obligation. Agreements with Ford also provide for various degrees of loss protection, principally on fleet and leasing receivables.

NOTE 7. SHORT-TERM DEBT

The average amount of short-term borrowings outstanding during the past three years was as follows (in millions): 1985—$11,343; 1984—$8,693; 1983—$6,501; the weighted average short-term interest rates per annum for these years were as follows: 1985—8.5%; 1984—10.8%; 1983—10.1%. The average remaining term of commercial paper was 27 days and 24 days at December 31, 1985 and 1984, respectively. Borrowing agreements with bank trust departments are payable on demand. Other short-term debt primarily consists of notes having a provision for optional redemption within one year.

Ford periodically acquires Ford Credit commercial paper or short-term notes at market prices and interest rates prevailing at dates of acquisition. Ford Credit commercial paper and short-term notes held by Ford averaged $132 million in 1985; $232 million in 1984, and $30 million in 1983. Interest payments to Ford related to these transactions were as follows (in millions): 1985—$12.4; 1984—$24.1; 1983—$2.8.

NOTE 8. LONG-TERM DEBT

Long-term debt at December 31, 1985 and 1984, excluding amounts payable within one year, was as follows:

	December 31, 1985		December 31	
	Rates of Interest*	Maturities	1985	1984
			(in millions)	
Unsecured Senior Indebtedness				
Notes	7.85 %—19 %	1987—2000	$ 9,650.8	$6,472.1
Debentures	7.5 %—13.25 %	1987—2004	1,119.0	1,202.9
Short-term debt expected to be refinanced	9.05 %— 9.1 %	1990	135.7	—
Unamortized discount			(133.9)	(84.6)
Total unsecured senior indebtedness			10,771.6	7,590.4
Unsecured Subordinated Indebtedness				
Notes	7.875%—10.75 %	1987—1994	555.0	577.5
Debentures	8.5%	1987—2002	131.9	141.3
Convertible debentures	4.5 %— 4.875%	1996—1998	19.2	92.4
Unamortized discount			(0.7)	(0.9)
Total unsecured subordinated indebtedness			705.4	810.3
Other			4.6	2.1
Total long-term debt			$11,481.6	$8,402.8

* Rates were variable on about 22% of these obligations including the effects of interest rate exchange agreements that converted fixed rate obligations to variable rate.

The aggregate amounts of long-term debt maturing in each of the five years following December 31, 1985 (including required sinking fund payments) are as follows (in millions): 1986—$2,205.2; 1987—$1,420.8; 1988—$1,907.8; 1989—$1,605.7; 1990—$2,047.5.

Included in long-term debt at December 31, 1985 were obligations payable in foreign currencies: $266 million in Australian dollars; $132 million in Canadian dollars; $106 million in West German marks; $53 million in Swiss francs; $36 million in European currency units. Certain of these obligations are denominated in currencies other than the currency of the country of the issuer. Such obligations are translated at the rates of exchange established under forward exchange contracts.

The Convertible Subordinated Debentures are convertible into Common Stock of Ford. Ford Credit has entered into agreements with Ford to purchase from Ford the Common Stock required to effect conversion.

Gains and (losses), net of applicable taxes, resulting from open market purchases of Ford Credit's debt securities were as follows (in millions): 1985—$3.9; 1984—$11.2; 1983—$(0.4). The principal amounts of the securities purchased during these periods were as follows (in millions): 1985—$209.4; 1984—$133.9; 1983—$90.4.

NOTE 9. INCOME TAXES

Ford Credit and its domestic subsidiaries join Ford in filing consolidated United States income tax returns. Pursuant to an arrangement with Ford, United States income tax liabilities or credits are allocated to Ford Credit in accordance with the contribution of Ford Credit and its subsidiaries to Ford's consolidated tax position.

The provision for income taxes consisted of the following:

	1985	1984	1983
		(in millions)	
Currently payable (refundable)			
U.S. Federal	$(58.1)	$(122.9)	$197.5
Foreign	8.3	10.9	13.2
State and local	9.0	1.5	17.4
Total currently payable (refundable)	(40.8)	(110.5)	228.1
Deferred (principally U.S. Federal)	218.1	209.8	(17.9)
Investment tax credits deferred	154.3	125.7	43.2
Total provision for income taxes	$331.6	$ 225.0	$253.4

Deferred income taxes result from timing differences in the recognition of revenues and expenses for financial statements and tax returns. The principal sources of these differences and the related effect of each on Ford Credit's provision for income taxes were as follows:

	1985	1984	1983
		(in millions)	
Leasing transactions	$ 537.9	$196.8	$ 29.6
Interest supplements	(222.1)	39.7	(61.7)
Provision for credit losses	(121.1)	(21.0)	—
Other	23.4	(5.7)	14.2
Total	$ 218.1	$209.8	$(17.9)

Investment tax credits applicable to assets leased to others are deferred and amortized as an element of financing revenue. Investment tax credits applicable to depreciable assets used in the business are deferred and amortized as an element of the tax provision over the useful life of the related assets. Total amortized investment tax credits were as follows (in millions): 1985—$91; 1984—$49.3; 1983—$20.7.

A reconciliation of the provision for income taxes as a percentage of income before income taxes with the United States statutory tax rate for the last three years is shown below:

	1985	1984	1983
U.S. statutory tax rate	46.0%	46.0%	46.0%
Effect of (in percentage points)			
Amortization of investment tax credits	(5.4)	(4.2)	(1.7)
Investment income not subject to tax or subject to tax at reduced rates	(3.6)	(1.7)	(0.6)
State and local income taxes	3.6	0.8	1.7
Asset basis reduction attributable to investment tax credits	2.6	2.2	—
Other	(0.3)	(1.1)	1.1
Effective tax rate	42.9%	42.0%	46.5%

Note 10. Transactions with Affiliated Companies

An agreement with Ford provides for quarterly payments by Ford to Ford Credit, to the extent required, as of the end of each quarter in any year through 1990 in an amount sufficient to cause income before income taxes of Ford Credit and its consolidated subsidiaries, for the portion of the calendar year ended at the end of such quarter, to be not less than 15% of fixed charges for the same period. For purposes of this ratio, earnings consist of income before income taxes and fixed charges; fixed charges consist of interest on borrowed funds, amortization of debt discount, premium and issuance expense, and all rentals on leased properties. The ratios of earnings to fixed charges for Ford Credit were as follows: 1985—1.35; 1984—1.28; 1983—1.36.

The agreement also contains a section that provides for payments by Ford to Ford Credit that would maintain Ford Credit's income before income taxes and net income at specified minimum levels. No payments have been made under this provision of the agreement.

Ford Credit and its subsidiaries from time to time purchase accounts receivable of certain divisions and subsidiaries of Ford. The amount of such receivables outstanding was $792.1 million at December 31, 1985 and $653.8 million at December 31, 1984. Agreements with Ford also provide for interest supplements on certain transactions. Total financing revenue includes amounts received from these and other transactions with Ford as follows (in millions): 1985—$359.7; 1984—$271.5; 1983—$239.6.

Ford Credit and its subsidiaries receive technical and administrative advice and services from Ford and its subsidiaries, occupy office space furnished by Ford and its subsidiaries, and utilize data processing facilities maintained by Ford. Payments to Ford and its subsidiaries for such services are charged to operating expenses and were as follows (in millions): 1985—$24.1; 1984—$21.3; 1983—$21.9.

Retirement benefits are provided for employees of Ford Credit and its subsidiaries in the United States under the Ford General Retirement Plan and for employees of the foreign subsidiaries (principally in Australia and Canada) under the respective Ford retirement plans. Employee retirement plan costs allocated to Ford Credit and its subsidiaries from Ford and charged to operating expenses were as follows (in millions): 1985—$9.7; 1984—$9.5; 1983—$9.8.

Ford Credit and its subsidiaries in the United States provide certain health care and life insurance benefits to retired employees under plans administered by Ford. In addition, similar types of benefits are provided to employees of Ford Credit's foreign subsidiaries. The costs of such benefits are charged to Ford Credit by Ford and were not material.

On December 20, 1985, Ford contributed $50 million to the paid-in surplus of the Company.

At December 31, 1985, Ford Credit had guaranteed $64 million of debt outstanding of other subsidiaries of Ford. See other notes for information regarding transactions with affiliated companies.

FORD MOTOR CREDIT COMPANY AND CONSOLIDATED SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS (Continued)

NOTE 11. LITIGATION AND CLAIMS

Various legal actions, governmental proceedings, and other claims are pending or may be instituted or asserted in the future against Ford Credit and its subsidiaries. Some of these matters involve or may involve class actions, compensatory, punitive or antitrust treble damage claims in very large amounts, or other requested relief which, if granted, would require very large expenditures.

Litigation is subject to many uncertainties, the outcome of individual litigated matters is not predictable with assurance, and it is reasonably possible that some of the foregoing matters could be decided unfavorably to Ford Credit or the subsidiary involved. Although the amount of liability at December 31, 1985 with respect to these actions, governmental proceedings, and claims cannot be ascertained, Ford Credit believes that any resulting liability should not materially affect the consolidated financial position of Ford Credit and its subsidiaries at December 31, 1985.

NOTE 12. SELECTED QUARTERLY FINANCIAL DATA (Unaudited)

Selected financial data by calendar quarter for the past two years were as follows:

	Total Revenue	Interest Expense	Provision for Credit Losses	Net Income
		(in millions)		
1985				
First Quarter	$ 905.5	$ 516.9	$ 66.6	$ 98.0
Second Quarter	972.7	544.5	74.0	108.5
Third Quarter	994.0	536.7	125.9	96.0
Fourth Quarter	1,121.0	600.6	105.2	138.0
Full year	$3,993.2	$2,198.7	$371.7	$440.5
1984				
First Quarter	$ 717.9	$ 419.5	$ 33.0	$ 84.0
Second Quarter	779.4	468.4	41.7	73.0
Third Quarter	827.2	514.6	43.4	82.1
Fourth Quarter	858.2	529.0	60.1	71.3
Full year	$3,182.7	$1,931.5	$178.2	$310.4

NOTE 13. SUPPLEMENTARY INFLATION DATA (Unaudited)

The financial statements have been prepared in accordance with generally accepted accounting principles, which require the measurement of financial position and operating results in historical dollars without regard to changes over time in the relative purchasing power of the dollar. In accordance with the guidelines established by the Financial Accounting Standards Board, the financial data set forth below have been adjusted to give recognition to the changes in the relative purchasing power of the historical dollar unit of measure applicable to the accounting periods presented.

NOTE 13. SUPPLEMENTARY INFLATION DATA (Unaudited)—Continued

Ford Credit has categorized all assets and liabilities as monetary because these amounts generally represent cash, claims to cash, or items that require the payment of a fixed sum of money. Non-monetary assets and liabilities included in the balance sheet are not material. As a result, there are no material differences between income reported on a historical cost/constant dollar basis and income computed on a current cost basis. Information relative to common share amounts is not presented because Ford Credit is a wholly owned subsidiary of Ford.

Historical Cost Data Adjusted for General Inflation to Average 1985 Dollars

	1985	1984	1983	1982	1981
	(dollar amounts in millions)				
Average Consumer Price Index	322.2	311.1	298.4	289.1	272.4
Revenue					
—Historical Dollars	$3,993.2	$3,182.7	$2,626.8	$2,634.4	$2,849.7
—Constant Dollars	3,993.2	3,296.3	2,836.3	2,936.0	3,370.7
Net Income					
—Historical Dollars	$ 440.5	$ 310.4	$ 291.8	$ 228.9	$ 186.2
—Constant Dollars	440.5	321.5	315.1	255.1	220.2
Cash Dividends					
—Historical Dollars	$ —	$ 125.0	$ 225.0	$ —	$ 100.0
—Constant Dollars	—	129.5	243.0	—	118.3
Net Assets at Year-End					
—Historical Dollars	$2,564.5	$2,081.8	$1,903.0	$1,842.2	$1,620.3
—Constant Dollars	2,523.8	2,126.0	2,020.3	2,029.9	1,854.6
Purchasing Power Loss on Net Monetary Items					
—Constant Dollars	$ 84.6	$ 81.7	$ 77.3	$ 72.1	$ 157.0

Users of financial statements should consider the overall demand for borrowed funds, governmental policies, the margin between Ford Credit's borrowing rates and the rates charged to its customers, and the maturities of various assets and liabilities along with the above data when attempting to draw conclusions regarding the impact of inflation on Ford Credit's operations.

FORD MOTOR CREDIT COMPANY AND CONSOLIDATED SUBSIDIARIES

Schedule VIII—Valuation and Qualifying Accounts
For the Years 1985, 1984 and 1983

(A)	(B)	(C) Additions		(D) Deductions		(E)
		(1)	(2)	(1)	(2)	
Description	Balance at Beginning of Period	Charged to Earnings	Charged (Credited) to Unearned Income	Losses Net of Recoveries	Amounts Related to Sold Receivables	Balance at End of Period
			(dollar amounts in millions)			
1985						
Allowance for credit losses	$354.5	$371.7	$(50.6)	$196.2	$ 8.8	$470.6
1984						
Allowance for credit losses	260.4	178.2	7.2	94.3	(3.0)	354.5
1983						
Allowance for credit losses	236.9	117.0	(18.5)	69.0	6.0	260.4

FORD MOTOR CREDIT COMPANY AND CONSOLIDATED SUBSIDIARIES

Schedule IX—Short-Term Borrowings(1)

For the Years 1985, 1984, and 1983

(A) Category of aggregate short-term borrowing.	(B) Balance at end of period	(C) Weighted average interest rate end of period	(D) Maximum amount outstanding during period	(E) Average amount outstanding during period (2)	(F) Weighted average interest rate during period (3)
	(mils.)		(mils.)	(mils.)	
1985					
Commercial paper	$11,160.4	8.05%	$11,373.6	$9,816.2	8.35%
STBAs	286.6	7.66	331.1	301.6	8.05
Bank debt	8.3	19.28	49.3	20.7	17.79
Other short-term debt(4)	765.4	8.51	1,484.7	1,204.7	9.77
1984					
Commercial paper	$8,601.8	9.07%	$8,601.8	$6,838.1	10.65%
STBAs	294.8	8.06	317.5	238.6	10.54
Bank debt	38.6	13.36	216.3	62.0	12.15
Other short-term debt(4)	1,468.2	11.81	1,765.2	1,554.3	11.54
1983					
Commercial paper	$5,839.2	10.09%	$5,839.2	$4,646.4	9.54%
STBAs	179.2	9.98	192.2	149.5	9.58
Bank debt	86.3	11.20	226.2	99.7	12.09
Other short-term debt(4)	1,490.9	10.75	1,831.9	1,605.9	11.76

(1) U.S. commercial paper, the majority of commercial paper outstandings, is comprised of short-term, unsecured promissory notes with maturities ranging from one day to 270 days. Borrowings under short-term borrowing agreements (STBAs) are payable on demand. Bank debt outstandings range from short-term borrowings to bank notes payable on specific dates.

(2) The average amount outstanding during the period represents the daily average debt outstanding.

(3) The weighted average interest rate represents total annual short-term interest expense divided by the daily average debt outstanding.

(4) Other short-term debt primarily consists of notes having either a provision for optional redemption within one year or original maturities of less than one year.

Exhibit 12-A

FORD MOTOR CREDIT COMPANY AND CONSOLIDATED SUBSIDIARIES

CALCULATION OF RATIO OF EARNINGS TO FIXED CHARGES

	For the Years Ended December 31				
	1985	1984	1983	1982	1981(1)
	(dollar amounts in millions)				
Fixed charges					
Interest expense	$2,198.7	$1,931.5	$1,502.2	$1,695.0	$2,039.0
Rents	12.9	10.6	9.7	9.2	8.3
Total fixed charges	2,211.6	1,942.1	1,511.9	1,704.2	2,047.3
Earnings					
Income before income taxes	772.1	535.4	545.2	411.5	310.0
Total earnings before fixed charges	$2,983.7	$2,477.5	$2,057.1	$2,115.7	$2,357.3
Ratio of earnings to fixed charges	1.35	1.28	1.36	1.24	1.15

(1) During the fourth quarter of 1981, Ford made non-interest-bearing demand loans to Ford Credit that reduced the level of Ford Credit's fixed charges by $12.6 million. Had these loans not been made, Ford Credit's ratio would have been 1.14 in 1981. These loans were repaid by Ford Credit as of December 31, 1981 and no such loans have been made since that date.

Exhibit 12-B

FORD MOTOR COMPANY AND CONSOLIDATED SUBSIDIARIES

CALCULATION OF RATIO OF EARNINGS TO FIXED CHARGES*

	For the Years Ended December 31				
	1985	1984	1983	1982	1981
	(dollar amounts in millions)				
Earnings					
Income (Loss) Before Income Taxes					
Ford and Consolidated Subsidiaries	$3,039.0	$3,810.3	$1,811.2	$ (607.0)	$(1,300.8)
Unconsolidated Subsidiaries	965.4	675.5	621.8	464.7	309.0
Total	4,004.4	4,485.8	2,433.0	(142.3)	(991.8)
Fixed Charges					
Ford and Consolidated Subsidiaries	559.6	624.4	676.8	848.2	766.5
Unconsolidated Subsidiaries	2,625.4	2,196.9	1,830.1	2,007.8	2,363.9
Total	3,185.0	2,821.3	2,506.9	2,856.0	3,130.4
Inter-group Fixed Charges	(91.8)	(94.5)	(70.4)	(118.0)	(109.5)
Total Combined Earnings Before Fixed Charges	$7,097.6	$7,212.6	$4,869.5	$2,595.7	$ 2,029.1
Fixed Charges					
Interest Expense					
Ford and Consolidated Subsidiaries	$ 475.0	$ 549.6	$ 583.7	$ 765.9	$ [illegible]
Unconsolidated Subsidiaries	2,610.2	2,183.6	1,817.0	1,995.6	[illegible]
Total	3,085.2	2,733.2	2,400.7	2,761.5	3,056.3
One-Third Rental Expenses					
Ford and Consolidated Subsidiaries	81.0	70.2	86.9	70.2	66.0
Unconsolidated Subsidiaries	15.2	13.3	13.1	12.2	11.7
Total	96.2	83.5	100.0	82.4	77.7
Amortization of Debt Discount	3.6	4.6	6.2	12.1	(3.6)
Inter-group Fixed Charges	(91.8)	(94.5)	(70.4)	(118.0)	(109.5)
Total Combined Fixed Charges	$3,093.2	$2,726.8	$2,436.5	$2,738.0	$ 3,020.9
Ratio of Earnings to Fixed Charges	2.3	2.6	2.0	**	**

* For purposes of the ratio of earnings to fixed charges, the income before income taxes of Ford Motor Company and Consolidated Subsidiaries includes the distributed income from less than fifty-percent-owned persons and excludes the equity in net income of all unconsolidated subsidiaries. The income before income taxes of unconsolidated subsidiaries consists of substantially all of the income before income taxes of Ford's unconsolidated subsidiaries as if consolidated. Fixed charges consist of interest on borrowed funds, amortization of debt discount, premium, and expense and one-third of all rental expense (the proportion deemed representative of the interest factor).

** The ratios were less than one-to-one in 1982 and 1981 because earnings were inadequate to cover fixed charges for those periods. Earnings for 1982 and 1981 would have had to be higher by $142 million and $992 million, respectively, in order to cover the deficiencies in those years.

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C.
20549

FORM 10-Q

QUARTERLY REPORT UNDER SECTION 13 OF THE
SECURITIES EXCHANGE ACT OF 1934

For Quarter Ended September 30, 1986 | Commission File Number 1-6368

FORD MOTOR CREDIT COMPANY
(Exact name of the registrant as specified in its charter)

Incorporated in Delaware (State of incorporation)	38-1612444 (I.R.S. Employer Identification No.)
The American Road, Dearborn, Michigan (Address of principal executive offices)	48121 (Zip Code)
250,000 (Number of shares of Common Stock of the registrant outstanding as of September 30, 1986)	313-322-3000 (Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes ✓ No ____

The registrant meets the conditions set forth in General instruction H(1)(a) and (b) of Form 10-Q and is therefore filing this Form with the reduced disclosure format.

FORD MOTOR CREDIT COMPANY AND CONSOLIDATED SUBSIDIARIES

PART 1. FINANCIAL INFORMATION

Item 1. Financial Statements

The interim financial data presented herein are unaudited, but in the opinion of management reflect all adjustments necessary for a fair presentation of such information. Results for interim periods should not be considered indicative of results for a full year. Reference should be made to the financial statements contained in the registrant's Annual Report on Form 10-K for the year ended December 31, 1985 (the "10-K Report"). Information relating to earnings a share is not presented because the registrant, Ford Motor Credit Company ("Ford Credit"), is a wholly owned subsidiary of Ford Motor Company ("Ford").

FORD MOTOR CREDIT COMPANY AND CONSOLIDATED SUBSIDIARIES
Consolidated Statement of Income and of Earnings
Retained for Use in the Business
For the Periods Ended September 30, 1986 and 1985
(in millions)

	Third Quarter		Nine Months	
	1986	1985	1986	1985
	(Unaudited)		(Unaudited)	
Financing revenue				
Retail	$ 976.2	$ 757.5	$2,756.9	$2,075.8
Wholesale	144.1	126.1	459.2	462.7
Diversified	25.7	25.0	74.3	[illegible]
Other	31.4	31.5	96.6	[illegible]
Total financing revenue	1,177.4	940.1	3,387.0	2,701.0
Insurance premiums earned	65.1	37.2	171.7	103.1
Investment and other income	38.3	16.7	115.6	68.1
Total revenue	1,280.8	994.0	3,674.3	2,872.2
Expenses				
Interest expense	636.6	536.7	1,898.9	1,598.1
Operating expenses	130.5	105.3	371.7	306.2
Provision for credit losses	155.0	125.9	395.5	266.5
Depreciation	39.5	29.1	106.1	81.3
Insurance losses	37.4	21.2	97.6	60.9
Amortization of policy acquisition costs	13.8	9.1	36.9	25.7
Total expenses	1,012.8	827.3	2,906.7	2,338.7
Income before income taxes	268.0	166.7	767.6	533.5
Provision for income taxes	112.5	70.7	319.3	231.0
Net income	155.5	96.0	448.3	302.5
Earnings retained for use in the business				
Beginning of period	2,111.1	1,584.3	1,818.3	1,3[illegible]
End of period	$2,266.6	$1,680.3	$2,266.6	$1,680.3

The accompanying notes are part of the financial statements.

FORD MOTOR CREDIT COMPANY AND CONSOLIDATED SUBSIDIARIES

Condensed Consolidated Balance Sheet
(in millions)

Assets	Sept. 30, 1986 (Unaudited)	Dec. 31, 1985	Sept. 30, 1985 (Unaudited)
Cash	$ 252.5	$ 71.8	$ 214.4
Investments in securities			
Bonds, notes and other securities, at amortized cost (market $702.4, $479.7 and $468.7)	681.9	469.8	472.9
Marketable equity securities, at market (cost $216.5, $127.3 and $109.1)	240.3	144.7	114.3
Total investments in securities	922.2	614.5	587.2
Finance receivables			
Retail	34,070.9	27,167.8	26,065.6
Wholesale	6,273.6	5,604.3	4,596.1
Diversified	1,222.3	1,113.1	994.8
Other	1,253.4	1,298.7	1,126.0
Total finance receivables	42,820.2	35,183.9	32,782.5
Deduct			
Unearned income	(5,134.5)	(4,521.3)	(4,331.2)
Allowance for credit losses	(614.6)	(470.6)	(468.9)
Finance receivables, net	37,071.1	30,192.0	27,982.4
Amounts due and deferred from sales of receivables	23.3	44.9	38.8
Accounts receivable from affiliated companies	365.3	125.2	316.4
Repossessed vehicles, at estimated realizable value	92.2	71.1	68.4
Office equipment and company automobiles, at cost less accumulated depreciation	29.1	26.8	23.7
Deferred charges and other assets	244.4	166.8	150.6
Total assets	$39,000.1	$31,313.1	$29,381.9

Certain amounts for September 30, 1985 have been revised to conform with the presentation adopted in fourth quarter 1985.

The accompanying notes are part of the financial statements.

FORD MOTOR CREDIT COMPANY AND CONSOLIDATED SUBSIDIARIES

Condensed Consolidated Balance Sheet
(in millions)

Liabilities and Stockholder's Equity	Sept. 30, 1986 (Unaudited)	Dec. 31, 1985	Sept. 30, 1985 (Unaudited)
Liabilities			
Accounts payable			
Dealers	$ 165.9	$ 152.1	$ 157.1
Affiliated companies	613.3	210.0	531.4
Trade and other	279.6	231.0	197.2
Total accounts payable	1,058.8	593.1	885.7
Income taxes currently payable	48.0	13.1	48.3
Debt			
Short-term debt, unsecured			
Commercial paper	14,402.4	11,160.4	10,684.4
Borrowing agreements with bank trust departments	295.8	286.6	287.4
Other short-term debt	407.3	773.7	986.3
Total short-term debt	15,105.5	12,220.7	11,958.1
Long-term debt payable within one year	2,029.8	2,205.2	1,948.8
Long-term debt	14,826.5	11,481.6	10,298.8
Total debt	31,961.8	25,907.5	24,205.7
Deferred income taxes including investment tax credits	1,068.1	879.6	790.6
Other liabilities and deferred income	1,269.7	1,005.3	789.1
Unpaid insurance losses	53.6	40.7	37.2
Unearned insurance premiums	525.4	309.3	251.5
Total liabilities	35,985.4	28,748.6	27,008.1
Stockholder's Equity			
Capital stock, par value $100 a share, 250,000 shares authorized, issued, and outstanding	25.0	25.0	25.0
Paid-in surplus (contributions by stockholder)	751.5	751.5	701.5
Unrealized gain on marketable equity securities, net of taxes	12.9	9.2	2.8
Foreign currency translation adjustments	(41.3)	(39.5)	(35.8)
Earnings retained for use in the business	2,266.6	1,818.3	1,680.3
Total stockholder's equity	3,014.7	2,564.5	2,373.8
Total liabilities and stockholder's equity	$39,000.1	$31,313.1	$29,381.9

The accompanying notes are part of the financial statements.

FORD MOTOR CREDIT COMPANY AND CONSOLIDATED SUBSIDIARIES

Consolidated Statement of Changes in Financial Position

For the Periods Ended September 30, 1986 and 1985
(in millions)

	Nine Months 1986 (Unaudited)	Nine Months 1985 (Unaudited)
Sources of Funds		
Operations		
Net income	$ 448.3	$ 302.5
Depreciation	106.1	81.3
Amortization of debt issuance costs	52.0	35.6
Amortization of policy acquisition costs	36.9	25.7
Changes in deferred taxes and investment tax credits	188.5	197.7
Changes in insurance liabilities and unearned premiums	229.0	129.4
Changes in other payables and other liabilities and deferred income	347.9	346.1
Total from operations	1,408.7	1,118.3
Borrowing and other funding activities		
Additions of long-term debt	6,537.1	4,141.0
Additions of short-term debt, net	2,884.8	1,554.7
Proceeds from sales of receivables, net of repurchases	952.0	293.6
Other changes		
Accounts payable to dealers and affiliated companies	417.1	388.5
Cash and investments	(484.7)	(135.5)
Receivables from affiliated companies	(240.1)	(240.5)
Other	(173.3)	(155.6)
Total	$11,301.6	$6,964.5
Uses of Funds		
Increases in finance receivables, net	$7,934.0	$5,262.4
Reductions of long-term debt	3,367.6	1,702.1
Total	$11,301.6	$6,964.5

Certain amounts for 1985 have been revised to conform with the presentation adopted in fourth quarter 1985.

The accompanying notes are part of the financial statements.

FORD MOTOR CREDIT COMPANY AND CONSOLIDATED SUBSIDIARIES

Notes to Financial Statements

Note 1. Transaction with Affiliated Company (Unaudited)

In accordance with an agreement approved by the Federal Home Loan Bank Board, Ford Credit may from time to time originate retail receivables on behalf of First Nationwide Bank, a Federal Savings Bank, the principal subsidiary of First Nationwide Financial Corporation (an affiliated company). In the first nine months of 1986, Ford Credit originated receivables with a principal value of $973 million for First Nationwide. Ford Credit receives a fee for servicing these receivables.

Note 2. Long-Term Debt (in millions)

	September 30, 1986				
	Rates of Interest*	Maturities	Sept. 30, 1986 (Unaudited)	Dec. 31, 1985	Sept. 30, 1985 (Unaudited)
Unsecured Senior Indebtedness					
Notes	5.9% - 17.75%	1987 - 2001	$14,072.3	$9,650.8	$ 8,558.0
Debentures	7.5 - 9.85	1987 - 2004	628.2	1,119.0	1,150.8
Short-term debt expected to be refinanced	-	-	-	135.7	[illegible]
Unamortized discount			(182.7)	(133.9)	(136.9)
Total unsecured senior indebtedness			14,517.8	10,771.6	9,571.9
Unsecured Subordinated Indebtedness					
Notes	7.875 - 10.5	1987 - 1994	220.0	555.0	567.5
Debentures	8.5	1987 - 2002	73.1	131.9	132.8
Convertible debentures	4.5 - 4.875	1996 - 1998	11.8	19.2	23.4
Unamortized discount			(0.3)	(0.7)	(0.7)
Total unsecured subordinated indebtedness			304.6	705.4	723.0
Other			4.1	4.6	3.9
Total long-term debt			$14,826.5	$11,481.6	$10,298.8

* Rates were variable on about 14% of these obligations including the effects of i[illegible]t rate exchange agreements that converted fixed rate obligations to variable rates.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Third Quarter 1986 Results of Operations

In the third quarter of 1986, Ford Credit's consolidated net income was $155.5 million, up $59.5 million from the same period a year ago. Income from financing operations was $135.6 million, up $51.8 million, reflecting higher levels of receivables. Lower borrowing rates were offset by lower financing rates. In the United States, Ford Credit's average borrowing rate declined from 9.5% in the third quarter of 1985 to 8.1% in the third quarter of 1986.

