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Report to the Secretary of the Treasury

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FINANCIAL MANAGEMENT

Treasury Tax and Loan Account Activity at Two Troubled Banks

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Accounting and Financial
Management Division

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The Honorable Nicholas F. Brady
The Secretary of the Treasury

Dear Mr. Secretary:

This report addresses the investment and withdrawal of federal funds in the Treasury Tax and Loan (TT&L) accounts at two troubled banks that subsequently failed, the Bank of New England and Freedom National Bank. In December 1990 and January 1991, reports in the media stated that the Bank of New England, a large bank, was given special treatment with respect to the investment and withdrawal of federal TT&L funds in an effort to keep the bank open, while Freedom National Bank, a much smaller, minority owned bank, was not provided the same opportunity. Because of concern raised over this issue, we reviewed the investment and withdrawal of federal funds in the TT&L accounts at these two banks.

Results in Brief

We noted no special treatment with respect to the Bank of New England's TT&L account. During calendar year 1990, the Department of the Treasury, through its fiscal agents, the Federal Reserve Banks of Boston and New York, maintained TT&L accounts at the Bank of New England and Freedom National Bank, both of which were considered troubled banks at that time. We found that the TT&L activity associated with TT&L funds at these two banks during 1990 was in accordance with Treasury regulations.

Despite financial instability, the Bank of New England increased the maximum amount of TT&L funds it was permitted to hold from $350 million in January 1990 to a high of nearly $1.8 billion in March 1990 and pledged collateral in accordance with Treasury regulations to secure the TT&L funds. Such increases are permissible for any financial institution in the TT&L program. In contrast, Freedom National Bank was not able to adequately collateralize the TT&L funds it held, resulting in Treasury and the Federal Reserve Bank of New York (1) decreasing the maximum amount of TT&L funds the bank was allowed to maintain from $15 million to $8 million and (2) accelerating the transfer of large TT&L deposits from the bank to the Federal Reserve.

Background

Our review focused on two commercial banks: the Bank of New England located in Boston, Massachusetts, and Freedom National Bank, a minority owned bank in New York, New York. The Federal Reserve Bank of Boston oversees the Bank of New England's TT&L transactions, while the Federal Reserve Bank of New York was responsible for Freedom National Bank's TT&L account. On the date that the Bank of New England failed,[1] it had reported assets of nearly $14 billion, while Freedom National Bank's reported assets were $121 million when it was closed.

The Department of the Treasury collects the majority of its taxes through the TT&L system, with $747 billion in taxes deposited to TT&L accounts in fiscal year 1990. These receipts, which consist primarily of payroll and corporate income taxes, are maintained in Treasury's accounts at the Federal Reserve Banks and in TT&L accounts at participating financial institutions. Financial institutions are required by Treasury regulations to provide the Federal Reserve Banks with collateral that is acceptable to Treasury. Examples of assets that can be used as collateral to secure TT&L accounts include Treasury, federal agency, and municipal securities as well as commercial loans. Participating institutions must maintain collateral balances at the Federal Reserve that are equal to or greater than the amount of Treasury funds in their TT&L accounts or face sanctions from Treasury.[2] These sanctions include suspension from the TT&L program or reductions in the amount of TT&L funds an institution can maintain.

Businesses deposit their taxes directly in participating financial institutions, where they remain on deposit until transferred to Treasury's account at the Federal Reserve Banks. In addition, when federal receipts are high and Treasury has excess operating cash, such as during major tax collection periods, it places these excess funds in interest bearing TT&L accounts at financial institutions that have elected to accept and collateralize the additional funds. In fiscal year 1990, Treasury received

[1]Three banks comprise a holding company referred to as the Bank of New England Corporation—Bank of New England, Connecticut Bank and Trust, and Maine National Bank. The reported combined assets of the holding company were $22 billion when it was taken over by the Federal Deposit Insurance Corporation. Because the majority of the TT&L funds during 1990 were in the Bank of New England, this report only addresses its TT&L transactions.

[2]During 1990, Treasury procedures generally allowed a bank to have up to 9 days of deficiencies per month before it was subject to sanctions that could lead to suspension from the TT&L program. In February 1991, this policy was changed to allow 3 days of deficiencies per month before Treasury could impose sanctions.

nearly $1.4 billion in interest earnings on funds invested in interest bearing TT&L accounts.

