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BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

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Banks Having Problems Need Better Identification And Disclosure

The Federal Deposit Insurance Corporation Headquarters focuses its attention on banks that are believed to pose a high degree of risk to the insurance fund--problem banks. Because of uncertain criteria, identification of these problem banks is largely a matter of subjective judgment. In addition, in the absence of headquarters guidance, the Corporation's regions have differing criteria for identifying banks requiring special attention at the regional level.

As a result there is no assurance that banks posing a similar degree of risk to the fund are being given the same supervisory attention. GAO recommends that specific and objective criteria be developed to improve indentification of problem banks and banks requiring regional attention.

The Corporation publicly issues problem bank list data as one indication of the banking industry's condition. GAO recommends that the Corporation release data classifying all the Nation's federally insured banks--not just problem banks--in order to provide more complete data on the condition of the banking industry.

UNITED STATES GENERAL ACCOUNTING OFFICE

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FOD-79-1
JANUARY 24, 1979

Report

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

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To the President of the Senate and the
Speaker of the House of Representatives

The Federal Deposit Insurance Corporation is to protect depositors against losses from bank failures, maintain confidence in the banking system, and promote safe and sound banking practices. The Corporation's supervision and examination of State-chartered banks which are not members of the Federal Reserve System are an essential part of fulfilling its mission. We reviewed the Corporation's bank supervisory process to determine areas that need strengthening. Particular emphasis was placed on the identification and disclosure of banks having financial or supervisory problems.

We are sending copies of the report to the Director, Office of Management and Budget; the Secretary of the Treasury; and the Chairman of the Board of Directors, Federal Deposit Insurance Corporation.

Elmer B. Staats
Comptroller General
of the United States

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

BANKS HAVING PROBLEMS NEED BETTER IDENTIFICATION AND DISCLOSURE

D I G E S T

The Federal Deposit Insurance Corporation supervises State-chartered insured banks which are not members of the Federal Reserve System and indirectly supervises State member and national banks.

The Corporation and the other two Federal agencies that regulate commercial banks are to be commended for adopting a uniform interagency rating system to judge all the Nation's federally insured banks. This system will separate all insured banks into five overall rating groups that reflect their condition. (See p. 5.)

The Corporation's Division of Bank Supervision defines its first priority to be effectively supervising and monitoring state nonmember banks with problems. As of March 31, 1978, Corporation headquarters was directing the supervision of 270 such banks which had been formally designated as problem banks because they posed a high degree of risk to the insurance fund. Under headquarters supervision, regional offices are required to:

--Formally meet with a bank's board of directors to discuss the bank's recognized problem status.

--Submit periodic formal reports on supervisory actions.

--Conduct more frequent examinations and/or supervisory visits.

About 779 other banks were judged by the Corporation's regional offices to present a sufficient but lower degree of risk to the

(3) --release data classifying all insured banks under the newly adopted uniform interagency rating system.

The Corporation strongly believes it places the proper amount of supervision on all banks with problems. Corporation officials stated that there had been a conscious decision to give the Regional Director the responsibility for identifying banks with problems that presented a lesser degree of risk to the insurance fund. Although the Corporation prescribes the same examination frequency for banks with either type of problem, it has not developed objective criteria to help the regions identify when a problem poses a risk to the insurance fund. Without criteria, the Corporation cannot be sure that all banks posing a risk to the insurance fund, are receiving an appropriate amount of supervision.

After GAO's review, the Corporation issued a revised bank examination policy that became effective on January 1, 1979. Under this new policy, headquarters designated problem banks (financial problem banks) will receive at least one full-scope examination every 12 months. Banks warranting increased regional office supervision (supervisory problem banks) will receive at least one full-scope examination every 18 months. The new policy does not remove the need for specific and objective criteria to identify problem banks.

The Corporation is considering changing the present manner in which it reports and releases data on problem banks to provide a clearer perspective on the condition of the banking industry.

C o n t e n t s

insurance fund to warrant their increased supervisory attention.1/

Some of these banks exhibit the same problems as those formally designated as problem banks and therefore would pose a similar risk to the insurance fund. There is a lack of specific and objective criteria for judging whether a bank should be designated as a problem bank. We believe some of these 779 banks should be receiving the same headquarters supervisory attention as the 270 problem banks.

In addition, in the absence of headquarters guidance, FDIC's regions have differing criteria for indentifying banks requiring special attention ~~at the regional~~ level.

Problem bank list data, which is released as one indication of the condition of the banking industry, can be misinterpreted. Releasing the number of problem banks does not provide complete data on the conditions of the Nation's insured banks as determined through bank examination. (See p. 17.)

For the Corporation to more efficiently supervise banks and to provide more meaningful data on the condition of the banking industry, ~~GAO recommends that~~ the Chairman of the ~~Federal~~ FDIC ~~Deposit Insurance Corporation~~ should

(1) --develop more specific and objective criteria for identifying banks requiring special supervision--at either the headquarters or regional level,

(2) --phase out the use of problem bank data as an indicator of the condition of the banking industry, and

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1/Headquarters designated problem banks are referred to in the body of this report as financial problem banks. Regional office designated banks requiring increased supervision are referred to in the body of this report as supervisory problem banks.

CHAPTER 1

INTRODUCTION

In our December 1977 report (FOD-77-8), we briefly commented on the Federal Deposit Insurance Corporation's (FDIC's) bank supervisory process. In that report, we stated that FDIC continues to be an effective bank supervisor but could improve. We indicated that FDIC should develop more definitive criteria for classifying problem banks and require more complete documentation of the decisionmaking process for classifying banks. This report continues our review of FDIC's supervision of insured State-chartered banks that are not members of the Federal Reserve System.

FDIC exists to protect both private and public depositors against losses from bank failures, help maintain confidence in the banking system, and promote safe and sound banking practices. To do this FDIC:

--Insures deposits in national, Federal Reserve member, and qualified State nonmember banks of up to $40,000 for each private depositor and $100,000 for individual accounts of Federal, State, and local governments.

--Supervises insured State nonmember banks by monitoring and examining them and enforcing regulations. It indirectly supervises national and State member banks, primarily by monitoring them but the Comptroller of the Currency and the Board of Governors of the Federal Reserve System, respectively, have direct supervisory responsibility over these banks.

FDIC has the legal authority to: (1) serve as receiver and liquidator of closed insured banks, (2) purchase assets from, make deposits in, or extend loans to insured banks which have failed or are in danger of failing, (3) make loans, purchase assets, or issue a guarantee to help one insured bank assume a failed or failing insured bank, and (4) organize deposit insurance national banks to provide limited banking services in communities where banks have failed.

FDIC uses two principal methods to protect depositors in banks that have failed: direct payoff and deposit assumption. The direct payoff method pays the net amount of insured deposits directly to depositors. The deposit assumption method allows another insured bank to assume the liabilities, deposits, and acceptable assets of a failed or failing bank. Under this method, FDIC advances to the assuming bank an

CHAPTER 2

BANK SUPERVISION: AN OVERVIEW

The Division of Bank Supervision is FDIC's principal office for supervising insured State-chartered commercial banks and mutual savings banks that are not members of the Federal Reserve System. The Division regularly examines these banks, monitors them between examinations through its Integrated Monitoring System, and provides more supervision to those banks needing it. These three processes form the backbone of bank supervision. In 1977, the Division and its 14 regional offices examined 7,169 of the 8,748 insured State-chartered nonmember banks and 304 of the 323 insured mutual savings banks.

EXAMINATION OF STATE-CHARTERED NONMEMBER INSURED BANKS

The overall objective of a bank examination is to determine the bank's safety, soundness, and compliance with laws and regulations. This is done by evaluating asset quality, the nature of liabilities, liquidity posture, earnings, capital adequacy, bank management and controls, policies, procedures, accounting practices, and insurance. The examination includes, among other things, a review of the bank's loan portfolio and other assets (such as securities) to determine their credit soundness.

General Memorandum No. 1 gives the Division's policy on examining banks--which to examine first, when, and how extensively. The memorandum defines two types of examinations: full-scope and modified examination. The Division generally uses the full-scope examination, tailoring it to the bank's size and complexity and designing it to fully use the bank's own reporting capabilities. The modified examination uses an abbreviated format, may be of reduced scope, and is used only for banks fitting certain criteria for size and financial condition.

The Division also conducts separate examinations, primarily to determine whether the banks operate according to consumer-oriented laws and regulations. Separate examinations of large trust departments are also conducted. We looked at full-scope safety and soundness examinations, except where indicated otherwise.

Examination schedule and scope

All insured State nonmember banks are to be examined in each 18-month period. However, a bank presenting financial

ABBREVIATIONS

CAMEL	capital adequacy, asset quality, management, earnings, and liquidity
FDIC	Federal Deposit Insurance Corporation
GAO	General Accounting Office
JAWS	just a warning system
PPO	potential payoff

reports and the form 96 may be looked at again only briefly before the Regional Director signs the reports and sends them to headquarters the State authority, and the bank. (Distribution procedures vary in some States.) As discussed in chapter 3, banks with problems receive additional regional review, with memorandums recommending formal problem disignation prepared as needed before sending the report to headquarters.

The first headquarters review step is to input the examination report's and form 96's data into its data processing system. This data is then compared with 14 characteristics indicative of problem or potential problem banks. Only commercial banks meeting one or more of these selection criteria or banks recommended for addition to or removal from the problem bank list receive further review. The headquarters commercial bank and/or problem bank review sections review these banks to formally identify problem banks. Due to the small number, all mutual savings bank examinations receive headquarters review.

The Problem Bank Review Section receives and reviews examination reports, forms 96, and, where appropriate, the regions' memorandums describing the problem and action being taken for all recommended and previously designated problem banks, those banks meeting selection criteria 1 or 2 (the most serious indicators), and those referred from other review sections.

New bank rating system

In May 1978 the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and FDIC adopted a uniform interagency bank rating system--CAMEL (capital adequacy, asset quality, management, earnings, and liquidity). This system is designed to provide the three agencies a basis for making comparable judgments about the Nation's federally insured banks. This rating system replaces individual rating systems from the three Federal bank supervisory agencies.

The new rating system has two main steps. First, the bank examiner assesses a bank's capital, assets, management, earnings, and liquidity. Each factor is rated with a number from 1 through 5, with 1 as the best. Secondly, the 5 factors are combined to get an overall bank rating, also on a 1-to-5 scale. The overall rating may not equal the arithmetical average of the 5 individual rating factors because the examiner can emphasize any one or combination of factors. If the regional office does not agree with the examiner's rating, it determines and assigns the bank's official rating.

amount of money equal to the assets retained by FDIC in case of liquidation. Depositors of the failing bank become depositors of the assuming bank, essentially protecting their deposits in excess of insurance limits.