Income from insurance operations was $19.9 million, up $7.7 million, reflecting higher levels of Extended Service Plan business and higher income from investment activities.

Gross receivables at September 30, 1986 were $42.8 billion, up $10 billion or 31% from a year earlier. The increase reflected principally Ford Credit's continued participation in Ford's special-rate financing programs. During the third quarter of 1986, Ford Credit arranged financing for 50.4% of all new Ford-built cars and trucks sold by Ford Motor Company dealers in the United States, up from 47.5% a year earlier. Ford Credit's U. S. wholesale market share was 66.4% compared with 65.6% a year earlier.

First Nine Months 1986 Results of Operations

In the first nine months of 1986, Ford Credit's consolidated net income was $448.3 million, up $145.8 million from the same period a year ago. Income from financing operations was $385.4 million, up $113 million from the same period a year ago, reflecting higher levels of receivables offset partially by higher credit losses. Income from insurance operations was $62.9 million, up $32.8 million, reflecting higher levels of Extended Service Plan business and higher income from investment activities.

Liquidity and Capital Resources

Ford Credit's outstanding debt at September 30, 1986 and at the end of each of the last five years was as follows:

	Sept. 30, 1986	December 31 1985	1984	1983	1982	1981
			(in millions)			
Commercial paper & STBA's a/	$14,699	$11,447	$ 8,896	$ 6,018	$ 4,031	$ 6,256 b/
Bank borrowings	8	8	39	86	742	1,031
Other short-term notes	399	766	1,468	1,491	1,374	277
Long-term debt (incl. current portion)	16,856	13,687	9,809	8,040	6,926	7,421 c/
Total debt	$31,962	$25,908	$20,212	$15,635	$13,073	$14,985
Memo:						
Total support facilities (billions)	$10.4	$9.2 d/	$9.1	$9.4	$8.6	$7.2
Use of sale-of-receivables facilities (billions)	0	0.2	0.7	1.3	1.4	0

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a/ Borrowing agreements with bank trust departments
b/ Includes $500 million of commercial paper held by Ford at December 31, 1981.
c/ Includes $400 million of bank borrowings classified as long-term debt
d/ As of January 1, 1986

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)

Liquidity and Capital Resources (Continued)

Support facilities represent additional sources of funds, if required. At September 30, 1986, Ford Credit had $10 billion of these facilities for use in the United States, substantially all of which were contractually committed. These facilities included approximately $6.4 billion of revolving credit agreements with banks (which are available at least through June 1991, and which included approximately $1.8 billion of Ford bank lines that may be used either by Ford or Ford Credit at Ford's option) and $3.6 billion of agreements to sell retail receivables ($3.5 billion of which are available at least through June 1991). At September 30, 1986, approximately $10 billion of these U. S. facilities were unused and available to support outstanding commercial paper and to finance growth in receivables. Outside the United States, Ford Credit had an additional $465 million of credit facilities to support borrowing operations in Canada and Australia.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

None to report

Item 2. Changes in Securities

Not required

Item 3. Defaults Upon Senior Securities

Not required

Item 4. Submission of Matters to a Vote of Security Holders

Not required

FORD MOTOR CREDIT COMPANY AND CONSOLIDATED SUBSIDIARIES

Item 5. Other Information

Information Concerning Ford

Following is a condensed consolidated statement of income (unaudited) of Ford for the periods ended September 30, 1986 and 1985 (in millions except a share amounts):

	Third Quarter		Nine Months	
	1986	1985	1986	1985
Sales	$ 14,365.8	$ 11,630.0	$ 46,453.4	$ 38,677.8
Total costs and expenses	13,663.4	11,474.8	43,409.3	36,466.6
Operating income	702.4	155.2	3,044.1	2,211.2
Net interest income	30.7	54.6	167.3	219.7
Equity in net income of unconsolidated subsidiaries and affiliates	203.7	134.0	615.1	364.8
Income before taxes	936.8	343.8	3,826.5	2,795.7
Provision for income taxes*	243.6	31.7	1,322.9	989.7
Minority interests in net income	(0.1)	(1.0)	3.6	10.9
Net income	$ 693.3	$ 313.1	$ 2,500.0	$ 1,795.1
Net income a share**	$ 2.61	$ 1.13	$ 9.33	$ 6.45
Net income a share assuming full dilution**	$ 2.57	$ 1.10	$ 9.17	$ 6.23
Cash dividends a share**	$ 0.55	$ 0.40	$ 1.57	$ 1.13

* The provisions for income taxes for the third quarter and first nine months of 1986 do not include tax increases applicable to those periods that will result from the Tax Reform Act of 1986. The Act did not become law until October 22, 1986 and, in accordance with a rule issued by the Financial Accounting Standards Board, these taxes are required to be recorded in fourth quarter 1986. If such taxes had been recorded as of September 30, 1986, they would have reduced net income by an estimated $137 million (51¢ a share).

** Adjusted to reflect the 3-for-2 stock split in the form of a 50 percent stock dividend declared on April 10, 1986.

FORD MOTOR CREDIT COMPANY AND CONSOLIDATED SUBSIDIARIES

Information Concerning Ford (Continued)

Third Quarter 1986 Results of Operations - Ford

Ford's net income in the third quarter of 1986 was a record $693 million ($2.61 a share), compared with net income of $313 million a year ago ($1.13 a share after adjusting for the 3-for-2 stock split in the form of a 50% stock dividend declared on April 10, 1986).

The earnings improvement compared with a year ago reflected higher factory unit sales and a more profitable product mix in North America (last year's sales and mix were affected by extensive new-model changeovers), productivity improvements worldwide, and a net gain of $102 million (38¢ a share) on sales of Ford's North American paint operations and Ford Aerospace's interest in Starnet Corporation. Higher depreciation and amortization expense, associated primarily with new products introduced during the past year, was a partial offset.

In the United States, Ford's net income in the third quarter of 1986 was $607 million, compared with $211 million in the same period last year. Outside the United States, Ford's net income in the third quarter of 1986 was $86 million. This was $16 million lower than a year ago. Higher earnings in Europe were more than offset by less favorable results in Asia-Pacific, which reflected primarily the effect of the stronger Japanese yen relative to the U. S. and Australian dollars.

Worldwide dollar sales of Ford products were $14.4 billion in the third quarter of 1986, up 24 percent from a year ago. Factory sales of cars, trucks, and tractors were 1,335,000 units, up 8 percent. In the United States, unit sales were up 102,400 or 15 percent; outside the United States, unit sales were down slightly.

In the third quarter of 1986, Ford Credit earned $155 million, up 62 percent from last year; First Nationwide Financial Corporation, which was acquired in December 1985, earned $30 million.

First Nine Months 1986 Results of Operations - Ford

Net income in the first nine months of 1986 was $2,500 million or $9.33 a share, compared with net income of $1,795 million or $6.45 a share in the prior year (adjusted for the 3-for-2 stock split in the form of a 50% stock dividend declared on April 10, 1986). The increase reflected primarily higher sales and continued productivity improvements worldwide, offset partially by the cost of new products and higher costs for marketing programs.

In the United States, Ford earned $1,995 million in the first nine months of 1986, up $547 million from the same period last year. The increase reflected primarily higher sales, more profitable product mix, and productivity improvements; costs of new products and higher marketing costs were a partial offset. The sales of Ford's North American paint operations and Ford Aerospace's interest in Starnet Corporation resulted in a net gain of $102 million (38¢ a share).

First Nine Months 1986 Results of Operations - Ford (Continued)

Outside the United States, Ford earned $505 million in the first nine months of 1986, up $158 million from the same period last year. The increase resulted primarily from higher profits in Europe partially offset by lower profits in Canada and Asia-Pacific.

Worldwide dollar sales of Ford products were $46.5 billion in the first nine months of 1986, up 20 percent from a year ago. Factory sales of cars, trucks, and tractors were 4,495,000 units, up 7 percent. In the United States, unit sales were up 260,000 or 11 percent; outside the United States, unit sales were up 43,000 or 2 percent.

Liquidity and Capital Resources - Ford

Cash and marketable securities were $8.1 billion at September 30, 1986, up $2.2 billion from December 31, 1985. During the first nine months of 1986, capital expenditures totaled $2.4 billion, Ford purchased $464 million of its Common Stock, and paid out cash dividends of $420 million. Cash generated by operations more than covered these uses of funds. Working capital (current assets less current liabilities) at September 30, 1986 was $3.2 billion, up $1.9 billion from December 31, 1985.

Effective January 1, 1986, Ford entered into long-term credit agreements under which $3 billion is available from various banks at least through June 30, 1991. Of this amount, $1.8 billion may be used, at Ford's option, by either Ford or Ford Credit.

Governmental Standards - Ford

Safety - With respect to the passive restraint regulations referred to in the third full paragraph on page 21 of the 10-K Report and in the fourth full paragraph on page 11 of Ford Credit's Report on Form 10-Q for the quarter ended March 31, 1986 (the "First Quarter 10-Q Report"), the petitions for reconsideration filed by Ford and other manufacturers were granted in part and denied in part by the National Highway Traffic Safety Administration (the "Safety Administration"). Ford is considering whether to again petition the Safety Administration for appropriate relief.

Fuel Economy - With respect to the matter regarding light truck CAFE standards referred to in the second full paragraph on page 22 of the 10-K Report, in the fifth paragraph on page 11 of the First Quarter 10-Q Report and in the fourth paragraph on page 12 of Ford Credit's Report on Form 10-Q for the quarter ended June 30, 1986, the CFAS suit challenging the 1987 and 1988 light truck CAFE standards of 20.5 mpg was voluntarily dismissed on September 30, 1986.

Governmental Standards - Ford (Continued)

Fuel Economy (Continued)

With respect to the passgenger car CAFE standards discussed in the fifth full paragraph on page 21 of the 10-K Report, on October 6, 1986 the Safety Administration issued a final rule reducing the fuel economy standard applicable to 1987 and 1988 model year passenger cars from 27.5 mpg to 26.0 mpg. Although no judicial challenge has been filed with respect to the new standards as of November 3, 1986, the applicable statute authorizes interested persons to file suit within 60 days after promulgation of the standards.

FORD MOTOR CREDIT COMPANY AND CONSOLIDATED SUBSIDIARIES

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

Designation	Description	Method of Filing
12-A	Calculation of ratio of earnings to fixed charges of Ford Credit.	Filed with this Report
12-B	Calculation of ratio of earnings to fixed charges of Ford.	Filed with this Report
15	Letter from Coopers & Lybrand dated November 12, 1986 regarding unaudited interim financial information.	Filed with this Report

(b) Reports on Form 8-K

Ford Credit filed the following reports on Form 8-K during the quarter ended September 30, 1986:

Date of Report	Item	Financial Statements Filed
July 18, 1986	Item 5 - Other Events	None
July 23, 1986	Item 5 - Other Events	None
August 1, 1986	Item 5 - Other Events	None
August 15, 1986	Item 5 - Other Events	None
August 28, 1986	Item 5 - Other Events	None
September 5, 1986	Item 5 - Other Events	None
September 12, 1986	Item 5 - Other Events	None

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

FORD MOTOR CREDIT COMPNY
(Registrant)

By F H Mason
F. H. Mason, Controller
(Chief Accounting Officer)

Date: November 12, 1986

FORD MOTOR CREDIT COMPANY AND CONSOLIDATED SUBSIDIARIES

Calculation of Ratio of Earnings to Fixed Charges
(dollar amounts in millions)

	First Nine Months		For the Years Ended December 31				
	1986	1985	1985	1984	1983	1982	1981 (1)
	(Unaudited)						
Fixed charges							
Interest expense	$1,898.9	$1,598.1	$2,198.7	$1,931.5	$1,502.2	$1,695.0	$2,039.0
Rents	10.0	8.7	12.9	10.6	9.7	9.2	8.3
Total fixed charges	1,908.9	1,606.8	2,211.6	1,942.1	1,511.9	1,704.2	2,047.3
Earnings							
Income before income taxes	767.6	533.5	772.1	535.4	545.2	411.5	310.0
Total earnings before fixed charges	$2,676.5	$2,140.3	$2,983.7	$2,477.5	$2,057.1	$2,115.7	$2,357.3
Ratio of earnings to fixed charges	1.40	1.33	1.35	1.28	1.36	1.24	1.15

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(1) During the fourth quarter of 1981, Ford made non-interest-bearing demand loans to Ford Credit that reduced the level of Ford Credit's fixed charges by $12.6 million. Had these loans not been made, Ford Credit's ratio would have been 1.14 in 1981. These loans were repaid by Ford Credit as of December 31, 1981 and no such loans have been made since that date.

Coopers
&Lybrand

certified public accountants

To the Board of Directors and Stockholder
of Ford Motor Credit Company:

We have made a review of the condensed consolidated balance sheet of Ford Motor Credit Company and Consolidated Subsidiaries at September 30, 1986 and 1985, and the related consolidated statements of income and of earnings retained for use in the business and changes in financial position for the periods set forth in Form 10-Q for the quarter ended September 30, 1986, in accordance with standards established by the American Institute of Certified Public Accountants.

A review of interim financial information consists principally of obtaining an understanding of the system for the preparation of interim financial information, applying analytical review procedures to financial data, and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an examination in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the financial statements referred to above for them to be in conformity with generally accepted accounting principles.

We have previously examined, in accordance with generally accepted auditing standards, the consolidated balance sheet at December 31, 1985, and the related consolidated statements of income and of earnings retained for use in the business and changes in financial position for the year then ended (not presented herein); and in our report dated February 7, 1986, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet at December 31, 1985 is fairly stated in all material respects in relation to the consolidated balance sheet from which it has been derived.

Coopers & Lybrand

Detroit, Michigan
October 23, 1986

Exhibit 12-3

FORD MOTOR COMPANY AND CONSOLIDATED SUBSIDIARIES

Calculation of Ratio of Earnings to Fixed Charges*
(dollar amounts in millions)

	Nine Months		For the Years Ended December 31				
	1986	1985	1985	1984	1983	1982	1981
	(Unaudited)						
Earnings							
Income (loss) before income taxes							
Ford and consolidated subsidiaries	$3,217.6	$2,437.1	$3,039.0	$3,810.3	$1,811.2	$ (607.0)	$(1,300.8)
Unconsolidated subsidiaries.......	991.9	607.7	965.4	675.5	621.8	464.7	309.0
Total..........................	4,209.5	3,044.8	4,004.4	4,485.8	2,433.0	(142.3)	(991.8)
Fixed charges							
Ford and consolidated subsidiaries	399.4	412.4	559.6	624.4	676.8	848.2	766.5
Unconsolidated subsidiaries........	2,779.6	1,856.6	2,625.4	2,196.9	1,830.1	2,007.8	2,363.9
Total..........................	3,179.0	2,269.0	3,185.0	2,821.3	2,506.9	2,856.0	3,130.4
Inter-group fixed charges...........	(72.2)	(65.7)	(91.8)	(94.5)	(70.4)	(118.0)	(109.5)
Total combined earnings before fixed charges..........	$7,316.3	$5,248.1	$7,097.6	$7,212.6	$4,869.5	$2,595.7	$2,029.1
Fixed Charges							
Interest expense							
Ford and consolidated subsidiaries	$ 349.5	$ 357.4	$ 475.0	$ 549.6	$ 583.7	$ 765.9	$ 704.1
Unconsolidated subsidiaries.......	2,768.3	1,850.6	2,610.2	2,183.6	1,817.0	1,995.6	2,352.2
Total..........................	3,117.8	2,208.0	3,085.2	2,733.2	2,400.7	2,761.5	3,056.3
One-third rental expenses							
Ford and consolidated subsidiaries	60.8	52.1	81.0	70.2	86.9	70.2	66.0
Unconsolidated subsidiaries	11.3	6.0	15.2	13.3	13.1	12.2	11.7
Total..........................	72.1	58.1	96.2	83.5	100.0	82.4	77.7
Amortization of debt discount.......	5.1	2.9	3.6	4.6	6.2	12.1	(3.6)
Inter-group fixed charges...........	(72.2)	(65.7)	(91.8)	(94.5)	(70.4)	(118.0)	(109.5)
Total combined fixed charges...	$3,122.8	$2,203.3	$3,093.2	$2,726.8	$2,436.5	$2,738.0	$ 3,020.9
Ratio of earnings to fixed charges....	2.3	2.4	2.3	2.6	2.0	**	**

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* For purposes of the ratio of earnings to fixed charges, the income before taxes of Ford Motor Company and Consolidated Subsidiaries includes the distributed income from less than fifty-percent-owned persons and excludes the equity in net income of all unconsolidated subsidiaries. The income before income taxes of unconsolidated subsidiaries consists of substantially all of the income before income taxes of Ford's unconsolidated subsidiaries as if consolidated. Fixed charges consist of interest on borrowed funds, amortization of debt discount, premium, and issuance expense and one-third of all rental expense (the proportion deemed representative of the interest factor).

** The ratios were less than one-to-one in 1982 and 1981 because earnings were inadequate to cover fixed charges for those periods. Earnings for 1982 and 1981 would have had to be higher by $142 million and $992 million, respectively, in order to cover the deficiencies in those years.

Exhibit 15

Coopers
&Lybrand

certified public accountants

Ford Motor Credit Company
The American Road
Dearborn, Michigan

Re: Ford Motor Credit Company Registration Statement No. 33-8440 on Form S-8, and 2-82744, 2-96762, 2-91104, 33-3808, 33-8126 and 33-8641 on Form S-3

We are aware that our report dated October 23, 1986 accompanying the unaudited interim financial information of Ford Motor Credit Company and Consolidated Subsidiaries for the periods ended September 30, 1986 and 1985 and included in the Ford Motor Credit Company Quarterly Report on Form 10-Q for the quarter ended September 30, 1986 is incorporated by reference in the Registration Statements. Pursuant to Rule 436(c) under the Securities Act of 1933, this report should not be considered a part of such registration statements prepared or certified by us within the meaning of Sections 7 and 11 of the Act.

Coopers & Lybrand

Detroit, Michigan
November 12, 1986

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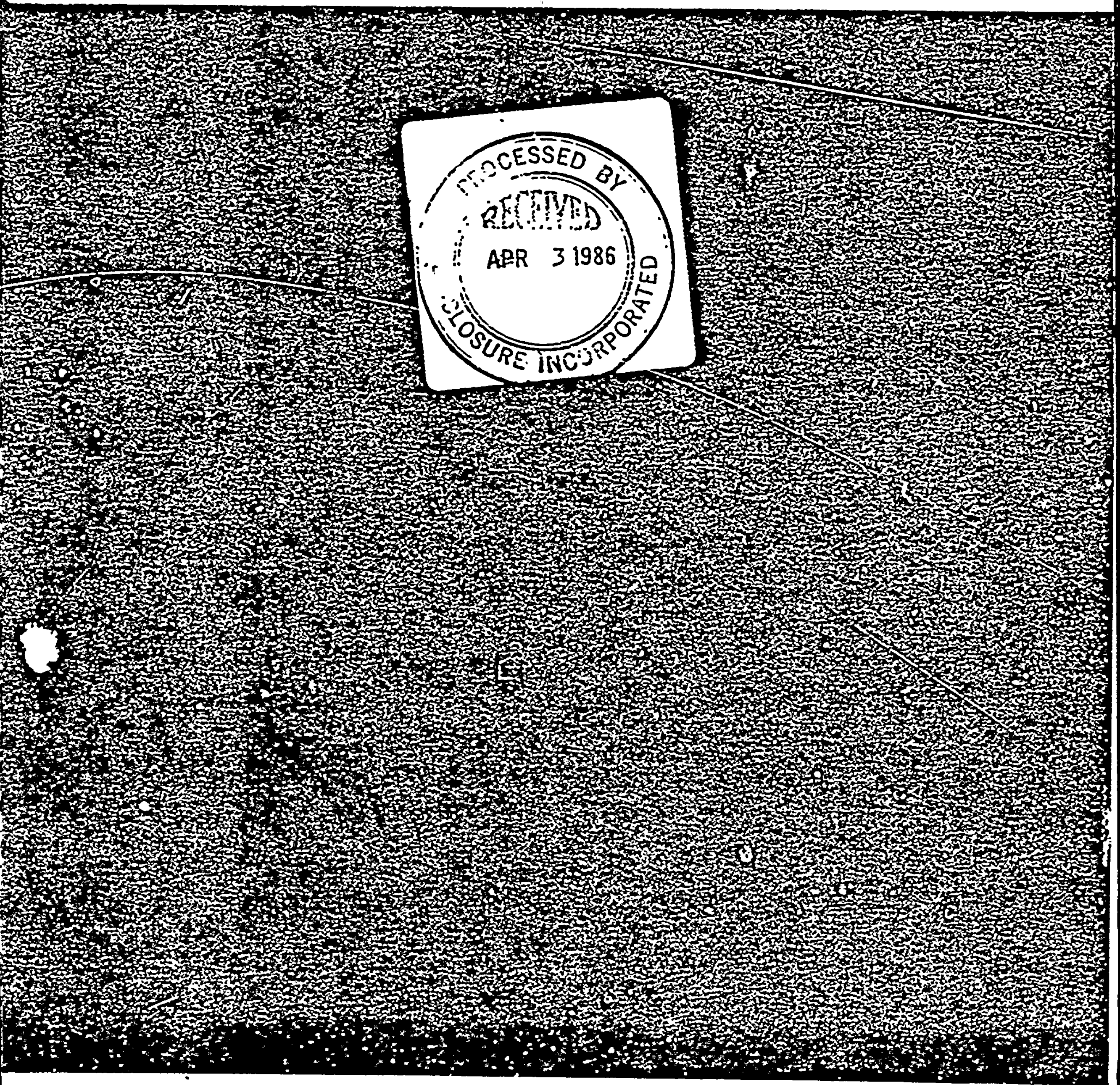
1985 Annual Report

FannieMae



[illegible]

Summary Statements of Operations

	1985	[illegible]
[illegible]	$ 70,469	[illegible]
[illegible]	345,150	[illegible]
[illegible]	142,230	[illegible]
[illegible]	205,500	[illegible]
Income before [illegible] income taxes	67,889	[illegible]
Provision for federal income taxes	(31,000)	[illegible]
Net income	$ 36,889	[illegible]
Cash dividends	$ 11,096	[illegible]
Per share		
Earnings	.52	[illegible]
Cash dividends	.16	[illegible]

Contents

Fellow Shareholders:

Nineteen eighty-five was an eventful year for our company. On balance, there was considerably more good news than bad. In this letter, I will review some of the highlights and my view of what lies ahead. Let me sum that up this way: In 1985, we made substantial headway toward putting the company in a position to earn a competitive return on our shareholders' investment in 1986 and later years. We do not lack for challenges, but that's what makes working at Fannie Mae interesting and worthwhile, and we are confident we can do a good job in meeting them.

For those with a deeper interest in the company, let me suggest, as I have in the past in these letters, that you review Management's Discussion and Analysis of Financial Results, as well as the financial statements themselves with accompanying notes. I don't see any point in repeating here that essential information about what happened in 1985.

As you know, management seeks to accomplish two complementary objectives for our shareholders. We want to earn the kind of return on equity that will attract capital to support our business, and we want to restructure the balance sheet so that we are insulated to the greatest extent possible from movements in interest rates.

In executing these strategies, we never lose sight of why we are here. Fannie Mae exists to provide a secondary market for residential mortgages. Congress permits us no activity that does not relate to this mission. Accordingly, I invite you to share our pride

David O. Maxwell, chairman of the board and chief executive officer, with employees Evon Streeter and Charles Burke.

that in 1985 the company provided financing for homes for 900,000 American families.

This achievement took a lot of hard work and creativity on the part of Fannie Mae employees. They deserve thanks for a job well done.

The profit we earned in 1985 can best be described as modest. What's noteworthy is its solid foundation. Unlike 1983, when a substantial part of our profit flowed from the sale of assets, in 1985 it was our basic business operations that produced black ink.

Moreover, other significant accomplishments in 1985 bode well for the future.

- We matched the estimated duration of loans purchased for portfolio to within two months of the duration of debt issued to finance those purchases.
- Our Mortgage-Backed Securities (MBS) issues exceeded purchases for the portfolio for the first time, substantially expanding our future

income stream from the guaranty fees generated by these securities.

- Short-term assets, which we began to buy in 1981, now constitute approximately 21 percent of the portfolio.

- The average maturity of our outstanding debt was three years, four months at year-end, longer than it has been since 1979.

- Most notable, of course, the spread on our total portfolio turned positive in the fourth quarter for the first time since 1979.

We strengthened our capital base to support our business in 1985 by issuing seven million shares of common stock in early May. The issue was underwritten by a syndicate headed by Dillon, Read & Co., Inc., and those shareholders who purchased the new shares at $15.88 must be pleased with the performance of the stock since we floated the issue. As I write this letter, we have just executed, through a syndicate headed by First Boston Corporation, a highly successful offering of $500 million of debt with warrants to purchase common stock, which will immediately buttress our stockholders' equity by $67.6 million. The exercise price for the warrants is $44.25, a 50 percent premium over the market price of the stock at the time of pricing the offering.

In truth, our Fannie Mae could hold her own as the star of one of those ads with the caption: "You've come a long way, baby!"

Nineteen eighty-five also brought us those challenges I mentioned: unprecedented foreclosure losses; the collapse of EPIC; a political shoot-out on "user fees"; and a General Accounting Office (GAO) report on Fannie Mae. Let me briefly discuss what happened in each of these areas, and the implications of these events for the future.

Foreclosure Losses Continue

We added $206 million to the allowance for losses in 1985. Conventional loan losses (excluding FHA/VA and MBS) charged off against this allowance amounted to $143 million. We are not counting on any improvement in these numbers in 1986. Indeed, continuing economic problems in sections of the country highly dependent on energy and other commodities could lead to increased additions to the allowance for losses and charge-offs against this allowance in 1986.

By and large, these losses constitute the price Fannie Mae is paying for having performed three absolutely critical tasks earlier in this decade: First, we adopted certain short-term strategies to stop the losses of as much as $1 million a day in 1981 and to ensure the survival of the corporation.

Second, we had to step up to bat as a provider of liquidity to the housing market during the worst economic conditions in our industry since the 1930s. Such conditions have always produced higher foreclosures. This activity was consistent with congressional expectations that we will fulfill our Charter Act responsibilities by staying in the market at all times, particularly when economic conditions lead other players in the secondary market to withdraw.

Third, when the housing industry needed a secondary market for a wide variety of adjustable-rate mortgages in the early stages of the development of those instruments, Fannie Mae provided that market. Some of those experimental types of mortgages have turned sour since we bought them, but that does not mean we should not have bought them at all. In fact, Fannie Mae's size and singleness of purpose confer on us a unique responsibility for research and development in the mortgage industry. The market has now moved to much greater standardization of adjustable-rate mortgages, an outcome we have always predicted and favored, but our activities in the early stages helped home builders, mortgage bankers, and thrift institutions to launch these essential instruments.

Our role in research and development is often overlooked, although recently we have attracted attention to it by our year-long study of the feasibility of a national mortgage exchange. Early in 1985, we assigned Gary Kopff, a vice president of the corporation, to explore this issue on a full-time basis, giving him the resources necessary to do so. Mr. Kopff is currently finishing his study and will be making recommendations to the management and our Board of Directors shortly. Until we have had an opportunity to review and evaluate the results of this work, I cannot predict what, if anything, we will decide to do further on this project.

Returning to the question of foreclosure losses, we have put in place the

[illegible]

organization and resources necessary to dispose of the properties we acquire through foreclosure. We are maintaining our loss reserves at a level that should make our shareholders and the investment community comfortable as to their adequacy. If, at any time, we conclude that we require greater protection against potential losses, we will not hesitate to increase the amount of the reserve. We don't want any unpleasant surprises in this department.

EPIC Plan Advances

On vacation last August, I received a telephone call from Mark Riedy which jolted me back into the "real world." He told me a firm called EPIC was on the verge of collapse with momentous consequences for the mortgage industry. We ourselves had slightly more than $100 million of EPIC loans in our portfolio, a small amount relative to our total volume, but nevertheless worthy of prompt attention. Soon thereafter, I returned to Washington to become fully involved in this situation, which by that time was making headlines all over the country.

EPIC was a prime example of an enterprise entirely dependent on the kind of strongly inflationary conditions that prevailed in the housing market of the 1970s. EPIC's original business, in the late 1970s, was buying model homes and leasing them back to relieve builders of the cost of carrying these models during the sale of homes in a development. EPIC sold models to limited partnerships and set up a mortgage company to make and pool loans on these models. The firm sold securities backed by these pools of mortgages, as well as some of the mortgages themselves (Fannie Mae's purchases were of whole loans) to a wide range of investors. The mortgages, and some mortgage pools, were insured by private mortgage insurers.

