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Report to the Congress

August 1987

FINANCIAL AUDIT

Federal Deposit Insurance Corporation's 1986 and 1985 Financial Statements

GAO

United States
General Accounting Office
Washington, D.C. 20548

Comptroller General
of the United States

B-114831

August 12, 1987

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

This report presents our unqualified opinion on the Federal Deposit Insurance Corporation's financial statements for the years ended December 31, 1986 and 1985, and our reports on the Corporation's system of internal accounting controls and on its compliance with laws and regulations.

Our report on internal accounting controls discloses that the Corporation was not following its internal control procedures that require certain Corporation and closed and assisted insured bank accounts to be reconciled monthly. The Corporation has since taken action to ensure that reconciliations are completed in a timely manner.

Over the last 5 years, the financial condition of certain sectors of the economy, particularly the energy and agricultural sectors, has adversely affected the banking industry's performance and, in turn, has required the Corporation to increase its expenditures for appropriate regulatory action. Between 1982 and 1985, the Corporation's net income exceeded $1 billion each year, but in 1986, it declined to less than $300 million. Moreover, although the Corporation's deposit insurance fund was $18.3 billion at the end of 1986, an increase of $4.6 billion since 1982, the ratio of the insurance fund to insured deposits has declined. The Corporation has stated that this ratio could further decline in 1987.

The Federal Deposit Insurance Corporation is an independent agency created by the Banking Act of 1933 to protect deposits in the nation's banks, help maintain confidence in the banking system, and promote safe and sound banking practices. We conducted our examinations pursuant to the provisions of 31 U.S.C. 9105 and in accordance with generally accepted government auditing standards.

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

Charles A. Bowsher
Comptroller General
of the United States

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of the United States

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To the Board of Directors
Federal Deposit Insurance Corporation

We have examined the statements of financial position of the Federal Deposit Insurance Corporation as of December 31, 1986 and 1985, and the related statements of income and the deposit insurance fund, and of the changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted government auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. In addition to this report on our examination of the Corporation's 1986 and 1985 financial statements, we are also reporting on our study and evaluation of internal accounting controls and compliance with laws and regulations.

Over the last 5 years, the financial condition of certain sectors of the economy, particularly the energy and agricultural sectors, has adversely affected the banking industry's performance. The number of FDIC-insured bank failures and problem banks has increased substantially and the Corporation expects this trend to continue in 1987. Although the failures and problem banks represent a small percentage of total FDIC-insured banks, the industry's problems have required the Corporation to substantially increase its expenditures for regulatory action. Between 1982 and 1985, the Corporation's net income exceeded $1 billion each year, but in 1986, it declined to less than $300 million. Further, although the Corporation's deposit insurance fund has increased from $13.7 billion at the end of 1982 to $18.3 billion at the end of 1986, the Corporation's ratio of the insurance fund to insured deposits has declined from about 1.2 percent to about 1.1 percent. As discussed in note 1 to the financial statements, if the ratio falls below 1.1 percent, the Depository Institutions Deregulation and Monetary Control Act of 1980 mandates that the Corporation reduce the percentage of net assessment income distributed to insured banks. The Corporation has stated that if the current trend in bank failures continues and the insurance fund remains at its current level, the ratio of the insurance fund to insured deposits could further decline in 1987.

In our opinion, the financial statements referred to above present fairly the financial position of the Federal Deposit Insurance Corporation as of December 31, 1986 and 1985, and the results of its operations and the changes in its financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Charles A. Bowsher

Charles A. Bowsher
Comptroller General
of the United States

May 29, 1987

Report on Internal Accounting Controls

We have examined the financial statements of the Federal Deposit Insurance Corporation for the years ended December 31, 1986 and 1985, and have issued our opinion thereon. As part of our examinations, we made a study and evaluation of the system of internal accounting controls to the extent we considered necessary to evaluate the system as required by generally accepted government auditing standards. This report pertains only to our study and evaluation of the system of internal accounting controls for the year ended December 31, 1986. Our report on the study and evaluation of internal accounting controls for the year ended December 31, 1985, is presented in GAO/AFMD-86-67, dated July 30, 1986.