FDIC's Board of Directors authorizes financial assistance in deposit assumptions when this will reduce the risk of or avert a threatened loss to FDIC. Deposit assumptions are generally approved when the assuming bank pays a premium to FDIC.

For these reasons FDIC has encouraged the deposit assumption method in recent years. Of the 26 bank failures from January 1, 1976, through June 30, 1978, 23 were deposit assumption transactions.

SCOPE OF REVIEW

We conducted our review at FDIC headquarters and selected regional offices. The review focused on the analysis of examination reports and FDIC files on those State non-member banks and mutual savings banks with supervisory or financial problems through March 1978. We also analyzed examination data and FDIC files on banks with characteristics of present or potential problems.

We reviewed 3 of FDIC's 14 regional offices' procedures for identifying and monitoring banks with supervisory or financial problems. We sampled these problem banks for analysis. The three regions--Atlanta, New York, and Richmond--contained 1,444 (16 percent) of the 9,071 insured State non-member banks and mutual savings banks as of December 31, 1977. They also contained 107 (29 percent) of the 368 designated problem banks as of that date. (See app. I.)

We also

--analyzed 1977 problem bank statistics;

--analyzed the reasons for bank failures during 1977 and through June 30, 1978; and

--reviewed bank examination and supervision policies and procedures and various FDIC reports as of December 31, 1977.

INCREASED SUPERVISORY ACTIONS

The regional offices can attempt to correct bank problems through supervisory methods other than examinations. These include requiring periodic progress reports from the bank, visits to the bank, conferences with bank directors and the State authority, or letters confirming correction programs agreed upon by the bank's board of directors. In addition, General Memorandum 6 requires the Regional Director to provide the Division Director an updated quarterly or semi-annual analysis of each financial problem bank.

Section 8 of the Federal Deposit Insurance Act authorizes FDIC to take formal enforcement action against banks. These actions include initiating (1) cease and desist proceedings against banks engaging in unsafe or unsound practices or violating a law, rule, regulation, or written agreement with the Corporation and (2) proceedings to terminate a bank's deposit insurance if, among other things, the bank is in an unsafe or unsound condition.

In 1977, FDIC's Board of Directors authorized 45 cease and desist proceedings, of which 39 resulted in final cease and desist orders. A total of 65 cease and desist orders were in force at the end of 1977.

During 1977, FDIC held proceedings to revoke three banks' deposit insurance. One bank's financial condition improved enough to warrant stopping the proceedings, while the other two proceedings were pending at the end of 1977. Three other proceedings remained pending from prior years, making a total of five proceedings outstanding at year end.

During 1977, FDIC did not act to remove an officer, director, or other bank manager for violation of law, rule, regulation, or final cease and desist order, unsafe or unsound banking practices, or breach of fiduciary duty.

In 1976, a 3-judge Federal district court ruled unconstitutional FDIC's authority to suspend officers, directors, and other people participating in the affairs of an insured State bank when those people were indicted for a felony involving dishonesty or breach of trust (Feinberg v. FDIC, 420 F. Supp. 109 (D.D.C. 1976)). According to FDIC, the constitutional defect has been remedied by Section 111 of Pub. L. No. 95-630 that was signed by the President on November 10, 1978. This law provides for a hearing in the event of a proposed suspension.

risk to the Insurance Fund (financial problem bank) must receive at least 1 full-scope examination every 12 months. Banks warranting increased regional office supervision (supervisory Problem Bank) will receive at least 1 full-scope examination every 18 months.

The regional offices schedule bank examinations of State nonmembers considering (1) the policy in General Memorandum No. 1, (2) banks with potential problems as indicated by the Bank Division's Integrated Monitoring System; and (3) when State banking authorities schedule their examinations.

Bank examiners determine an examination's scope by reviewing a bank's strengths and weaknesses indicated by prior examination reports, the Integrated Monitoring System, and/or other related records. Although the examination includes some audit tests, FDIC does not consider a bank examination to be an audit.

Processing and reviewing examination reports

Once the bank examination is completed, the bank examiner prepares the examination report and forwards it to the regional office for processing and review. Division policy requires the examiner to meet with the bank's Board of Directors or a committee which includes some Board members for each full-scope examination to discuss the examination results. Bank managements' commitments and/or reactions are included in the examination report.

Senior regional office managers review the report to identify and assign priority processing to those banks of special interest, including those with known or potential problems. The reports are then censored, which is essentially editing and checking mathematical accuracy.

Next, a regional review examiner formally reviews the report, determining supervisory and followup actions and whether to recommend (1) classifying the bank as a problem and/or (2) initiating formal enforcement measures.

As part of the regional review, the review examiner prepares a Summary analysis of Examination Reports form, referred to as a form 96. It contains examination data, the bank's rating, and certain key ratios used in rating and classifying the bank. Form 96 also includes the review examiner's comments on the bank's condition based on the examination report. When a bank is not a problem, the examination

--Other problem--an other problem bank which has definite weaknesses but less financial risk and requires more than ordinary concern and agressive supervison.

The Division will continue to identify problem banks in addition to the overall rating given banks under the newly adopted uniform interagency rating system discussed in chapter 2.

Indicators of problem banks

The Division uses several indicators to help it identify and classify problem banks, including:

--A nominal or negative net capital and reserves figure.

--A management rating of unsatisfactory or poor.

--Excessive loan deficiencies.

--Violations of law or regulations.

--A rapid rate of asset deterioration.

--An unusually low adjusted capital position (book capital and reserves less all assets classified as losses and 50 percent of all assets classified as doubtful).

--An undesirable liquidity position.

These factors do not have specific values which automatically indicate a problem bank. Judgment and experience are used in assessing problems, particularly in the other problem category.

In our prior report we recommended that FDIC (1) develop more definitive criteria for classifying problem banks and (2) require review examiners to document more completely their reasons for classifying a bank as nonproblem. While some evidence shows that review examiners are more completely documenting their reasons, the Division has not developed specific and objective criteria for identifying problem banks. Because of this, we continue to have the same problem as last year: What is a problem bank?

Identifying problem banks

Although a problem bank is generally first identified when it is examined, the regions or headquarters can initiate the problem designation whenever they become aware of problems which may affect the bank's solvency.

The agencies have agreed on the 5 rating groups. (See app. II.) Banks sound in almost every aspect rate a one, those with excessive weaknesses requiring urgent aid rate a 5. The agencies are gaining experience with the bank rating system and may consider developing new or additional guidelines as more experience is achieved.

MONITORING BANKS BETWEEN EXAMINATIONS

On November 1, 1977, the Division implemented its integrated monitoring system to monitor banks between examinations. The idea is to alert the Division of a deteriorating situation before it becomes serious so that it can be quickly corrected. At present, only State nonmember banks, excluding mutual savings banks, are monitored by this system.

The essence of the Integrated Monitoring Systems is JAWS (Just A Warning System). JAWS uses eight tests to measure the adequacy of the bank's capital, liquidity, profitability, and the combination and growth of assets and liabilities. Banks submit data to FDIC in their Reports of Condition and Income. FDIC then enters this data into a computer system which provides detailed analyses directly to the regional offices for banks failing one or more of the eight JAWS tests.

Also, the regions receive quarterly reports from Division headquarters on each bank failing one or more JAWS tests. The regions must then prepare a formal action report. This report outlines a bank's problems or adverse trends, their causes, and the corrective methods to be applied. The regions submit it to headquarters, which is responsible for controlling the report and ascertaining that regional office actions are appropriate.

In addition to the JAWS analysis, the regional office staff makes a thorough financial analysis of each State nonmember bank with the Annual Review Report. This report shows examination information for the three most current reports of examination and shows ratios evaluating earnings, liquidity, growth, and capital for the past 3 years. Ratios of a bank's peer group are also compared for the most recent year. After the regional office has analyzed an Annual Review Report, it forwards an Annual Review Memorandum to headquarters for review. This memorandum describes any apparent adverse trends or conditions and compares these results with the peer group data in the Annual Review Report.

On May 30, 1978, the Division's Projects and Planning Branch began a detailed evaluation of the Integrated Monitoring System. This evaluation was not complete when we finished our review in July 1978.

Although the Division does not keep formal records on the number of changes it makes to the Regional Director's recommendations, informal records indicate that such changes are made.

The following example illustrates the subjective nature of identifying problem banks at both the Headquarters and regional levels.

Case study--bank A

Regional examination of March 1, 1976--The examination found the bank's condition unacceptable. Problems included: adverse loan and other asset classifications, resulting in a slightly negative net capital position; poor liquidity; negative net earnings, primarily due to loan chargeoffs; and management weaknesses, reflected in a "fair" management rating. The bank indicated that a future sale of new capital would improve its capital position. The region recognized the bank as a supervisory problem bank and requested progress reports on the classified assets and the liquidity problem but did not recommend formally designating it a financial problem bank. The region also assigned the bank priority consideration when scheduling future examinations.

The headquarters review of this examination recognized the bank as a borderline problem, but felt that the indicated future sale of additional capital would "diminish the risk to the Corporation to the point that a problem designation is not warranted at this time."

Regional examination of May 27, 1977--After a 15-month interval, this examination found more classified assets, 57 percent of which were not previously classified. Numerous other problems cited included extremely poor earnings, with little hope of improvement; a slightly negative capital ratio; and weak management, rated "unsatisfactory." The sale of additional capital stock had faltered, with only approximately 3,000 of an authorized 25,000 shares sold. The region continued to regard the bank as a supervisory problem and continued the progress report requirement.

The headquarters review comments stated that, overall, the bank seemed to be a problem but that management was believed to be "stronger than the report indicates and capable of bringing about desired changes." Putting the bank on the problem list was not thought necessary.

In the September 30, 1977, quarterly report, FDIC's Integrated Monitoring System indicated a 7.5-percent decline in equity capital due to continuing loan chargeoffs. The March

CHAPTER 3

THE TWO TYPES OF PROBLEM BANKS

The Division of Bank Supervision policy recognizes two types of problem banks--financial and supervisory. The Division identifies and classifies financial problem banks by determining the degree of financial risk they pose to the deposit insurance fund. Supervisory problem banks have similar types of deficiencies; however, in the Division's opinion, their risk to the insurance fund is less than that of the financial problem banks.