In the early 1980s, EPIC's managers began a rapid expansion of the firm's business. They started to buy leftover homes in housing developments and then, in about 1983, they started to make forward commitments to builders to buy large numbers of houses including some entire developments. The houses EPIC bought were rented, but rental income was insufficient to pay the carry on the mortgages. The shortfall required to service the mortgages on these houses was made up from various sources, including resyndications, refinances, sales of the houses themselves and contributions from limited partners. As housing prices leveled off and even declined in certain areas, EPIC used its newly acquired Maryland thrift institution, Community Savings and Loan, to advance shortfalls in mortgage payments. When Community was told by regulators to divest itself of its EPIC interest in the summer of 1985, the whole house of cards began to collapse. Most of the EPIC Partnerships filed for bankruptcy, and most of the approximately 20,000 loans outstanding on EPIC properties went into default.

In September, we formed a committee with nine other investors in EPIC mortgages and mortgage-backed securities to find and implement a solution to the problems created by EPIC's collapse. I agreed to serve as chairman of that committee. We went to work to develop an orderly plan for the disposition of EPIC's properties that would minimize loss to investors, mortgage insurers, the state of Maryland, and limited partners. Since that time, through countless meetings and negotiations, we have come a long way toward our objective.

Thanks to the cooperation of all concerned, especially the Federal Home Loan Bank Board and the three principal mortgage insurers involved—MGIC, RMIC, and TMIC—we have filed with the bankruptcy court a plan that we believe will provide the basis for minimizing losses in this situation. At this writing, I am hopeful that some final obstacles to the implementation of this plan will be cleared away so that the court can approve it and put it into effect before April 30, 1986.

I must tell my fellow shareholders that I have spent a good deal of my time on this matter since last Fall, assisted greatly by Caryl Bernstein, our General Counsel, and Ed Pinto, our Senior Vice President for Marketing. Although Fannie Mae's exposure is smaller relative to our size than that of many other investors in EPIC mortgages and mortgage-backed securities, we felt it incumbent on our company, as a leader of this industry, to leave no stone unturned in helping to find a solution to a problem which posed a threat, not just to many thrift institutions, but also to the integrity of the mortgage system itself. If we can succeed in removing the last

obstructions to implementation of the workout plan, we will feel this has been time well spent.

Industry Unites Against User Fees

Last year, in this letter, I discussed the Administration's proposal in the fiscal year 1986 federal budget for the imposition of "user fees" on our company. We fought hard against that proposal, and the Congress rejected it.

This year, I regret to say the Administration's fiscal year 1987 federal budget contains an even more onerous proposal for "user fees," as well as several other fees and restrictions on federal support which, taken together, could put affordable housing beyond the reach of millions of American families of modest means. With the possible exception of VA loan guaranties, these federal supports, like Fannie Mae, cost the taxpayers nothing.

Under this proposal, Fannie Mae would pay a fee to the Treasury each year on the company's borrowings and MBS. The fees would be phased in, ultimately resulting in a full 50 basis points (one-half of one percent) charged each year on all debt and 10 basis points (one-tenth of one percent) on all MBS. This could impose additional costs on Fannie Mae of more than $1 billion just in the first five years. The budget proposes similar fees at varying levels for Freddie Mac, the Federal Home Loan Banks, the Farm Credit System, and Sallie Mae.

I am pleased to report that I have never seen our industry so united as it is today in opposition to these "user fees," as well as the other ill-advised proposals of the Office of Management and Budget to curtail drastically FHA, VA, and Ginnie Mae. I believe Congress again will reject this proposal for many reasons, including the following:

- This "user fee" is not a user fee at all. It is an excise tax on Fannie Mae's borrowing. User fees are proper charges to recoup taxpayers' outlays for services. Taxpayers do not support Fannie Mae. Fannie Mae does not spend federal taxes; it pays them. The company has been a victim, not a maker, of the federal budget deficit.
- The government sold Fannie Mae to its private shareholders in 1970 for $216 million. Today, these 30,000 shareholders provide the capital base for the company; in 1981-82, they—not the taxpayers—bore losses of nearly $300 million. To use the failures of federal fiscal policy as a pretext to impose an added tax on them would be unconscionable.
- The government continues to restrict Fannie Mae to a single business—providing a secondary market for residential mortgages for low-, moderate-, and middle-income home buyers. Only Fannie Mae's ability to tap the private capital markets for large sums at reasonable rates enables it to survive as a private company with but one government-mandated business. To tax this borrowing ability while continuing to mandate and restrict the company's business would be shameful and ultimately ruinous.
- Chase Econometrics estimates that over the five-year period 1988-92, the effect on housing of this tax on Fannie Mae would be 163,000 fewer housing starts; 320,000 fewer housing sales; and higher mortgage rates.
- This "user fee" is not deficit reduction. Revenues from any such tax Fannie Mae could afford to pay would not make a dent in the deficit. Indeed, Chase Econometrics has found that, "if Fannie Mae can successfully pass on the user fees, the negative effects in the economy include . . . lost output in real terms of $24 billion over the five-year period; this leads to an increase—not a decrease—in the deficit in nominal terms of $17 billion, which is only partly offset by user fees collected. . . ." The fact of the matter is that this proposal is disguised as deficit reduction to hide its true nature as a radical change in national housing policy.

GAO Report Issued

In 1985, the General Accounting Office (GAO), which has become famous for its assigned role under Gramm-Rudman-Hollings (a role ruled unconstitutional by a federal court in a case now on appeal to the Supreme Court), did something else of

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note to our shareholders. The congressional watchdog agency published a long report on Fannie Mae.

The authors of this report reached the conclusion that the risk posed to the government by Fannie Mae's portfolio required closer supervision and regulation. In the section of the report reserved for our comments, we respectfully disagreed. During the five years I have served as chairman, HUD and Treasury have faithfully discharged their obligation to regulate this company under our Charter Act. Our principal regulator, Secretary Pierce of HUD, has supported the steps we needed to take to turn the company around, and we are grateful to him for that. He has been a strong and fair regulator. Indeed, regulation beyond that which we have experienced in this period could hobble the continued improvement of our balance sheet and thus lead to even greater risk for the government

I do think the GAO conducted a thorough and fair examination of the company. Working with them as closely as we did required the allocation of substantial corporate resources, but this proved worthwhile, because the GAO team clearly came to understand the validity of the business strategy we have pursued. The final report reflects that understanding.

Last May, shareholders elected two new directors: Roger E. Birk, Chairman Emeritus of Merrill Lynch & Co., Inc., and James A. Aliber, Chairman and Chief Executive Officer of First Federal of Michigan. In July, President Reagan named three new presidential directors: Samuel W. Bartholomew, Jr., Chairman and Principal of Donelson, Stokes & Bartholomew, Nashville, Tennessee; Alberto R. Cardenas, Partner in Broad and Cassel, Miami, Florida; and Henry C. Cashen II, Partner in Dickstein, Shapiro & Morin, Washington, DC. These three presidential appointees joined Dianne Ingels and Merrill Butler, who have served by appointment of President Reagan since 1981. Our company and your management are fortunate in having outside directors who take their responsibilities to Fannie Mae with the utmost seriousness. I am grateful for their hard work and wise counsel.

What Lies Ahead for the Company?

I foresee the following:

- Continuing low inflation and interest rates should give us a good opportunity to continue to rebuild retained earnings and restructure our balance sheet in 1986. In 1985, our debentures issued averaged almost six years in maturity and total debt issued almost four years. This extension of debt carries a price, of course, in immediate earnings. However, we view this as a necessary and worthwhile investment in risk reduction—one that will make our company much less sensitive to interest rate movements in the future.

- As I said earlier, foreclosure losses will remain high. It will be years before this particular pig works its way entirely through the snake. Moreover, there is no sign on the horizon of a dramatic recovery in sections of the country where foreclosure losses are highest. The very decline in interest rates that benefits the company's interest margin so substantially is linked directly to the economic conditions, including lower oil prices, that exacerbate foreclosure losses.

- The loans Fannie Mae is buying today are of higher quality than some of the loans we felt obliged to buy earlier in the decade. We have implemented new underwriting guidelines that are becoming a standard for the industry. It is true that some home buyers will have to defer their purchases or settle for less house, but that is far preferable to undergoing the pain of foreclosure. I am happy to report that, since our new standards went into effect last October, our volume of business has held up well.

- With respect to pricing, we intend to maintain our spreads to the extent possible in a highly competitive market. Bearing in mind Fannie Mae's responsibility to furnish the lowest cost mortgage financing consistent with an adequate return for our shareholders, we monitor the pricing of our products on a daily basis. Last year, our spread on purchases of loans for our portfolio averaged 1.34 percent (134 basis points). It is probable we will not achieve spreads as high as that in a lower-rate environment this year, but we will continue to buy loans at a profitable spread.

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• In 1985, liquidations of loans in portfolio, excluding mortgage sales, were approximately $10 billion, or 11 percent. We expect liquidations to remain at this high level in 1986, as mortgagors sell or refinance their homes to take advantage of lower interest rates.

• We will pursue our all-out promotion of Fannie Mae's MBS. This product provides the best ticket to a future insulated from over-sensitivity to movements in interest rates. Moreover, the guaranty fees from this product accumulate like an annuity, as the volume of securities outstanding grows. We have developed a number of uses for the product that are highly positive for the thrift industry—for example, in its issuances of collateralized mortgage obligations—and for state and local housing finance agencies in their issuances of bonds for the construction of housing for low- and moderate-income people.

• This is the year that our advance in technology called LASER will begin to give us better control over reporting and accounting for our portfolio. We intend to begin gradually phasing in this technology during the year. The full implementation of LASER will take several more years. We have spent a great deal of money on this effort, but we expect it will pay off handsomely in future business. Meanwhile, Fannie Mae Software Systems is poised to gain market share for its origination and servicing products for mortgage lenders.

• While we are unalterably committed to the defeat of "user fees," we will maintain our cordial and constructive relationship with our governmental regulators at HUD and Treasury. We anticipate the possibility of oversight hearings, perhaps this year, by the Senate or House Banking Committee, or both, to review the role of the federal government in supporting housing, both in the origination of mortgages and in the secondary market. If these hearings should occur, I would welcome the opportunity to state the case for Fannie Mae, and I am confident the Congress would give that case a sympathetic hearing.

As I think you can tell by now, my colleagues and I look forward to 1986 with a sense of happy anticipation. We have the plans in place to meet our challenges. We think it can be a very good year for our company and its shareholders. You can be sure we will work tirelessly to make that promise a reality.

David O. Maxwell

David O. Maxwell
Chairman of the Board and
Chief Executive Officer

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Year of Progress

first five years of the 1980s argu- y represented the most tumultuous iod in housing finance in the past y years. In this brief span, the ustry had to withstand many ls: historically high interest rates; deepest, most severe recession e the Great Depression; deregula- of the financial markets; and a iod of unprecedented adaptation experimentation.

se were tumultuous years for nie Mae as well. Saddled with a erely mismatched portfolio of assets and liabilities, the corporation set its sights on a return to profitability and financial health. The journey, however, was not an easy one for the company's stockholders and employees. Fannie Mae lost money in three of those five years.

While not offering a distinct break from the upheaval of the immediate past, 1985 nonetheless was a year of consolidation for the housing finance industry. In effect, the marketplace took stock of the changes, accepting some new ways of doing business and rejecting others. Clearly, the volume and diversity of activity in both the primary and secondary markets in 1985 were an indication that home buyers, lenders, and investors will have more choices in the post-deregulation era. Spurred by a drop in interest rates of between 250 and 300 basis points during the year—the lowest rates seen in the 1980s—home mortgage originations climbed to an estimated $234 billion last year, a new record.

In 1985, Fannie Mae's interest margin—the return on the mortgage portfolio and marketable securities, less the cost of debt—was $71 million, the first positive margin reported since 1980. This turnaround, in addition to the marked increase in fee income, highlights the progress Fannie Mae has made toward ensuring earnings growth over the long term.

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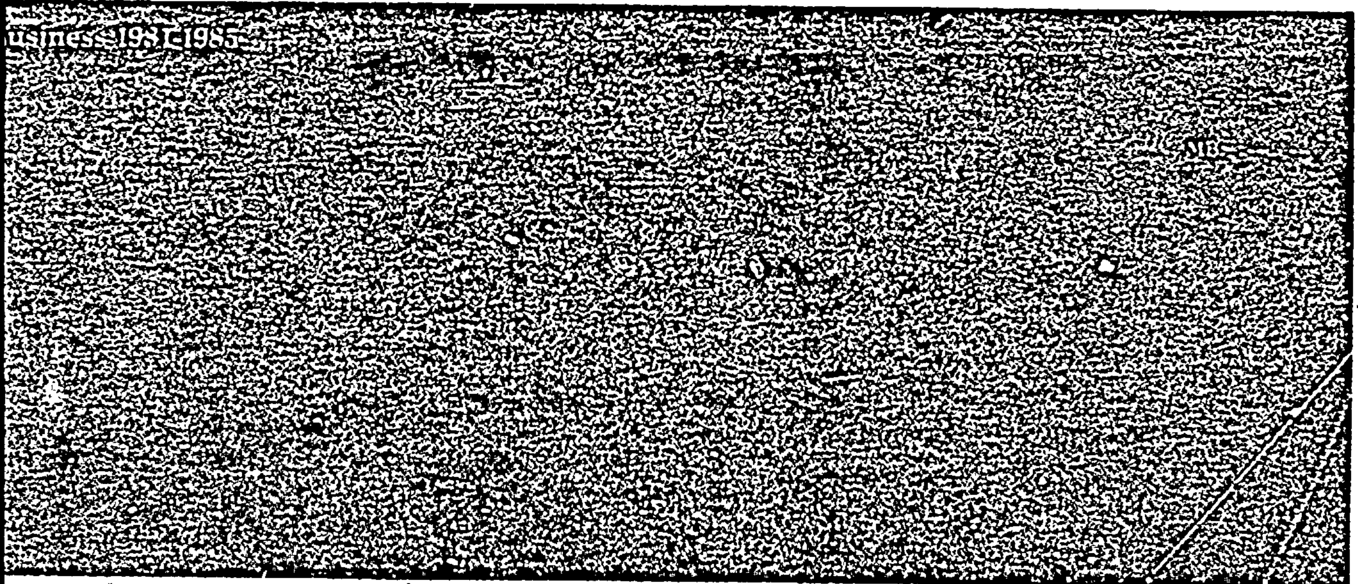

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nations also rekindled the mortgage securities market. Issues of mortgage-backed securities soared from $60 billion in 1984 to $107 billion in 1985.

The diversity in the primary market accelerated the evolving role of the secondary market as the dominant source of funds for mortgage lenders. At the close of the last decade, secondary market sales accounted for 41 percent of originations. In 1985, this figure had grown to an estimated 75 percent.

The consolidation in the marketplace manifested itself in the moderation of the creativity and experimentation of earlier years. Mortgage insurance companies and Fannie Mae announced tighter underwriting criteria for certain loan types and loan characteristics that were proven to lead to a higher incidence of default. Throughout the country, lenders responded to these changes by insisting on either greater equity through a higher down payment or higher income from the borrower. Another change was the growing standardization in the adjustable-rate mortgage (ARM) market. Consumer protection features and common indices became the norm in the origination and sale of these mortgages during 1985.

Fannie Mae's progress in 1985 was even greater than that of the market. The company returned to profitability, while at the same time accomplishing significant restructuring of its portfolio. Through its purchase of mortgages for portfolio and issues of Mortgage-Backed Securities (MBS), the corporation channeled $45 billion of funds to home buyers through mortgage lenders. Lenders used these funds to finance an estimated 900,000 homes during the year. Of this total business, Fannie Mae issued $24 billion in Mortgage-Backed Securities, bringing the company's total issues from a standing start in 1981 to more than $55 billion outstanding by the end of 1985—the fastest start-up of this type of security in the industry's history.

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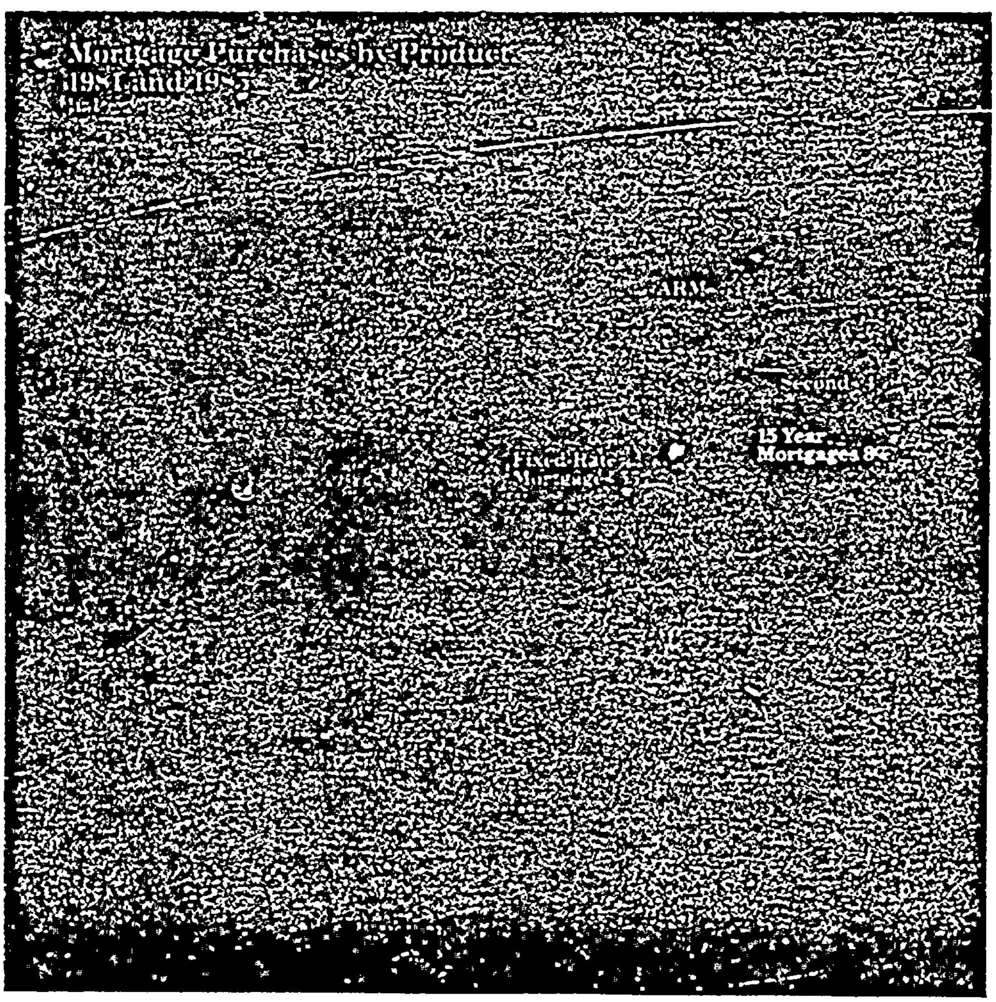
Last year Fannie Mae also put into place a portfolio strategy of matching the estimated durations of its new mortgage investments with the duration of the liabilities funding those investments. At the same time, the company continued to take advantage of market opportunities to extend the maturity of the debt backing loans the company purchased or already had on its books. In the favorable financial environment that prevailed in 1985, this strategy paid off handsomely. Not only did Fannie Mae return to profitability, but the company also significantly reduced the duration mismatch of its portfolio from 2.4 years at the end of 1984 to just 1.6 years at the end of last year—a dramatic improvement that foretells more stable profits over the long term for investors.

The following pages highlight Fannie Mae's year of progress, encompassing developments in the areas of new investments, MBS, financing, and portfolio management.



Since 1981, Fannie Mae has emphasized the purchase of shorter-term mortgages for its portfolio and has thus improved the duration match of its assets and liabilities. This strategy helps reduce the corporation's sensitivity to interest rate changes.

New Investments

The diversity of Fannie Mae's business with lenders reached new heights of accommodation in 1985. The company's record level of purchases, $21 billion, reflected the broadest array of any investor in the secondary market:

- 30-year, conventional, fixed-rate mortgages
- 15-year, conventional, fixed-rate mortgages
- Conventional multifamily mortgages
- Single-family and multifamily mortgages through housing finance agencies
- Adjustable-rate mortgages
- Second mortgages
- Low-coupon mortgages

A nationwide network of 1,600 lenders channeled this diverse business—as well as loans for MBS—to Fannie Mae, with 45 percent of the company's business coming from thrifts, 43 percent from mortgage banking firms, and 12 percent from commercial banks and other financial institutions.

The company made notable progress in purchasing shorter-term and more flexible mortgages, whose shorter expected durations can be matched more easily with the company's liabilities. Fannie Mae purchased $7.1 billion of adjustable-rate mortgages, adding significantly to the company's portfolio of this important asset. What is most significant is that these purchases came after Fannie Mae had led the market in standardizing consumer protection features in ARMs, which effectively limited the types of these mortgages the company will buy from lenders.

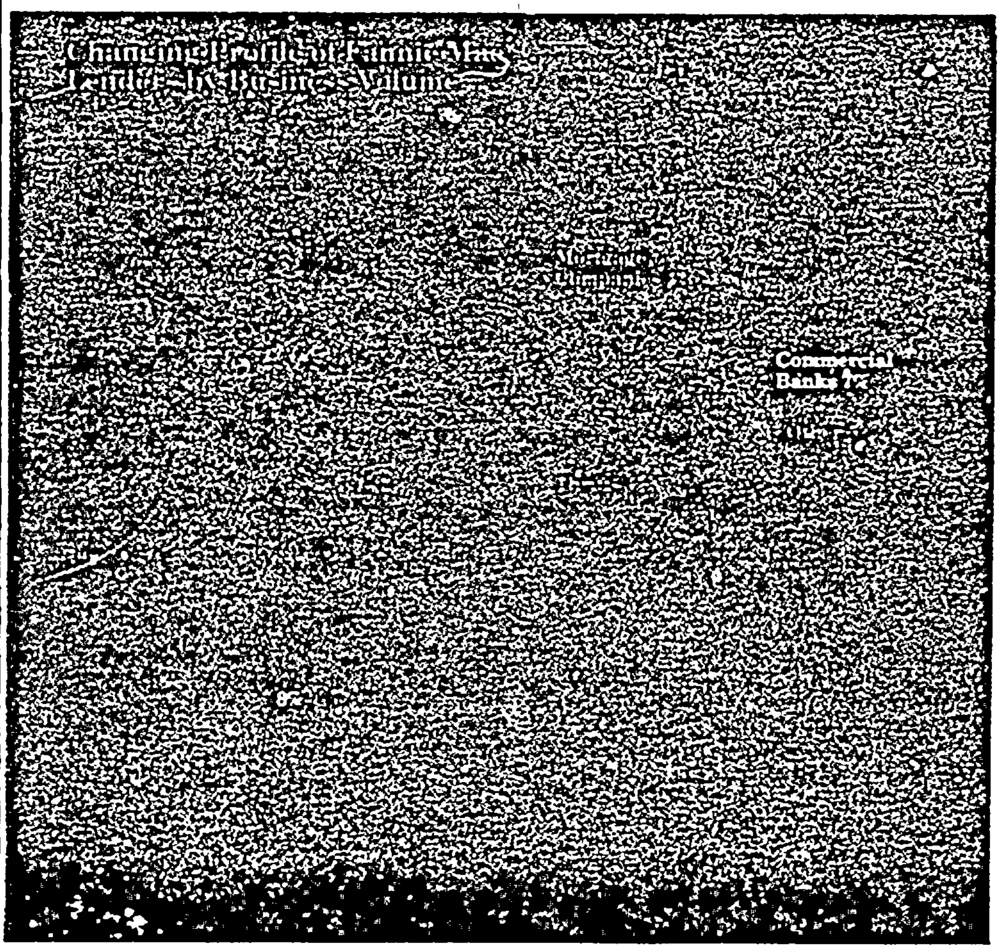
Nineteen eighty-five also marked the emergence of the 15-year mortgage as an increasingly popular consumer alternative to the traditional 30-year,

fully amortizing, fixed-rate mortgage. Fannie Mae found this intermediate-term mortgage, with its shorter expected duration, to be an attractive addition to the company's portfolio. The increased popularity of the 15-year mortgage among borrowers, lenders, and investors allowed Fannie Mae to demonstrate its unique value to the market as both a portfolio investor and issuer of MBS. During the year, the company purchased $1.7 billion of 15-year mortgages for portfolio and issued $2.9 billion in MBS backed by these mortgages.

Fannie Mae also served lenders' liquidity needs by purchasing, at market yields, $1.9 billion in low-coupon mortgages during the year. They represent a secure investment for the company and, because of their more stable prepayment expectations, serve as an excellent match for fixed-term liabilities.

For the year, Fannie Mae earned $196 million in commitment fees. But the icing on the 1985 cake was the fact that the company's annualized interest margin on the $21 billion of mortgages purchased last year was about $280 million—an outstanding return on the year's book of business.

In 1981, more than two-thirds of Fannie Mae's business came from mortgage bankers. During the next four years, the corporation worked to more greatly diversify its customer base. As a result, in 1985, Fannie Mae's business with mortgage bankers and thrift institutions was nearly equal.



Mortgage-Backed Securities

From all perspectives, 1985 was a record year for the Fannie Mae MBS. For the first time, the company's MBS issues exceeded portfolio purchases. Since beginning the program in 1981, Fannie Mae has issued over $65 billion in MBS—proof of the excellent market acceptance of this product and of the company's strong commitment to this business.

As evidenced by the record volumes and milestones in 1985, the company made significant progress in maintaining the competitiveness of the MBS in the mortgage market. Last year, the Fannie Mae MBS proved that it is truly the product for all seasons. In the high interest rate environments of 1982 and 1984, Fannie Mae responded to lenders' liquidity needs by issuing Mortgage-Backed Securities backed predominantly by seasoned loans. Lenders then used the securities for repurchase agreements, long-term borrowings, or outright sales. As the market shifted back to originations of fixed-rate mortgages in the lower interest rate environment of 1985, lenders used the Fannie Mae MBS to support their current originations, and this became the company's predominant form of issue during the year.

While interest rates certainly have played a dominant role in determining the mix of Fannie Mae's MBS business, the company also has played the leading role in developing new products—such as adjustable-rate and multifamily mortgage securities—to serve lenders' needs irrespective of rate movements. In the past four years, Fannie Mae has issued more than $8 billion in variable-rate and

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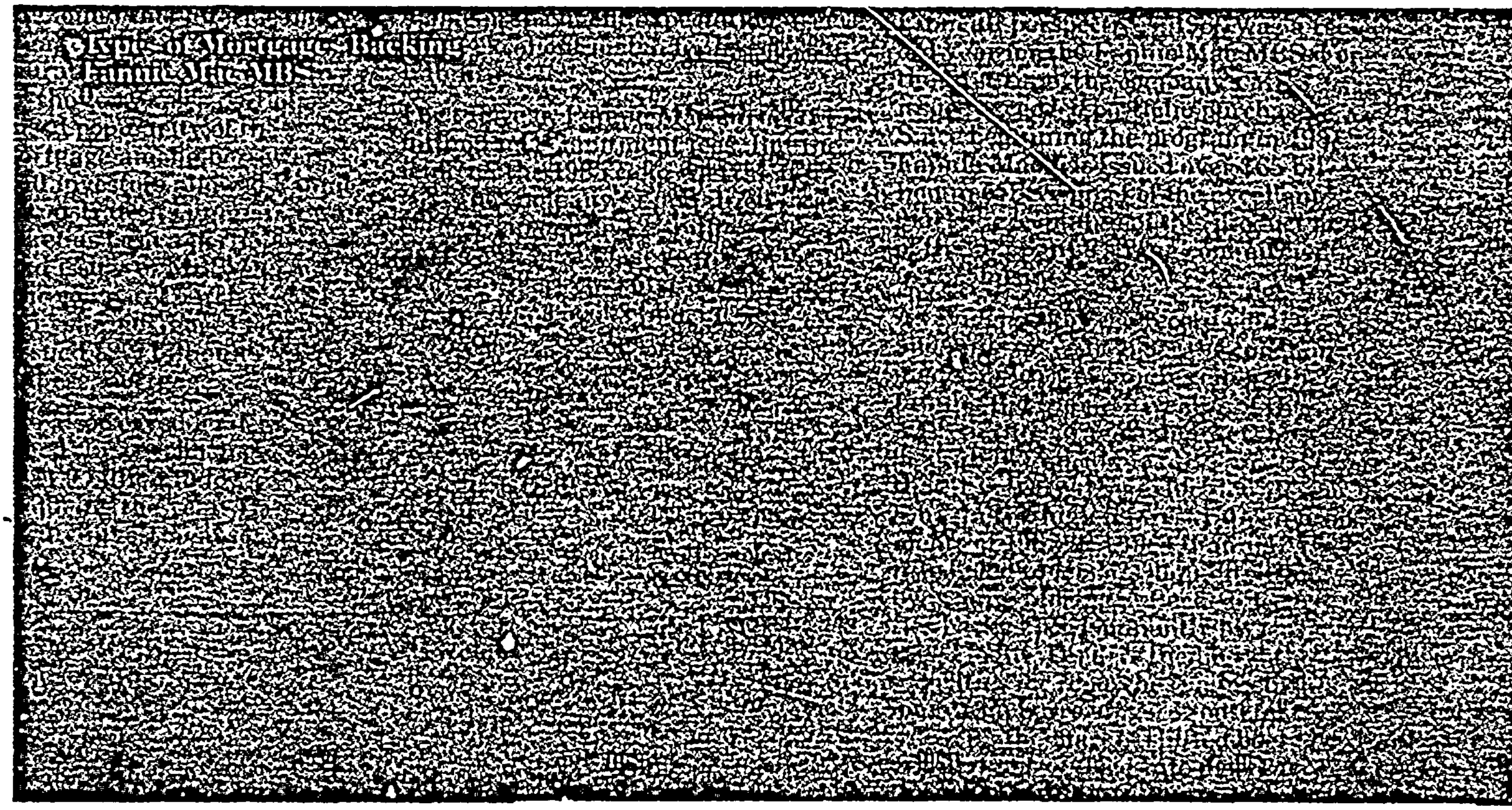

Lenders typically pool more seasoned loans for Fannie Mae MBS when interest rates are higher; they sell more current loans for Fannie Mae MBS in years, such as 1985, when interest rates are lower. Special product MBS—those backed by multifamily, adjustable-rate, and variable-rate mortgages—give mortgage originators greater flexibility in meeting the needs of the marketplace and attract a variety of investors to MBS. Whatever the interest rate environment, the Fannie Mae MBS program meets lenders' and investors' needs.

adjustable-rate MBS. In 1985 alone the company issued nearly $4 billion in securities backed by these mortgages. These products also appealed to investors, who looked for interest-rate-risk protection in the falling interest rate environment of 1985.