The purpose of our study and evaluation was to determine the nature, timing, and extent of the auditing procedures necessary for expressing an opinion on the Corporation's financial statements. For purposes of this report, we have classified the significant internal accounting controls into the following categories:

- assessments,
- assistance to problem banks,
- expenditures,
- financial reporting, and
- treasury.

Our study and evaluation included all of the control categories listed above except for treasury and the other expenses portion of the expenditures category. For those categories, we found it more efficient to rely solely on substantive audit tests.

The Corporation's management is responsible for establishing and maintaining an effective system of internal accounting controls. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of a system of internal accounting controls are to provide management with reasonable assurance that (1) obligations and costs are in compliance with applicable laws, (2) funds, property, and assets are safeguarded against waste, loss, and unauthorized use or misappropriation, and (3) assets, liabilities, revenues, and expenditures applicable to operations are properly recorded and accounted for to permit the preparation of reliable financial reports and to maintain accountability over the Corporation's assets. Because of inherent limitations in any system of internal accounting controls, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the degree of compliance with procedures may deteriorate.

Our study and evaluation, made for the limited purpose described in the second paragraph, would not necessarily disclose all material weaknesses in the system. Accordingly, we do not express an opinion on the Corporation's system of internal accounting controls taken as a whole or on the categories of controls identified in the second paragraph. However, our study and evaluation did disclose the following condition that represented an internal accounting control weakness that warranted management's attention and correction. As discussed below, the Corporation has initiated action to correct this condition.

Accounting Records Not Reconciled in a Timely Manner

The Corporation's accounting procedures require certain Corporation and closed and assisted insured bank accounts to be reconciled monthly. During 1986, the Corporation did not follow these procedures on a timely basis and, as a result, the unreconciled balance increased substantially in 1986:

- at the end of March 1986, the Corporation's records of amounts owed to it by closed and assisted insured banks were $338 million less than the banks' records;
- at the end of June 1986, the Corporation's records were $134 million less than the banks' records;
- at the end of September 1986, the Corporation's records were $542 million greater than the banks' records; and
- at the end of December 1986, the Corporation's records were $926 million greater than the banks' records.

By December 31, 1986, the accounts of 441, or 88 percent, of the 502 closed and assisted insured banks did not agree with the Corporation's records and had not been reconciled.

In September 1986, the Corporation initiated substantial efforts to reconcile the existing out-of-balance accounts. As part of this initiative, the Corporation delegated responsibility for performing the monthly reconciliations to Corporation personnel located at closed and assisted insured banks and conducted training sessions on accomplishing reconciliations. Although this effort has yielded positive results to date, as of May 29, 1987, the end of our fieldwork, the reconciliation project was not complete.

Subsequent to December 31, 1986, the Corporation prepared and provided us reconciliations for some of the major discrepancies. Our evaluation of reconciliations provided by the Corporation indicated that in about two-thirds of the cases, the banks' records were in error, and in about one-third of the cases, the Corporation's records were incorrect. Because the amounts in error tended to offset each other, we determined that the out-of-balance condition did not materially affect the Corporation's 1986 financial statements. Nonetheless, the fact that significant unreconciled differences existed throughout the year and amounted to over $900 million at year-end clearly indicates an internal accounting control weakness that warranted management's attention and correction.

Conclusions and Recommendations

Timely reconciliation of the Corporation's records with the closed and assisted insured banks' records and the resolution of any differences is an important internal accounting control procedure to ensure that accounting information is correct. With the passage of time, it becomes increasingly difficult to identify sources of discrepancies. The Corporation has assigned responsibility for the reconciliations to personnel located at the closed and assisted insured banks and needs to assure itself that these personnel devote sufficient attention to completing the reconciliations in a timely manner.

Accordingly, we recommend that the Chairman of the Board of Directors instruct the Director of the Division of Accounting and Corporate Services to

- report monthly on the status of the current reconciliation project until it is completed and, after the project is completed, to report any additional major unreconciled differences and
- reiterate to personnel responsible for the reconciliations the importance of timely completion of the reconciliations.