The Division formally recognizes a financial problem bank and provides it with increased headquarters supervision. Under this supervision, regional offices are required to

--formally meet with a bank's Board of Director's to discuss the bank's recognized problem status,

--submit periodic formal reports on supervisory actions, and

--conduct more frequent examinations and/or supervisory visits.

The Division informally recognizes supervisory problem banks and allows the regional offices to classify these banks. The regional offices then provide increased supervision to these banks. Some of the supervisory problem banks exhibit the same problems as those formally designated as problem banks and, therefore, would pose a similar risk to the insurance fund. We believe some of the supervisory problem banks should be receiving the same headquarters supervisory attention as those classified as problem banks.

FINANCIAL RISK--THE THIN LINE

Determining financial risk is often based on decisions where reasonable people may differ. The Division's three categories for problem banks indicate the severity of their problems and the possibility of insurance payments from the fund. The categories are:

--Serious problem--potential payoff; an advanced serious problem bank which has a 50-percent or more chance of requiring financial assistance in the near future.

--Serious problem--a serious problem bank threatens to ultimately require insurance payments unless drastic changes occur.

However, if a bank has been designated as a problem bank, headquarters' supervision requires the regional office to (1) formally meet with only the Bank's Board of Directors, (2) submit periodic formal reports on supervisory actions, and (3) conduct more frequent examinations and/or supervisory visits.

Generally, supervisory problem banks exhibit similar types of deficiencies as financial problem banks. Since the Division has not spelled out for the regions the specific guidelines needed to identify supervisory problem banks the regional offices have developed their own criteria. Of the three regions visited, all had different methods for identifying supervisory problem banks.

The Atlanta Regional Office uses a list of guidelines covering all aspects of the bank, including management, asset quality, liquidity, capital adequacy, earnings, and supervision (such as cease and desist orders). These guidelines appear to be a particularly systematic approach in identifying supervisory problem banks.

In contrast, the Richmond Regional Office identifies all banks with management ratings of fair, unsatisfactory, or poor as supervisory problem banks. The New York Regional Office identifies its banks by judgment and experience concerning the severity of problems. These two regions may well consider all the factors considered by the Atlanta Regional Office. However, the wide variation in numbers of supervisory problem banks reported by these and all other regions as compared to formally recognized financial problem banks could point to the differences in criteria used in identifying supervisory problem banks.

As of March 31, 1978, the regions had reported 779 identified supervisory problem banks, as compared to 270 financial problem banks designated by FDIC at the same date.

The examples below show the similarities between supervisory and financial problem banks and the need for specific and objective criteria.

Case study--bank B

Regional examination June 16, 1977--The State authority's examination revealed adverse loan classifications equal to 179 percent of capital and reserves, resulting in a mostly negative net capital position. Most substandard classifications were nonperforming agricultural loans with assigned collateral, apparently protecting the bank from ultimate loss. Liquidity was cited as a potential problem and

In the region, the examiner can recommend that the bank be put on the problem bank list. However, the review examiner prepares a memorandum to initiate the Regional Director's problem bank recommendation. This memorandum contains statistical data from the current and past two examination reports and a narrative portion that explains the problem, corrective action being taken, and other general information about the bank.

The report and the review examiner's memorandum generally are reviewed by a senior or head review examiner or an Assistant Regional Director before the Regional Director reviews them. If the Regional Director agrees with the recommendation, he signs the memorandum and forwards it and the report to Division headquarters. Examination reports are distributed to the State authority and the bank at the same time they are sent to headquarters.

In January 1978, FDIC adopted a previously experimental policy of formally notifying a bank's board of directors that the region recommended their institution as a problem bank. The regional office notifies the bank's directors by letter at the same time the report goes to the bank. Division policy also requires that, for a formally designated or recommended problem bank, the Regional Director or designated representative attend the board meeting held during the examination or a meeting of the entire board convened at the Regional Director's request after the examination.

As discussed in chapter 2, the headquarters Problem Bank Review Section reviews all regional problem bank recommendations. It also reviews recommendations to remove banks from the problem list and banks with problem characteristics not recommended by the region for problem classification.

As part of this review, the headquarters review examiner can contact the regional office for futher information or clarification. If the review examiner agrees with the Regional Director that a bank is a problem and that the proposed corrective action is needed, the region's memorandum is signed to indicate concurrence. When the headquarters review uncovers a problem bank not recommended by the region, the Problem Bank Review Section or the Regional Director prepares the memorandum to designate the bank a problem.

Differences of opinion on problem classification or corrective action between the Problem Bank Review Section and the Regional Director are usually resolved through discussions with the Regional Director. However, if agreement cannot be reached, the matter can go as high as the Division Director for the final decision.

management continued, including poor credit risks and inadequate collateral. The bank was taken off the problem list.

Regional examination June 21, 1977--The regional review examiner noted that the overall condition of the bank had deteriorated with large increases in classified loans, 43 percent being new credit extensions not previously criticized. The Division, after receiving a recommendation from the Region designated the bank a Serious Problem and instituted cease and desist action to reduce classifications to a more acceptable level.

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These examples show situations where senior Division managers would not be informed unless the bank were formally designated a financial problem. In addition, the status of these banks or the effect of FDIC supervisory action would also be unknown, because without specific and objective criteria it is not known whether all banks have been properly identified.

The thin line between a financial problem and a supervisory problem bank is a matter of subjective judgment. Yet the above examples show the similarity between the two types of problem banks.

New capital may change a bank's financial position, but it does not insure correction of the deficiencies that create the problem situation. In all the examples, the formal problem designation was withheld or removed, based on events which might or might not have corrected the bank's problems. These events would only delay a more severe financial risk unless the underlying deficiencies are corrected.

CONCLUSIONS

The Corporation's Division of Bank Supervision defines its first priority to be effectively supervising and monitoring state nonmember banks with problems. As of March 31, 1978, Corporation headquarters was directing the supervision of 270 such banks which had been formally designated as problem banks because they posed a high degree of risk to the insurance fund.

About 779 other banks were judged by the Corporation's regional offices to present a sufficient but lower degree of risk to the insurance fund to warrant their increased supervisory attention.

1978, comments to this report indicated sale of new capital was still meeting with little success. The comments also indicated that the region was making periodic visits to the bank. The bank still does not appear on the problem bank list.

The decisions not to add this bank to the problem list were subjective. The headquarters review of the March 1, 1976, examination did not list the bank as problem because of potential new capital. In our opinion, the sale of new capital is an example of a future event which may have unpredictable results.

The headquarters review of the region's May 27, 1977, examination second guessed the region on the ability of the bank's management to bring about desired changes. Again, the decision not to designate the bank a problem was subjective because it was based on an unproven future condition.

Corporation officials informed us that subsequent to our review the capital infusion in the bank had been completed and the latest examination report showed that the volume of adversely classified assets had significantly decreased. They further stated that the adjusted capital of the bank had risen to 8.9 percent and the net capital to 4.7 percent. We duly note the improvements but would like to suggest that infusion of new capital may only be a temporary solution to a long term problem.

SENIOR MANAGERS NEED TO BE MORE CONCERNED WITH SOME SUPERVISORY PROBLEM BANKS

FDIC's failure to develop specific and objective criteria for classifying problem banks prevents it from knowing whether all problem banks are receiving proper supervision. We found some supervisory problem banks that exhibit the same problems as those formally designated as problem banks and, therefore, would pose a similar risk to the insurance fund. Yet these banks weren't receiving the increased headquarters supervision.

In FDIC's Atlanta, New York, and Richmond regions, supervisory problem banks received the following supervision

--progress reports from the bank to the regional office,

--periodic visits and/or conferences with the bank's board of directors or some designated committee, and

--more frequent examinations than nonproblem banks.

Under this new policy, headquarters designated problem banks (financial problem banks) will receive at least one full-scope examination every 12 months. Banks warranting increased regional office supervision (supervisory problem bank) will receive at least one full-scope examination every 18 months. The new policy does not remove the need for specific and objective criteria to identify problem banks.

management was rated "fair." The region participated with the State in a meeting with the bank's board of directors at the conclusion of the examination and planned to participate in the State's 60-day visits. The State also requested progress reports. The region did not recommend putting the bank on the problem list.

The Problem Bank Review Section did not review the bank until December 1977. During the interim, the region visited the bank in November. According to the regional office, but not included in the form 96 comments we reviewed, the Problem Bank Review Section contacted the regional office to determine why, based on the State examination, the bank was not recommended for the problem bank list. The region said the agricultural nature of the bank's business precluded a forecast of possible crop income. This income could affect the volume of delinquent loans.

Regional office visitation November 5, 1977--Based on the November visit, the Regional Director recommended putting the bank in the Other Problem category. Classified assets were reduced slightly (to 158 percent of capital reserves), but with a large increase in the loss classifications formerly classified substandard. Liquidity was improved, but was regarded as potentially dangerous. Management remained fair. The Regional Director's memorandum indicated a planned February 1978, FDIC examination and stated that the Serious Problem designation might be in order following this examination.

The region had not examined the bank as of our visit in late April 1978. However, the region participated in another visit to the bank in February 1978. The Other Problem designation was retained.

Case study--bank C

The Division designated bank C as a Serious Problem based on a December 17, 1974, examination and retained this designation after a June 2, 1975, examination. These designations were due to the large volume of classified loans and other assets resulting in largely negative net capital position. A November 3, 1975, examination found that the capital position had improved slightly by a reduction in classified assets, and the problem designation was lessened to Other Problem.

Regional examination May 14, 1976--Bank C had obtained $355,000 more capital since the last examination which, combined with a reduction in loan classifications, created a slightly positive net capital position. Problems in loan

	Number of banks		Estimated insured deposits	
	1977	1976	1977	1976
			(000 omitted)	
All problem banks:				
Serious Problem--Potential Payoff (PPO)	12	24	$ 696,259	$ 394,355
Serious Problem	100	91	5,363,352	4,960,192
Other Problem	256	264	20,521,021	18,781,290
Total	368	379	$26,580,632	$24,135,837
Nonmember:				
Serious Problem--PPO	10	19	$ 565,266	$ 350,345
Serious Problem	82	72	4,277,851	3,715,936
Other Problem	194	210	5,013,698	6,842,976
Total	286	301	$ 9,856,815	$10,909,257
State member:				
Serious Problem--PPO	1	1	$ 6,332	$ 3,767
Serious Problem	3	3	83,236	55,398
Other Problem	18	15	8,094,103	4,095,470
Total	22	19	$ 8,183,671	$ 4,154,635
National:				
Serious Problem--PPO	1	4	$ 124,661	$ 40,243
Serious Problem	15	16	1,002,265	1,188,858
Other Problem	44	39	7,413,220	7,842,844
Total	60	59	$ 8,540,146	$ 9,071,945

Some of these banks exhibit the same problems as those formally designated as problem banks and therefore would pose a similar risk to the insurance fund. There is a lack of specific and objective criteria for judging whether a bank should be designated as a problem bank. We believe some of these 779 banks should be receiving the same headquarters supervisory attention as the 270 problem banks.