Financial institutions in the TT&L program participate as either remittance option or note option institutions. Remittance option institutions receive tax deposits and remit them the next business day to the Federal Reserve. Note option institutions hold the deposits in an interest bearing account until needed by Treasury or until the account balance exceeds the maximum amount authorized for their account. Both the Bank of New England and Freedom National Bank were note option institutions. In addition, about 150 note option institutions also receive investments of excess Treasury operating cash. These note option institutions are commonly referred to as direct investment institutions. The Bank of New England was also a direct investment institution because it elected to receive and collateralize excess funds that Treasury may decide to invest.

A note option institution can increase the maximum amount it can maintain in its TT&L account by pledging collateral that meets Treasury requirements. Treasury relies on the Federal Reserve Banks, as its fiscal agents, to ensure that the collateral pledged is properly valued and is consistent with the types of collateral specified in Treasury regulations, and that the total amount is adequate to secure all TT&L funds. According to Federal Reserve and Treasury officials, since TT&L balances must be completely collateralized, Treasury does not generally consider the financial condition of an institution which holds these federal funds.

Direct investments of excess Treasury operating cash are made on a proportional or formula basis, which is applied uniformly to all participating institutions. The amount of excess cash Treasury invests in each of the institutions participating in the direct investment program is based on a percentage derived by dividing the total amount Treasury has available for investment by the total amount of available investment capacity (the difference between the maximum amount of funds the institutions participating in the program are authorized to accept and their current TT&L account balances). Treasury instructs the Federal Reserve Banks to multiply this percentage against each institution's available investment capacity to determine the amount of excess cash that will be invested in each institution.

For example, if the available investment capacity of the participating institutions was $10 billion and Treasury had $1.5 billion of excess cash to invest, the Federal Reserve would invest in each institution 15 percent of each institution's available capacity. An automatic, computerized calculation determines the investment distribution among the participating financial institutions. During calendar year 1990, Treasury instructed the Federal Reserve Banks to invest funds in direct investment institutions on 64 occasions for a total of over $200 billion.

Likewise, when Treasury needs additional operating cash from the TT&L system, a similar calculation is made and the required amounts are automatically withdrawn from note option institutions. In calendar year 1990, Treasury withdrew funds from note option accounts on 170 occasions, providing over $500 billion to Treasury's Federal Reserve account.

Objective, Scope, and Methodology

Our objective was to determine whether Treasury and the Federal Reserve Banks gave increased financial support by the special placement of Treasury investments in a large bank, the Bank of New England, while not providing similar support to a small minority owned bank, Freedom National Bank. Specifically, we determined whether

- direct investments to the Bank of New England's TT&L account were made in accordance with Treasury regulations,
- TT&L withdrawals at the two banks were made in accordance with Treasury regulations, and
- the reported amount of collateral pledged by the two banks to secure TT&L funds and any corrective actions taken were in accordance with Treasury regulations.

To achieve our objective, we examined daily account registers maintained by the Federal Reserve Banks that recorded the taxpayer deposits, Treasury investments, and withdrawals from the TT&L accounts at the Bank of New England and Freedom National Bank from January 1990 through December 1990 to determine whether the transactions were made in accordance with Treasury's established criteria. In order to determine the accuracy of investments and withdrawals computed by the Federal Reserve Banks, we analyzed each of the 64 investment decisions and 170 withdrawals applicable to these banks for calendar year 1990 by recomputing the investment and withdrawal calculations made by the Federal Reserve Banks. We also verified the direct investment and withdrawal calculations for institutions administered by the Federal Reserve Bank of Boston on four dates selected judgmentally to ensure that Treasury instructions were applied consistently to similar institutions. These recalculations were based on Treasury's standard formula to determine how the money should have been invested or withdrawn.

We also reviewed collateral monitoring reports prepared by the Federal Reserve Banks for calendar year 1990, which would identify any collateral deficiencies for these banks, to determine the extent of collateral deficiencies and if action was taken to correct any such deficiencies. We also reviewed information for calendar year 1989 to determine whether these two banks had previous collateral deficiencies that warranted additional review. In addition, we discussed relevant events and activities associated with the Bank of New England and Freedom National Bank with cognizant representatives of Treasury and the Federal Reserve.