To help ensure that this effort achieves the intended results, we also recommend that the Chairman instruct the Director, Office of Corporate Audits and Internal Investigations, to monitor and report on the progress and effectiveness of the reconciliation project.

Other Opportunities for Improvement

During the course of our examination, we also identified several other internal accounting control matters which, although not material, nonetheless merit corrective action to strengthen the Corporation's internal accounting controls. Accordingly, we are reporting them separately to the Corporation.

All of the above conditions were considered in determining the nature, timing, and extent of the audit tests to be applied in our examination of the Corporation's 1986 financial statements, and this report does not affect our May 29, 1987, opinion on the financial statements.

Agency Comments

We did not request official written comments on this draft. However, we provided a draft of this report to Corporation officials and have incorporated their comments. The Deputy to the Chairman and Division of Accounting and Corporate Services officials agreed that reconciliations should be done on a timely basis and assured us of their commitment to completing reconciliations properly and in a timely manner.

Report on Compliance With Laws and Regulations

We have examined the financial statements of the Federal Deposit Insurance Corporation for the years ended December 31, 1986 and 1985, and have issued our opinion thereon. Our examinations were made in accordance with generally accepted government auditing standards and, accordingly, included such tests of compliance with laws and regulations as we considered necessary in the circumstances. This report pertains only to our review of compliance with laws and regulations for the year ended December 31, 1986. Our report on the review of compliance with laws and regulations for the year ended December 31, 1985, is presented in GAO/AFMD-86-67, dated July 30, 1986.

In our opinion, the Corporation complied with the terms and provisions of laws and regulations for the transactions tested that could have materially affected its financial statements. In connection with our examination, nothing came to our attention that caused us to believe that the Corporation was not in compliance with the terms and provisions of laws and regulations for those transactions not tested.

Statements of Financial Position

FEDERAL DEPOSIT INSURANCE CORPORATION
STATEMENTS OF FINANCIAL POSITION
(In thousands)

	December 31 1986	December 31 1985
ASSETS:		
CASH	$ 42,477	$ 23,186
INVESTMENT IN U.S. TREASURY OBLIGATIONS (Note 2)	16,602,959	15,841,869
ACCRUED INTEREST RECEIVABLE ON INVESTMENTS AND OTHER ASSETS	503,557	499,229
CERTIFICATES, NOTES AND OTHER RECEIVABLES FROM INSURED BANKS (Note 3)	662,090	590,254
NET RECEIVABLES FROM ASSISTANCE TO INSURED BANKS (Note 4)	1,854,691	2,712,842
NET RECEIVABLES FROM FAILURES OF INSURED BANKS (Note 5)	2,690,842	2,358,554
PROPERTY AND BUILDINGS (Note 6)	51,010	47,164
TOTAL ASSETS	$22,407,626	$22,073,098

The accompanying summary of significant accounting policies and notes to financial statements are an integral part of these statements.

FEDERAL DEPOSIT INSURANCE CORPORATION
STATEMENTS OF FINANCIAL POSITION
(In thousands)

	December 31 1986	1985
LIABILITIES AND THE DEPOSIT INSURANCE FUND:		
ACCOUNTS PAYABLE, ACCRUED LIABILITIES AND OTHER	$ 266,708	$ 80,649
LIABILITIES INCURRED IN ASSISTANCE TO INSURED BANKS (Note 7)	3,034,108	3,442,752
LIABILITIES INCURRED FROM FAILURES OF INSURED BANKS (Note 8)	847,242	578,367
ESTIMATED LOSSES FROM CORPORATION LITIGATION (Note 9)	6,251	14,340
TOTAL LIABILITIES	4,154,309	4,116,108
DEPOSIT INSURANCE FUND	18,253,317	17,956,990
TOTAL LIABILITIES AND THE DEPOSIT INSURANCE FUND	$22,407,626	$22,073,098

The accompanying summary of significant accounting policies and notes to financial statements are an integral part of these statements.