RECOMMENDATIONS

For the Corporation to more efficiently supervise banks, GAO recommends that the Chairman of the Federal Deposit Insurance Corporation develop specific and objective criteria to improve identification of problem banks and banks requiring regional attention.

AGENCY COMMENTS

FDIC officials stated that a conscious decision was made (1) to allow the regions to identify banks of special supervisory concern and (2) to tailor the characteristics of such banks to the geographic regions in which the banks are located.

As discussed in this chapter, without providing the regions criteria for identifying supervisory problem banks, Division senior managers cannot be sure all such banks are identified and receive proper supervision.

FDIC officials also commented that supervisory problem banks do not exhibit the same deficiencies, nor do they receive the same degree of supervision as financial problem banks.

We believe the case studies in this chapter demonstrate the difficulty of classifying supervisory and financial problem banks. We also believe disagreements between the regions and the Division on problem classifications indicate the similarity of deficiencies between supervisory and financial problem banks.

In addition, the regions determine necessary supervisory action depending on the condition of the bank, not the formal problem classification. The region may not change the supervision even if Division headquarters disagrees with the region's recommended problem classification for the bank. We believe this further indicates the confusion that can exist in defining a financial problem and a supervisory problem bank.

After our review, the Corporation issued a revised bank examination policy that became effective on January 1, 1979.

Bank Closings

Bank and location	Date closed	Estimated insured deposits	Estimated loss to FDIC (note a)
		(000 omitted)	
1977 closings:			
First State Bank, Foss, Oklahoma	3/10/77	$ 1,789	$ 425
The Monroe Bank & Trust Company, Monroe, Connecticut	3/28/77	2,624	0
First Augusta Bank & Trust Company, Augusta, Georgia	5/20/77	19,718	2,300
Republic National Bank, New Orleans, Louisiana	7/29/77	4,686	525
Donahue Savings Bank, Donahue, Iowa	8/26/77	4,579	0
Banco Economias, San German, Puerto Rico	9/02/77	141,110	14,000
1978 closings:			
Drovers National Bank of Chicago, Chicago, Illinois	1/19/78	$144,447	$ 7,612
First Bank of Macon County, Notasulga, Alabama	1/26/78	3,718	0
Wilcox County Bank, Camden, Alabama	3/01/78	10,300	0
Banco Credito Y Ahorro Ponceno, Ponce, Puerto Rico	3/31/78	534,532	0

a/Estimated loss is actual FDIC provision for loss for 1977 closings as of 12/31/77 and estimated by Division of Liquidation for 1978 closings.

These 368 problem banks represent only about 2 percent of all insured banks. As of June 30, 1978, the number of problem banks had decreased to 354, continuing a gradual decline from a peak of 385 in November 1976.

INTERPRETING THE PROBLEM BANK LIST

Although the problem bank list is used to indicate the condition of the banking industry, FDIC acknowledges that doing so requires considerable interpretation of the list. For example, the increase or decrease of problem bank numbers reflects economic declines or upturns only after a timelag, due to examination scheduling and processing. Other shortcomings of the list also limit its effectiveness in portraying the condition of the banking industry.

The problem bank list identifies and classifies the risk of FDIC financial involvement with a floundering bank that could fail. While meaningful to FDIC the list implies but does not measure potential loss to the insurance fund or to the depositors of problem banks. It emphasizes a negative aspect of bank supervision--potential bank failure--when through FDIC efforts such failures historically do not result in loss to the insurance fund or bank depositors.

As of December 31, 1977, the deposit insurance fund amounted to about $8 billion with actual and expected losses from liquidating acquired assets shown as $308.4 million. FDIC also reported that, for 541 bank failures from January 1, 1934, to the end of 1977, 99.8 percent of the depositors had received or were assured of payments of their deposits in full.

The problem bank list also does not reflect all the financial risk to the deposit insurance fund. It only indicates problem conditions known to exist in specific insured banks at a given point. FDIC knows that banks can fail for reasons undetected during or between examinations. Examples include defalcations, embezzlement, manipulations, or rapid asset deterioration. During 1977, six banks closed; four more closed in the first 6 months of 1978. Data on these banks is presented on the next page.

--Release data classifying all insured banks under the newly adopted uniform interagency rating system. This should show the total number of banks in each of the five overall rating groups.

AGENCY COMMENTS

FDIC agreed to consider phasing out the release of problem bank data, and, instead, to release data classifying all the Nation's insured banks under the uniform interagency rating system.

However, in responding to our recommendations FDIC officials commented that

--supervisory problem banks are discussed in the releases of problem bank data; and

--banks not on the problem bank list, and which fail due to unforeseen or unpredictable reasons, would also not be identified as supervisory problem banks for these reasons.

We agree with these comments; however, FDIC problem bank data releases only mention that regional offices maintain unofficial watch lists of banks posing supervisory concern. The data releases do not indicate how many supervisory problem banks are involved. We believe that without data on both types of problem banks, supervisory and financial, this data does not provide a perspective of FDIC supervisory concern for the Nation's insured banks. Releasing data classifying all insured banks under the uniform interagency rating system should provide this perspective.

Of the six banks that failed during 1977, three were undetected until the eleventh hour. One failed due to an illegal bad check writing scheme and was added to the problem bank list only days before its closing. Another suffered severe loan portfolio deterioration between examinations and was added to the problem list approximately 1 month before failure. Embezzlement caused the third of these banks to fail, and it was not listed on the problem list at all before it closed. The remaining three banks were on the problem list for approximately 14 months or more before failure.

Of the four banks that failed in 1978, two were added to the problem list based on examinations about 12 months before they failed. The remaining two were on the list over 2 years.

FDIC's Division of Liquidation compiles statistics on the reasons for bank failures. These statistics indicate that 25 percent of the bank failures from 1960 through 1977 resulted from defalcations, embezzlement, or manipulations by bank officials or employees. This means approximately 25 percent of the bank failures could go undetected and unreported in problem bank statistics.

CONCLUSIONS

The problem bank list internally communicates to FDIC's Board of Directors those banks with known problems which in the Division's opinion might financially affect the deposit insurance fund. However, we believe the list can be misinterpreted and that it incompletely conveys information on the condition of the banking industry to the Congress, the general public, and the banking industry itself.

The newly adopted interagency rating system will rate all insured banks in one of five overall rating groups according to the banks' conditions. We believe showing all banks in the overall rating groups is a more appropriate means of conveying the condition of the banking industry than financial risk to FDIC's insurance fund alone.

RECOMMENDATIONS

We recommend that the Chairman, FDIC:

--Phase out the use of problem bank data as an indicator of the condition of the banking industry.

Uniform Interagency Bank Rating System

Overview

The rating system is based upon an evaluation of five critical dimensions of a bank's operations that reflect in a comprehensive fashion an institution's financial condition, compliance with banking regulations and statutes and overall operating soundness. The specific dimensions that are to be evaluated are the following:

Capital adequacy
Asset quality
Management/Administration
Earnings
Liquidity

Each of these dimensions is to be rated on a scale of one through five in descending order of performance quality. Thus, 1 represents the highest and 5 the lowest (and most critically deficient) level of operating performance.

Each bank is accorded a summary or composite rating that is predicated upon the evaluations of the specific performance dimensions. The composite rating is also based upon a scale of one through five in ascending order of supervisory concern. In arriving at a composite rating, each financial dimension must be weighed and due consideration given to the interrelationships among the various aspects of a bank's operations. The delineation of specific performance dimensions does not preclude consideration of other factors that, in the judgment of the examiner or reviewer, are deemed relevant to accurately reflect the overall condition and soundness of a particular bank. However, the assessment of the specific performance dimensions represents the essential foundation upon which the composite rating is based.

Composite Rating

The five composite ratings are defined and distinguished as follows:

Composite 1

Banks in this group are sound institutions in almost every respect; any critical findings are basically of a minor nature and can be handled in a routine manner. Such banks are resistant to external economic and financial disturbances and capable of withstanding the vagaries of business conditions more ably than banks with lower composite ratings.

Composite 2

Banks in this group are also fundamentally sound institutions but may reflect modest weaknesses correctible in the normal course of business. Such banks are stable and also able to withstand business fluctuations quite well; however, areas of weakness could develop into conditions of greater concern. To the extent that the minor adjustments are handled in the normal course of business, the supervisory response is limited.

Composite 3

Banks in this group exhibit a combination of weaknesses ranging from moderately severe to unsatisfactory. Such banks are only nominally resistant to the onset of adverse business conditions and could easily deteriorate if concerted action is not effective in correcting the areas of weakness. Consequently, such banks are vulnerable and require more than normal supervision. Overall strength and financial capacity, however, are still such as to make failure only a remote possibility.

Composite 4

Banks in this group have an immoderate volume of asset weaknesses, or a combination of other conditions that are less than satisfactory. Unless prompt action is taken to correct these conditions, they could reasonably develop into a situation that could impair future viability. A potential for failure is present but is not pronounced. Banks in this category require close supervisory attention and financial surveillance.

Composite 5

This category is reserved for banks whose conditions are worse than defined under No. 4 above. The volume and character of weaknesses are such as to require urgent aid from the shareholders or other sources. Such banks require immediate corrective action and constant supervisory attention. The probability of failure is high for these banks.

Performance Evaluation

As already noted, the five key performance dimensions – capital adequacy, asset quality, management/administration, earnings, and liquidity – are to be evaluated on a scale of one to five. Following is a description of the gradations to be utilized in assigning performance ratings:

Rating No. 1 – indicates strong performance.
It is the highest rating and is indicative of performance that is significantly higher than average.

Rating No. 2 – reflects satisfactory performance.
It reflects performance that is average or above; it includes performance that adequately provides for the safe and sound operation of the bank.

Rating No. 3 – represents performance that is flawed to some degree; as such, is considered fair. It is neither satisfactory nor marginal but is characterized by performance of below average quality.

Rating No. 4 – represents marginal performance which is significantly below average; if left unchecked, such performance might evolve into weaknesses or conditions that could threaten the viability of the institution.