One of the principal reasons for the success of the Fannie Mae MBS is its financial structure. Each type of mortgage-backed security has a built-in timing delay, which is the period between the time a lender collects the payment from the borrower and when the investor receives it. The Fannie Mae MBS holds this delay down to just 25 days. In addition, Fannie Mae guarantees timely payment of principal and interest—even if the borrower does not make his or her payment.

Because of these features—the timely payment of interest and principal and the short payment delay—the MBS is becoming the preferred conventional security to be used as collateral for structured financings including collateralized mortgage obligations (CMOs). Lenders and dealers using the MBS are able to maximize their net proceeds, and this has added to the popularity of the security.

The structure of the Fannie Mae MBS also appealed strongly to other members of the investment community in 1985. Investors and dealers are willing to pay more for the Fannie Mae MBS

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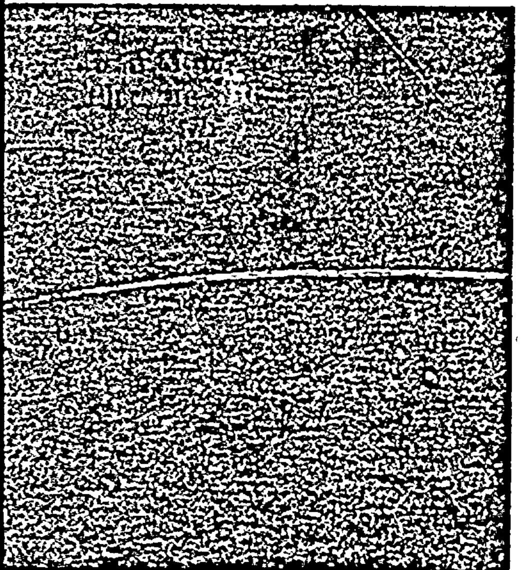


by doing good. Tax-exempt housing agencies at the state and local levels use the Fannie Mae MBS as collateral to improve their bond rating and lower their cost of issuance. These savings are passed on to the consumer in the form of lower rents or lower mortgage payments. Last year, Fannie Mae issued nearly $2 billion in commitments to housing agencies and facilities for single-family and multifamily mortgages financed through tax-exempt bond issues. The Muni Mae program helped finance over 55,000 rental housing units in 1985. Fannie Mae benefited in the process, generating both commitment fees of $19 million and an annuity stream of future income from its guaranty fees.

Moreover, the corporation enhanced the efficiency of the MBS program in 1985. To simplify investors' bookkeeping and to provide faster transfer of funds, Fannie Mae converted its fixed-rate MBS issues to the New York Federal Reserve Bank's book-entry system.

Financing

Fannie Mae's long-term financing objective since 1981 has been to improve its asset life/debt maturity match by increasing, when opportune, the average maturity of its debt outstanding. Last year, the corporation increased its average debt maturity by 30 percent over 1984.

The corporation raised some $40 billion in 1985 through its traditional debenture and short term note issuances. The 300 to 400 basis point drop in rates between the summer of 1984 and the end of 1985 clearly had a highly favorable impact on the corporation's ability to achieve savings in its borrowing costs and to extend its debt.

Moreover, Fannie Mae reaped significant cost savings through non-traditional financing programs. Significant among these innovations were the corporation's overseas offerings. When Congress repealed the 30 percent withholding tax on foreign investment in American securities, Fannie Mae was among the first American corporations to tap the European and Japanese markets with attractive investment instruments.

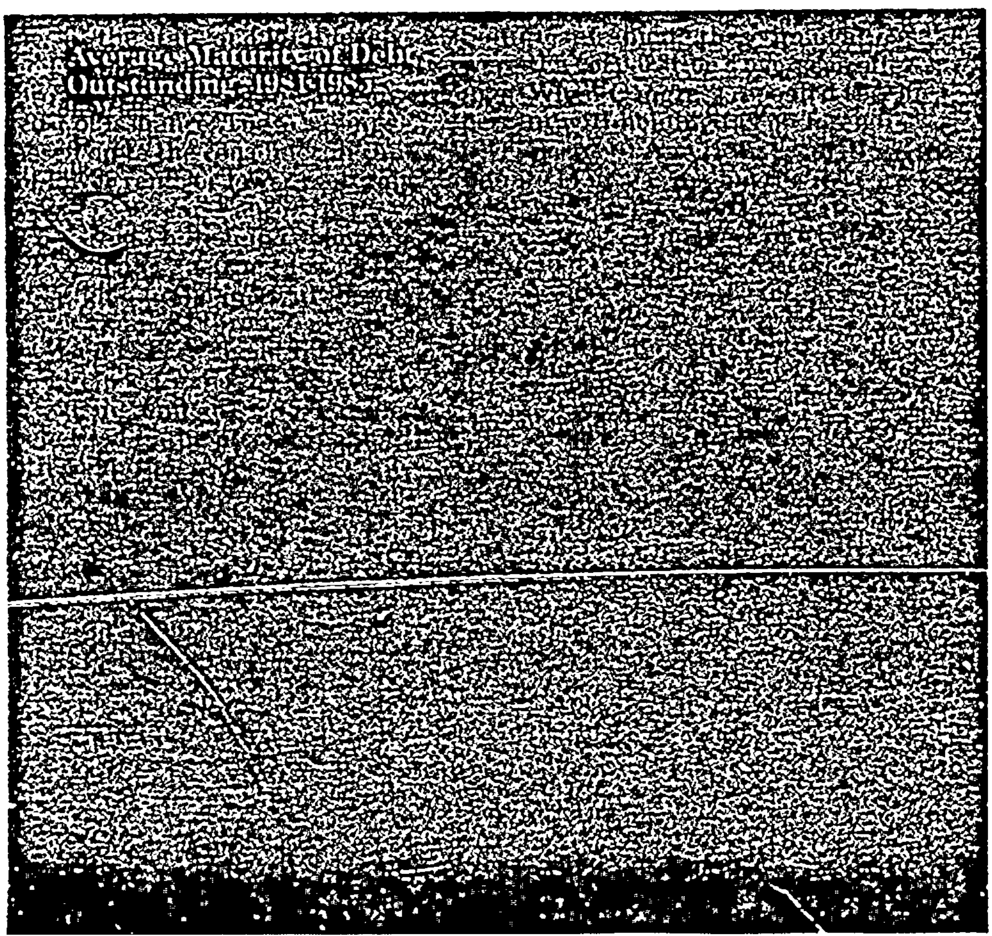
In 1985, Fannie Mae issued $1.2 billion of securities targeted to foreign investors, including a wide variety of innovative instruments—dual currency bonds, Eurodollar and Euroyen

bonds, and dollar and yen borrowings in the Japanese markets. Fannie Mae issued ¥30 billion ($139 million) in yen-denominated securities in the United States market, becoming the first corporation to issue a yen security in the domestic market.

Domestically, Fannie Mae continued to expand its volume of innovative financing techniques. The corporation's most successful non-traditional form of financing in terms of volume and cost savings in 1985 was Investment Agreements. These agreements provide a specialized investment vehicle for bond issuers, so that they can manage better the cash flow of their offerings. These AAA-eligible investments provide the issuer with either a fixed or variable rate of return on its funds. The corporation established 457 new accounts for a net increase of $4.5 billion in 1985, compared with 55 accounts for a net increase of $1.3 billion in 1984. In 1985, year-end annualized savings from this form of financing totaled an estimated $20 million, versus savings of approximately $5 million in the previous year.

Investment Agreements are popular because Fannie Mae is willing to negotiate complex contracts to meet the needs of a wide range of borrowers. Tax-exempt bond and CMO issuers often choose Fannie Mae Investment Agreements to manage the cash flows from bond offerings. For example, the State of New York Mortgage Authority used the Fannie Mae Investment Agreement program for a three-year project to construct single-family homes throughout the state.

During 1985, with interest rates at the lowest levels since 1979, Fannie Mae made substantial progress toward reducing its sensitivity to interest rate fluctuations. A significant component of this effort was lengthening the maturity of debt outstanding.



Interest rate swaps, which are individually negotiated agreements with 5- to 10-year terms and with AAA or equivalent counterparties, continued to be a valuable financing vehicle for the corporation in 1985. Fannie Mae swaps interest payments on short-term debt with other borrowers' interest payments on long-term debt, thereby achieving debt extension at significantly better rates than those available from the corporation's traditional funding sources. The majority of the corporation's swap counterparties are foreign sovereigns or sovereign-related entities who borrow in the Euromarket.

The company's non-traditional debt—defined as Investment Agreements, targeted foreign issues, interest rate swaps, and master notes—as a percentage of net debt outstanding, has increased from one percent to five percent to fourteen percent in 1983, 1984, and 1985, respectively.

Fannie Mae also found 1985 to be an opportune time to increase its equity base. In May, the company issued seven million shares of common stock that provided $107 million in equity capital for the corporation. New and old shareholders benefited from the appreciation of Fannie Mae's stock from $15.38 per share at the end of 1984 to $25.88 at year-end 1985.

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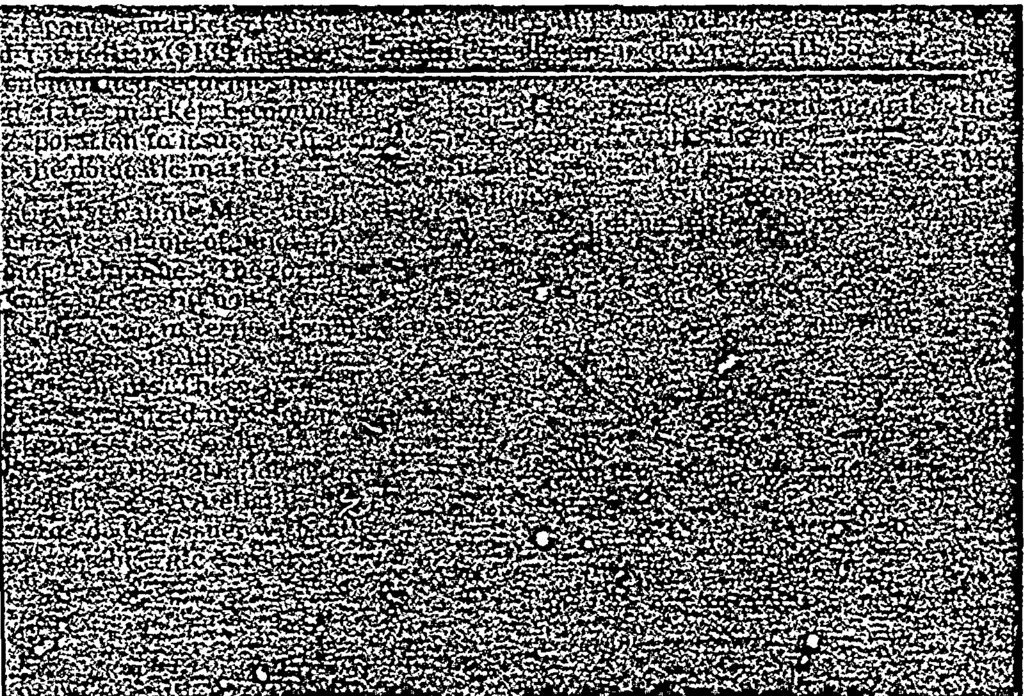

Portfolio Management

The benefits of the corporation's business strategies—duration matching on new investments, extension of debt on existing investments, emphasis on purchases of shorter-term assets, and aggressive pursuit of borrowing efficiencies—are most vividly illustrated by the performance of Fannie Mae's portfolio in 1985.

The falling rate environment during the year, on balance, had favorable effects on Fannie Mae's interest margin. Given the number of ARMs in portfolio adjusting downward and the number of higher yielding, fixed-rate mortgages paid off by refinancing home buyers, Fannie Mae's yield on its portfolio of mortgages actually declined slightly from 10.93 percent at the start of the year to 10.81 percent at year-end. However, lower borrowing costs from both domestic and international activities reduced the cost of debt by more than this decline in asset yield—producing a positive spread on Fannie Mae's portfolio for the last four months of the year. This was the first extended period with a positive spread since the fourth quarter of 1979. The spread had been a negative 63 basis points at the end of 1984.

Even more dramatic was the improvement in the duration mismatch of assets and liabilities during the year. Prior to 1985, the 1980s had dealt particularly harshly with portfolio investors carrying mismatched assets and liabilities on their books. And Fannie Mae was no exception. The corporation began 1981 with an estimated duration gap between liabilities and assets of three years. As rates spiked up to their peak in 1981, Fannie Mae's mismatch accelerated the corporation's losses. Since that time, the corporation has managed both sides of the balance sheet aggressively to bring down the mismatch to a level that will reduce the corporation's exposure to interest rate volatility. This effort culminated in a reduction of the duration mismatch from 2.4 years at year-end 1984 to 1.6 years at year-end 1985.

A Promise Fulfilled

In a real sense, Fannie Mae's progress in 1985 was a ringing endorsement of the strategies set in place five years ago to restructure the company's balance sheet and diversify its operations. Fannie Mae has emerged from its most trying period as a private corporation stronger and better able to withstand the vagaries of economic cycles.

But the real measure of Fannie Mae's progress will be the long-term value of the corporation—both to its stockholders and to its customers. And it is in this context that the roles that Fannie Mae and the secondary market played in 1985 provide a solid foundation for optimism about the future.

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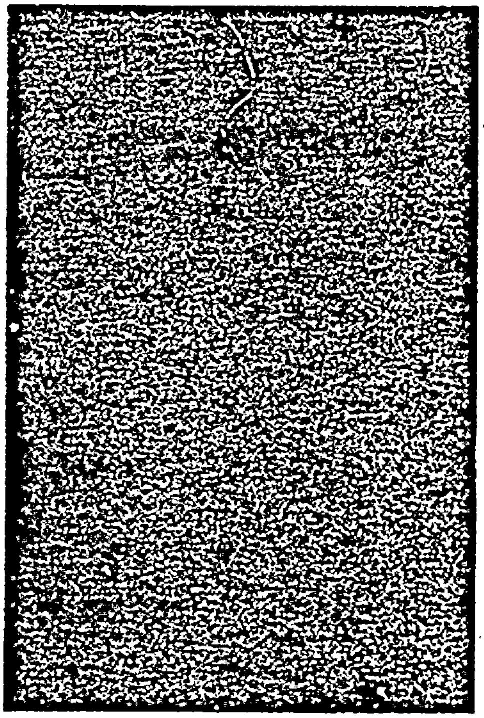
President's Message

My report will focus on the 1985 operations of Fannie Mae and how we managed the company during the year in pursuit of our twin goals of increasing the corporation's long-term earnings capacity, while reducing its sensitivity to interest rate fluctuations.

Fannie Mae is unique in being both a portfolio investor and a mortgage-backed securities (MBS) issuer. No other institution serves primary mortgage lenders more comprehensively than we do. But the way we serve the market today has changed dramatically from the role we played just five years ago. Prior to 1981, the staff of this company did not have a single title with the word "marketing" or "sales" in it. Prior to 1981, we did not offer a mortgage-backed security. Today, Fannie Mae has a cohesive, professional mortgage marketing organization in the home office and regions, and an MBS program that has gotten off to the fastest and most successful start in this business. In addition, we are well along the way toward building a state-of-the-art computer-based mortgage accounting system that will electronically link Fannie Mae with its customers via a nationwide telecommunications network.

These initiatives have helped keep Fannie Mae in the forefront of services provided in the secondary mortgage market. And, as Fannie Mae has adapted to rapid change, our operational challenge has been that of keeping pace with today's volume and diversity of business. In this regard, we worked toward five operational priorities in 1985: (1) the competitiveness of our MBS business; (2) portfolio management; (3) quality control; (4) our investment in technology; and (5) expense management.



Dr. Mark J. Riedy
President and
Chief Operating Officer

Mortgage-Backed Securities

Nineteen eighty-five was a record year for the Fannie Mae MBS. We issued approximately $24 billion in MBS, an increase of $10 billion over our previous record for a year's issuances. This volume of business helped push our MBS guaranty fee income to $112 million for the year. From a standing start at the end of 1981, we had issued $65 billion in MBS by year-end.

The decision to purchase mortgages for portfolio or to issue mortgage-backed securities is a balancing act for Fannie Mae. As an asset, a mortgage purchased for portfolio brings us significant spread income during the first few years. The MBS, however, provides the important benefit of an annuity-like stream of future income that is relatively insensitive to interest rate fluctuations. By contrast, even when we match durations perfectly on the loans we purchase for portfolio, some element of interest rate risk remains. However, both business activities are critical to the continued viability of Fannie Mae.

Our operational objective for MBS last year was to maintain our competitiveness in the markets for both lender-originated current production and seasoned portfolios. To accomplish this objective, we worked hard to communicate the structural advantages of the Fannie Mae MBS for lenders and for housing finance agencies. I am pleased to say that this concentration of effort rewarded us handsomely. We managed to increase our share of the lender-originated current production market, while opening up new business opportunities via our issuance of securities backed by ARMs, California variable-rate mortgages, multifamily loans, and 15-year mortgages. Our targeted campaign to promote the advantages of the MBS as collateral for housing finance agency bonds resulted in our supporting $2 billion of single-family and multifamily mortgages made through these agencies during 1985.

These successes speak well of the ability of the Fannie Mae MBS to serve a diversity of lender needs and in a

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variety of economic climates. We will continue to devote the necessary resources to this important business to keep it growing and competitive in 1986.

Portfolio Management

In pursuing our mortgage investment strategy, we have divided our portfolio into two components: new investments, over which we have control of both volumes and maturities; and our existing portfolio, over which our control is limited to shifts in the maturities of the liabilities we take on to finance those loans. We define the existing portfolio as the loans on our books at the end of the previous year. And we actively manage our portfolio over the twists and turns of the interest rate cycle.

The strategy for managing our new portfolio investments is three-pronged. First, we plan to match the expected durations of the mortgages we purchase with the liabilities used to fund those mortgages to a tolerance of plus or minus six months. During 1985, we were able to hold the mismatch to just two months.

The second element of our new investment strategy has been to purchase loans at a spread that equals or exceeds our target return on equity of 16 percent after taxes. During 1985, our average spread of about 130 basis points on purchases of $21 billion was a major factor in helping return our overall portfolio spread to a positive number.

"... we plan to match the expected durations of the mortgages we purchase with the liabilities used to fund those mortgages to a tolerance of plus or minus six months. During 1985, we were able to hold the mismatch to just two months."

The third part of our new investment strategy emphasizes commitment fees. In 1985, commitment fees totaled $196 million, exceeding our goal for the year and helping to return the corporation to profitability on an overall basis.

The strategy for managing our existing portfolio is more straightforward. We attempt to extend the liabilities funding those mortgages to reduce the duration gap. In so doing, we forgo some current profits for less interest-rate-risk exposure in the future, and we achieve a reasonable trade-off in the process.

With respect to the existing portfolio, we also wrestle with the potential benefits of selling low yielding loans out of portfolio in order to hasten the asset restructuring process. We have concluded, however, that the costs of portfolio sales—other than to support our MBS program—outweigh the benefits. During 1985, we supported our MBS program through five public offerings of MBS, totaling $1.1 billion, consisting of loans from our existing portfolio. These loan sales, as an investment in the future success of the MBS program, were extremely successful.

Quality Control

Fannie Mae's two businesses for the long haul are portfolio investment and MBS. Unfortunately, during 1985 we had no choice [illegible] invest heavily in a third major activity: the management and disposition of real estate owned properties, or REOs. Our intent is to get out of this business as quickly as we possibly can.

Last year, we addressed the problem head-on, more than doubling the number of staff dedicated to the management and disposition of properties during 1985. We also doubled our post-purchase reviews, worked more closely with lenders experiencing special problems, accelerated property sales through special sales incentives and auctions, and tightened our underwriting guidelines significantly during the year, which increased the quality of the loans we are willing to purchase. But all of these actions are methods of coping with the symptoms of a disease. The disease itself was rooted in the recession of 1981-82—a downturn that many economists now agree was the most severe recession

since the 1930s. It is painfully ironic that the so-called "energy belt" states of the Southwest—markets that were booming in the early 1980s and in which Fannie Mae purchased a substantial volume of loans—now continue to reel from the aftershocks of this recession. By the end of the year, our inventory of REO properties managed by Fannie Mae stood at 7,701, up 43 percent from the previous year. Forty-two percent of these properties were in the Southwest.

Our efforts to control the bad loan problem have been successful, especially if you focus on dispositions of properties—where the numbers climbed from 866 in the first quarter of the year, to 1,488, 2,346, and 2,962 in the final three quarters of the year. However, despite this progress, acquisitions of newly foreclosed properties showed no signs of abatement—averaging 2,491 per quarter over the course of the year. Our strategy remains unchanged at this time: continue to emphasize property dispositions in order to stay ahead of the influx of newly acquired properties.

Technology

Nineteen eighty-five was the second full year of Fannie Mae's investment in the technology that will be so crucial to the long-term success of our corporation. We currently own or guarantee nearly four million loans, and over the past five years the mix of these loans has changed dramatically. The challenge to our internal computer operations is to merge four distinct accounting systems, currently operating on three different computer systems. The ultimate mortgage accounting system toward which we are working is called LASER, and upon completion of the conversion process, it will give us a state-of-the-art, highly automated, flexible loan processing system with data available on a loan-by-loan basis (versus summary data only for the majority of our loans at present). The LASER system will cover the life of a loan as it works its way through Fannie Mae, from our committing and purchasing activities, through reporting on the loan once it is in our portfolio or backing MBS, to the final liquidation or disposition of the loan.

"Nineteen eighty-five was the second full year of Fannie Mae's investment in the technology that will be so crucial to the long-term success of our corporation."

The size and complexity of this computer conversion process are enormous, and, like many such conversion efforts, it is running late and over budget. Fortunately, we are beginning to see the light at the end of the tunnel. We currently are testing the LASER system, a process scheduled for completion in August 1986. At the end of the tests in August, we will implement all current and historical loan level detail business on LASER. We will then implement all other summary and current business on a lender-by-lender basis, starting in early 1987.

In a sense, our investment in LASER is like that of an airline reservations system: the cost to develop such a system and the necessity of capturing literally mountains of data are formidable, but they also provide competitive advantages.

Within the technology area, another priority for 1985 was to get our new Software Systems Division up and running. We formed this division at the beginning of the year when we purchased the mortgage-related software assets of Financial Software, Inc. of Norcross, Georgia. The value of the Software Systems Division will be that of enhancing our overall business relationships with our customers, as they continue to adapt to the era of high technology.

Expenses

One of my highest priorities for the year was to slow the rate of increase of administrative expenses to maintain our low expense ratio. Over the past

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four years, these expenses have increased as our business has grown in volume and complexity. Clearly, on the basis of "catch-up" alone, a case can be made for the higher costs; at the same time, I want you to know that your management is committed to bringing the rate of increase down substantially.

My personal commitment is to control and manage the administrative budget carefully to support a high quality, high-volume of business. Each dollar of administrative expenses will support approximately $1,000 of portfolio growth and MBS activity over time without too much deviation above or below that basic ratio. By any measure, we believe that our low expense ratio is a definite competitive advantage to Fannie Mae, and we intend to maintain that advantage.

I am optimistic about the future of Fannie Mae because we are strongly committed to investing wisely in the best long-term interests of our shareholders. We have assembled the best professional staff and senior management team in the mortgage finance and technology fields. And, we have identified and squarely addressed areas of problems and business opportunities: REO management, quality control, technology, Mortgage-Backed Securities, and the duration matching of assets and liabilities.

Some of these initiatives have direct and immediate effects on our budget and our bottom line. Others do not. But, the overarching point is that the investment in these activities allowed us to return to profitability in 1985 while, at the same time, restructuring our operations for even greater long-term stability and earnings. We believe our stategies will prove to be in the best interests of our shareholders in the years ahead.

Mark J. Riedy

Dr. Mark J. Riedy
President and Chief Operating Officer

1985 Financial Review

Contents

Management's Discussion and Analysis of Financial Results

General

Nineteen eighty-five was both a profitable year for Fannie Mae and a year in which the corporation made major progress in restructuring its debt and mortgage portfolios to better match their maturities. In addition, the corporation achieved significant growth in its Mortgage-Backed Securities (MBS) program, further building this stable earnings base. Performance was adversely affected, however, by an increased level of foreclosure losses that caused a substantial increase in the provision for loan losses.

The corporation's performance continues to be affected by the movement of interest rates, because a large portion of its mortgage portfolio consists of long-term fixed-rate mortgages financed with debt of shorter maturities. Since 1981, the corporation has adopted strategies to reduce its sensitivity to interest rate changes. They include emphasizing the purchase of adjustable-rate mortgages (ARMs) and other shorter term mortgages, extending the maturity of debt outstanding when rates are favorable, and developing sources of income that are less susceptible to changes in interest rates, such as guaranty fees from MBS. In 1985, the corporation implemented a strategy of matching within six months' tolerance the estimated duration of new mortgage purchases and the duration of the debt used to finance these purchases.

This discussion reports on the corporation's operating activities and financial results for the three years ended December 31, 1985.

Results of Operations

Fannie Mae earned net income of $37 million in 1985, compared with a loss of $57 million in 1984 and earnings of $75 million in 1983. Lower interest rates and increased earnings from commitment fees contributed significantly to the improved results for 1985; however, loan losses were at a higher level than in 1984 and 1983 and reduced overall performance for the year.

For 1985, Fannie Mae reported fully diluted earnings per share of $0.52, compared with a loss of $0.87 per share in 1984 and earnings of $1.13 per share in 1983. Cash dividends were $0.16 per share in each of the years 1985, 1984, and 1983.

Interest margin—the return on the mortgage portfolio and marketable securities, less the cost of debt—was $71 million in 1985, the first positive margin reported since 1980. During 1984 and 1983, interest margins were a negative $152 million and a negative $62 million, respectively.

The most important factor affecting interest margin is the spread, or difference, between the average net yield on the mortgage portfolio and the average cost of outstanding debt. This spread showed improvement throughout 1985. In September, the corporation began earning a positive spread on its portfolio for the first time since December 1979. For the full year of 1985, however, the average portfolio yield was 10.92 percent and the average cost of outstanding debt was 11.14 percent, resulting in an average negative spread of .22 percent. In 1984, the average portfolio yield was 10.81 percent and the average cost of outstanding debt was 11.39 percent, producing an average negative spread of .58 percent. In 1983, the average portfolio yield was 10.67 percent and the average cost of outstanding debt was 11.12 percent, for an average negative spread of .45 percent.

The other factor affecting interest margin is the interest earned on marketable securities. Fannie Mae earned $124 million of such interest in 1985, compared with $197 million in 1984 and $222 million in 1983. The reduced earnings on marketable securities reflect the lower interest rate environment, as well as the corporation's decision to maintain a smaller average liquidity position in 1985 than in the previous two years.

Commitment fees were $196 million in 1985, compared with $114 million in 1984 and $151 million in 1983. Because of a change in the product mix of commitments, fee income was higher in 1985 than in 1984, even though total commitment volume was slightly less. In 1985, the corporation issued a greater volume of commitments for 30-year fixed-rate mortgages, which carry higher fee rates than ARMs and other shorter term mortgage products that were more popular in 1984. The decline in commitment fees in 1984 compared with 1983 was attributable to a change in product mix toward shorter term mortgages.

In December 1985, the Financial Accounting Standards Board issued an exposure draft proposing a change in accounting for commitment fees. Currently, the corporation recognizes most fee income in the period in which the committing service is rendered; however, the exposure draft proposes that such fees be deferred and amortized over the contract life of the related mortgage as a yield adjustment. If adopted, the proposed accounting standard, which may require retroactive application, likely would have a significant adverse impact on Fannie Mae's

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financial statements in the future. The proposed standard would not be implemented until 1987 or later.

MBS guaranty fees increased to $112 million in 1985 from $78 million in 1984 and $54 million in 1983. These fees grow in relation to the securities outstanding. At December 31, 1985, there were $55.0 billion in securities outstanding, compared with $36.2 billion and $25.1 billion at December 31, 1984 and 1983, respectively.

There were no significant gains or losses on sales of mortgages in 1985, while gains of $12 million and $31 million were reported in 1984 and 1983, respectively. Mortgage sales are discussed under the section entitled Mortgage-Backed Securities.