Statements of Income and the Deposit Insurance Fund

FEDERAL DEPOSIT INSURANCE CORPORATION
STATEMENTS OF INCOME AND THE DEPOSIT INSURANCE FUND
(In thousands)

	For the year ended December 31 1986	1985
INCOME:		
Gross assessments earned	$ 1,587,375	$ 1,434,578
Provision for assessment credits	70,473	1,081
Net assessments earned	1,516,902	1,433,497
Interest on U.S. Treasury obligations	1,634,415	1,599,745
Other income	149,744	352,203
TOTAL INCOME	3,301,061	3,385,445
EXPENSES AND LOSSES:		
Administrative operating expenses	180,267	179,209
Merger assistance losses and expenses (Note 10)	(86,043)	199,377
Provision for insurance losses (Notes 3, 4, 5, and 11)	2,868,660	1,568,992
Nonrecoverable insurance expenses (Note 12)	41,850	10,356
TOTAL EXPENSES AND LOSSES	3,004,734	1,957,934
NET INCOME	296,327	1,427,511
DEPOSIT INSURANCE FUND - January 1	17,956,990	16,529,479
DEPOSIT INSURANCE FUND - December 31	$18,253,317	$17,956,990

The accompanying summary of significant accounting policies and notes to financial statements are an integral part of these statements.

Statements of Changes in Financial Position

FEDERAL DEPOSIT INSURANCE CORPORATION
STATEMENTS OF CHANGES IN FINANCIAL POSITION
(In thousands)

	For the year ended December 31 1986	1985
FINANCIAL RESOURCES WERE PROVIDED FROM:		
Operations:		
Net Income	$ 296,327	$1,427,511
Add (deduct) items not involving cash in the period:		
Amortization of U.S. Treasury obligations	125,640	57,575
Depreciation on buildings	1,285	1,115
Income maintenance agreement adjustments	(83,700)	(109,517)
Amortization of merger assistance agreements	22,108	39,128
Provision for insurance losses	2,868,660	1,568,992
Resources provided from operations	3,230,320	2,984,804
Other resources provided from:		
Maturity and sale of U.S. Treasury obligations	3,196,626	3,798,500
Collections on certificates, notes, and other receivables	98,217	259,641
Collections on receivables from assistance to insured banks	668,323	549,295
Collections on receivables from failures of insured banks	1,799,101	924,353
Liabilities incurred in assistance to insured banks	-0-	128,027
Liabilities incurred from failures of insured banks	753,270	91,999
Other decreases (increases)	39,896	(125,118)
TOTAL FINANCIAL RESOURCES PROVIDED	$9,785,753	$8,611,501
FINANCIAL RESOURCES WERE APPLIED TO:		
Purchase of U.S. Treasury obligations	$4,083,356	$5,261,658
Acquisition of certificates, notes and other receivables	144,365	251,527
Increased receivables from assistance to insured banks	200,966	146,708
Increased receivables from failures of insured banks	4,491,035	2,089,501
Additions to property and buildings	5,131	6,578
Payments on liabilities incurred in assistance to insured banks	408,644	533,617
Payments on liabilities incurred in failures of insured banks	430,968	302,884
Disbursements for Corporate Litigation	1,997	-0-
Increase (decrease) in cash	19,291	19,028
TOTAL FINANCIAL RESOURCES APPLIED	$9,785,753	$8,611,501

The accompanying summary of significant accounting policies and notes to financial statements are an integral part of these statements.

Notes to Financial Statements

FEDERAL DEPOSIT INSURANCE CORPORATION
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 1986 AND 1985

1. Summary of Significant Accounting Policies:

General. These statements do not include accountability for assets and liabilities of closed insured banks for which the Corporation acts as receiver or liquidating agent. Periodic and final accountability reports of its activities as receiver or liquidating agent are furnished by the Corporation to courts, supervisory authorities, and others as required.