Rating No. 5 — is considered unsatisfactory.
It is the lowest rating and is indicative of performance that is critically deficient and in need of immediate remedial attention. Such performance by itself, or in combination with other weaknesses, could threaten the viability of the institution.

Capital Adequacy
Capital is rated (1 through 5) in relation to: (a) the volume of risk assets; (b) the volume of marginal and inferior quality assets; (c) bank growth experience, plans, and prospects; and (d) the strength of management in relation to (a), (b), and (c). In addition, consideration may be given to a bank's capital ratios relative to its peer group, its earnings retention and its access to capital markets or other appropriate sources of financial assistance.

Banks rated 1 or 2 are considered to have adequate capital, although the former's capital ratios will generally exceed those of the latter. A 3 rating should be ascribed to a bank's capital position when the relationship of the capital structure to points (a), (b), or (c) is adverse even giving weight to management as a mitigating factor. In most instances such banks would have capital ratios below peer group averages. Banks rated 4 and 5 are clearly inadequately capitalized, the latter representing a situation of such gravity as to threaten viability and solvency. A 5 rating also denotes a bank that requires urgent assistance from shareholders or other external sources of financial support.

Asset Quality
Asset quality is rated (1 through 5) in relation to (a) the level, distribution and severity of classified assets; (b) the level and composition of nonaccrual and reduced rate assets; (c) the adequacy of valuation reserves; and (d) demonstrated ability to administer and collect problem credits. Obviously, adequate valuation reserves and a proven capacity to police and collect problem credits mitigate to some degree the weaknesses inherent in a given level of classified assets. In evaluating asset quality, consideration should also be given to any undue degree of concentration of credits or investments, the nature and volume of special mention classifications, lending policies, and the adequacy of credit administration procedures.

Asset quality ratings of 1 and 2 represent situations involving a minimal level of concern. Both ratings represent sound portfolios although the level and severity of classifications of the latter generally exceed those of the former. A 3 asset rating indicates a situation involving an appreciable degree of concern, especially to the extent that current adverse trends suggest potential future problems. Ratings 4 and 5 represent increasingly more severe asset problems; rating 5, in particular, represents an imminent threat to bank viability through the corrosive effect of asset problems on the level of capital support.

Management/Administration
Management's performance must be evaluated against virtually all factors considered necessary to operate the bank within accepted banking practices and in a safe and sound manner. Thus, management is rated (1 through 5) with respect to (a) technical competence, leadership and administrative ability; (b) compliance with banking regulations and statutes; (c) ability to plan and respond to changing circumstances; (d) adequacy of and compliance with internal policies; (e) depth and succession; (f) tendencies toward self-dealing; and (g) demonstrated willingness to serve the legitimate banking needs of the community.

A 1 rating is indicative of management that is fully effective with respect to almost all factors and exhibits a responsiveness and ability to cope successfully with existing and foreseeable problems that may arise in the conduct of the bank's affairs. A 2 rating reflects some deficiencies but generally indicates a satisfactory record of performance in light of the bank's particular circumstances. A rating of 3 reflects performance that is lacking in some measure of competence desirable to meet responsibilities of the situation in which management is found. Either it is characterized by modest talent when above average abilities are called for, or it is distinctly below average for the type and size of bank in which it operates. Thus, its responsiveness or ability to correct less than satisfactory conditions may be lacking. The 4 rating is indicative of a management that is generally inferior in ability compared to the responsibilities with which it is charged. A rating of 5 is applicable to those instances where incompetence has been demonstrated. In these cases, problems resulting from management weakness are of such severity that management must be strengthened or replaced before sound conditions can be brought about.

Earnings
Earnings will be rated (1 through 5) with respect to (a) the ability to cover losses and provide for adequate capital; (b) earnings trends, (c) peer group comparisons; and (d) quality and composition of net income. Consideration must also be given to the interrelationships that exist between the dividend payout ratio, the rate of growth of retained earnings and the adequacy of bank capital. A dividend payout rate that is sufficiently high as to cause an adverse relationship to exist suggests conditions warranting a lower rating despite a level of earnings that might otherwise warrant a more favorable appraisal. Quality is also an important factor in evaluating this dimension of a bank's performance. Consideration should be given to the adequacy of transfers to the valuation reserve and the extent to which extraordinary items, securities transactions, and tax effects contribute to net income. Earnings rated 1 are sufficient to make full provision for the absorption of losses and the accretion of capital when due consideration is given to asset quality and bank growth. Generally, banks so rated will have earnings well above peer group averages. A bank whose earnings are relatively static or even moving downward may receive a 2 rating provided its level of earnings is adequate in view of the considerations discussed above. Normally, banks so rated will have earnings that are in line with or slightly above peer group

norms. A 3 should be accorded earnings that are not sufficient to make full provision for the absorption of losses and the accretion of capital in relation to bank growth. The earnings pictures of such banks may be further clouded by static or inconsistent earnings trends, chronically insufficient earnings, a high dividend payout rate or less than satisfactory asset quality. Earnings of such banks are generally below peer group averages. Earnings rated 4, while generally positive, may be characterized by erratic fluctuations in net income, the development of a downward trend, intermittent losses or a substantial drop from the previous year. Earnings of such banks are ordinarily substantially below peer group averages. Banks with earnings accorded a 5 rating should be experiencing losses or reflecting a level of earnings that is worse than defined in No. 4 above. Such losses may represent a distinct threat to the bank's solvency through the erosion of capital.

Liquidity

Liquidity is rated (1 through 5) with respect to (a) the volatility of deposits; (b) reliance on interest-sensitive funds and frequency and level of borrowings; (c) technical competence relative to structure of liabilities; (d) availability of assets readily convertible into cash; and (e) access to money markets or other ready sources of cash. Ultimately, the bank's liquidity must be evaluated on the basis of its capacity to promptly meet the demand for payment of its obligations and to readily fill the reasonable credit needs emanating from the communities which it serves. In appraising liquidity, attention should be directed to the bank's average liquidity over a specific time period as well as its liquidity position on any particular date. Consideration should be given, where appropriate, to the overall effectiveness of asset-liability management strategies and compliance with and adequacy of established liquidity policies. The nature, volume and anticipated usage of a bank's credit commitments are also factors to be weighed in arriving at an overall rating for liquidity.

A liquidity rating of 1 indicates a more than sufficient volume of liquid assets and/or ready and easy access on favorable terms to external sources of liquidity within the context of the bank's overall asset-liability management strategy. A bank developing a trend toward decreasing liquidity and increasing reliance on borrowed funds, yet still within acceptable proportions, may be accorded a 2 rating. A 3 liquidity rating reflects an insufficient volume of liquid assets and/or a reliance on interest-sensitive funds that is approaching or exceeds reasonable proportions for a given bank. Ratings of 4 and 5 represent increasingly serious liquidity positions. Banks with liquidity positions so critical as to constitute an imminent threat to continued viability should be accorded a 5 rating. Such banks require immediate remedial action or external financial assistance to allow them to meet their maturing obligations.

May 1978

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D.C. 20429

OFFICE OF DIRECTOR - DIVISION OF BANK SUPERVISION

August 11, 1978

Mr. Donald Pullen
Assistant Regional Manager
Washington Regional Office
803 W. Broad Street
Falls Church, Virginia 22146

Dear Mr. Pullen:

I appreciate the opportunity to review the draft report on the Federal Deposit Insurance Corporation's examination and supervision of insured banks. Comments with respect to the draft follow.

In our response to your 1977 audit report (FOD-77-8), we expressed concern with your then new format of placing on the cover page criticisms of FDIC together with certain recommendations. We stated that such a format could "certainly mislead an uninformed reader" (FOD-77-8 - Appendix III, Page 49) because your comments stood alone without any explanation or rebuttal. We also stated on Page 50 of Appendix III of that report that we were not sure there was any need for recommendations to appear unilaterally on the cover. We reiterate and repeat all of those comments with respect to the 1978 GAO audit report. There is a very real danger that the uninformed and even the informed might be misled by the one-sided summary of GAO findings on the cover page since the rebuttal to and explanation of those statements which are not referenced might be overlooked. We urge again that the format of summarizing your criticisms and recommendations on the cover page not be followed. If it is followed, we urge that GAO, in the interest of fairness, at least reference on the cover page the fact that FDIC has commented on the GAO criticisms and recommendations in the appendix of the report.

In the second sentence of the first paragraph of the cover page the statement is made that the Corporation "restricts itself by emphasizing financial risk to the insurance fund as the only concern of top management." The corollary implicit in this assertion is that top management of the Corporation ignores supervisory problems. Simply stated, the assertion is inaccurate.

From calendar year 1976 to date the Corporation has issued 15 emergency cease and desist orders under Section 8(c) and 83 cease and desist orders under Section 8(b) of the Federal Deposit Insurance Act. Three, or 20%, of the emergency orders and twelve, or more than 14%, of the regular cease and desist orders were issued against banks not formally designated problem banks. In every instance, cease and desist orders of any type are not only reviewed and analysed by top Washington staff personnel but also are reviewed, analysed and issued by the Corporation's Board of Directors. These data belie the assertion that top management of the Corporation, either in the Regional Offices or in the Washington Office, are only concerned with banks posing serious financial problems and are completely unconcerned with those posing supervisory concerns.

As indicated in our comments to the 1976 and 1977 GAO audit reports, the Corporation's Regional Directors maintain unofficial lists of supervisory problems. The Regional Directors are considered part of the top management of the Corporation, upon whom we rely with confidence to be fully cognizant of and to take or recommend necessary measures to correct any supervisory concerns in their Regions. Nevertheless, Washington Office staff perform an oversight function of the activities of the Regional Offices by reviewing and analysing examination reports of State nonmember insured commercial banks which are earmarked by the weekly computer-generated examination analysis of 14 weighted variables (hereafter "the edit check list") and the documentation of the Regions generated by the computerized Integrated Monitoring System ("IMS"). For every action report generated by the IMS and every bank examination report earmarked by the edit check list for review and analysis in the Washington Office a permanent record is made on the Summary Analysis of Examination Report (Form 6620/22, formerly form 96; hereafter "Summary Analysis"). From a practical standpoint, it is impossible for senior Washington staff to have detailed knowledge of each State nonmember insured bank presenting a supervisory, as distinguished from a financial, problem. However, the number of banks that present supervisory problems are reported to senior Washington staff on a quarterly basis and details on these banks are available on request.

We suggest, therefore, that the GAO delete that portion of the second sentence of the first paragraph on the cover of the draft report which reads "but restricts itself by emphasizing" and the word "only," and substitute therefor language similar to the following: "and emphasizes financial risk to the insurance fund as one of the primary concerns of top management."