The provision for loan losses increased to $206 million in 1985 from $86 million in 1984 and $48 million in 1983, reflecting the corporation's increased foreclosure loss experience, primarily with conventional home loans. The increase in the provision in 1985 resulted from the increase in mortgage purchases, the issuance of a higher volume of MBS without recourse to the lender, the full-year effect of higher provision rates adopted in late 1984, and other additions made in response to the higher level of foreclosure losses.

During 1985, charge-offs of conventional home mortgages in the corporation's loan portfolio totaled $143 million, compared with $87 million in 1984 and $39 million in 1983. Higher foreclosure losses are an industry-wide problem and are due, in part, to a substantially reduced level of housing inflation and adverse economic conditions in certain geographical areas. In October 1985, Fannie Mae tightened its underwriting standards and credit requirements for certain of its mortgage products. These changes should contribute to improved foreclosure experience after several years.

Administrative expenses increased to $142 million in 1985 from $112 million in 1984 and $81 million in 1983. The increases were due primarily to increases in the number of employees required because of the growth and restructuring of the business, the need to develop automated business systems, and an increased emphasis on quality control and management of acquired properties.

The Mortgage Portfolio

The corporation's net mortgage portfolio totaled $95.0 billion at December 31, 1985, compared with $84.6 billion and $75.7 billion at December 31, 1984 and 1983, respectively. ARMs and second mortgages represented 21 percent of the portfolio balance at December 31, 1985, up from 17 percent at December 31, 1984 and 12 percent at December 31, 1983.

Fannie Mae issues commitments to purchase standard mortgage products through its "open window," for which required mortgage yields are posted daily. The corporation also purchases non-standard products, issuing such commitments on a negotiated basis.

Most of the commitments that the corporation issues are for mandatory delivery, with the yield set upon issuance of the commitment. Fannie Mae also issues market-rate standby commitments in which the corporation commits only to purchase a designated amount of mortgages. To deliver mortgages, the lender must convert the standby commitment to a mandatory delivery commitment, at which time the yield is established at Fannie Mae's current posted window rate.

During 1985, the corporation issued $20.2 billion in mortgage purchase commitments, compared with $21.0 billion in 1984 and $18.6 billion in 1983. Negotiated transactions represented 68 percent of the total commitments issued in 1985, compared with 83 percent in 1984 and 58 percent in 1983. The lower level of negotiated transactions in 1985 reflects the popularity of the standard fixed-rate mortgage when mortgage rates are relatively low.

The corporation purchased a record volume of mortgages in 1985, totaling $21.5 billion at an average yield of 11.59 percent, compared with $16.7 billion at 12.79 percent in 1984 and $17.6 billion at 12.65 percent in 1983. ARMs were 33 percent of mortgage purchases in both 1985 and 1984, while second mortgages were 4 percent of 1985 purchases, down from 6 percent in 1984. In 1983, ARMs and second mortgages were 24 percent and 8 percent of total purchases, respectively.

Mortgage repayments totaled $9.0 billion in 1985, compared with $5.4 billion in 1984 and $6.2 billion in 1983. The increase in repayments in 1985 reflects the large number of refinancings that occurred in response to the declining level of mortgage rates, as well as higher prepayments, reflecting the general increase in home sales.

Financing Activities

During 1985, with interest rates on average at the lowest levels since 1979, Fannie Mae made substantial

progress toward reducing its sensitivity to interest rate fluctuations by matching within two months the estimated duration of new mortgage purchases and that of the debt used to finance the mortgages and by lengthening the average maturity of outstanding debt. As a result of these actions, the corporation reduced the duration gap between assets and liabilities from 2.4 years at December 31, 1984 to 1.6 years at December 31, 1985.

Fannie Mae raised a total of $48.2 billion of debt at an average cost of 9.62 percent and an average maturity of 46 months in 1985, including $10.0 billion in debt with effective maturities of 7 years or more. During 1984, the corporation issued $48.0 billion in debt at an average cost of 11.47 percent and an average maturity of 29 months; while in 1983, the corporation issued $40.0 billion in debt at an average cost of 10.07 percent and an average maturity of 29 months.

As a result of these activities, the average cost of debt outstanding at December 31, 1985 was reduced to 10.79 percent from 11.56 percent at December 31, 1984, while the average maturity was extended to 40 months from 31 months. At December 31, 1983, the average cost of debt was 11.12 percent and the average maturity was 29 months.

In recent years, Fannie Mae has expanded its investor base both domestically and abroad. The corporation has become active with innovative financings, obtaining rates lower than those that could generally be achieved through traditional sources. The corporation raised over $1 billion directly in the European and Japanese markets in 1985, in addition to the funds raised from foreign investors through regular debt offerings in the United States. The corporation also issued the first yen-denominated debentures sold in the domestic market by a U.S. corporation. On all borrowings denominated in a foreign currency, the corporation has negated the foreign exchange risk by concurrently entering into swap arrangements for U.S. dollars.

During 1985, Fannie Mae further expanded its investment agreement and master note programs, both of which provide funds at costs lower than those of traditional forms of borrowing. In addition, the corporation continues to enter into interest rate swaps to reduce its overall debt costs and to extend the maturity of its debt.

The corporation added $107 million to stockholders' equity in 1985 by issuing 7 million shares of common stock, raising the total number of shares outstanding to 73 million.

Mortgage-Backed Securities

The corporation's MBS continues to grow. Over $65 billion in securities have been issued since the program was introduced in 1981, with securities outstanding of $55.0 billion at December 31, 1985.

The corporation began issuing MBS as part of its overall effort to reduce its sensitivity to interest rate fluctuations. The amount of guaranty fee income, which is earned by the corporation for guaranteeing the timely payment of principal and interest on the mortgage securities, is related to the total amount of securities outstanding.

In 1985, the corporation issued $23.6 billion in MBS, compared with $13.5 billion in 1984 and $13.3 billion in 1983. Most of the MBS are issued through swap transactions, where participating lenders place pools of mortgages in trust in exchange for securities. Fannie Mae also issues MBS by pooling mortgages from its portfolio and selling securities for cash through public offerings or private placements. These mortgage sales both enhance the liquidity of the MBS market and advance the corporation's portfolio restructuring efforts. Sales from portfolio totaled $1.3 billion in 1985, compared with $1.0 billion in 1984 and $4.4 billion in 1983.

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Financial Statements and Reports

Report of Management

To the Stockholders of Federal National Mortgage Association:

The management of the corporation is responsible for the accompanying audited financial statements and the unaudited financial and other information appearing elsewhere in this report. In our opinion, the financial statements have been prepared in conformity with generally accepted accounting principles appropriate in the circumstances, and the other financial information in this report is consistent with such statements. In preparing the financial statements and in developing the other financial information, it has been necessary to make informed judgments and estimates of the effects of business events and transactions. We believe that these judgments and estimates are reasonable, that the financial information contained in this report reflects in all material respects the substance of all business events and transactions to which the corporation was a party, and that all material uncertainties have been appropriately accounted for or disclosed.

The corporation utilizes a system of internal accounting controls designed to provide reasonable assurance that transactions are executed in accordance with appropriate authorization, to permit preparation of financial statements in conformity with generally accepted accounting principles, and to establish accountability for the assets of the corporation.

The system of internal accounting controls includes written policies and procedures for the execution, documentation, and recording of transactions, and an organizational structure which provides an effective segregation of duties and responsibilities. The corporation has an internal Office of Auditing whose responsibilities include monitoring compliance with established policies and procedures and evaluating the corporation's system for internal accounting controls. Organizationally, the internal Office of Auditing is independent of the activities it reviews.

The Board of Directors of the corporation exercises its oversight of the accounting system and related controls through an Audit Committee, which is composed solely of directors who are not officers or employees of the corporation. The Audit Committee meets with management and the internal auditors periodically to review the work of each and to evaluate the effectiveness with which they discharge their respective responsibilities. In addition, the committee meets periodically with the independent public accountants, Peat, Marwick, Mitchell & Co., who have free access to the committee, without management present, to discuss internal accounting controls, the quality of financial reporting, and other matters relative to their examination of the corporation's financial statements. The appointment of the independent public accountants is made annually by the Board of Directors subject to ratification by the stockholders. The examination by Peat, Marwick, Mitchell & Co. of the corporation's financial statements is made in accordance with generally accepted auditing standards, including study and evaluation of the corporation's internal accounting controls, for the purpose of expressing their opinion on the financial statements.

BCMcMillen

Bruce C. McMillen
Executive Vice President
and Chief Financial Officer

RJMahn

Robert J. Mahn
Senior Vice President and Controller

Report of Independent Certified Public Accountants

PEAT MARWICK
Washington, D.C.

The Board of Directors and Stockholders
Federal National Mortgage Association:

We have examined the balance sheets of Federal National Mortgage Association as of December 31, 1985 and 1984, and the related statements of operations and changes in financial position for each of the years in the three-year period ended December 31, 1985. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the aforementioned financial statements present fairly the financial position of Federal National Mortgage Association at December 31, 1985 and 1984 and the results of its operations and the changes in its financial position for each of the years in the three-year period ended December 31, 1985, in conformity with generally accepted accounting principles applied on a consistent basis.

Peat, Marwick, Mitchell & Co.

January 24, 1986

Statements of Operations

Dollars in millions, except per share amounts	Year Ended December 31, 1985	1984	1983
Interest income:			
Mortgage portfolio, net of servicing fees	$9,873	$8,647	$7,705
Marketable securities	124	197	222
Total interest income	9,997	8,844	7,927
Interest on borrowings and related costs	9,926	8,996	7,989
Interest margin	71	(152)	(62)
Other income:			
Commitment fees	196	114	151
Gain on sales of mortgages	—	12	91
Guaranty fees	112	78	54
Other	37	36	33
Total other income	345	240	329
Other expenses:			
Administrative	142	112	81
Provision for losses	206	86	48
Total other expenses	348	198	129
Income (loss) before federal income taxes	68	(110)	138
Provision for federal income taxes:			
Current	(14)	(112)	(15)
Deferred	45	59	78
	31	(53)	63
Net income (loss)	$ 37	$ (57)	$ 75
Per share:			
Earnings (loss):			
Primary	$ .52	$ (.87)	$ 1.15
Fully diluted	.52	(.87)	1.13
Cash dividends	.16	.16	.16

See Notes to Financial Statements

Balance Sheets

Dollars in millions	December 31,	
Assets	**1985**	**1984**
Mortgage portfolio, net	$95,038	$84,599
Cash	63	49
U.S. Government and Federal Agency securities—at cost, which approximates market	475	265
Federal funds	1,391	1,575
Accrued interest receivable	949	871
Federal income taxes refundable	153	265
Accounts receivable and other assets	441	259
Acquired property and foreclosure claims, less allowance for losses on claims of $21 million in 1985 ($14 million in 1984)	474	400
Unamortized debenture issue costs	103	76
Total assets	$99,087	$88,359

Liabilities and Stockholders' Equity		
Liabilities:		
Bonds, notes, and debentures, net:		
Due within one year	$31,939	$31,261
Due after one year	61,957	52,458
	93,896	83,719
Accrued interest payable	2,288	2,153
Mortgagors' escrow deposits, exclusive of approximately $574 million held by servicers in 1985 ($575 million in 1984)	328	309
Deferred federal income taxes	672	627
Other liabilities	561	343
Total liabilities	97,745	87,151
Stockholders' equity:		
Preferred stock, adjustable rate, series A, $100 stated value, 4,500,000 shares authorized, no shares issued	—	—
Common stock, $6.25 stated value, no maximum authorization—73,078,937 shares issued in 1985 (66,045,677 shares in 1984)	457	413
Additional paid-in capital	375	311
Retained earnings	512	486
	1,344	1,210
Less treasury stock, at cost—179,906 shares in 1985 (208,926 in 1984)	2	2
Total stockholders' equity	1,342	1,208
Total liabilities and stockholders' equity	$99,087	$88,359

See Notes to Financial Statements

Statements of Changes in Financial Position

Dollars in millions	Year Ended December 31, 1985	1984	1983
Funds Provided			
Net income (loss)	$ 37	$ (57)	$ 75
Items not (providing) using funds:			
Interest capitalized on graduated payment mortgages, net	(112)	(136)	(99)
Provision for deferred federal income taxes	45	59	78
Provision for losses	206	86	48
Funds provided by (applied to) operations	176	(48)	102
Proceeds from issuance of debentures and bonds	25,688	24,822	19,734
Net increase in notes and investment agreements	3,870	1,113	214
Mortgage repayments, less discount amortized	8,491	4,961	5,735
Claim collections and proceeds from disposition of properties	764	595	425
Sale of mortgages, excluding gains and losses	1,303	942	4,370
Net increase in stockholders' equity resulting from stock issuances and debenture conversions	108	—	8
Increase (decrease) in accrued interest payable/receivable, net	(13)	26	22
Other items, net	185	(62)	196
Total funds provided	40,572	32,349	30,806
Funds Applied			
Debentures and bonds retired	19,449	16,840	14,991
Mortgage purchases, less discount	21,072	15,329	16,537
Dividends paid	11	11	11
Total funds applied	40,532	32,180	31,539
Increase (decrease) in cash and marketable securities	40	169	(733)
Cash and marketable securities, beginning of year	1,889	1,720	2,453
Cash and marketable securities, end of year	$ 1,929	$ 1,889	$ 1,720

See Notes to Financial Statements

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Statement of Significant Accounting Policies

The corporation operates in the residential mortgage finance industry. Its accounting policies conform to generally accepted accounting principles. The following is a description of significant accounting policies and practices:

Mortgage Portfolio and Purchase Discount

Mortgages acquired for investment are carried at their unpaid principal balances less unamortized discount. Discount is recognized as income using an amortization method that, in the aggregate, approximates a level yield over the estimated life of the related mortgages. The corporation discontinues the accrual of interest on conventional mortgages when they become 90 days delinquent.

Guaranteed Mortgage-Backed Securities

The corporation guarantees the payment of principal and interest on Mortgage-Backed Securities. These securities represent interests in pools of mortgages held in trust by the corporation. These mortgages are not assets of the corporation, nor are the outstanding securities liabilities of the corporation: accordingly, neither is reflected in the accompanying balance sheets.

Foreclosure Losses

On conventional home mortgages acquired for portfolio, the corporation maintains an allowance for losses that may be incurred as a result of defaults. The allowance is established by charges to income when mortgages are purchased and adjusted at other times to maintain the allowance at an appropriate level. The corporation reduces the allowance to recognize net losses on foreclosures.

On U.S. Government insured or guaranteed loans, the corporation establishes an allowance for losses when specific loans are determined to be in default. At that time, an allowance is recorded to provide for estimated unreimbursable foreclosure costs.

On Mortgage-Backed Securities where the corporation assumes the foreclosure loss risk related to the mortgages, a liability for estimated losses is maintained. The corporation records the liability by making charges to income at the time Mortgage-Backed Securities are issued or transfers the related allowance when it sells mortgages from portfolio into Mortgage-Backed Securities.

Real estate acquired as a result of foreclosure is carried at the lower of the investment in the property or its estimated net realizable value.

Risk Management

From time to time, the corporation takes positions in financial markets to hedge against fluctuations in interest rates that may affect the cost of certain planned borrowings or the yield on certain mortgage purchases. Results of hedging activities are deferred and amortized over the lives of the related borrowings or assets.

Commitment Fees

Commitment fees generally are recognized as income upon the execution of the commitment contract. Commitment fees that are considered to be an adjustment to the yield on the related mortgages purchased, however, are deferred and recognized as income using an amortization method that, in the aggregate, approximates a level yield over the estimated life of the related mortgages.

Income Taxes

Certain income and expense items are recognized in different periods for financial reporting and income tax purposes. The corporation provides deferred income taxes for such timing differences. Investment tax credits are recognized as reductions from income tax expense in the year the related assets are purchased (flow-through method).

Earnings Per Share

Earnings per share are computed using the weighted average number of shares outstanding, including dilutive common stock equivalents. Fully diluted earnings per share are computed on the assumption that all outstanding subordinated convertible capital debentures were converted at the beginning of the year, after increasing earnings for the related interest expense, net of federal income taxes.

Mortgage Portfolio, Net

The mortgage portfolio balances consist of the following investments at December 31:

Dollars in millions	1985	1984
Home mortgages:		
First mortgages:		
Government insured or guaranteed	$27,414	$29,016
Conventional fixed-rate	45,035	38,781
Conventional adjustable-rate	16,895	11,729
Second mortgages	2,889	2,817
	92,233	82,343
Multifamily mortgages:		
Government insured	4,951	5,060
Conventional fixed-rate	1,319	635
Conventional adjustable-rate	46	71
	6,316	5,766
Total unpaid principal balance	98,549	88,109
Less:		
Unamortized discount	3,399	3,414
Allowance for losses	112	96
	$95,038	$84,599

The total unpaid principal balance of conventional home loans in non-accrual status (those 90 days or more delinquent or in the process of foreclosure) was $1.0 billion at December 31, 1985 and $0.7 billion at December 31, 1984.

Allowance for Foreclosure Losses

Changes in the allowances for loan losses and the liability for estimated foreclosure losses on Mortgage-Backed Securities for the years 1983-1985 are summarized below:

	Mortgage Portfolio			
Dollars in millions	Government Insured or Guaranteed	Conventional	Mortgage-Backed Securities	Total
Balance, January 1, 1983	$ 7	$125	$ 5	$137
Provision	11	35	2	48
Net foreclosure losses charged-off	(4)	(39)	—	(43)
Transfers	—	(9)	9	—
Balance, December 31, 1983	14	112	16	142
Provision	13	68	5	86
Net foreclosure losses charged-off	(9)	(87)	(2)	(98)
Transfers	—	(1)	1	—
Balance, December 31, 1984	18	92	20	130
Provision	16	161	29	206
Net foreclosure losses charged-off	(8)	(143)	(19)	(170)
Transfers	—	(3)	3	—
Balance, December 31, 1985	$26	$107	$33	$166

The total allowance for foreclosure losses at December 31 is included in the following balance sheet accounts:

Dollars in millions	1985	1984
Mortgage portfolio, net	$112	$ 96
Foreclosure claims, less allowance for losses	21	14
Other liabilities	33	20
	$166	$130

Bonds, Notes, and Debentures, Net

The average cost of all debt outstanding at December 31, 1985 and 1984 (including the amortization of issuance costs and hedging results, and the effect of interest rate swaps) was 10.79 percent and 11 56 percent, respectively. The average effective maturity of all debt outstanding (including the effect of interest rate swaps but excluding investment agreements) was 40 months at December 31, 1985 and 31 months at December 31, 1984.

Pursuant to the corporation's Charter Act and related regulations, no debt instrument may be issued without the approval of the Secretary of the Treasury. Under current regulatory authority, the maximum amount of the corporation's general obligations outstanding (those neither subordinated nor secured) at any time generally may not exceed 30 times the sum of stockholders' equity, subordinated capital debentures, and reserves.

In addition to debt restrictions under the Charter Act, the corporation is subject to a restriction set forth in certain subordinated capital debenture agreements, which limits the amount of subordinated capital debentures outstanding to not more than two times the sum of the corporation's common stock, additional paid-in capital, and retained earnings. At December 31, 1985, the corporation could have issued an additional $577 million in subordinated capital debentures and still have been in compliance with this restriction.

The Charter Act authorizes the Secretary of the Treasury to purchase obligations of the corporation, as a public debt transaction, up to a maximum of $2.25 billion outstanding at any one time. The interest rate on such obligations would be based upon the average rate on marketable obligations of the United States outstanding as of the last day of the month preceding the date of making such purchases. The corporation has never utilized the Treasury borrowing authority.

Borrowings due within one year consist of the following at December 31:

Dollars in millions	1985	1984
Short-term notes—net of $209 million discount in 1985 ($369 million in 1984)	$ 8,946	$10,165
Master notes	1,783	1,220
Investment agreements	4,863	1,275
Mortgage-backed bonds	76	34
Debentures	15,971	18,067
Capital debentures	300	500
Total due within one year	$31,939	$31,261

Short-term notes are general obligations of the corporation with maturities that range up to 360 days. Master notes have varying maturities and carry a floating interest rate that is adjusted weekly and is tied to 91-day U.S. Treasury bill rates. Investors have the option of increasing or decreasing the principal amount outstanding on master notes on a daily basis, usually within a range of 80 to 120 percent of the original principal balance.

The corporation had short-term and master notes outstanding of $10.9 billion (face amount) at December 31, 1985 and $11.8 billion at December 31, 1984. The largest aggregate amount of short-term and master notes outstanding at any month-end was $14.2 billion in 1985 and $13.4 billion in 1984. The average cost to the corporation of notes outstanding at December 31 1985 and 1984 was 8.21 percent and 11.16 percent, respectively. The average remaining terms were approximately 121 days and 129 days at December 31, 1985 and 1984, respectively. The average aggregate amount of notes outstanding during 1985 was $12.1 billion at an average cost of 9.30 percent; during 1984, it was $12.2 billion at an average cost of 10.70 percent.

Investment agreements are individually negotiated agreements that provide for the investment of a variable principal amount at a fixed or floating rate of interest. The agreements remain in effect for various periods of time. The average total outstanding during 1985 was $2.5 billion at an average cost of 8.98 percent, compared with an average total outstanding of $110 million during 1984 at an average cost of 10.89 percent. The average cost to the corporation of investment agreements outstanding was 8.49 percent at December 31, 1985 and 9.65 percent at December 31, 1984.

The corporation has interest rate swap agreements with various parties to extend the effective maturity of its debt obligations. Under these agreements, the corporation makes periodic payments based on fixed rates applied to a notional principal amount and in exchange receives periodic payments based on short-term variable rates. At December 31, 1985, the corporation had interest rate swap agreements outstanding with an average remaining term of 6 years, 9 months on notional amounts totaling $3.4 billion, compared with an average remaining term of 5 years, 4 months on notional amounts totaling $1.3 billion for similar swap agreements outstanding at December 31, 1984. The effect of these agreements is not reflected in the maturities of the debt obligations reported in the summaries of borrowings.

Borrowings due after one year consist of the following at December 31:

Dollars in millions Maturity	1985 Average Cost	1985 Amount Outstanding	1984 Average Cost	1984 Amount Outstanding
Mortgage-backed bonds, 1986-2010	8.95%	$ 292	8.42%	$ 368
Investment agreements, 1987-1990	9.18	939	—	—
Debentures, net of $57 million of discount in 1985 (none in 1984):				
1986	—	—	11.74	12,941
1987	11.53	17,464	11.58	16,948
1988	11.04	13,933	11.48	9,845
1989	11.31	8,000	11.97	4,650
1990	10.57	6,050	10.73	1,200
1991-1995	10.93	11,869	10.43	3,496
1996-2000	7.14	154	7.14	154
2001-2015	11.77	750	12.45	500
	11.15	58,220	11.53	49,734
Exchangeable debentures, 1991	12.66	450	12.66	450
Zero coupon debentures, net of $5,752 million of discount in 1985 ($5,779 million in 1984), 2014	11.50	248	11.50	221
Zero coupon subordinated capital debentures, net of $6,517 million of discount in 1985 ($6,539 million in 1984), 2019	10.22	233	10.22	211
Subordinated capital debentures, net of $18 million of discount in 1985 ($19 million in 1984):				
1986	—	—	8.19	300
1989	12.99	635	12.99	635
1990	9.15	400	—	—
1997	7.44	250	7.44	250
2002	9.21	263	9.21	261
	10.46	1,548	10.35	1,446
Subordinated convertible capital debentures, 1996	4.43	27	4.43	28
Total	11.10%	$61,957	11.48%	$52,458

The average cost includes the amortization of discounts, issuance costs, and hedging results. Annual maturities of all debt for the years 1987-1991 are $17.6, $14.1, $8.9, $7.0, and $1.8 billion, respectively.

The mortgage-backed bonds were issued pursuant to authority contained in the Charter Act to issue bonds secured by mortgages from the corporation's portfolio. At December 31, 1985 and 1984, respectively, $359 million and $393 million of the mortgage-backed bonds outstanding were guaranteed as to principal and interest by the Government National Mortgage Association (GNMA). Assets of approximately $542 million at December 31, 1985 and $538 million at December 31, 1984 were restricted for the payment of principal and interest on mortgage-backed bonds.

In 1985, the corporation issued debt securities in which principal, interest, or both were denominated in a foreign currency. Concurrently, the corporation entered into foreign currency exchange agreements to offset the risk of any future exchange rate fluctuations. These foreign currency exchange agreements effectively establish an obligation of the corporation at a cost that remains fixed in U.S. dollars throughout its term. The foreign currency denominated debt issuances are included in the above summary of borrowings due after one year and are reflected in the accompanying balance sheet at their equivalent U.S. dollar value as set forth by their respective foreign currency exchange agreements, net of any unamortized discount. At December 31, 1985, the U.S. dollar equivalent face amount of these foreign currency denominated borrowings was $972 million.

The following debentures are redeemable at par, in whole or in part, at the option of the corporation: $154 million due in 1997: $250 million due in 2013 (beginning in 1993); and $250 million due in 2014 (beginning in 1994).

The subordinated capital debentures, due in 1997 and 2002, are redeemable at par, in whole or in part, at the option of the corporation, on any interest payment date commencing October 1, 1982 and July 10, 1988, respectively.

The corporation may call for the conversion of the exchangeable debentures at any time on or prior to March 15, 1991, in which case the debenture holders have two options. They may accept the conversion and receive 10 shares of adjustable-rate preferred stock, series A for each $1,000 principal amount of exchangeable debentures. Alternatively, they may reject the call for conversion by extending the maturity date of those debentures to March 15, 1994. The corporation may call for the conversion only once and only on the entire issue.

The subordinated convertible capital debentures are convertible into 1.4 million shares of common stock at a price of $19.63 per share, subject to adjustment in certain events. These debentures are redeemable at par, at the option of the corporation.

Stockholders' Equity

Transactions in common stock, additional paid-in capital, retained earnings, and treasury stock for the years 1983, 1984, and 1985 are summarized as follows:

Dollars in thousands	Common Stock	Additional Paid-in Capital	Retained Earnings	Treasury Stock	Total Stock-holders' Equity
Balance, January 1, 1983	$410,313	$305,750	$489,161	$(1,895)	$1,203,329
Conversions of convertible debentures	2,429	5,163	—	—	7,592
Net income	—	—	75,492	—	75,492
Dividends	—	—	(10,502)	—	(10,502)
Balance, December 31, 1983	412,742	310,913	554,151	(1,895)	1,275,911
Conversions of convertible debentures	43	93	—	—	136
Net loss	—	—	(57,374)	—	(57,374)
Dividends	—	—	(10,534)	—	(10,534)
Balance, December 31, 1984	412,785	311,006	486,243	(1,895)	1,208,139
New shares issued, May 8, 1985	43,750	63,465	—	—	107,215
Conversions of convertible debentures	208	450	—	—	658
Treasury stock issued for stock options and benefit plans	—	102	—	264	366
Accrual for stock appreciation rights	—	145	—	—	145
Net income	—	—	36,889	—	36,889
Dividends	—	—	(11,096)	—	(11,096)
Balance, December 31, 1985	$456,743	$375,168	$512,036	$(1,631)	$1,342,316

Pursuant to the corporation's Charter Act and related regulations, approval of the Secretary of Housing and Urban Development is required prior to the issuance of any stock of the corporation or a change in the stockholding requirements for lenders. The corporation is authorized by the Charter Act to have preferred stock on such terms and conditions as the Board of Directors of the corporation may prescribe. To date, the Board of Directors has authorized a maximum of 4,500,000 shares of adjustable-rate preferred stock, series A, $100 stated value. These shares may be issued only in exchange for the 12.50 percent exchangeable debentures due 1991. No shares have been issued.

In 1982, the corporation adopted a performance share plan, under which awards were made to officers for three separate four-year periods starting in 1982, 1983, and 1984.

Performance shares will be issued, generally half in cash and half in stock, provided certain financial goals are attained. No more than 200,000 shares of common stock can be distributed under the plan. As of December 31, 1985, 49,200 performance shares were outstanding for the 1983-86 period and 121,400 for the 1984-87 period. None of the 181,800 shares awarded for the 1982-85 period was issued.

In 1984, the corporation adopted a stock option plan for key employees. Under the plan, the corporation may grant options to purchase up to one million shares of common stock. The number of shares that can be granted under the plan may be increased by up to 200,000 shares, but only to the extent that shares are not issued under the previously described performance share plan. The options do not become exercisable until at least one year after the date granted and generally expire ten years from the date of grant. The purchase price of the common stock covered by each option is equal to the fair market value of the stock on the date that the options are granted.

A summary of stock option activity follows:

	Number of Shares	Option Price
Balance, January 1, 1984	—	
Granted in 1984	323,100	$16.12-$23.75
Less: Terminated in 1984	18,500	$16.12
Balance, December 31, 1984	304,600	$16.12-$23.75
Granted in 1985	94,800	$14.81-$23.94
Less: Exercised in 1985	400	$16.12
Terminated in 1985	69,400	$16.12-$23.75
Balance, December 31, 1985	329,600	$14.81-$23.94

At December 31, 1985, stock options on 100,683 shares were exercisable. There were no stock options exercisable at December 31, 1984.

Subsequent to the adoption of the 1984 stock option plan for key employees, the Board of Directors granted stock appreciation rights (SARs) on 42,049 shares relating to certain previously granted stock options. In 1985, the SARs were awarded to certain officers of the corporation and permit them to exercise the SAR in place of the remaining related stock options, either in whole or in part. Upon exercise, they would receive an amount, half in cash and half in common stock, equivalent to the difference between the market price of the corporation's stock on the date of exercise and the option price granted under the 1984 stock option plan. The exercise of the SAR cancels the related stock option and the exercise of the stock option cancels the SAR. The SARs may be exercised only during a limited period in 1986. After this period, unexercised SARs expire and the related stock options remain available to be exercised.