Our review was restricted to the deposit and withdrawal of TT&L funds at the Bank of New England and Freedom National Bank. This report does not examine actions taken by Treasury, the Comptroller of the Currency, the Federal Deposit Insurance Corporation (FDIC), or the Federal Reserve to provide funding or other assistance to these banks.

In addition, we did not determine, for either bank, whether the collateral pledged to secure their TT&L accounts was properly valued by the Federal Reserve Banks.[3] However, we did determine whether the Federal Reserve Bank of Boston used the same valuation techniques for collateral pledged by the Bank of New England as those used to value collateral pledged by other institutions it administered. We were unable to review any of the collateral pledged by Freedom National Bank because the bank was closed and its collateral removed from the Federal Reserve Bank of New York prior to the start of our review.

We conducted our review from December 1990 through August 1991 and performed our work at the Department of the Treasury in Washington, D.C., and at the Federal Reserve Banks of Boston and New York. Our review was performed in accordance with generally accepted government auditing standards. We discussed the results of our review with responsible Treasury and Federal Reserve officials and incorporated their comments where appropriate.

[3]As part of another currently ongoing review for which we will separately report, we are assessing the accounting for and controls over TT&L collateral at six Federal Reserve Banks, including the Federal Reserve Banks of Boston and New York.

Bank of New England's TT&L Transactions Made in Accordance With Treasury Regulations

We examined the daily transactions in the TT&L account of the Bank of New England, a note option and direct investment bank, and found that all investments and withdrawals made in calendar year 1990 were in accordance with the Treasury's investment and withdrawal instructions. In addition, the Bank of New England did not have any collateral deficiencies during 1989 or 1990 that would have caused it to be suspended from the TT&L program or led to a reduction of the bank's investment limit under Treasury regulations. On January 6, 1991, when the Bank of New England failed and was taken over by FDIC, it had $213 million in its TT&L account, which was backed by collateral with a face value of about $1.1 billion. These assets were valued by the Federal Reserve Bank of Boston at $739 million for TT&L collateral purposes.

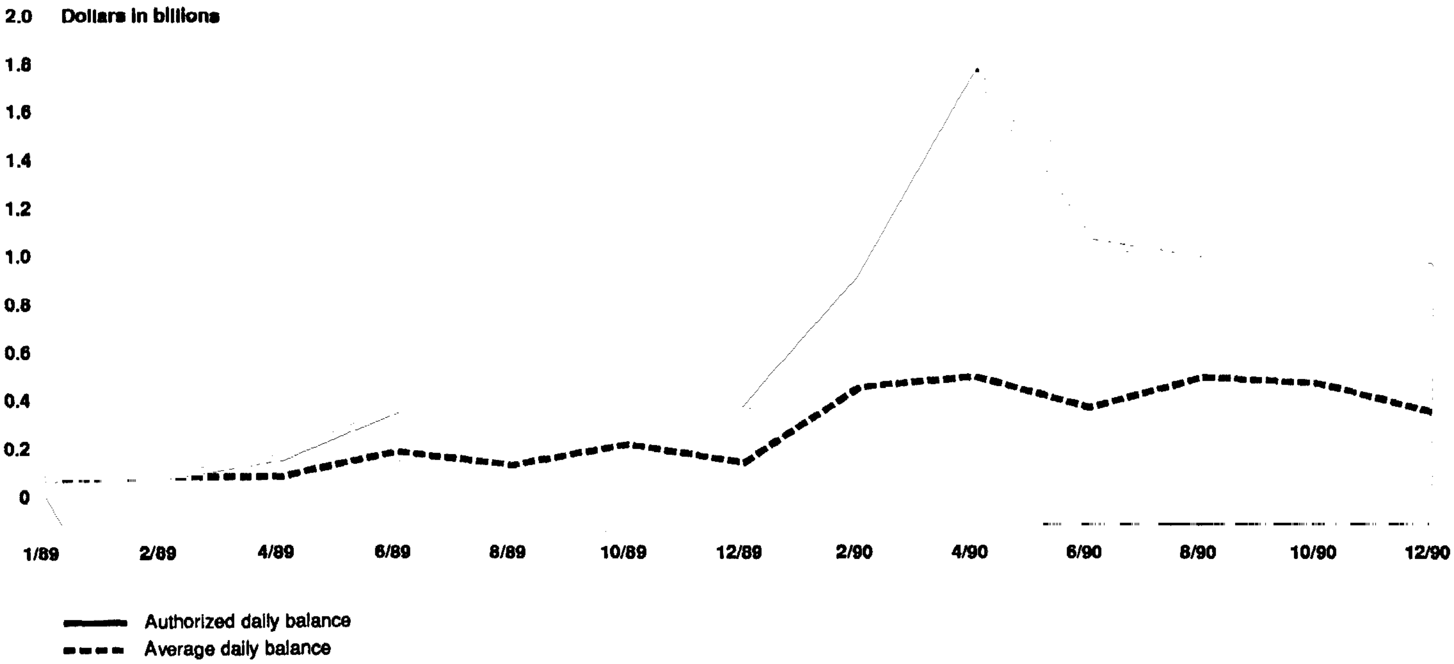
We reviewed the applicable investment and withdrawal instructions issued by Treasury that applied to TT&L accounts maintained by direct investment institutions. We found that the Federal Reserve Bank of Boston, using the formulas specified in Treasury regulations, properly calculated the investments and withdrawals called for by the Treasury instructions during 1990 for the Bank of New England.