The second paragraph on the cover on the draft report contains a recommendation that the "Corporation release data on the conditions of all the Nation's federally insured banks, and not just problem banks posing financial risk." We would be less than candid if we did not indicate that we simply do not understand this recommendation. The Corporation releases a wide variety of data on the condition of the Nation's federally insured banks including, but not limited to, problem bank data. The Annual Report of the Corporation contains, among other things, data on the supervisory activity of the Corporation, on the formal enforcement actions taken by the Corporation in the course of the calendar year, and pages upon pages of tables of statistical data on federally insured banks setting forth such information as capital, total assets, earnings performance and so on, all of which directly relate to the condition of federally insured banks. The Corporation also publishes or makes available to the public many other publications containing financial data on the banking system. For example, a publication entitled "Bank Operating Statistics" enables the reader to compare bank operations in each state and in some instances within more immediate areas. A list of the various FDIC publications with a brief description of each is included as Attachment I. The GAO may wish to rethink the recommendation stated on the cover page and either delete it or qualify it in some way that does not create the impression that the only data released by the Corporation is that related to formally designated problem banks.

Our remaining comments are directed at the body of your draft report and generally follow its numbering scheme:

1. Digest, page ii - Beginning on the third line from the top of this page, you indicate that only financial problems are identified to the Division of Bank Supervision's Washington Office. You also indicate that the Regional Offices use their own criteria for identifying supervisory problem banks and that this results in differences between Regions. You then conclude that, without knowledge of the supervisory problem banks, senior Corporation managers cannot be certain that supervison is proper and uniform throughout the Regions. As indicated in our opening comments, the number of supervisory problem banks are identified to senior Washington staff on a quarterly basis and detailed data on those banks are available upon request. The Corporation has made a conscious decision to allow the Regions to exercise the flexibility to identify banks of special supervisory concern in each Region and to tailor the characteristics of such banks to the geographic region in which the bank is located. We concluded that such banks could be better handled if Corporation personnel closer to the situation were allowed a broader range of options to deal with those banks. However, the Regions are not given unbridled rein in handling banks with special supervisory concerns. Oversight of the handling of those banks in each Region is performed in the Washington Office, as we have stated, through, among other things, the edit check list and the IMS. On the other hand, the Corporation has, after much thought and experience in dealing with failed and failing banks, determined that banks posing financial problems require greater concern by Washington Office senior staff, because they are inherently the most likely to fail and a greater risk to the insurance fund. Although we are confident that our present system of identifying financial problem banks, as well as those exhibiting supervisory concern, has worked well, we are, nevertheless, hopeful that the recently inaugurated Uniform Interagency Bank Rating System ("Bank Rating System") will enable the Corporation to establish more uniform inter- and intra-agency criteria for supervisory as well as financial problems without seriously inhibiting the desirable flexibility in the present system. More detailed discussion of the range of possible uses of the Bank Rating System is presented in our comments on Chapters 3 and 4 of the draft report.

2. Digest, page ii - The first full paragraph on this page states that the problem bank list can be misleading. A similar comment is made on pages 32 and 34 of your draft report. Although we will have more to say about the characterization "misleading" in our commentary on Chapter 4 of your draft report, suffice it to say that we disagree with your suggestion that problem bank data released by the Corporation is or can be misleading. We agree, however, that, like most things, the identification

and classification of problem banks can be improved. Further, the present system may not be the best way of interpreting the condition of the banking industry. We are, therefore, continuing our efforts to refine our criteria and heighten objectivity in designating problem banks and in assuring that senior management is provided with the necessary amount of useful and employable information for the proper performance of their duties. We are hopeful that, when greater experience is gained in the use of the Bank Rating System, it will provide a better measure of the condition of the banking industry. For additional comments on this subject refer to our commentary on Chapters 3 and 4 of the draft report.

3. Digest, pages ii and iii - With respect to the recommendations appearing on the bottom of pages ii and iii, please refer to our comments on Chapters 3 and 4 of the draft report.

4. Chapter 1, page. 1 - On the third line from the bottom of the page you refer to the twelve Federal Reserve banks as having direct supervisory responsibility of State member banks. We suggest that reference might more properly be to the Board of Governors of the Federal Reserve System as possessing supervisory authority over state member banks.

5. Chapter 2, page. 4 - (a) In the first sentence of the first paragraph of this page, the Division of Bank Supervision is characterized as the "Corporation's principal supervisor." The Corporation itself is the principal supervisor of State nonmember insured banks. We, therefore, suggest that the first sentence of the first paragraph be amended to indicate that the Division of Bank Supervision is the Corporation's principal office for carrying out the supervisory responsibility of the Corporation.

(b) The first sentence of the second paragraph attempts to describe the overall objective of bank examination. To the extent that the first sentence limits the overall objective to safety and soundness it is incomplete. An equally important objective of bank examination is to determine compliance with laws and regulations. Accordingly, the sentence should be amended to delete the period after the word "soundness" and add the following: "and compliance with laws and regulations." If you agree, the reference to compliance with laws and regulations on the third line of the second paragraph may be deleted.

(c) The second sentence of the second paragraph attempts to set forth the manner in which bank examination seeks to obtain its objective. The use of the word "determining" is somewhat misplaced and should be replaced by the word "evaluating." Furthermore, as we read "(1)" of the second sentence, it seems incomplete. Analysis and evaluation of the liquidity posture and earnings performance of a bank under examination are an integral part of the bank examination process and should be included in "(1)." In addition, the word "policies" should be added on the fourth line of the second paragraph after the word "controls." The last sentence of this paragraph seems to indicate that securities are examined only to determine their credit soundness. Securities are also examined to ascertain their marketability and liquidity. We suggest that the phrase ", among other things, " be inserted between the word "includes" and "a" on line 6 of paragraph 2.

6. Chapter 2, page 5 - (a) The first sentence of the first full paragraph on this page states that the Division conducts separate examinations to determine whether banks are operating according to laws and regulations. The separate examinations conducted by the Division of Bank Supervision are primarily designed to ascertain compliance with consumer-oriented laws and regulations. Other laws such as the Bank Secrecy Act and the Bank Protection Act are also included in the separate compliance examinations. However, as we have stated, the determination of compliance with banking laws and regulations is an integral part of the regular safety and soundness examination. The referenced sentence should be amended to read similar to the following: "The Division also conducts separate examinations primarily to determine whether banks operate in accordance with consumer-oriented laws and regulations."

(b) In the third full paragraph you state that the Regional Offices schedule bank examinations. In several of our Regions bank examinations are scheduled by Field Offices and not by the Regional Office. The first line of the third full paragraph on the page should be amended to read "Bank examinations are scheduled giving consideration to...." In the fourth full paragraph of this page you set forth what bank examiners review in determining the scope of a given examination. An important aspect of determining the scope of any safety and soundness examination involves a review of the correspondence file of the bank about to be examined. Hence, review of the correspondence file by the examiner should be added to the first sentence of the fourth paragraph on this page.

7. Chapter 2, page 6 - On the second line from the top of the page, you indicate that the examiner is required to meet with "top officials" of the bank after each full-scope examination. Division policy requires that the examiner meet with the board of directors of the bank or a committee some of whose members must be members of the bank's board of directors. The sentence should be amended to reflect that requirement. The third line from the top of the page indicates that bank "managers' commitments and/or reactions are included in the examination report." The word "managers" is not appropriate and should be replaced by the word "managements'."

8. Chapter 2, page 7 - (a) On the first line of this page you refer to the 14 items of the edit check list as: "characteristics of problem or potential problem banks." The 14 items of the edit check list are not intended to be, nor are they in fact, characteristics of problem or potential problem banks. They are 14 potentially unfavorable characteristics which must be looked at and analysed individually before any meaningful conclusions can be drawn regarding the earmarked bank (see our discussion at p. 54, Appendix III, FOD 77-8). The portion quoted above should be deleted and the phrase "potentially unfavorable characteristics" substituted in its place.

(b) On the fifth line from the top of the page you state that the banks earmarked by the edit check list are reviewed "to formally identify problem banks." Actually the purpose of the review is to determine the reasons why the bank is exhibiting potentially unfavorable characteristics. Accordingly, the fifth line from the top of the page should be amended by deleting the phrase "to formally identify problem banks" and substituting in its place language similar to the following: "To determine the nature and cause of the potentially unfavorable characteristics. If the review establishes the need, the bank will be designated a problem."

(c) The last sentence on this page seems to imply that the examiner assigns the rating for banks under the newly adopted Bank Rating System. In actuality the examiner assigns the initial individual and composite rating for the bank and if the Regional Office does not agree with the examiner's rating, the Regional Office assigns its own rating on the same page and the Regional Office rating constitutes the official rating. In short, the examiner recommends and the Regional Office assigns the final rating. The last sentence on the page should be amended to reflect that policy.

9. <u>Chapter 2, page 8</u> - (a) Line 3 of the third sentence of the first paragraph on this page states that the agencies are developing more specific guidelines in rating banks. In fact the agencies are not at this time developing any more specific guidelines than are contained in the Bank Rating System. The agencies are gaining experience with the Bank Rating System and after more experience has been achieved may then consider developing new or additional guidelines.

(b) The second sentence of the second paragraph states, in part, that the idea of the IMS is to alert the Division "of a problem before it becomes serious." The use of the word "problem" in this context could create the impression that the IMS is intended to identify "problem banks." As you know, the IMS was never designed to identify problem banks. The second sentence of the second full paragraph should be amended, in part, to read similar to the following: "The idea is to alert the Division to the presence of a deteriorating situation before it becomes serious, so it can be quickly corrected."

(c) The third sentence of the third paragraph says that banks submit their reports of condition and income on a quarterly basis. Only those banks of $300 million or more are required to submit income reports on a quarterly basis. Reports of condition, of course, are submitted by all banks on a quarterly basis. The third sentence should be amended to reflect the fact that banks under $300 million do not submit reports of income on a quarterly basis.

(d) We question the relevance of the last paragraph. Our reading of the paragraph suggests an attempt to compare the IMS with the edit check list. The two cannot be compared because they are completely separate systems and are dependent for their data from two separate and distinct sources--the IMS measures condition and income data submitted by the banks whereas the edit check lists measures examination report data. It is noteworthy that the IMS does include some examination data in the computerized analysis information provided to the analyst.