In 1984, the Board of Directors adopted the 1985 Employee Stock Purchase Plan. In 1985, the plan received the approval of the corporation's stockholders and a favorable tax ruling from the Internal Revenue Service. Under the plan the corporation can issue up to 500,000 shares of common stock to qualified employees at a price equal to 85 percent of the fair market value of the stock on the first day of the period in which employees can elect to purchase the stock. The corporation can grant each employee the right to purchase up to 200 shares of stock during a purchase period. At December 31, 1985, Fannie Mae employees had purchased 28,620 shares under the plan's 1985 offering. The Board of Directors has granted a similar offering in 1986 to Fannie Mae employees.

Income Taxes

Deferred federal income tax expense relating to timing differences consists of the following:

Dollars in millions	1985	1984	1983
Amortization of purchase discount	$ (4)	$32	$53
Losses on dispositions of mortgages	5	(3)	44
Provision for losses—conventional mortgages	16	—	(8)
Risk management activities	39	27	(9)
Accrued interest expense not currently deductible	(7)	—	—
Systems development costs	2	6	1
Other items, net	(6)	(3)	(3)
Total deferred federal income tax expense	$45	$59	$78

The Internal Revenue Service has completed its examinations of the corporation's federal income tax returns through the year 1982. All subsequent years are subject to examination. With respect to years examined, the Internal Revenue Service has proposed certain adjustments. The corporation has filed a protest contesting the adjustments and has also filed amended tax returns or claims for refund of taxes paid in certain of these years. All of the proposed adjustments and claims relate to losses on sales or exchanges of mortgages or on amounts added to the allowance for loan losses. The applicable tax and related interest on all disputed amounts have either been substantially accrued or paid. It is management's opinion that any unfavorable determinations would have no material adverse impact on the results of operations.

At December 31, 1985, the corporation had tax credit carryforwards of $2.4 million (expiring at various dates from 1996 to 2000), which are available to reduce future federal income taxes. Certain tax losses totaling $119 million are being carried forward and are available to reduce future taxable income through 1998.

The corporation is exempt from state and local taxes, with the exception of real estate taxes.

Retirement Plans

All permanent, full-time employees of the corporation are covered by the non-contributory Federal National Mortgage Association Retirement Plan or by the contributory Civil Service Retirement Law. Pension expenses for these plans were $1.1 million and $0.2 million, respectively, for the year ended December 31, 1985 ($0.7 million and $0.2 million in 1984, and $0.6 million and $0.2 million in 1983). For the corporation's defined benefit pension plan, pension expense includes unfunded past service costs, which are being amortized over 10 years. Prior to 1984, the corporation made annual contributions to the plans equal to the amounts accrued for pension expense. During 1984, the corporation contributed $0.2 million to the corporation's pension plan and recorded a $0.5 million liability to the plan at December 31, 1984. The corporation made no payments to its pension plan in 1985 and had a $1.6 million liability to the plan at December 31, 1985. Accumulated plan benefits, total actuarial liabilities and plan assets for the corporation's defined benefit pension plan at January 1 follows:

Dollars in millions	1985	1984
Actuarial present value of accumulated plan benefits:		
Vested	$ 9	$ 8
Nonvested	2	1
Total accumulated benefits	$11	$ 9
Total actuarial liability	$25	$22
Net assets available for benefits	$39	$34

The rate of return for determining the present value of accumulated plan benefits is 7.5 percent.

The corporation also has an Executive Pension Plan, which supplements for key senior officers the benefits payable to them under the Federal National Mortgage Association Retirement Plan. Participants are granted pension goals generally ranging from 30 to 60 percent of high-three total compensation as defined in the Plan, reduced by any benefits payable under the Federal National Mortgage Association Retirement Plan. Estimated benefits under the plan are recorded as expenses over the period of employment.

In addition to providing pension benefits, the corporation provides certain health care and life insurance benefits for retired employees. All employees who retire from the corporation are eligible for these benefits. The cost of retiree health care and life insurance benefits is recognized as an expense as premiums are paid. In 1985 and 1984 these costs totaled $0.5 million and $0.6 million, respectively.

Commitments and Contingencies

Portfolio

The corporation had mandatory delivery commitments outstanding to purchase $1.6 billion of mortgages at an average net yield of 10.62 percent at December 31, 1985, compared with $3.5 billion at 12.32 percent at December 31, 1984.

The corporation also issues standby commitments, which must be converted to mandatory delivery commitments in order for the seller to deliver mortgages. The yield is set on the date of conversion. The corporation had $1.8 billion of such commitments outstanding at December 31, 1985, compared with $2.8 billion at December 31, 1984.

Mortgage-Backed Securities

As issuer and guarantor of Mortgage-Backed Securities, the corporation is obligated to disburse scheduled monthly installments of principal and interest (at the certificate rate), whether or not such amounts have actually been received, unscheduled principal payments when received, and the full principal balance upon liquidation of any foreclosed mortgage, whether or not such principal balance is recovered. Either the corporation or the participating lender from whom the mortgages were acquired can assume the foreclosure loss risk on the mortgages in a pool.

The total outstanding principal balance of Mortgage-Backed Securities guaranteed by the corporation was $55.0 billion at December 31, 1985, compared with $36.2 billion at December 31, 1984. These amounts include $16.7 billion at December 31, 1985 and $9.5 billion at December 31, 1984 where the corporation had assumed the foreclosure loss risk.

At December 31, 1985, the corporation had commitments outstanding to issue and guarantee $3.9 billion of Mortgage-Backed Securities, upon delivery of the related mortgages by participating lenders (generally at their option), compared with $2.9 billion at December 31, 1984. At December 31, 1985, the corporation also had outstanding $6.1 billion of mandatory delivery commitments to issue and guarantee Mortgage-Backed Securities, compared with $1.6 billion at December 31, 1984. The mandatory delivery commitments include $2.0 billion at December 31, 1985 and $0.4 billion at December 31, 1984 related to the credit enhancement of future tax-exempt bond issues.

Unaudited Interim Period Results of Operations

The following unaudited results of operations include, in the opinion of management, all adjustments (consisting of normal recurring accruals) necessary for a fair presentation of the results of operations for such periods.

Dollars in millions, except per share amounts	1985 Quarter Ended December	September	June	March
Interest margin	$ 67	$ 50	$ 1	$ (47)
Commitment fees	50	52	52	42
Guaranty fees	32	29	26	25
Other income	9	11	10	7
Administrative expenses	(40)	(39)	(33)	(30)
Provision for losses	(80)	(61)	(36)	(29)
Income (loss) before federal income taxes	38	42	20	(32)
Provision for federal income taxes	(17)	(20)	(9)	15
Net income (loss)	$ 21	$ 22	$ 11	$ (17)
Per share:				
Earnings (loss) (a)	$ .28	$ .31	$ .16	$(.26)
Cash dividends	.04	.04	.04	.04

Dollars in millions, except per share amounts	1984 Quarter Ended December	September	June	March
Interest margin (b)	$ (79)	$ (56)	$ (22)	$ 5
Commitment fees	45	17	28	24
Guaranty fees	23	20	19	16
Other income	10	9	12	17
Administrative expenses	(37)	(27)	(25)	(23)
Provision for losses	(22)	(44)	(8)	(12)
Income (loss) before federal income taxes	(60)	(81)	4	27
Provision for federal income taxes	29	38	(2)	(12)
Net income (loss) (b)	$ (31)	$ (43)	$ 2	$ 15
Per share:				
Earnings (loss)	$(.47)	$(.66)	$ .04	$ .22
Cash dividends	.04	.04	.04	.04

(a) The total of the four quarters does not equal the amount for the year, because the amount for each period is calculated independently based on the weighted average number of shares outstanding during that period.

(b) Effective October 1, 1984, the corporation stopped accruing interest on all conventional loans that were 90 days or more delinquent. The effect of this change was to reduce interest income by approximately $11.6 million in the fourth quarter of 1984, increasing the corporation's after-tax loss by approximately $6.0 million ($.09 per share).

Unaudited Financial Data Adjusted for Effects of Changing Prices

The corporation is subject to a requirement, promulgated by the Financial Accounting Standards Board (FASB), that it provide supplementary financial information, which is intended to disclose the impact of changing prices (inflation) on its financial condition and the results of operations. As a financial institution, the corporation does not maintain inventories or significant amounts of plant and equipment. Accordingly, the adjustments to income required by the statement for these items are not material and need not be reported.

The FASB statement also provides that the impact of inflation on the corporation's financial condition be shown by reporting the loss from the decline in purchasing power of its net monetary assets. For the corporation, the definition of net monetary assets is approximately equivalent to stockholders' equity. The loss from the decline in purchasing power is required to be measured by restating net monetary assets in constant dollars using the Consumer Price Index for All Urban Consumers.

In accordance with the FASB statement, an unaudited five-year comparison of the impact of changes in purchasing power on certain financial data is shown below:

Financial Data Adjusted for Effects of Changing Prices

Dollars in millions, except per share amounts	1985	1984	1983	1982	1981
Interest margin:					
As reported	$ 71	$ (152)	$ (62)	$ (506)	$ (463)
In constant dollars (a)	71	(157)	(66)	(564)	(547)
Net income (loss):					
As reported	37	(57)	75	(105)	(190)
In constant dollars (a)	37	(59)	81	(117)	(225)
Net monetary assets at end of year:					
As reported	1,288	1,159	1,233	1,164	1,204
In constant dollars (a)	1,266	1,181	1,306	1,278	1,372
Loss in purchasing power of average net monetary assets for the year	44	49	46	50	139
Per share:					
Fully diluted earnings (loss):					
As reported	.52	(.87)	1.13	(1.72)	(3.22)
In constant dollars (a)	.52	(.90)	1.22	(1.92)	(3.81)
Cash dividends:					
As reported	.16	.16	.16	.16	.40
In constant dollars (a)	.16	.17	.17	.18	.47
Year-end market price:					
As reported	25.88	15.38	23.00	24.50	8.50
In constant dollars (a)	25.43	15.67	24.37	26.90	9.69
Average consumer price index	322.0	311.1	298.4	289.1	272.4

(a) Constant dollars are computed by reference to the Consumer Price Index for All Urban Consumers and are expressed in average 1985 dollars.

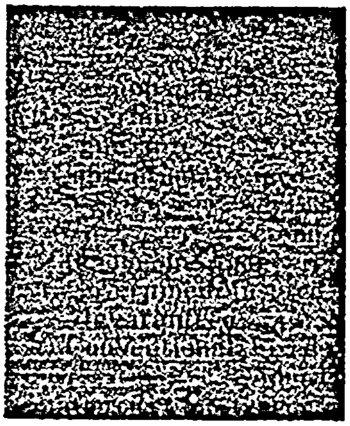
Financial and Statistical Summary

For the Year Dollars in millions, except per share amounts	1985	1984	1983	1982	1981	1980
Summary statements of operations:						
Interest income	$ 9,997	$ 8,844	$ 7,927	$ 6,821	$ 5,534	$ 4,945
Interest expense	9,926	8,996	7,989	7,327	5,997	4,924
Interest margin	71	(152)	(62)	(506)	(463)	21
Commitment, guaranty, and other fees	345	228	238	301	125	68
Gain on sales of mortgages	—	12	91	44	—	—
Administrative expenses	(142)	(112)	(81)	(60)	(50)	(44)
Provision for losses	(206)	(86)	(48)	(36)	28	(19)
Income (loss) before federal income taxes and extraordinary item	68	(110)	138	(257)	(360)	26
Provision for federal income taxes	(31)	53	(63)	123	170	(12)
Income (loss) before extraordinary item	37	(57)	75	(134)	(190)	14
Extraordinary item: gain on early retirement of debt	—	—	—	29	—	—
Net income (loss)	$ 37	$ (57)	$ 75	$ (105)	$ (190)	$ 14
Per share:						
Earnings (loss) before extraordinary item:						
Primary	$ .52	$ (.87)	$ 1.15	$ (2.20)	$ (3.22)	$ .24
Fully diluted	.52	(.87)	1.13	(2.20)	(3.22)	.23
Earnings (loss):						
Primary	.52	(.87)	1.15	(1.72)	(3.22)	.24
Fully diluted	.52	(.87)	1.13	(1.72)	(3.22)	.23
Cash dividends	.16	.16	.16	.16	.40	1.12
Commitments issued:						
Portfolio:						
Home: Government insured or guaranteed	$ 197	$ 68	$ 141	$ 923	$ 2,971	$ 5,570
Conventional: Fixed-rate	11,902	11,838	10,562	13,405	4,927	2,511
Adjustable-rate	6,525	7,072	6,573	6,024	1,360	—
Second mortgage	808	1,240	1,325	1,745	213	—
Total home mortgages	19,432	20,218	18,601	22,097	9,471	8,081
Project: Government insured or guaranteed	—	—	—	9	—	2
Conventional: Fixed-rate	793	703	6	—	—	—
Adjustable-rate	—	86	—	—	—	—
Total project mortgages	793	789	6	9	—	2
Total portfolio	$20,225	$21,007	$18,607	$22,106	$ 9,471	$ 8,083
Mortgage-Backed Securities	$32,957	$42,235	$15,722	$15,517	$ 3,259	$ —
Mortgages purchased:						
Home: Government insured or guaranteed	$ 482	$ 190	$ 186	$ 901	$ 2,284	$ 5,272
Conventional: Fixed-rate	12,398	9,544	11,703	9,443	3,544	2,802
Adjustable-rate	7,066	5,403	4,246	[illegible]10	107	—
Second mortgage	871	937	1,408	1,5[illegible]	176	—
Total home mortgages	20,817	16,074	17,543	15,107	6,111	8,074
Project: Government insured or guaranteed	—	—	12	9	2	27
Conventional: Fixed-rate	693	567	2	—	—	—
Adjustable-rate	—	80	—	—	—	—
Total project mortgages	693	647	14	9	2	27
Total mortgages	$21,510	$16,721	$17,557	$15,116	$ 6,113	$ 8,[illegible]
Average net yield on mortgages purchased	11.59%	12.79%	12.65%	15.00%	15.38%	12.27%
Debt issued:						
Short-term notes, master notes, and investment agreements	$22,481	$23,136	$20,262	$34,196	$30,185	$17,654
Debentures	25,363	24,195	19,756	20,456	10,221	11,000
Subordinated capital debentures	400	641	—	280	—	500
Mortgage-backed bonds	—	—	—	49	—	—
Total	$48,244	$47,972	$40,018	$54,981	$40,406	$29,154
Average cost of debt issued	9.62%	11.47%	10.07%	12.82%	16.22%	13.37%
Mortgage-Backed Securities issued	$23,649	$13,546	$13,340	$13,970	$ 717	$ —

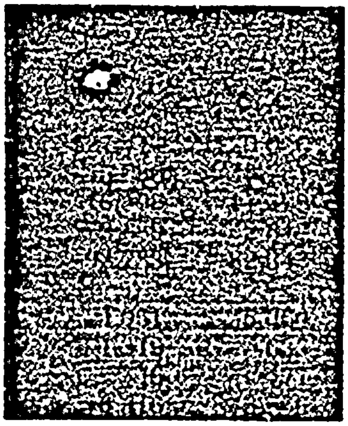
At Year-End Dollars in millions	1985	1984	1983	1982	1981	1980
Summary balance sheets:						
Mortgages at unpaid principal balances:						
Home: Government insured or guaranteed	$27,414	$29,016	$31,000	$33,742	$34,551	$33,417
Conventional: Fixed-rate	45,035	38,781	32,533	27,789	21,153	18,258
Adjustable-rate	16,895	11,729	7,126	3,332	107	—
Second mortgage	2,889	2,817	2,386	1,636	175	—
Total home mortgages	92,233	82,343	73,045	66,499	55,986	51,775
Project: Government insured or guaranteed	4,951	5,060	5,148	5,284	5,426	5,552
Conventional: Fixed-rate	1,319	635	63	31	—	—
Adjustable-rate	46	71	—	—	—	—
Total project mortgages	6,316	5,766	5,211	5,315	5,426	5,552
Total unpaid principal balance	98,549	88,109	78,256	71,814	61,412	57,327
Less unamortized discount and allowance for losses	3,511	3,510	2,591	2,100	1,566	1,585
Net mortgage portfolio	95,038	84,599	75,665	69,714	59,846	55,742
Other assets	4,049	3,760	3,253	3,753	2,052	2,426
Total assets	$99,087	$88,359	$78,918	$73,467	$61,898	$58,168
Bonds, notes, and debentures, net:						
Due within one year:						
Notes, debentures, and mortgage-backed bonds	$31,639	$30,761	$26,860	$25,781	$17,365	$15,542
Subordinated capital debentures	300	500	—	—	—	—
Total due within one year	31,939	31,261	26,860	25,781	17,365	15,542
Due after one year:						
Debentures and mortgage-backed bonds	60,149	50,773	46,196	42,289	39,900	38,052
Subordinated capital and convertible capital debentures	1,808	1,685	1,538	1,544	1,286	1,286
Total due after one year	61,957	52,458	47,734	43,833	41,186	39,338
Total	93,896	83,719	74,594	69,614	58,551	54,880
Other liabilities	3,849	3,432	3,048	2,650	2,104	1,831
Total liabilities	97,745	87,151	77,642	72,264	60,655	56,711
Stockholders' equity	1,342	1,208	1,276	1,203	1,243	1,457
Total liabilities and stockholders' equity	$99,087	$88,359	$78,918	$73,467	$61,898	$58,168
Average yield (net of servicing) on mortgage portfolio	10.81%	10.93%	10.70%	10.73%	9.85%	9.24%
Average cost of debt outstanding	10.79%	11.56%	11.12%	11.38%	11.42%	10.11%
Book value per share	$ 18.41	$ 18.35	$ 19.38	$ 18.39	$ 21.03	$ 24.65
Shares outstanding, in thousands	72,899	65,837	65,830	65,441	59,109	59,109
Commitments outstanding:						
Portfolio:						
Home: Government insured or guaranteed	$ 17	$ 12	$ 8	$ 44	$ 920	$ 2,246
Conventional: Fixed-rate	1,697	3,015	1,554	4,016	1,468	1,008
Adjustable-rate	1,276	2,913	3,828	3,331	1,279	—
Second mortgage	205	331	66	206	31	—
Total home mortgages	3,195	6,271	5,456	7,597	3,698	3,254
Project: Government insured or guaranteed	—	—	—	9	19	24
Conventional fixed-rate	207	113	4	—	—	—
Total portfolio	$ 3,402	$ 6,384	$ 5,460	$ 7,606	$ 3,717	$ 3,278
Mortgage-Backed Securities	$10,093	$ 4,505	$ 1,627	$ 2,331	$ 2,555	$ —
Mortgage-Backed Securities outstanding	$54,987	$36,215	$25,121	$14,450	$ 717	$ —

[illegible]

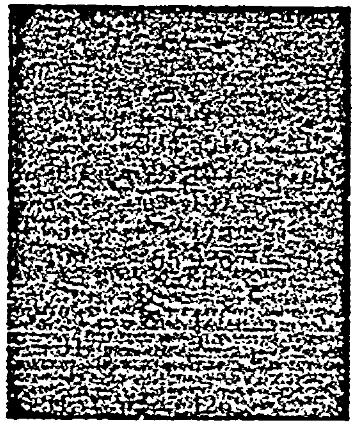
Fannie Mae Board of Directors



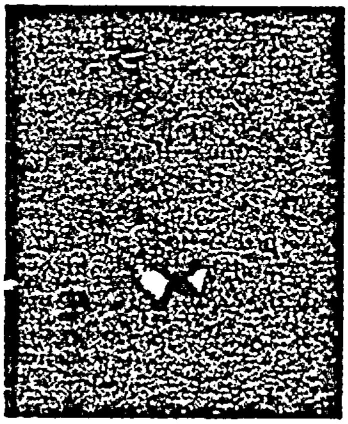
David O. Maxwell
Chairman of the Board and
Chief Executive Officer
Federal National Mortgage Association



Dr. Mark J. Riedy
President and Chief Operating Officer
Federal National Mortgage Association



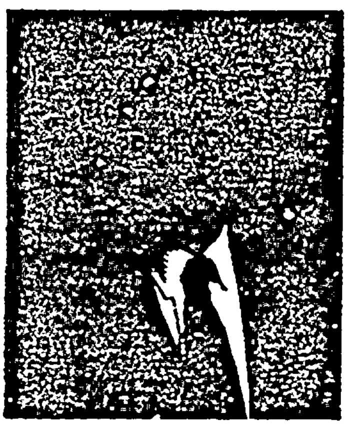
James A. Aliber
Chairman of the Board and
Chief Executive Officer
First Federal of Michigan
Detroit, Michigan



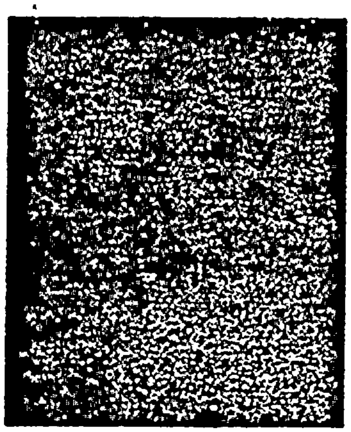
Samuel W. Bartholomew, Jr., Esq.*
Chairman and Principal
Donelson, Stokes & Bartholomew
Nashville, Tennessee

Felix M. Beck
Chairman of the Board and
Chief Executive Officer
Margaretten & Co., Inc.
Perth Amboy, New Jersey

Roger E. Birk
Chairman Emeritus
Merrill Lynch & Co., Inc.
New York, New York

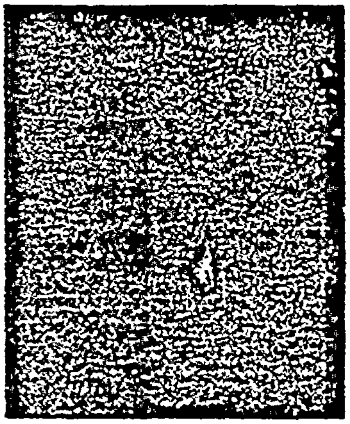


Eli Broad
Chairman and Chief Executive Officer
Kaufman and Broad, Inc.
Los Angeles, California

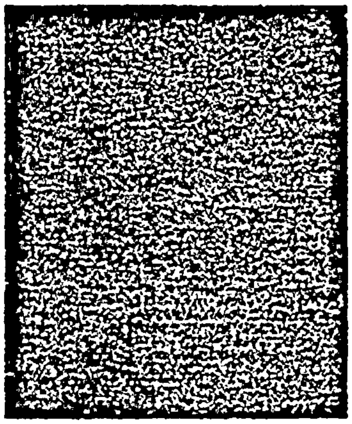


Merrill Butler*
Chairman of the Board
The Butler Group, Inc.
Santa Ana, California

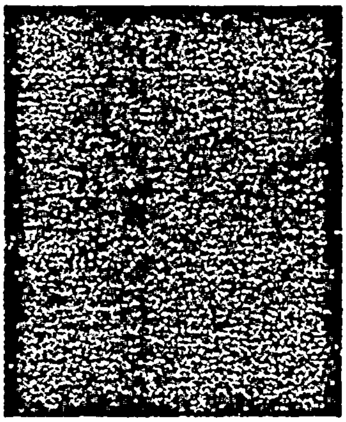
Alberto R. Cardenas, Esq.*
Partner
Broad and Cassel
Miami, Florida



Joseph P. Hayden
Chairman and Chief Executive Officer
The Midland Company
Cincinnati, Ohio

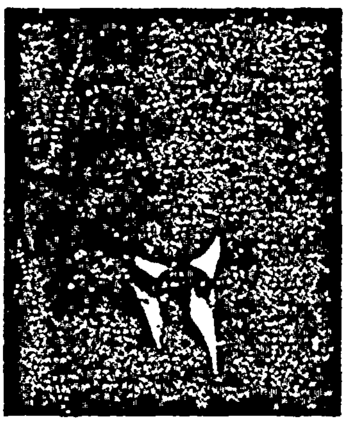


Carla A. Hills, Esq.
Partner
Latham, Watkins & Hills
Washington, DC



John M. O'Mara
Managing Director
Chase Manhattan Capital Markets Corp.
New York, New York

Samuel J. Simmons
President
*The National Caucus & Center on Black Aged, Inc.
Washington, DC



Richard C. Van Dusen, Esq.
Chairman
Dickinson, Wright, Moon, Van Dusen, & Freeman
Detroit, Michigan

Mallory Walker
President
Walker & Dunlop, Inc.
Washington, DC

*Presidential appointee

Fannie Mae Officers

as of February 20, 1986

David O. Maxwell*
Chairman of the Board and
Chief Executive Officer

Dr. Mark J. Riedy*
President and Chief
Operating Officer

Caryl S. Bernstein
Executive Vice President, General
Counsel and Secretary

William A. Dawson
Executive Vice President–Technology

Bruce C. McMillen
Executive Vice President and
Chief Financial Officer

Dale P. Riordan
Executive Vice President–Administration
and Corporate Relations

Michael A. Smilow
Executive Vice President–
Mortgage Operations

Glenn T. Austin, Jr.
Senior Vice President–
Southeastern Region

Douglas M. Bibby
Senior Vice President–
Corporate Affairs

Rebecca T. Boyd
Senior Vice President–
Mortgage-Backed Securities

Richard H. Daniel
Senior Vice President–
Regional Activities

John H. Fulford, III
Senior Vice President–
Western Region

Deane W. Hall
Senior Vice President–
Southwestern Region

Dr. Thomas R. Harter
Senior Vice President–Customer and
Management Information Services

Charles W. Harvey, Jr.
Senior Vice President–
Northeastern Region

John R. Hayes
Senior Vice President–
Midwestern Region

J. Timothy Howard
Senior Vice President–
Economics and Planning

Robert J. Levin
Senior Vice President for
Corporate Finance

Robert J. Mahn
Senior Vice President
and Controller

Gary L. Perlin
Senior Vice President–
Finance and Treasurer

Edward J. Pinto
Senior Vice President–
Marketing and Product Management

David E. Roberts
Senior Vice President–
Corporate Information Services

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Vice President for Marketing

Judith Dedmon
Vice President for Quality Standards

Hugh E. Flaherty
Vice President for
External Communications

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Vice President for Information Technology

Lynda Horvath
Vice President for MBS
Financial Analysis

William S. Jones
Vice President for Quality
Control/Operations
Southwestern Region

Gary J. Kopff
Vice President National
Mortgage Exchange Project

Thomas A. Lawler
Vice President for Economics

Jeffrey A. Lebowitz
Vice President and General Manager
Fannie Mae Software Systems

Richard M. Leegant
Vice President for Mortgage Accounting

William R. Maloni
Vice President for Congressional Relations

Anthony F. Marra
Vice President and Deputy General
Counsel

Raymond J. McClendon
Vice President for Public Finance

James P. McMann
Vice President and Deputy General
Counsel

Edward L. Middleton
Vice President for Technology
Administration

Robert A. Nelson
Vice President and Deputy General
Counsel

Philip R. Nichols, Jr.
Vice President for Quality
Control/Operations
Northeastern Region

Paul Paquin
Vice President for Investor Relations

James T. Parks
Vice President and Assistant Controller

Alan C. Quirion
Vice President for MBS
Development & Operations

Tim J. Ryan
Vice President–Marketing
Midwestern Region

Jayne Shontell
Vice President for MBS
Sales and Marketing

Patricia Redman Singletary
Vice President for Human Resources

Stephen B. Smith
Vice President and Assistant
to the Chairman

John H. Spitzer
Vice President for Corporate Planning

Mary Lou Stellman
Vice President for Marketing
Southwestern Region

Thomas J. Swanson, Jr.
Vice President for Quality
Control/Operations
Southeastern Region

John K. Watsen
Vice President for Audit

James H. Whitehead
Vice President–Marketing
Southeastern Region

Judith A. Winchester
Vice President and Executive
Assistant to the President

C. William Yockey
Vice President for
Multifamily Activities

*Member of the Board

About Fannie Mae Stock

[illegible]

Quarterly Common Stock Data

[illegible]

Transfer Agent and Registrar: Manufacturers Hanover Trust Company, 450 West 33rd Street, New York, New York [illegible]. Co-Transfer Agents and Co-Registrars are First National Bank of Chicago, One First National Plaza, Chicago, Illinois [illegible] and First Interstate Bank of California, [illegible] Wilshire Boulevard, Los Angeles, California [illegible]

A dividend reinvestment service [illegible] available to shareholders who wish to apply quarterly dividends, plus cash deposits [illegible] desired, toward the additional purchase of Fannie Mae stock. The plan is administered solely by Manufacturers Hanover Trust Company, Dividend Reinvestment Department, P.O. Box 24850, Church Street Station, New York, New York [illegible]

Notice of Annual Meeting

The Annual Meeting of Stockholders of the corporation will be held on Thursday, May [illegible], 1986, at 10:00 a.m. in The Madison Hotel, 15th and M Streets, NW, Washington, DC. Formal notice [illegible] the proxy statement and proxy [illegible] be mailed [illegible] stockholders [illegible]

For More Information

[illegible]

Fannie Mae Offices

[illegible]

[illegible]

[illegible]

FannieMae

END

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT UNDER SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the Quarter Ended September 30, 1986 — Commission file number 1-5717

IRVING BANK CORPORATION

(Exact name of registrant as specified in its charter)

New York (State of Incorporation)	13-6195557 (I.R.S. Employer Identification No.)
One Wall Street, New York, New York (Address of principal executive offices)	10005 (Zip Code)

Registrant's telephone number, including area code: (212) 635-1075

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes __X__ No_____

Number of shares outstanding of Common Stock ($10 par value), as of October 31, 1986: 18,015,036

IRVING BANK CORPORATION

PART I. FINANCIAL INFORMATION

The financial information set forth below, except for the consolidated balance sheet as of September 30, 1986 and December 31, 1985, is contained in the September 30, 1986 Quarterly Report to Shareholders filed herewith as Exhibit 20 and is incorporated herein by reference. Page numbers, except for the consolidated balance sheet, refer to page numbers of such Quarterly Report to Shareholders.