U.S. Treasury Obligations. Securities are shown at amortized cost which is the purchase price of securities less the amortized premium or plus the accreted discount. Such amortizations and accretions are computed on a daily basis from the date of acquisition to the date of maturity. Interest is also calculated on a daily basis and recorded monthly using the constant-yield method.

Deposit Insurance Assessments. The Corporation assesses insured banks at the rate of 1/12 of one percent per year on the bank's average deposit liability less certain exclusions and deductions. Assessments are due in advance for each six-month period and credited to income each month. Based on operational results, the Depository Institutions Deregulation and Monetary Control Act of 1980 authorizes up to 60 percent of the net assessment income to be transferred in the form of an assessment credit to insured banks each July 1 of the following calendar year. Additionally, the Act authorizes the FDIC Board of Directors to make adjustments to this percentage within certain limits in order to maintain the Deposit Insurance Fund between 1.25 and 1.40 percent of estimated insured deposits. If this ratio falls below 1.10 percent, the FDIC is mandated to reduce the percentage of net assessment income credited to a limit of 50 percent. If this ratio exceeds 1.40 percent, the FDIC is mandated to increase the percentage of net assessment income credited by such an amount as it determines will result in maintaining that ratio at not more than 1.40 percent.

Allowance for Loss. The Corporation records as a receivable the funds advanced to the FDIC Receiver for assisting and closing insured banks, and establishes an estimated allowance for loss shortly after the insured bank is assisted or closed. The allowance for loss represents the difference between the funds advanced and the expected repayment, based on the estimated cash recoveries from the assets of the assisted or failed bank, net of all liquidation costs. The Corporation does not state the estimated contingent liability for future bank failures because such estimates are impossible to make. The Corporation's liability for eventual net losses from assisting or closing banks depends upon factors which can not be assessed until after the bank is actually assisted or closed. The Corporation's entire Deposit Insurance Fund and borrowing authority are available for any assistance or closing activity.

Depreciation. The Washington Office Buildings are depreciated on a straight-line basis over a 50-year estimated life. The San Francisco Condominium Offices are depreciated on a straight-line basis over a 35-year estimated life. The cost of furniture, fixtures, and equipment is expensed at time of acquisition.

Income Maintenance Agreements. The Corporation records its liability under an income maintenance agreement at the present value of each estimated cash outlay at the time the agreement is accepted. Estimated cash outlays are anticipated future payments the Corporation will provide to offset the difference between the annualized cost of funds and the annualized return on the declining volume of earning assets acquired in a merger transaction, plus an amount to cover overhead costs. The charge is recorded to insurance loss. The present value of the liability is then accreted daily and recorded monthly over

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Income Maintenance Agreements (Continued).

the term of the agreement. Any differences between the estimated and actual cash outlays are recorded as payment adjustments. The present value of remaining estimated cash outlays is also reviewed and adjusted each year when interest rate changes occurring in the marketplace appear material or permanent in nature. The originally recorded loss, plus or minus any payment and present value adjustments, will then be prorated between insured banks and the Deposit Insurance Fund as provided in Section 7(d) of the Federal Deposit Insurance Act.

Reclassifications. Reclassifications have been made in the 1985 Financial Statements to conform to the presentation used in 1986.

2. U.S. Treasury Obligations:

All cash received by the Corporation which is not used to defray operating expenses or for outlays related to assistance to banks and liquidation activities is invested in U.S. Treasury securities. The Corporation's investment portfolio consists of the following (in thousands):

		December 31, 1986		December 31, 1985	
Maturity	Description	Book Value	Market Value	Book Value	Market Value
One Day	Special Treasury Certificates	$ 2,049,700	$ 2,049,700	$ 1,682,000	$ 1,682,000
Less Than 1 year	U.S.T. Bills, Notes and Bonds	3,283,654	3,370,283	3,215,419	3,253,159
1-3 years	U.S.T. Notes and Bonds	6,162,104	6,610,032	6,738,907	7,045,385
3-5 years	U.S.T. Notes and Bonds	5,107,501	5,409,786	4,205,543	4,473,698
		$16,602,959	$17,439,801	$15,841,869	$16,454,242