10. Chapter 2, page 9 - (a) As we read the first sentence at the top of the page, it implicitly conveys the impression that the Regions only receive quarterly reports in connection with the JAWS tests under the IMS. In fact, each Region is equipped with a computer terminal which not only provides JAW's test data but also condition and income report data on each State nonmember insured bank for the last three years as well as some examination data for analysis purposes. The analyst can, as soon as the condition and income report data are placed in the computer, begin the financial analysis in his or her Region without awaiting receipt of the quarterly reports. The third sentence of the same paragraph states, in part, that the Action Report outlines a bank's problems or adverse trends. It would be more accurate, in our judgment, to say that the report outlines the nature of the test failure, why it occurred, and any corrective measures needed. Hence, the third sentence of the paragraph should be amended to read similar to the following: "This report outlines the nature of the test failure, why the failure occurred and any corrective measures which may be needed." The last sentence of the paragraph seems to imply that follow-up on Action Reports is conducted in the Washington Office. The Regional Offices are responsible for follow-up if any is needed. The Washington Office performs an oversight function to ascertain that the analysis and review conducted by the Region are accurate and that appropriate corrective measures are taken where necessary.

(b) The second paragraph of this page discusses, to some extent, the Annual Review Report and the Annual Review Memorandum. However, there is no mention of the review of the Annual Review Memorandum in the Washington Office. We believe that an important oversight review is performed by the Washington Office which should be included in your discussion of the Annual Review Report and Annual Review Memorandum.

11. Chapter 2, page 10 - (a) Line four of the second sentence of the first full paragraph should be amended by deleting "conducting" and substituting in its place "engaging" and by deleting "business" and substituting in its place "practices." On line five of the same paragraph, we suggest that the phrase "entered into with the Corporation" be inserted between the words "agreement" and "and." Finally, we suggest that the last line of this paragraph be amended by inserting the phrase", among other things," between the words "if" and "the," by inserting "in an" between "is" and "unsafe," and by adding the word "condition" at the end of the sentence. This last suggestion is made because an unsafe or unsound condition is only one of the statutory reasons for terminating a bank's deposit insurance.

(b) The last paragraph of this page contains a discussion of the Corporation's authority to remove officers, directors, or other persons participating in bank management. The Corporation's power to remove these persons is contained in Section 8(e) of the Federal Deposit

Insurance Act. Under Section 8(e), the Corporation must allege and prove in each removal case that the act complained of involved personal dishonesty. The burden is difficult and, as the legislative history of the statute makes clear, is tantamount to proving a crime. The Corporation, in conjunction with the other two Federal bank regulatory agencies, has proposed amendments to Section 8(e) to Congress which would substantially lessen the burden by, among other things, removing the need to prove personal dishonesty.

12. Chapter 2, page 11 - In the interest of clarity, you may wish to consider amending the last sentence on this page to read along the following lines: "The Corporation also issued regulations to cover the deficiencies in the statute found by the court."

13. Chapter 3 - The comments here cover the general themes of the chapter; namely, that there is a need for more specific guidelines in classifying banks as financial and supervisory problems, that there is at present confusion as to which are problem or nonproblem banks, and that senior managers need to be more concerned about supervisory problems. Additional detailed comments will be made with respect to certain specific portions of Chapter 3.

Certainly there are and will be a few borderline or near problem cases where reasonable persons may disagree as to whether a bank is a supervisory concern only or also poses such an exceptional financial risk to the Corporation as to merit formal problem bank status. It is equally certain that in most instances the distinction between financial and supervisory problem banks is clear cut. Thus, the problem bank list represents overall an accurate appraisal of those banks possessing the highest potential for failure based upon the state of the Division of Bank Supervision's knowledge at that time. Even in the few borderline cases, the decision to designate or not to designate a bank as a problem is not lightly made. On the contrary, that decision represents the composite judgment of individuals skilled and experienced in the analysis and evaluation of a bank's condition. While a few close cases are encountered, no confusion exists within the Corporation in designating or withholding formal problem bank status.

In our comments to previous GAO studies, we stressed that mechanical formulae can not be applied universally to determine whether or not an operating bank warrants FDIC problem status and that such status should be imposed only on a case-by-case basis after a comprehensive, in-depth analysis of the entire bank. We stressed also our firm conviction that the decision to designate a bank formally as a problem is dependent on several variables and in the final analysis involves the judgment of experienced professionals. When a bank's condition deteriorates to the point where problem bank status is warranted, a memorandum providing detailed information on the nature of the problem and the status of the bank is disseminated to management at the highest levels in the Corporation.

Although similar, banks of special supervisory concern do not have the same essential characteristics as financial problem banks; namely, a high degree of risk to the insurance fund and the greatest likelihood of failure. Conceptually, our primary emphasis in the supervision of financial problem banks is rehabilitation--to return the bank to nonproblem status. On the other hand, our primary emphasis with banks of special supervisory concern is preventive--to keep the bank from deteriorating to a level necessitating formal problem designation. Thus, it is a misconception to suggest that both types of banks exhibit the "same" deficiencies and that supervisory concerns generally are afforded the same degree of supervison as financial problem banks. In the case of banks formally designated as problems, the magnitude or degree of supervision is more intense than the supervision of banks of special supervisory concern because financial problem banks constitute a more imminent threat of failure.

As indicated previously, we are hopeful that the newly adopted Bank Rating Svstem will, over time, enhance our capabilities in formally designating problem banks and in providing even more meaningful information to the Corporation's senior management. The definitions of composite groups 3, 4, and 5 are similar to the kinds of banks currently found in our supervisory and/or financial problem categories. These new ratings are in the process of being phased-in as each bank is examined and it probably will take at least 18 months before each bank is rated. Furthermore, it may well be that at the threshold stage inconsistencies in assigning ratings under the new svstem between examiners, Regions, and even regulatory agencies might occur. Until we are assured that an appropriate level of consistency has been achieved, utilization of the current system will continue in tandem with the new rating system in assigning banks problem and near problem status. Assuming that the start-up problems associated with the Bank Rating System can be and are solved, the Corporation will certainly consider phasing out the current method of designating problem banks and replacing it with the composite ratings under the Bank Rating System. If that occurs, we would also consider reporting data on the entire banking industry by aggregates based upon the new rating system.

We note in passing that Case Study A, appearing on pages 16-18 of the draft report is labeled as an illustration of the "extremely subjective nature" of identifying problem banks by the Corporation. The report states further that the decision not to designate the bank in question as a problem was "subjective because it was based on an unproved future condition," i.e. a capital infusion. Since completing the GAO draft report, the capital infusion in the bank has been completed and the latest examination report shows that the volume of adversely classified assets has significantly decreased. Our latest information shows that the adjusted capital of the bank has risen to 8.9% and the net capital to 4.7%. Net capital is adjusted capital minus the remaining half of the assets classified "doubtful" and all the assets classified "substandard."

14. Chapter 3, page 12 - We suggest that on the first line of this page the word "emphasizes" be changed to "recognizes." In the last sentence of the first paragraph, you state that the Division does not consider that supervisory problems pose a risk to Corporation financial involvement. Since every bank in operation poses some degree of risk to the insurance

fund, you may wish to consider rephrasing that sentence by deleting the word "a" in line 8 from the top of the page and inserting in its place the words "an undue." For purposes of clarity, you may also wish to add to the definition of "Serious Problem--Potential Payoff" on the second line from the bottom of the page, the words "or more" between "percent" and "chance."

15. <u>Chapter 3, page 15</u> -- In the last sentence of the third full paragraph you state that when the headquarters review uncovers a problem bank not recommended by the Region "The Problem Bank Section prepares the memorandum and notifies the Regional Director of this action." The procedure is that the Problem Bank Section contacts the Regional Director and, if agreement is reached, the problem bank memorandum may be either written in the Region or in the Washington Office. The last sentence of the third full paragraph should be amended to reflect this procedure.

16. <u>Chapter 3, page 16</u> -- In the second full paragraph the identification of problem banks by the FDIC is described as "extremely subjective." As we have stated many times, the designation of a problem bank is the product of assiduous analysis and review by skilled and experienced personnel. The final decision to place a bank on a problem bank list or to withhold such designation is made at the highest levels within the Division of Bank Supervision. Describing the process as "extremely subjective" suggests that the final decision is no more than a whim or caprice and, as such, is inappropriate.

17. <u>Chapter 3, page 20</u> -- The draft report displays the banks designated as problem banks by the Corporation, as well as those identified by the Regional Offices as special supervisory concerns, according to the Regional Office in which the bank is located. Corporation policy and practice are not to release data or information on problem banks by geographic sections of the country. Our concern is that by releasing data in the manner followed in the draft report, you may unwittingly provide the capability of identifying a specific problem bank or cause a lack of confidence in the banking system in certain areas of the country. Furthermore, with respect to the banks identified as special supervisory problems, we believe that data should not be released at all because that list pertains only to State nonmember banks and not to national and State member banks. The release of the data in the form proposed in the draft may also be violative of the Agreement between the FDIC and the GAO to preserve the confidentiality of bank data, Paragraph II(6) (b) (iii), which states that the GAO will not provide detail in its report that can lead to identification of any bank or bank customer.

18. <u>Chapter 3, page 21</u> -- In the interest of clarity, you may wish to recast the last sentence on this page.

19. <u>Chapter 4</u>, - Once again the comments that follow will cover the general thrust of the chapter; namely, that the information released on problem banks by the Corporation is misleading, that use of problem bank data as an indicator of the condition of the banking industry be phased out, and

that release of data on the condition of all the Nation's insured banks based on the newly adopted bank rating system be implemented.

The Corporation has confidence in the accuracy and reliability of the problem bank data released to the public as a credible measure of those banks which pose the greatest degree of financial risk to the insurance fund and possess the highest likelihood of failure. Obviously, the designation of a bank as a problem bank and the release of aggregate data on problem banks to the public can only be based on those problem conditions known to exist by the Corporation at that given point in time. No doubt, from time to time banks not included on the problem bank list will fail because of unforeseen or largely unpredictable reasons. Sudden and large asset deterioration between examinations or the commission of a criminal act are the kinds of eventualities which do not lend themselves to prediction by financial analysis and oversight nor can they normally be foreseen in a particular bank before their occurrence. Those types of situations would not be helped by maintaining a formal list of supervisory concerns or near problem banks.