*Captioned "Financial Review" in the Quarterly Report to Shareholders.

The financial statements included herein are unaudited. In the opinion of the management of Irving Bank Corporation, all adjustments necessary for a fair presentation of the results of operations have been included. The results of operations for the period ended September 30, 1986 are not necessarily indicative of the results of operations which may be expected for the entire year 1986.

IRVING BANK CORPORATION

CONSOLIDATED BALANCE SHEET

	September 30 1986	December 31 1985
	(In Thousands)	
ASSETS		
Cash and Due from Banks	$ 1,880,596	$ 1,624,180
Interest-Bearing Deposits with Banks	2,139,419	2,197,925
Investment Securities:		
U.S. Government and Federal Agency Obligations	1,297,959	609,921
Obligations of States and Political Subdivisions	550,564	682,752
Other Securities	159,217	139,406
Total Investment Securities (Approximate Market Value of $2,015,305 and $1,417,885)	2,007,740	1,432,079
Trading Account Assets	832,441	503,265
Federal Funds Sold and Securities Purchased Under Agreements to Resell	563,246	252,887
Loans (Less Unearned Discount of $147,020 and $176,961)	12,947,449	12,744,500
Less: Allowance for Loan Losses	190,731	179,697
Net Loans	12,756,718	12,564,803
Premises and Equipment	422,027	396,583
Customers' Acceptance Liability	1,284,634	1,403,156
Accrued Interest Receivable	204,829	236,629
Other Assets	821,719	1,039,149
TOTAL ASSETS	$22,913,369	$21,650,661
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits:		
Domestic Office Noninterest-Bearing	$ 4,259,437	$ 4,703,342
Foreign Office Noninterest-Bearing	143,181	161,160
Domestic Office Interest-Bearing	4,724,821	3,988,257
Foreign Office Interest-Bearing	4,928,103	5,173,516
Total Deposits	14,055,542	14,026,275
Federal Funds Purchased and Securities Sold Under Agreements to Repurchase	3,386,714	1,831,017
Other Borrowed Funds	1,733,748	2,156,517
Acceptances Outstanding	1,292,465	1,414,660
Accrued Interest Payable	89,687	109,923
Accrued Taxes and Other Expenses	139,471	84,259
Other Liabilities	589,589	466,910
Total Liabilities Excluding Long-Term Debt	21,287,216	20,089,561
Long-Term Debt	596,857	605,174
Shareholders' Equity:		
Preferred Stock, Authorized 10,000,000 Shares		
Cumulative Adjustable Rate Outstanding 1,500,000 Shares	75,000	75,000
$4 Convertible, Cumulative Outstanding 23,183 and 27,870 Shares	464	557
Common Stock, $10 Par Value, Authorized 40,000,000 Shares, Outstanding 18,010,186 and 17,763,978 Shares Less 570 and 470 Shares Held in Treasury	180,096	177,634
Surplus	114,467	107,000
Retained Earnings	659,269	595,735
Total Shareholders' Equity	1,029,296	955,926
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$22,913,369	$21,650,661

IRVING BANK CORPORATION

PART II. OTHER INFORMATION

Item 6. <u>Exhibits and Reports on Form 8-K</u>

(a) Exhibits:

Exhibit 3.9 - By-Laws of the Corporation, as amended.

Exhibit 20 - Quarterly Report to Shareholders.

(b) No reports on Form 8-K have been filed during the third quarter of 1986.

IRVING BANK CORPORATION

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

IRVING BANK CORPORATION
(Registrant)

Date: November 12, 1986

By Robert E. Garber
Robert E. Garber
Associate Secretary

Date: November 12, 1986

By W.R. Hamcke
William R. Hamcke
Treasurer
(Principal Financial Officer)

IRVING BANK CORPORATION

EXHIBIT INDEX

Exhibit 3.9 - By-Laws of the Corporation, as amended.

Exhibit 20 - Quarterly Report to Shareholders.

N0010MM530001

8701280100 870121
PDR ADOCK 05000529
P CF

International
North American Rockwell

SUPPORTING DOCUMENT

NUMBER	ER-001-530-001
REV LTR/CHG NO.	6 (SEE SUMMARY OF CHG)
PROGRAM TITLE	VIBRATION AND LOOSE PARTS MONITORING SYSTEMS
DOCUMENT TYPE	ENGINEERING REPORT
KEY NOUNS	V&LP, Installation
DOCUMENT TITLE	INSTALLATION PROCEDURE
ORIGINAL ISSUE DATE	7-24-74
GO NO.	4068
S/A NO.	10000
PAGE 1 OF	19
TOTAL PAGES	23
REL. DATE	8-8-74 BK

PREPARED BY/DATE	DEPT	MAIL ADDR
P. J. Pekrul PJP	731	LB18

IR&D PROGRAM? YES [X] NO [ ] IF YES, ENTER TPA NO. 430

APPROVALS	DATE
O. R. Hillig Orval R. Hillig	
A. W. Thiele A.W. Thiele	7-24-74

SECURITY CLASSIFICATION

(CHECK ONE BOX ONLY)	AEC	DOD
UNCL	[X]	[ ]
CONF.	[ ]	[ ]
SECRET	[ ]	[ ]

(CHECK ONE BOX ONLY)	
RESTRICTED DATA	[ ]
DEFENSE INFO.	[ ]

AUTHORIZED CLASSIFIER — DATE

DISTRIBUTION

*	NAME	MAIL ADDR
*	O.R.Hillig	LA24
	E. H. Carter	LB18
*	P.E.McCourt	LA37
	P. G. Jencek	NB14
	P.J.Pekrul (25)**	LB18
	J.G.Radcliff	T009
*	C.R.Spencer	LA37
	A.W.Thiele	NB14
*	H. Weiseneck	LB19

**3/8" 3-hole punch

* TITLE PAGE ONLY

ABSTRACT

The Vibration and Loose Parts Monitoring System sensor assemblies installation procedures are presented.

FORM 734-C REV 4-71

REV	SUMMARY OF CHANGE	APPROVALS AND DATE
	CHANGE # 1 Page 5: Section 4.6 changed to include 10-32 threaded pilot	PJ Pekrul 10-11-74 O.R. Hillig 10-16-74
	CHANGE # 2 Page 7.1: Added Section 4.9, Waterhammer Sensor Assembly	PJ Pekrul 3-31-75 REL DATE 4-1-75
	CHANGE # 3 Add Installation Checklist. Corrections on pages 4, 7, 11, 12, 13, 14, 15. REL.DATE: 9-17-75	PJ Pekrul 9-13-75 G.W. [illegible] 9-16-75
	Change #4 Added Figure 6 and J-Box hole spacing to Page 5.	PJ Pekrul 1-19-76 G.W. [illegible] 1-19-76
	CHANGE #5 Updated for latest methods. Correction on pages 3, 4, 6, 7. REL DATE: 8-1-77	PJ Pekrul 7-29-77 G.W. [illegible]
	CHANGE #6 Figure 1, page 11 replaced REL. DATE: 8/19/77	PJ Pekrul 8-10-77 G.W. [illegible]

INSTALLATION PROCEDURE
V&LP SENSOR AND PREAMP
INSTALLATION AND CHECKOUT

1.0 SCOPE

This procedure describes the installation and checkout of the sensors (accelerometers) for the Vibration and Loose Parts Monitor system.

2.0 APPLICABLE DOCUMENTS

1) Interface Specification
2) Operation Manual
3) Installation
4) Purchase Order, Proposal or Contract
5) Buyer Specification

3.0 DESCRIPTION

See Operating Manual and other applicable documents.

4.0 PROCEDURE (Sensor Installation and Cable Checkout)

4.1 Parts

Check availability of parts. All parts or approved substitutes are required before starting. Installation can be started with partial availability only with engineering approval.

4.2 Tools Required

1) Standard Electricians Hand Tools
2) Volt Ohmmeter (VOM)
3) 7/8" Spotface and chamfer

4) Alcohol or other acceptable solvent

5) Power drill and No. 21 drill bit

6) 10-32 start and bottom taps

7) Torque wrench and socket (3/8" drive, 5/8" long socket and 0-50 in-lb torque wrench)

8) 600 volt Megohm meter (Megger)

9) Fiberglass tape

10) Standard Electricians Vinyl Tape

4.3 Installation Conditions

1) Cabinet to preamp cable, and/or conduit has been installed per the Interface Specification.

2) Preamp junction box installed per applicable A&E installation drawing.

3) Rigid conduit from preamp junction box to within 3' of sensor location in place.

4) Cabinet in place (welded if required) and 120 volt, 60 Hz power connected with breaker in "off" position. Low noise instrument power required.

NOTE: Sensors can be installed without cabinet in place.

4.4 Connector Installation

1) Attach Indicator Assembly cable connectors per instruction sheet.

2) Attach preamp cable connectors per instruction sheet.

4.5 Sensor Installation - Mounting Block

1) Assemble mounting as shown in Figure 3-3 and 3-4.

2) Attach flexible conduit to sensor J-Box. Then install pull box between flexible and rigid conduit.

3) Pull sensor to the preamp cable through conduit.

CAUTION: Maximum tensile load on 10-32 connector is to be less than 5 lbs. Use caution so as not to scratch or deform cable.

4) Attach coupling to sensor-preamp cable at sensor end.

5) Attach high temperature coax leader to coupling.

6) Tape with fiberglass tape.

NOTE: Omit step 4, 5 and 6 for low temperature sensors.

7) Attach a known resistance (approximately 1 K Ω) to sensor end of sensor cable assembly and using a VOM check continuity. Also check resistance from signal wire to ground and shield to ground. Remove 1 K resistor. Using a 600 volt Megger, insulation resistance of signal to shield should be greater than 10^4 MΩ/1000 ft. and shield to ground should be greater than 10^3 MΩ/1000 ft. Complete Table I. Discharge cables upon completion.

8) Repeat step 7 on preamp to cabinet cable by attaching resistance at one end and checking continuity.

9) Clean mounting surface with alcohol or other solvent.

10) Screw insulated stud in place and torque to 25 inch pounds.

NOTE: Extreme caution should be taken to assure that sensor and preamp cables are not broken or shorted to conduit.

11) Screw sensor in place and torque to 18 inch pounds.

12) Attach sensor connector and safety wire in place.

4.6 <u>Sensor Installation - Stud Mounting</u>

1) Locate exact sensor location. If necessary, remove insulation.

2) Center punch and drill #21 hole. Depth not to exceed 3/8 in. Tap for 10-32 screw. Complete hole by using bottom tap. 5/16 in. of threads are necessary. (see Figure 6)

3) Clean threaded hole and install 10-32 threaded pilot.

4) Spot face to smooth base metal. Spot face should be about 0.010 in. deep.

5) Chamfer pilot hole 1/32 in. with 1/4 in. drill.

6) Clean area with alcohol or other solvent.

7) Screw stud in place and torque to 25 in. pounds.

8) Place junction box in position around stud. Do not mount junction box with screws at this step.

9) Repeat steps 2 through 8 of section 4.5.

10) The junction box can now be positioned to allow for the best orientation of the flexible conduit and to minimize load on the wiring.

11) Center punch mounting holes for the J-box. (see Figure 4)

The J-Box hole spacing is:

3 in. J-box	1.20 ± 0.03 in.
4 in. J-box	1.325 ± 0.03 in.

12) Drill (#21 drill) and tap (bottom tap) for 10-32 screws. Depth is not to exceed 3/8 in.

13) Clean area and holes with solvent.

14) Install mounting screws to secure junction box.

15) Screw sensor in place and torque to 18 in. pounds.

16) Attach sensor connector and safety wire in place (see Figure 4 AND FIGURE 6). SAFETY WIRE SHOULD BE INSTALLED AT SAFETY WIRE HOLES ON SENSOR CONNECTOR IF NON-INSULATED STUD IS USED (SEE FIGURE 6A)

17) Attach sensor J-box cover.

4.7 Sensor Installation - Magnetic Mounting

1) Assemble mounting per Figure 7 & 8. Attach flexible conduit.

2) Determine actual sensor mounting location.

3) Clean surface with alcohol or other acceptable solvent and check to assure that surface beneath magnet is flat to within ±0.002" and a minimum of surface material is between vessel steel and magnet.

4) Install pull box between flexible and rigid conduit.

5) Repeat steps 3 through 9 of Section 4.5.

6) Apply high temperature adhesive (.010") evenly over entire top of sensor. Allow to set for one hour. Remove any adhesive on the side of the sensor.

7) Attach high temperature leader to sensor with spring over leader.

8) Tape with fiberglass tape the 10-32 coupling on top of sensor <u>one revolution only</u>.

9) Slide assembly into retainer (Fig. 7) and verify smooth movement over entire stroke. Correct until smooth movement is present.

10) Apply .005" adhesive on base of sensor.

11) Holding entire assembly (conduit, magnet and sensor) in place, attach assembly to mounting location. Check to assure that sensor alignment has been maintained and that magnet is in contact with surface at all poles.

12) Apply a 20 pound force, perpendicular to the mounting surface, to the magnet. Magnet should remain in place. If not, check mounting surface, alingment, and magnet flux and then repeat #5. Recheck adhesive.

4.8 Sensor Installation - Threaded Fasteners

1) Clear threads of threaded receptical. Use bottom tap if necessary. Clean area with acceptable solvent.

2) Insert threaded fastener through J Box and mount.* Threaded fastener's torque should be appropriate for size of thread.

3) Repeat steps 3 through 12 of Section 4.5.

* Upper vessel fasteners use mounting stud to hold J-Box in place.

4.9 Waterhammer Flush Mounting Sensor/Adaptor Assembly Installation.

(Refer to figure 3) The following procedure applies to assemblies 602R, 612(X)1 and 612(X)2. Proceed as follows:

1) Determine pressure chamber wall thickness at intended installation site; determine by how much overall thickness exceeds accumulated cavity dimension 0.465/0.435-inch. Excess is dimension X.

2) Drill through, using 21/64 (0.328)-inch dia drill.

3) Ream through 0.328-inch dia to 0.332-inch dia, using size Q standard reamer.

4) If required, counterbore 0.750-inch dia by X dimension, using flat-end counterbore or spot-facer with size Q pilot.

5) Counterbore to form seal recess and seal surface, 7/16 (0.4375)-inch dia x 0.05-inch depth, using flat-end spot-facer with size Q pilot.

   CAUTION: Seal surface must have 32 finish.

6) Chamber 0.332 Bore, 90° x 0.39-inch dia.

7) Tap through, using 3/8-24 - 2B taps.

8) Remove all chips and cutting oil; clean cavity thoroughly.

9) Coat adaptor threads and seal surfaces with film of silicone grease; coat a new seal, Model 200E10 (0.062 thk) with silicone grease and place on assembly. Insert into cavity and tighten finger tight.

10) Tighten assembly to suggested maximum torque of six to eight foot-pounds, using 7/16-inch six-point socket with torque wrench.

   NOTE: Do not remove protective cap until installing cable.

4.9.1 Testing for Leaks at Installation. Before operating the pressure source, test for leaks. Three methods are listed in order of preference:

1) Apply soapy solution at seal, only; pressurize chamber with air or nitrogen. Observe for bubbles. Clean thoroughly, afterward.
2) Connect a pressure gauge to chamber and apply pressure, Block input and outlet and observe gauge for long enough elapsed time to assure a seal.
3) Observe for extruded liquid.

4.9.2 Cable Installation. The cable should be routed to avoid kinking and sharp bends, particularly at the connectors. All connections must be clean and dry at assembly and the hookup should be kept as clean and dry as possible in use. The connection between cable and sensor can be made waterproof with heat-shrinkable tubing applied as shown in Figure 3. Installations which are subjected to severe vibration should have the cable connector secured to the sensor with a small amount of epoxy cement applied only to the external threads of the sensor connector at assembly.

CAUTION: Do not use Loctite or other thread sealant which can contaminate connector insulation!

4.9.3 Safety Wire. Safety wire connector in place.

4.9.4 J-Box. Attach J-Box and cover.

5.0 PROCEDURE (Preamp Checkout)

When the Indicator Assembly is available install and checkout the preamps according to the following.

5.1 Install Preamps

1) Install preamps in designated J-Boxes by mounting preamp bracket. Note serial numbers.

2) Attach sensor cable connectors.

3) Attach cabinet cable connector at preamp.

NOTE: Do not tape preamp connectors until each channel is completely checked out.

5.2 Preamp Electrical Checkout

NOTE: Steps 1 through 4 are performed at cabinet.

1) Attach a 1 KΩ resistor at Indicator Assembly to each preamp cable input connector. Do not connect preamp to indicator assembly.

2) Turn-on Indicator Assembly.

3) 3.9 volts should be measured across the 1 KΩ resistor on each channel. (See Table II)

4) Remove the 1 KΩ resistor. 20 volts should be measured at each preamp cable across signal and shield.

5) Attach each preamp with a BNC "T" inbetween the preamp and Indicator Assembly. About 4 volts should be measured on "T" across signal to shield terminal. Remove T's after completion .

6) Listen to each channel on audio monitor. The characteristic plant background noise should be heard.

7) Complete Table II.

8) Calibrate each V&LP channel per the appropriate procedure. (See Operation Manual)

9) Tape preamp and preamp connectors with two layers of vinyl electrical tape.

TABLE I

CABLE CHECKOUT

Channel Number	Cable Number	Signal to Ground	Shield to Ground	Signal to Shield	
				Open	R
1					
2					
3					
4					
5					
6					
7					
8					
9					
10					
11					
12					
13					
14					
15					
16					
17					
18					
19					
20					

TABLE II

PREAMP CHECKOUT

Channel Number	1 K Voltage	Open Ckt Voltage	Preamp Voltage	Signal Content
1				
2				
3				
4				
5				
6				
7				
8				
9				
10				
11				
12				
13				
14				
15				
16				
17				
18				
19				
20				

GOLDEN CRIMP Change 6

ASSEMBLY INSTRUCTIONS

PLUG & JACK

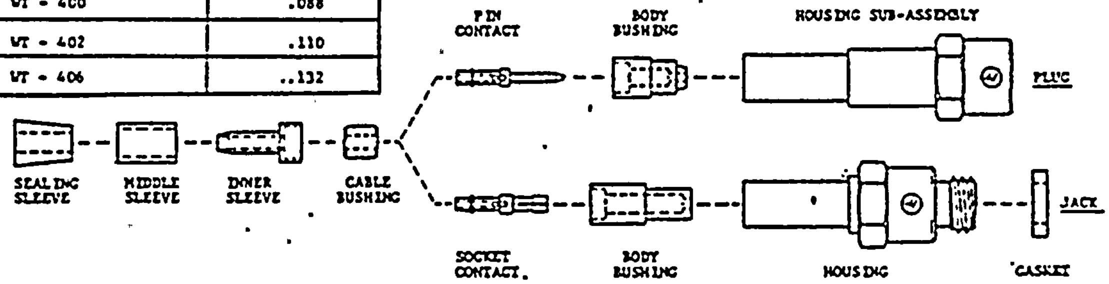
RF-ASMB-8

TABLE I (CONTACT CRIMP TOOLS)

MICRODOT PART NUMBER	MANUFACTURERS PART NUMBER
010-0065—0000	DAVO PRODUCTS # 810
010-0134 (SETTING #1) WITH 001-0104 LOCATOR	DANIELS #MH750 (SETTING #1) WITH LOCATOR # P79

TABLE II (HOUSING CRIMP TOOLS)

MICRODOT PART NUMBER	THOMAS & BETTS PART NO	MAXIMUM CABLE DIA.
010-0081	WT - 400	.088
010-0082—0600	WT - 402	.110
010-0083	WT - 406	..132



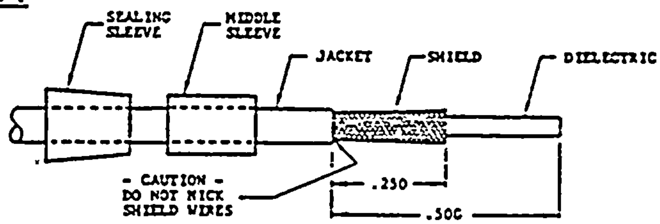
STEP 1

SLIP SEALING SLEEVE AND MIDDLE SLEEVE OVER CABLE AS SHOWN IN FIGURE I.

STEP 2

STRIP CABLE TO DIMENSIONS SHOWN IN FIGURE I. FAN SHIELD SLIGHTLY, BUT DO NOT UNBRAID. EXTREME CARE MUST BE TAKEN TO AVOID NICKING OR CUTTING SHIELD WIRES WHEN TRIMMING JACKET.

FIG. I



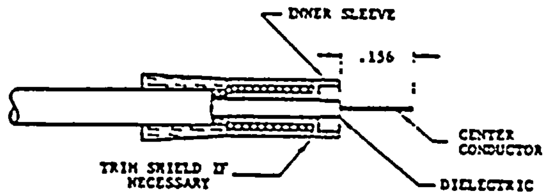
STEP 3

SLIDE INNER SLEEVE (SMALL END FIRST) OVER DIELECTRIC AND UNDER THE SHIELD UNTIL SHIELD WIRES ARE FLUSH WITH SHOULDER. (TRIM EXCESS SHIELD IF NECESSARY.) SLIDE MIDDLE SLEEVE FLUSH WITH SHOULDER OF INNER SLEEVE. SLIDE SEALING SLEEVE UNTIL IT BUTTS AGAINST THE MIDDLE SLEEVE AS SHOWN IN FIGURE II.

STEP 4

TRIM DIELECTRIC FLUSH WITH FACE OF INNER SLEEVE; BUT DO NOT NICK CENTER CONDUCTOR. TRIM CENTER CONDUCTOR TO LENGTH SHOWN IN FIGURE II.

FIG. II



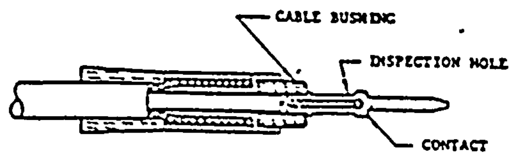
STEP 5

SLIDE CABLE BUSHING OVER CENTER CONDUCTOR AND INTO INNER SLEEVE AS SHOWN IN FIGURE III.

STEP 6

SLIDE CONTACT OVER CENTER CONDUCTOR AND PRESS INTO CABLE BUSHING AS SHOWN IN FIGURE III. CENTER CONDUCTOR MUST BE VISIBLE THRU INSPECTION HOLE. WITH ALL PARTS FITTED SECURELY, CRIMP CONTACT WITH ANY ONE OF MICRODOT CRIMP TOOLS SPECIFIED IN TABLE I.

FIG. III



STEP 7

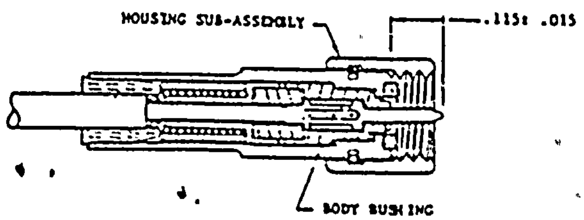
SLIDE BODY BUSHING OVER CONTACT AND PRESS ONTO CABLE BUSHING. INSERT ASSEMBLY INTO HOUSING (JACKS) OR HOUSING SUB-ASSEMBLY (PLUGS) AS SHOWN IN FIGURE IV. MAKE SURE IT IS PROPERLY FITTED AND IN AS FAR AS POSSIBLE. (ROTATE WHILE PUSHING TO SECURE A TIGHT FIT.) CRIMP REAR OF HOUSING WITH PROPER TOOL AS INDICATED IN TABLE II.

THIS COMPLETES PLUG ASSEMBLY. SEE STEP 8 FOR JACKS.

STEP 8

LOCATE THE RUBBER GASKET IN THE RELIEF DIRECTLY BEHIND THE MATING THREADS.

FIG. IV



NOTES:

1. TEST VOLTAGE - 1000 V. R.M.S.
2. INSULATION RESISTANCE - 5.0 X 10⁹ OHMS MIN.

MICRODOT INC

GC-ASMB-8 *Printed in U.S.A.*

N001OMM530001

coaxial connectors

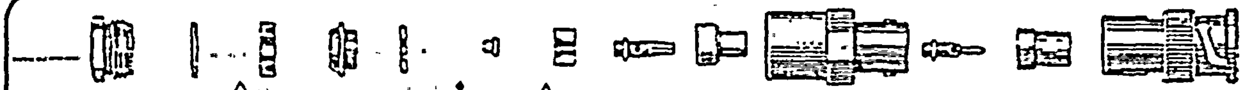
assembly instructions

BNC

Captivated Contacts - continued

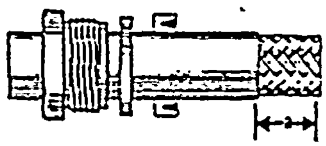
ER-001-530-001
Page 12

Figure 2



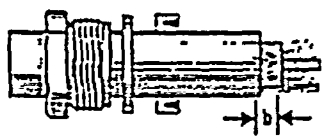
△ cross section views ◆ this part is only used when RG-62 & -71/U cables are employed.

cables RG-59/U, RG-59A/U, RG-59B/U, RG-62/U, RG-62A/U, RG-62C/U, RG-71/U, RG-71B/U, RG-140/U



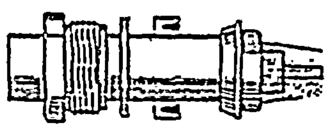
Cut end of cable sharp and square. Slide nut, washer and gasket, with "V" groove toward clamp over jacket, and cut off jacket to dimension a shown below.

dimension	plugs	all others
a	[illegible]	½"

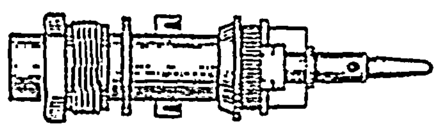


Comb out braid and fold out. Cut off cable dielectric to dimension b shown below. Cut to be sharp and square. Do not nick center conductor.

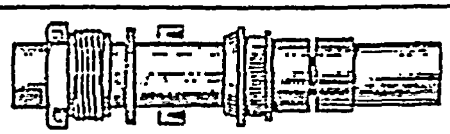
dimension	RG-59/U, RG-59A/U, RG-59B/U, RG-140/U	RG-62/U, RG-62A/U, RG-62C/U, RG-71/U, RG-71B/U
b	[illegible]	[illegible]



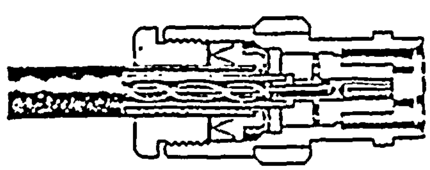
Pull braid wires forward and taper toward center conductor. Place clamp over braid and push back against cable jacket.



Fold back braid wires as shown, trim to proper length and evenly form over clamp as shown. Tin exposed center conductor using minimum amount of heat.■ Do not distort dielectric so as to prevent proper mating with bushing and rear insulator.
Slide on bushing, (for RG-62 & -71/U cable, add insulator bushing), rear insulator and contact. These parts must butt, as shown. Solder contact to center conductor.■ Remove flux and excess solder from contact O.D.



Slide front insulator over contact and butt against contact shoulder as shown. Do not reverse direction of insulator.



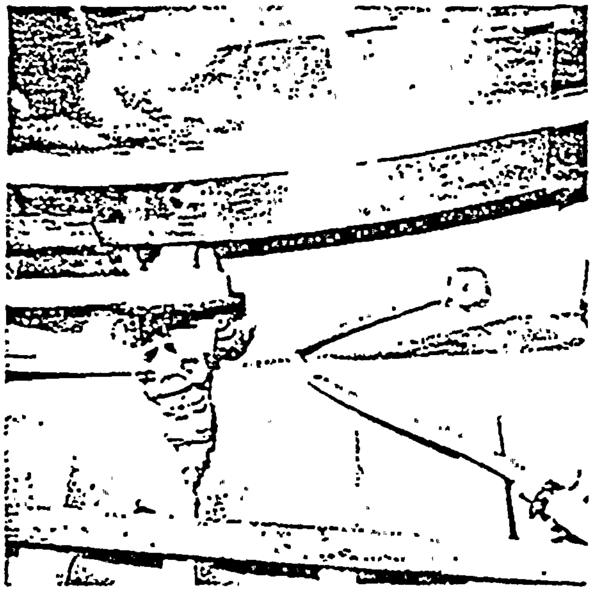
Insert prepared cable termination into conductor body. Make sure sharp edge of clamp seats properly in gasket. Tighten nut, holding body stationary.

■ Use Divco #276 (or other high temp. alloy) solder for high temp. applications.