3. Certificates, Notes and Other Receivables from Insured Banks:

The Corporation's outstanding principal balances on certificates, notes and other receivables from insured banks are as follows (in thousands):

	December 31 1986	December 31 1985
Certificates:		
Net worth certificates	$129,809	$219,847
Allowance for losses	(74,503)	(136,996)
	55,306	82,851
Notes receivable to:		
Assist operating banks	27,000	27,000
Facilitate deposit assumptions	88,136	90,755
Facilitate merger agreements	401,648	389,648
	516,784	507,403
Other receivables:		
Special assistance	131,805	8,500
Allowance for losses	(41,805)	(8,500)
	90,000	-0-
	$662,090	$590,254

3. Certificates, Notes and Other Receivables from Insured Banks (Continued):

The net worth certificate program was established at the FDIC by authorization of the Garn-St Germain Depository Institutions Act of 1982. Under this program, the Corporation would purchase a qualified institution's net worth certificate and, in a non-cash exchange, the Corporation would issue its non-negotiable promissory note of equal value. The total assistance outstanding to qualified institutions as of December 31, 1986 and 1985 is $526,094,000 and $705,446,000 respectively. As of December 31, 1986 and 1985, the financial statements excluded $396,284,000 and $485,599,000 respectively of net worth certificates, for which no losses are expected because of the non-cash exchange nature of the transactions. The authority to issue new net worth certificates expired October 15, 1986.

4. Net Receivables from Assistance to Insured Banks:

On July 26, 1984, the FDIC, the Federal Reserve Board, the Comptroller of the Currency and a group of major U.S. banks agreed to provide a "permanent assistance program" to the Continental Illinois National Bank and Trust Company of Chicago ("CINB") and its parent, Continental Illinois Corporation. This program, which became effective on September 26, 1984, after Continental Illinois Corporation shareholder approval, replaced a temporary, emergency assistance package among the same parties that had been in effect since May 1984. Major elements of the new package included a financial assistance plan to remove problem loans from CINB and infuse new capital resources into CINB, the continuation of on-going lines of credit from the Federal Reserve Board and a group of major U.S. banks to alleviate liquidity pressures and the installation of a new management team. Additionally, the FDIC agreed to commit more capital or other forms of assistance if the permanent assistance program proves to be insufficient for any reason.

The key aspects of the permanent assistance program applicable to the FDIC are embodied in an Implementation Agreement and an Assistance Agreement between the FDIC and CINB, Continental Illinois Corporation, and Continental Illinois Holding Corporation, a new holding company formed to own all Continental Illinois Corporation stock as of the effective date for the purpose of implementing the FDIC Option. Discussed below are the major aspects of the FDIC's participation in the permanent assistance program and their effect on the FDIC financial statements.

The assets against which the FDIC is to recover its assistance to CINB are as follows (in thousands):

	December 31	
	1986	1985
Loans and related assets	$2,322,793	$2,126,894
Promissory note	459,994	927,948
Preferred stock investment	804,698	1,000,000
Allowance for losses	(1,732,794)	(1,342,000)
	$1,854,691	$2,712,842

Loans and related assets were selected by CINB with the restrictions that such loans were nonperforming, classified or otherwise of poor quality (i.e., "troubled loans"). Certain foreign loans were excluded from selection. On September 26, 1984, after consumation of the permanent assistance program, CINB transferred $2.0 billion of troubled loans to the FDIC. The unpaid legal principal value of these loans was approximately $3.7 billion.

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4. Net Receivables from Assistance to Insured Banks (Continued):

Also, on September 26, 1984, the FDIC received a promissory note from CINB for $1.5 billion. At CINB's option, the promissory note can be paid anytime within three years by transfer of additional troubled loans (subject to the above restrictions) at CINB's book value as of the date of transfer. Until such time as the promissory note is paid, interest will be charged. Through December 31, 1986, CINB transferred $1,040,006,000 of additional troubled loans to the FDIC as partial repayment on the original promissory note. As a result, the outstanding principal balance of the Note as of December 31, 1986, is $459,994,000.