Beginning in early 1989, the Bank of New England requested and received substantial increases in the maximum amount authorized for its TT&L account and pledged collateral in accordance with Treasury regulations to support the increases. From January 1989 to June 1989, it increased its maximum authorized amount from $75 million to $350 million, and, by March 1990, it sought and received a maximum amount of nearly $1.8 billion. At the time the bank was taken over by FDIC, the Bank of New England had decreased the maximum TT&L account balance it would agree to collateralize to $800 million.

During 1990, Treasury was actively seeking to increase the maximum balances financial institutions were willing to hold in their TT&L accounts. For example, a Treasury official told us that routine notices to note option institutions were sent six to eight times during the year encouraging these institutions to increase their maximum balances. Treasury took additional steps in an effort to interest institutions participating in the TT&L program to increase the funds they were willing to accept for investment. Treasury placed articles in a variety of banking-related publications, contacted funds managers for large note option banks, and held funds management seminars.

Figure 1 shows the changes in the Bank of New England's maximum authorized TT&L account balance and the actual TT&L balances for calendar years 1989 and 1990. Its maximum authorized TT&L balance increased during 1989 and peaked in early 1990 at about $1.8 billion. Its actual average daily TT&L balance for 1990 was about $400 million.

Figure 1: Bank of New England's Average Daily Balance and Maximum Authorized Average Daily Balance for 1989 and 1990



Daily balances in a TT&L account vary widely. As stated previously, Treasury issued 234 different instructions relating to the TT&L accounts (64 direct investments and 170 withdrawals) during 1990. In addition, an individual financial institution's TT&L balance is significantly affected by when and how much tax revenue taxpayers deposit in the institution. For example, table 1 shows the balances in the Bank of New England's TT&L account after a major tax due date (April 15) and 4 weeks later.

Table 1: Sample Daily Balances in the Bank of New England's TT&L Account

Date	Ending balance
4/16/90	$37,039,503
4/17/90	1,002,388,020
4/18/90	1,391,401,137
4/19/90	455,485,770
4/20/90	465,210,697
5/14/90	852,186,836
5/15/90	343,922,613
5/16/90	359,724,527
5/17/90	380,210,328
5/18/90	357,770,932

A financial institution can use a variety of ways to maximize the benefits from maintaining a TT&L account. For example, an institution that has substantial loans from the Federal Reserve can achieve interest savings by using TT&L funds to pay off its loans or reduce any additional borrowings from the Federal Reserve. The interest savings occur because Treasury regulations require that the interest rate paid by participating banks on TT&L funds be 1/4 of a percentage point (25 basis points) below the federal funds rate.[4] At the time the Bank of New England increased its TT&L balances, it had substantial loans from the Federal Reserve Bank of Boston. The interest rate on these loans was 1/2 of a percentage point (50 basis points) above the federal funds rate. By increasing its TT&L ceiling, the Bank of New England was able to obtain additional TT&L funds, which would have reduced the bank's cost of funds for these amounts by 3/4 of a percentage point (75 basis points).