In making public information on banks formally designated as problems, the Corporation has never, expressly or impliedly, suggested that the problem bank information released is the only determinant needed to assess the condition of the banking industry. Indeed, the Corporation carefully informed the public that the problem bank data is only part, albeit an important part, of the data available to better understand the general condition of the banking industry. In the news release on problem bank data (PR-65-77 (8-22-77)) the FDIC expressly stated: "The FDIC list includes some, but not all, of the banks being more closely supervised by the Comptroller of the Currency and the Federal Reserve. Their watch lists, as well as similar lists of banks maintained by FDIC Regional Offices, include some banks with supervisory problems that appear to pose little risk to the insurance fund and which are not likely to involve any financial outlays by the FDIC." A copy of the news release is included as Attachment 2. A similar statement appears at page 10 of the FDIC's Annual Report for calendar year 1976. Clearly, delineating the problem bank information released to the public as "misleading" and incomplete is lacking in merit. Furthermore, as indicated above, the FDIC publishes and makes available a plethora of information and statistical data on the condition of the Nation's banking system, much of which is used by banks and professional financial advisers in evaluating the health and earnings performance of insured banks.

If the number of banks formally designated as problems by the Corporation is viewed in light of the number of actual failures over the years, there seems little doubt that the Corporation's problem bank list more than meets the test of informing the public of those banks evincing the greatest propensity for closing, based upon review and analysis of relevant data. If valid criticism were to be leveled at the Corporation's problem bank list, that criticism more properly might be that the list covers too many, rather than too few, banks. For example, the number of banks on the problem bank list at year-end 1975 was 349 while 13 banks actually closed during that calendar year. Similarly in 1976 the number of problem banks listed at year-end was 379 with 16 actual closures, and at year-end 1977 problem banks numbered 368 with 6 actual closures. The percentage of banks actually closing in relation to the number of banks on the problem list for the years 1975, 1976, and 1977 is less than 4%, less than 5%, and less than 2%, respectively. Even GAO's review of banks closed in 1977 and 1978 shows that 7 out of the 10 banks were on the problem list for a year or more prior to their closure. Of the remaining three, two were closed as a result of unforeseen criminal acts and one resulted from a sudden asset deterioration which occurred between examinations. In all likelihood, because of the unforeseen and largely unpredictable event causing their failure, none of the three would have been detected or designated as special supervisory concerns or near problems other than, as happened, when knowledge of the event was obtained by the Corporation.

20. Chapter 4, page 34 - Our opening comments on Chapter 3 are responsive to GAO recommendations and those comments are incorporated here by reference.

These comments are somewhat lengthy but are intended to be helpful.

Sincerely,

John J. Early
Director

Attachments

GAO note: Page references in this appendix refer to the draft report and do not necessarily agree with the page numbers in the final report.

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D.C. 20429

OFFICE OF INFORMATION

March 1978

Single copies of the following publications can be procured from the OFFICE OF INFORMATION without charge, unless otherwise indicated.

ANNUAL REPORT OF THE FEDERAL DEPOSIT INSURANCE CORPORATION

In conformity with the provisions of Section 17 of the FDI Act, as amended, the Corporation makes an annual report of its operations to the Congress as soon as practicable after the first of the year. An abbreviated Annual Report generally is published in March. It is available in quantity for classroom use. The March Report is reprinted later in the year together with bank merger decisions, tables of commercial and mutual savings bank statistical data, etc. Single copies are available.

ASSETS & LIABILITIES – COMMERCIAL & MUTUAL SAVINGS BANKS and REPORT OF INCOME

These reports are published semi-annually as of June 30 and December 31. They are based on data in Reports of Condition and Reports of Income. This is a combined effort of the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Office of the Comptroller of the Currency.

BANK OPERATING STATISTICS

The Corporation publishes annually a presentation of year-end data, in a geographical framework, based on the Report of Condition and Report of Income submitted by all insured commercial banks.

CHANGES AMONG OPERATING BANKS AND BRANCHES

This is an annual publication as of year-end which sets forth the changes which occurred during the year in number and classification of operating banks and branches.

ELECTRONIC FUNDS TRANSFER SERIES

EFTS Introduction to Point of Sale Systems
EFTS Introduction to EFT Security
EFTS Introduction to Automated Tellers
EFTS Introduction to the Automated Clearing House
A Guide to EDP and EFT Security

FEDERAL DEPOSIT INSURANCE CORPORATION – LAW, REGULATIONS AND RELATED ACTS

This information is presented in loose-leaf format in two volumes and includes the FDI Act, Rules and Regulations issued as prescribed by the Corporation's Board of Directors, and certain other statutes and regulations which affect the operations of insured banks. The service includes also Report Bulletins issued at two-month intervals which reflect the text of any statutory or regulatory changes that may have occurred, and summarizes Congressional and Federal agency actions affecting insured banks. *The charge for this information is $50 for each service per calendar year.* Orders and checks (payable to FDIC) should be sent to the Office of Information at the above address.

NEWS RELEASES

News releases on actions of the FDIC which affect the status of commercial and mutual savings banks, amended regulations and policy statements, addresses by FDIC officials, payoffs to depositors in insured banks that have been closed, FDIC assistance to failing banks, personnel changes and other matters considered of interest to the public.

OPERATING BANKING OFFICES

A list of operating banking offices is published annually as of December 31, in limited quantity. It includes the cities and states in which the offices are located — it does not include street addresses, zip codes or names of officers.

ROSTERS

FDIC Regional Directors
State Banking Authorities

SUMMARY OF DEPOSITS

From 1964 through 1972, the aggregate results of a June 30 survey of deposits of commercial and mutual savings banks were published at two-year intervals in the even years. Since 1973, the data have been published annually, with the format and general presentation changing from year to year. The data are grouped by state, county, SMSA and FDIC Region in the following types of accounts: (1) Demand, IPC; (2) Savings, IPC; (3) Other time, IPC; (4) Public funds, demand; (5) Public funds, time and savings; and (6) All other.

TRUST ASSETS OF INSURED COMMERCIAL BANKS

An annual publication of trust department data collected from all insured commercial banks and presented by type of account, asset distribution, and size of trust department. This publication lists also trust assets by type of account (but not asset distribution) for each of the 300 largest trust departments — ranked according to total trust assets.

YOUR INSURED DEPOSIT

A pamphlet which provides examples of insurance coverage under the Corporation's rules on certain types of accounts commonly held by depositors in insured banks. This pamphlet is available in quantity for classroom use.

The following data are available from the DATA REQUEST SECTION OF THE DIVISION OF MANAGEMENT SYSTEMS AND FINANCIAL STATISTICS.

DEPOSIT DATA

Deposit data can be generated for all banking offices of a specific bank on a computer printout; all banking offices within a given city, county, SMSA, or state on a computer printout; and all banking offices in the country on magnetic tape. Nominal fees are charged for these services.

A series of books of 1976 DEPOSIT DATA — one for each of the 14 FDIC Regions which groups each banking office by FDIC Region, state, county and SMSA, with total deposits and the percentage thereof in each of the six categories of deposits. There is a $5.00 charge for each book in the series.

REPORTS OF CONDITION and REPORTS OF INCOME (10-year Retension)

The captioned Reports must be requested by name of bank — in writing — addressed to the Division of Management Systems and Financial Statistics. *Reports of Condition* available on quarterly basis; *Reports of Income* available on annual basis through December 1976 and semiannual basis since June 1977. There is a charge of $1 for the first Report and $0.25 for each additional Report.

The following pamphlets are available in quantity, without charge, from the PUBLICATIONS AND GRAPHIC SERVICES BRANCH.

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FDIC

FEDERAL DEPOSIT INSURANCE CORPORATION

For Immediate Release PR-65-77 (8-22-77)

FDIC RELEASES MIDYEAR PROBLEM BANK DATA

Chairman George A. LeMaistre of the Federal Deposit Insurance Corporation has released June 30, 1977, problem bank data. The release of this information continues the practice the Corporation has followed in recent years to aid the Congress, the general public and the banking industry to better understand the general condition of the nation's approximately 15,000 insured commercial and mutual savings banks.

Chairman LeMaistre reported that there were 368 banks on the problem list as of June 30, 1977, one more than a year earlier but significantly less than the peak of 385 reached in November 1976 and the 379 as of December 31, 1976. He said, "We expect some continued moderate decline in the number over the coming months." He pointed out that there have been only four insured bank failures to date in 1977, compared with ten as of this date in 1976 and eight in 1975.

The FDIC, through its Division of Bank Supervision, presently segregates its problem banks into three categories:

> Serious Problem-Potential Payoff: An advanced serious problem situation with an estimated 50 percent chance or more of requiring financial assistance from the FDIC in the near future.
>
> Serious Problem: A situation that threatens ultimately to involve the FDIC in a financial outlay unless drastic changes occur.
>
> Other Problem: A situation wherein a bank contains significant weakness but where the FDIC is less vulnerable. Such banks require more than ordinary concern and agressive supervision.

The FDIC problem bank list is not limited to the State-chartered nonmember banks it regularly examines. It includes also national banks and State-chartered banks that are members of the Federal Reserve System. The Corporation subjects all the banks to the same criteria in making its designations, using the most recent information available to it. The FDIC list includes some, but not all, of the banks being more closely supervised by the Comptroller of the Currency and the Federal Reserve. Their watch lists, as well as similar lists of banks maintained by FDIC Regional Offices, include some banks with supervisory problems that appear to pose little risk to the insurance fund and which are not likely to involve any financial outlays by the FDIC.

During the first half of 1977, 91 banks were added to the list and 102 were removed (3 by actual failure). The net decrease of 11 results from decreases of 15 in the "Other Problem" and 6 in the "Serious Problem-Potential Payoff" categories, and an increase of 10 in the "Serious Problem" group. From a deposit-

- more -

size standpoint, 292 had deposits under $50 million, 34 between $50 and $100 million, 27 between $100 and $500 million, 7 between $500 million and $1 billion, and 8 with $1 billion or more.

One hundred nineteen of the listed banks, compared with 115 at the beginning of 1977, were in the two more serious categories. However, 92 of these banks had deposits of less than $50 million. The remaining 27 banks in these two categories included 10 banks having deposits between $50 and $100 million, 13 between $100 and $500 million, 3 between $500 million and $1 billion, and one with deposits of $1 billion or more. There were no banks with deposits of over $350 million considered to be in the "Serious Problem-Potential Payoff" category. Twelve banks in this category had deposits of less than $25 million and 3 had deposits between $25 and $50 million.

The number of banks on the problem list represents approximately 2.5 percent of all insured banks. Conversely, it is to be remembered that 97.5 percent of all insured banks are <u>not</u> on the FDIC problem list; also, that the overall experience in recent years has been that about 75 percent of the banks listed on a given date will no longer be considered in problem status 2 years later due to the progress that will have been made in correcting their deficiencies.

Reference is directed to the 1976 FDIC Annual Report for more background on the meaning of the Corporation's problem bank list.

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