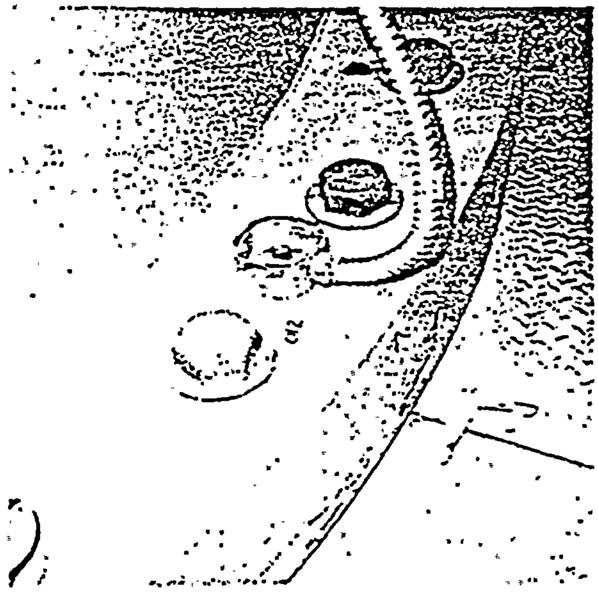
note: For RG-141/142-type copper jacketed cable, see assembly instructions for Improved Type connectors.

TYPICAL SENSOR INSTALLATION* FOR AI'S VIBRATION AND LOOSE PARTS MONITORING SYSTEM

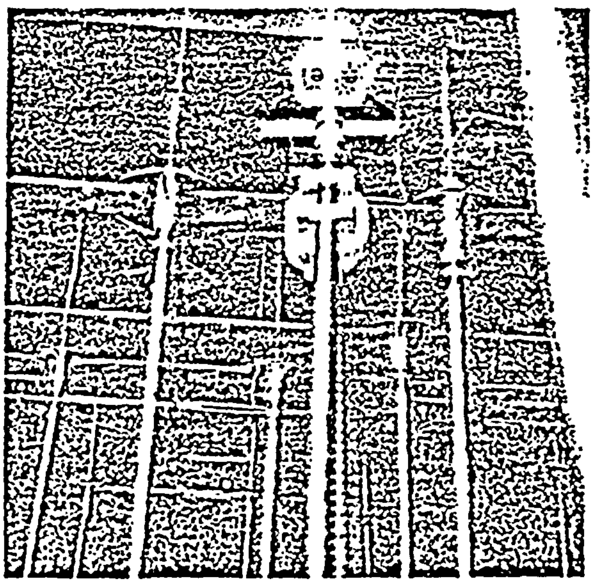
Figure 3

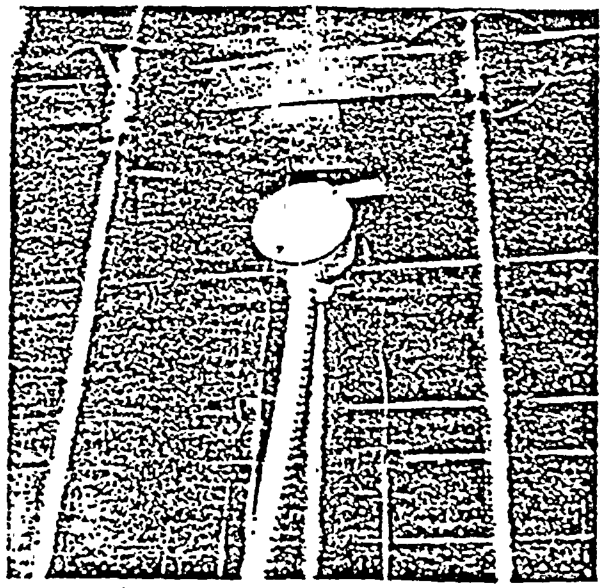


3.1 STEAM GENERATOR Sensor Mounted on Upper Tubesheet



3.2 REACTOR UPPER VESSEL Sensor Mounted Between Bolts of Service Structure Flange





3.3, 3.4 REACTOR LOWER VESSEL Sensor Mounting Clamped to Instrument Guide Tubes

* Photographs depict actual sensor installations on Arkansas Power & Light Co., Nuclear One

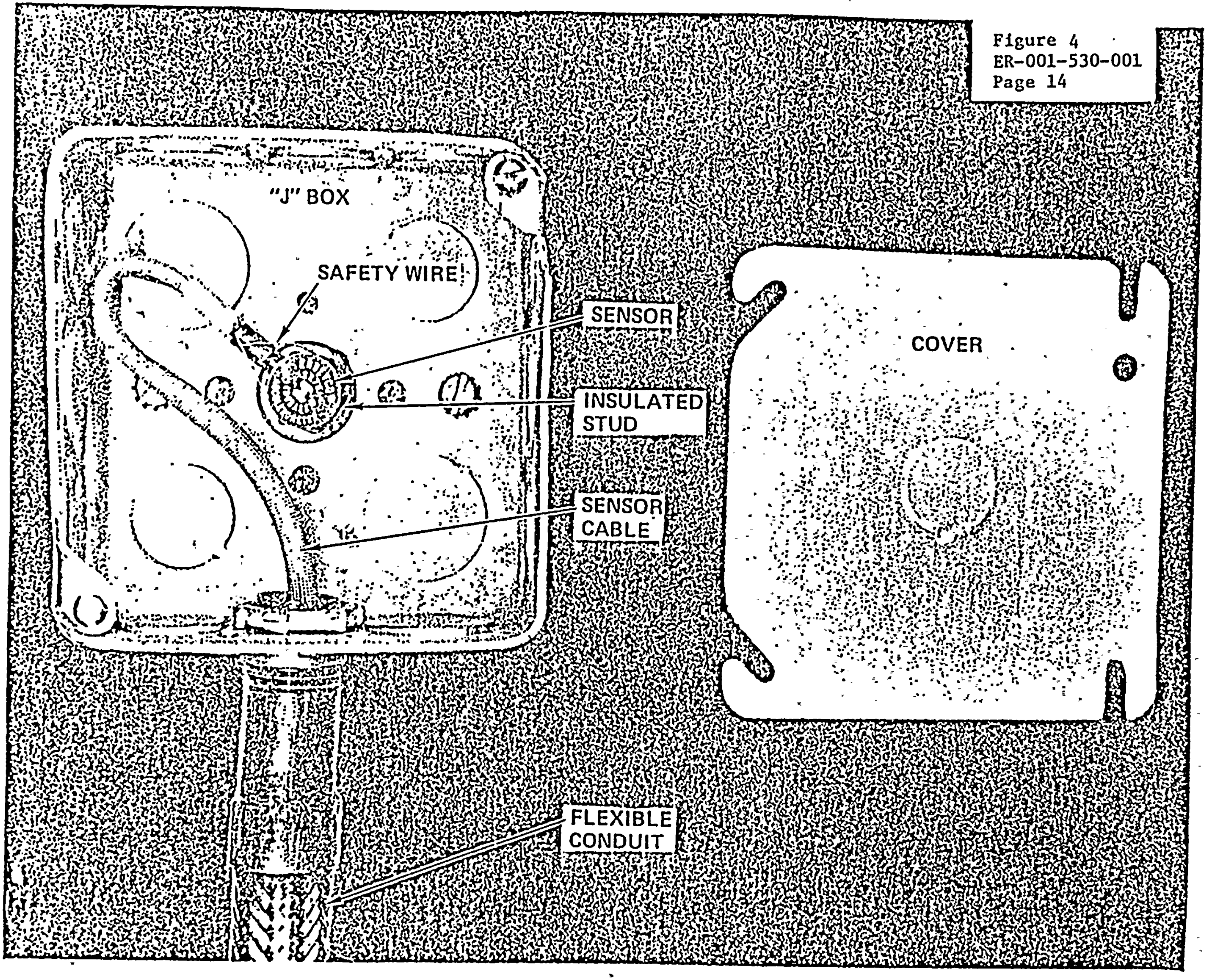
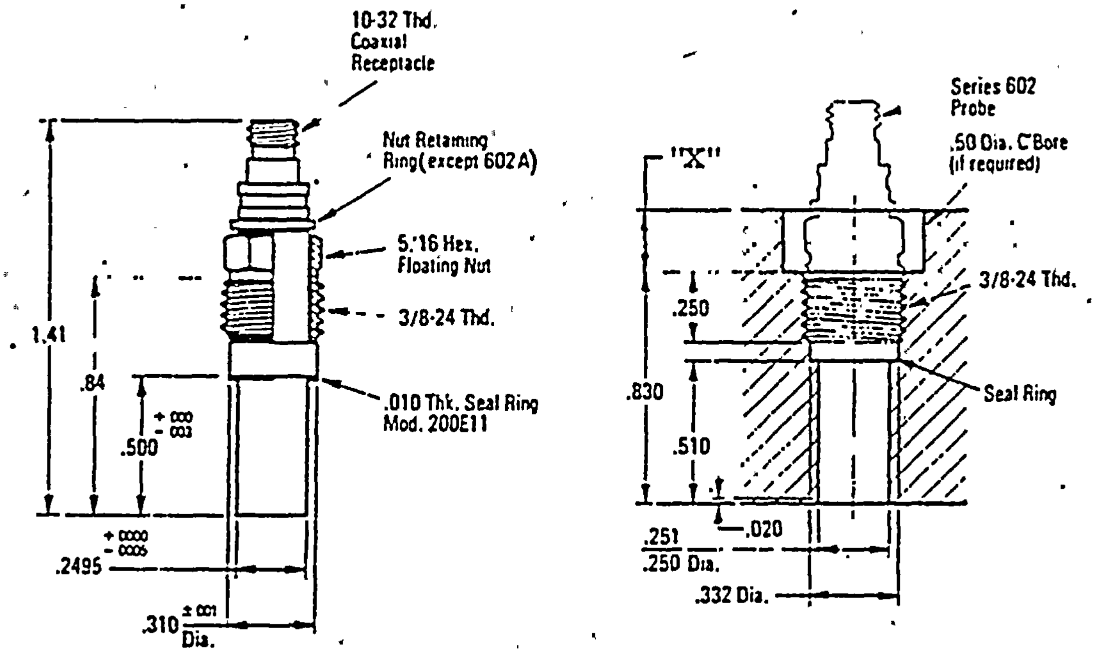
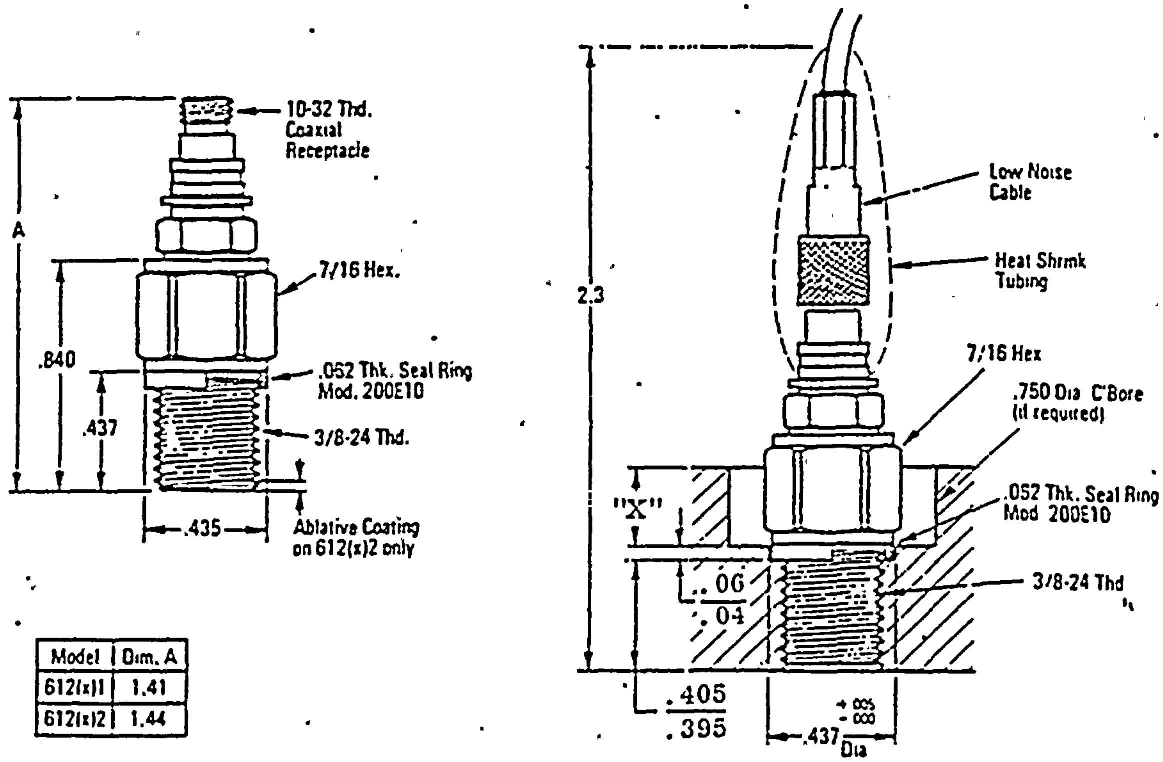

"J" BOX
SAFETY WIRE
SENSOR
INSULATED STUD
SENSOR CABLE
FLEXIBLE CONDUIT
COVER

Figure 5



Sensor and Typical Flush Mounting



Model	Dim. A
612(x)1	1.41
612(x)2	1.44

Sensor/Adaptor Assembly, Flush Mounting

Note: Dimensions in inches

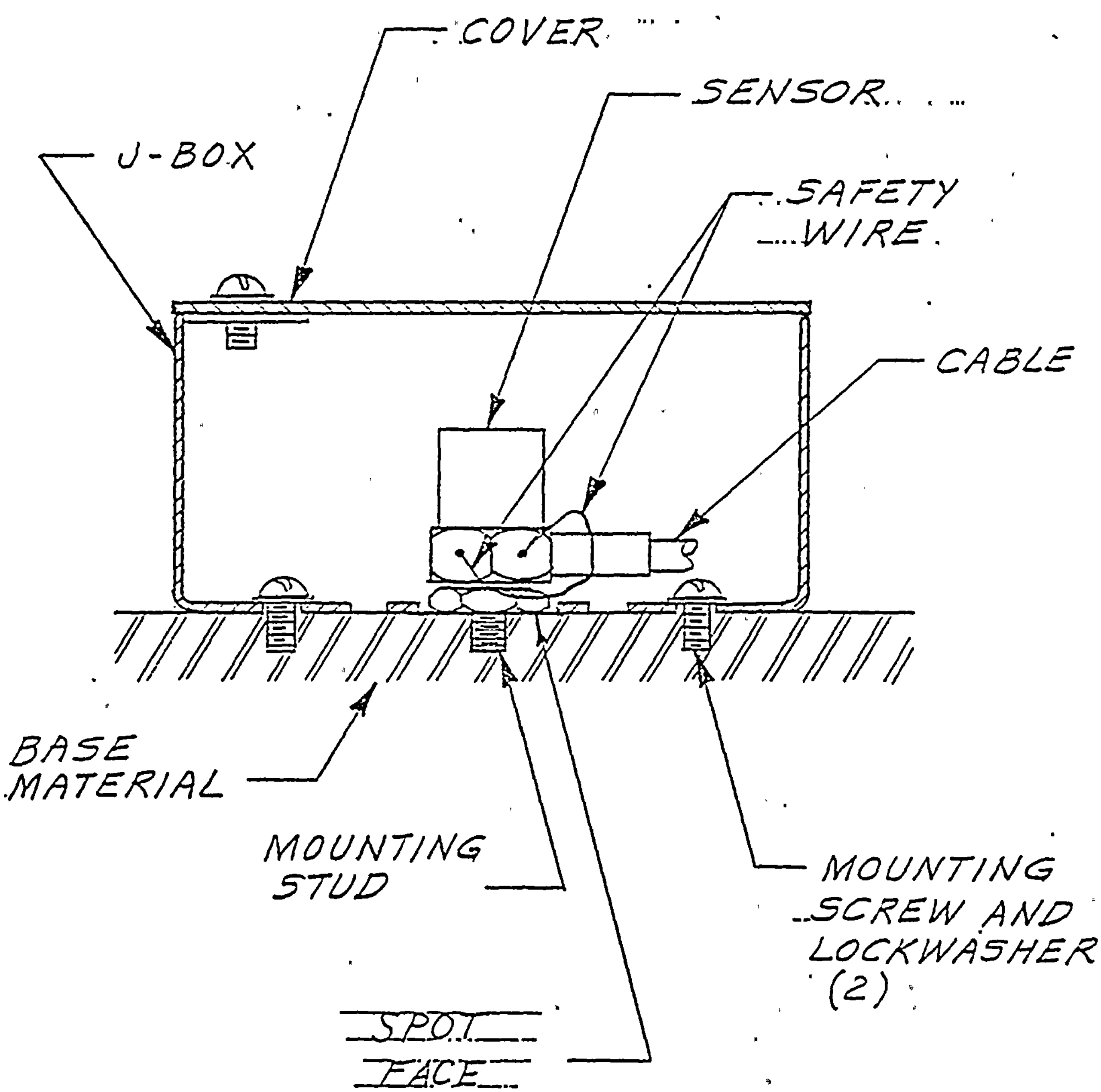


FIGURE 6
STUD MOUNTING CROSS SECTION

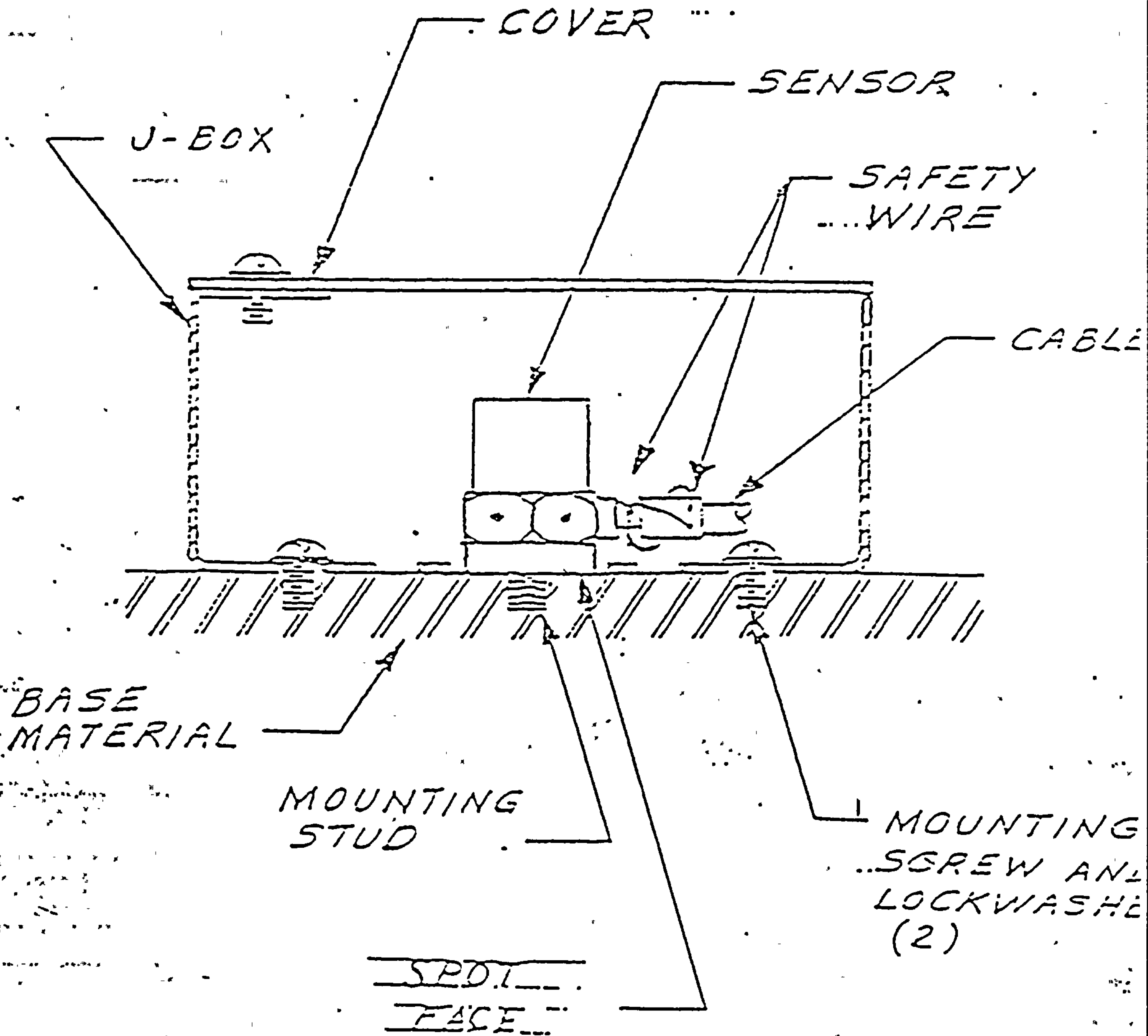


FIGURE 6A NON INSULATED
STUD MOUNTING CROSS SECTION

FIGURE 7

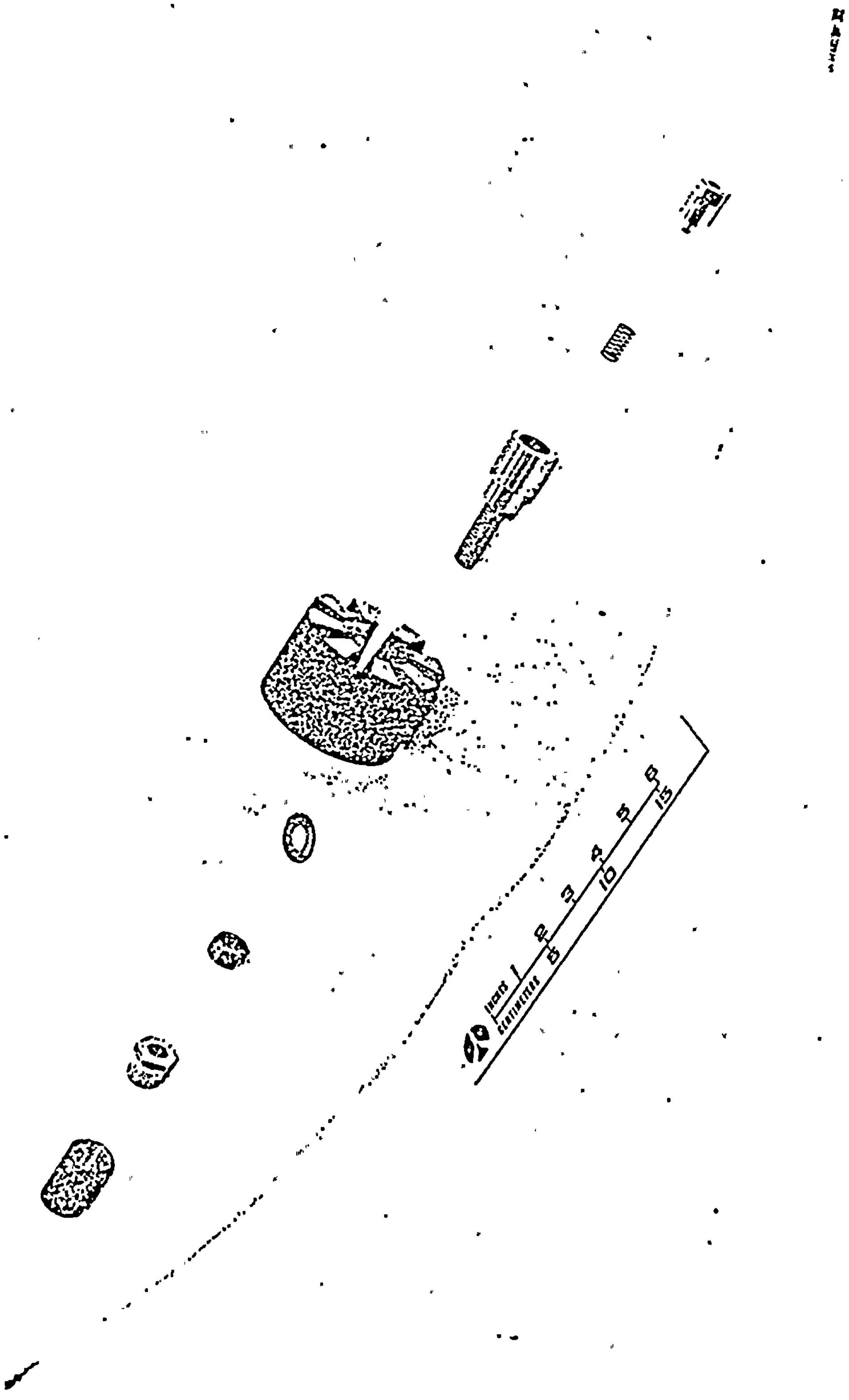


FIGURE 8

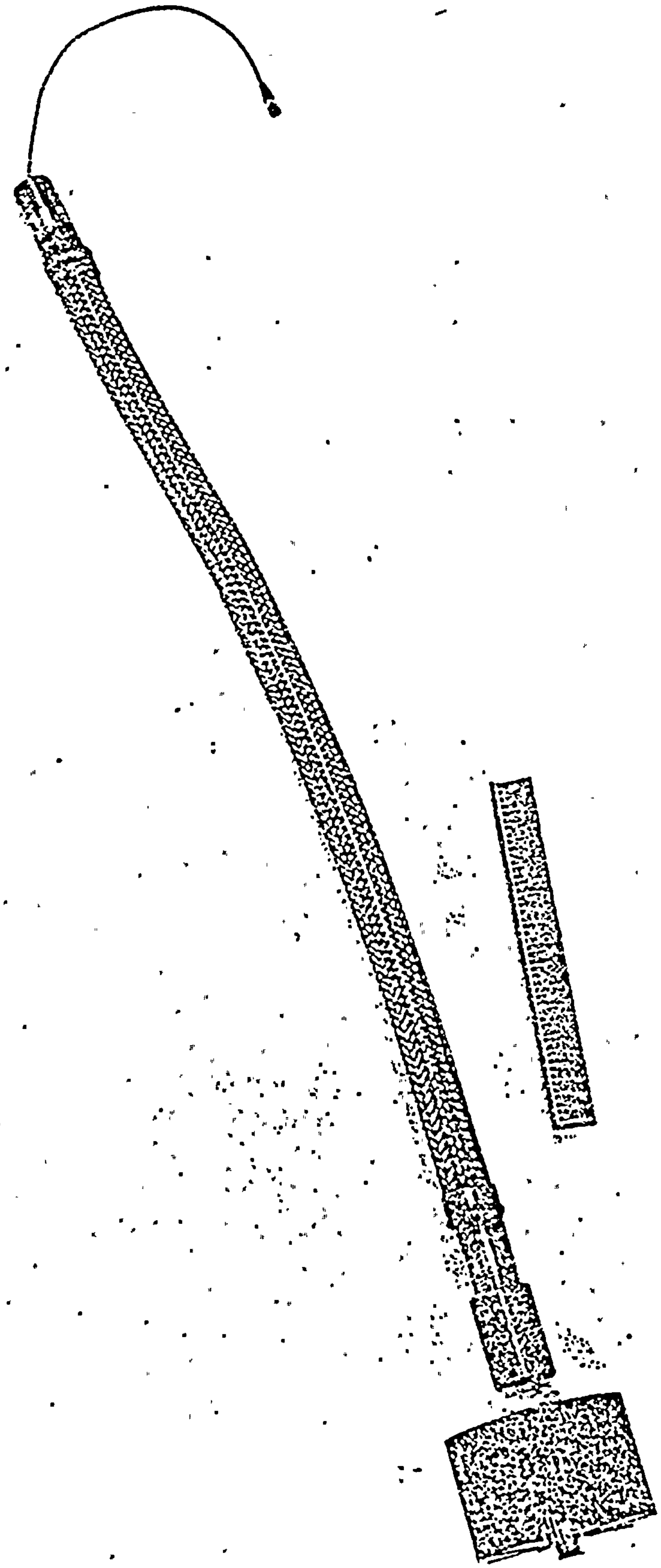


TABLE II

V&LPM INSTALLATION CHECKLIST

1. All sensor installations inspected.

2. All preamp installations inspected.

3. All cable installations inspected, including sensor and preamp cables inside containment, penetrations and ex-containment cables.

4. Table I complete.

5. Table II complete.

6. All major components in V&LPM system; i.e., indicator assembly, spectrum analyzer, X-Y plotter, tape recorder, calibrator, functionally checked for proper operation.

7. Section 5.0 of the test procedure DTP-001-530-OXX repeated.

8. System accepted by customer or agent.

Customer Signature	Date

9. Telephone report to AI project.

Arizona Nuclear Power Project
P.O. BOX 52034 • PHOENIX, ARIZONA 85072-2034

January 21, 1987
ANPP-39768-JGH/JKR/98.05

Director of Nuclear Reactor Regulation
Attention: Mr. George W. Knighton, Project Director
PWR Project Directorate #7
Division of Pressurized Water Reactor Licensing - B
U.S. Nuclear Regulatory Commission
Washington, D.C. 20555

Subject: Palo Verde Nuclear Generating Station (PVNGS)
Unit 2
Docket No. STN-529 (License NPF-51)
Loose Part Detection Program Report
File: 87-F-056-026

Dear Mr. Knighton:

Enclosed is the Loose Part Detection Program Report as required by Regulatory Guide 1.133.

If you should have any questions regarding this matter, please contact Mr. William F. Quinn of my staff.

Very truly yours,

J. G. Haynes

J. G. Haynes
Vice President
Nuclear Production

JGH/JKR/rw
Enclosure

cc: O. M. De Michele
E. E. Van Brunt, Jr.
E. A. Licitra
A. C. Gehr
R. P. Zimmerman

PA01
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12