We estimated that the Bank of New England could have had interest savings of $1.7 million through its increased levels of TT&L funds. We calculated that the bank's 1990 average daily balance of about $400 million would have been about $170 million if the bank had maintained its January 1, 1990, maximum authorized balance of $350 million.[5] If the additional $230 million had been used to pay off Federal Reserve Bank loans, the Bank of New England's cost of funds for that amount would have been reduced by 3/4 percent, resulting in about $1.7 million in

[4]The federal funds rate is the rate at which banks borrow and lend money to each other in the federal funds market. The federal funds rate is the primary interest rate in the money market, and all other short-term rates are based on it.

[5]For simplicity, we assumed that the total investment capacity for the TT&L system would have remained unchanged from the actual levels during calendar year 1990.

interest savings. These interest savings are insignificant when compared to the bank's reported losses of $450 million during the last quarter of 1990.

Freedom National Bank's TT&L Transactions Made in Accordance With Treasury Regulations

We examined the transactions in the TT&L account of Freedom National Bank, which was a note option bank that did not elect to receive direct Treasury investments. Similar to the Bank of New England's transactions, all TT&L fund withdrawals from Freedom National Bank's TT&L account between January 1, 1990, and November 9, 1990 (the date the bank was closed by the Comptroller of the Currency), were made in accordance with Treasury regulations. In every case, Treasury's standard formula was properly calculated.

We reviewed the applicable instructions issued by Treasury that applied to TT&L accounts maintained by institutions similar to Freedom National Bank. We found that the Federal Reserve Bank of New York, using the formulas specified in Treasury regulations, properly calculated the withdrawals called for by the Treasury instructions during 1990 for Freedom National Bank.

However, unlike the Bank of New England, Freedom National Bank was experiencing large deficiencies in the collateral used to support its TT&L funds and received several formal collateral deficiency notices from the Federal Reserve Bank of New York. Subsequently, Treasury and the Federal Reserve Bank of New York took actions, consistent with Treasury regulations, to ensure the continued safety of the federal funds on deposit with Freedom National Bank and to help resolve the collateral deficiencies. Appendix I provides a listing of the actions taken by Treasury and the Federal Reserve Bank of New York.

In a letter dated January 19, 1990, the Federal Reserve Bank of New York notified Freedom National Bank that a "pattern" of collateral deficiencies had been established in 1989. This letter was similar to a letter sent by the Federal Reserve Bank of New York in September 1989, which notified Freedom National Bank that the frequency and size of collateral deficiencies that occurred in June 1989 were of concern. The Federal Reserve Bank of New York's January 1990 letter pointed out that on several occasions Freedom National Bank had incurred significant collateral deficiencies, especially when compared to its reported assets of $124 million. For example, the letter noted that on March 15, 1989, Freedom National had incurred a collateral deficiency of $406 million in its TT&L account. This was 16 times the $26 million provided by the bank to the Federal Reserve Bank of New York to collateralize its TT&L account at that time.

Treasury and the Federal Reserve Bank of New York attempted to assist Freedom National Bank in resolving its collateral problems. In January 1990, the Federal Reserve Bank of New York proposed to Freedom National Bank that it notify the Federal Reserve Bank of New York of any large deposits to its TT&L account so that the Federal Reserve Bank could withdraw the deposits in excess of collateral on the same day as the deposit, thereby avoiding collateral deficiencies. Ordinarily, deposits that exceed an institution's maximum TT&L account limit are withdrawn on the day following the deposit, although the institution is required by Treasury regulations to pledge sufficient collateral for such deposits. Freedom National did not initially agree to this proposal and informed the Federal Reserve Bank of New York that it would try to deliver the additional collateral. On March 2, 1990, following a letter from Treasury that suggested similar options to those proposed by the Federal Reserve Bank of New York to correct the situation, Freedom National agreed to notify the Federal Reserve Bank of New York of large deposits so that the excess amounts could be withdrawn on the same day received. Additionally, in accordance with Treasury regulations, Treasury lowered Freedom National Bank's maximum balance from $15 million to $8 million.

The same day withdrawals and the reduction in its maximum account balance improved Freedom National Bank's ability to properly collateralize its TT&L account. For example, from March 20, 1990, until November 1, 1990, the Bank had 15 collateral deficiencies, the largest of which was $3.8 million. On November 9, 1990, Freedom National was closed by the Comptroller of the Currency. When the Bank failed, its TT&L account totaled $8 million and was covered by $19.4 million in collateral.

Conclusions

Treasury's established regulations for investments to and withdrawals from its TT&L accounts were followed by the Federal Reserve Banks of Boston and New York for the Bank of New England and Freedom National Bank, respectively, during 1990. In this context, the Bank of New England was treated the same as the other institutions administered by the Federal Reserve Bank of Boston participating in the direct investment program.

The Bank of New England was able to increase its maximum authorized TT&L account balance significantly because it pledged collateral in accordance with Treasury regulations to secure the additional federal funds it received. In contrast, Freedom National Bank experienced large and frequent collateral deficiencies. Treasury and the Federal Reserve Bank of New York took actions consistent with Treasury regulations to accelerate TT&L fund transfers to the Federal Reserve Bank of New York and to reduce Freedom National Bank's maximum TT&L account balance.

We are sending copies of this report to the Chairman of the Board of Governors of the Federal Reserve System; the Chairman of the Senate Committee on Banking, Housing and Urban Affairs; and other interested parties. We will also make copies available to others upon request.

Please contact me at (202) 275-9454 if you or your staff have any questions concerning this report. Major contributors to this report are listed in appendix II.

Sincerely yours,

Jeffrey C. Steinhoff
Director, Civil Audits

Chronology of Significant Events Relating to Freedom National Bank

Date	Description of event
9/21/89	Letter from the Federal Reserve Bank of New York to Freedom National Bank reiterating Treasury regulations on collateral and stating that the bank had nine collateral deficiencies during June 1989 with an aggregate deficiency of $239 million, including one deficiency of $127 million.
1/19/90	Letter from the Federal Reserve Bank of New York to Freedom National Bank again emphasizing Treasury regulations concerning collateral and stating that Freedom National Bank was deficient seven times during December 1989, including one deficiency of $147 million.
1/19/90	Letter from the Federal Reserve Bank of New York to Treasury citing Freedom National Bank's pattern of collateral deficiencies. Letter noted that the Federal Reserve Bank of New York had not taken action because the deficiencies had been sporadic and none had exceeded 2 days. The Federal Reserve Bank of New York expressed concerns about the size of Freedom National Bank's deficiencies when compared to its assets of $123.9 million. The letter specifically cited deficiencies of $406 million on March 15, 1989, $307 million on September 15, 1989, and $146 million on December 15, 1989.
1/31/90	Letter from the Federal Reserve Bank of New York to Treasury citing several telephone conversations with Freedom National Bank regarding the need for additional collateral. The Federal Reserve Bank of New York stated that a proposal whereby tax deposits would be remitted to the Federal Reserve Bank of New York on the day of deposit was rejected by Freedom National Bank. Freedom National Bank said it would try to increase collateral.
2/8/90	Letter from Treasury to Freedom National Bank citing the failure to pledge sufficient collateral to secure its TT&L account on several occasions in the past year. Letter advised Freedom National Bank that failure to comply with Treasury requirements jeopardizes the Treasury/Freedom National Bank relationship and may lead to termination of the bank's TT&L account. Further, Freedom National Bank was told that, in lieu of additional collateral, it could (1) transmit to the Federal Reserve Bank of New York all large tax deposits on the day deposited or (2) instruct its taxpayers to use another depository or the Federal Reserve.
3/2/90	Letter from Freedom National Bank to Treasury agreeing to remit large tax deposits to the Federal Reserve Bank of New York on the same day as received. The letter also stated that Freedom National Bank was reviewing whether to lower its TT&L maximum balance from $15 million to $8 million.
4/3/90	Letter from Freedom National Bank to Treasury confirming that the maximum balance for its TT&L account had been lowered by the Federal Reserve Bank of New York to $8 million at Treasury's request.
5/21/90	Letter from Freedom National Bank to the Secretary of the Treasury requesting special treatment regarding Treasury's collateral requirements for its TT&L accounts.

(continued)

Date	Description of event
6/28/90	Letter to Freedom National Bank from the Fiscal Assistant Secretary of the Treasury responding to Freedom National Bank's May 21, 1990, letter. The items addressed included the following: — Options to correct collateral deficiencies have been offered to Freedom National Bank. — Of the $1.2 million earnings on its TT&L account for 1989 cited by Freedom National Bank, $700,000 resulted from deposits not fully collateralized. — Although the overnight use of funds gives financial institutions interest free use of tax deposits, the feature was not intended to provide a major source of revenue.
11/9/90	Freedom National Bank was closed by the Comptroller of the Currency.

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