These assets were, in part, funded by the assumption of $3.5 billion of indebtedness to the Federal Reserve Bank of Chicago (FRB) on behalf of CINB. These borrowings will bear interest at specified rates established by the FRB and the U.S. Treasury. The FDIC will repay these borrowings by making quarterly remittances of its collections, less expenses, on the troubled loans. If there is a shortfall at September 26, 1989, the FDIC will make up such deficiency with its own funds.

The Implementation Agreement provides for the FDIC to be reimbursed each quarter for its expenses related to administering the transferred loan portfolio and for interest paid on the indebtedness to the FRB which it assumed. Thus, such costs are recorded as assets. The FDIC and CINB have entered into a service agreement whereby CINB will administer the transferred loan portfolio on behalf of the FDIC. The FDIC is also permitted to establish a special reserve account from troubled loan collections. The balance in this account, if any, reverts to the FDIC in those quarters when loan collections have been insufficient to cover interest owing on the indebtedness which it assumed. For financial accounting purposes, cash collections received on the transferred loan portfolio (plus certain other amounts) are applied quarterly in accordance with the Implementation Agreement terms, as follows: 1) to the administrative expenses paid by the FDIC; 2) to the interest owing on the assumed indebtedness; 3) to fund the special reserve account such that this account plus accrued interest thereon is at least $75 million; and 4) to principal owing under the FRB Agreement. The FDIC is entitled to receive interest on the cumulative deficiencies between cash collections and the costs incurred in administering the troubled loans and the interest on the assumed debt. Further, CINB has assigned to the FDIC all its existing and future claims against any party which may be related to any loss incurred in connection with any transferred loan.

Total cash flow consists of the above collections of principal and interest on the transferred loan portfolio, interest payments on the CINB promissory note and interest earned on daily collections. For the year ending December 31, 1986, the FDIC received net cash flow totaling $498,880,000. Cash flow was applied to administrative costs and to interest expense of $23,795,000 and $204,466,000, respectively, and to payment of principal owing under the FDIC-FRB agreement amounting to $270,619,000.

Ultimate collection results on the transferred loan portfolio are subject to significant uncertainties because of the financially troubled nature of the borrowers and the effects of general economic conditions on their industries. As of December 31, 1986, the Corporation estimated an allowance for loss amounting to $1,732,794,000. This allowance represents the difference between the amount FDIC will pay the FRB and the collections on the loan portfolio after expenses.

The FDIC holds an option to acquire up to 40.3 million shares of Continental Illinois Corporation common stock. The shares subject to the option are owned by Continental Illinois Holding Corporation, which is owned by the former stockholders of Continental Illinois Corporation. The option cannot be exercised prior to the fifth anniversary of the commencement date, September 26, 1989. Further, the option is excercisable only if the FDIC suffers a loss (disregarding any profit or loss from the FDIC's interest in Continental Illinois Corporation preferred or common stock) on the transferred loan portfolio, including

4. Net Receivables from Assistance to Insured Banks (Continued):

unrecovered administrative costs and interest expense. If the FDIC suffers a loss, the FDIC will be entitled to retain any remaining transferred loans and to exercise the FDIC Option for one share of Continental Illinois Corporation common stock for every $20 of loss, at the exercise price of $0.00001 per share of common stock. Because of uncertainty, FDIC has not recorded a value for the FDIC Option. If the FDIC does not suffer any loss under the permanent assistance program, all remaining loans and other assets acquired will be returned to CINB and the option would not be exercisable.

The FDIC also purchased $1 billion of two non-voting, Continental Illinois Corporation, preferred stock issues. The proceeds of these issues were transferred to CINB in the form of a capital contribution. The Junior Perpetual Convertible Preference Stock, in the amount of $720 million, is convertible into 160 million shares of Continental Illinois Corporation common stock upon sale or transfer by the FDIC. Dividends are to be received on this preferred stock only to the extent that dividends are paid on the Continental Illinois Corporation common stock and are equivalent to that which would be paid on 160 million shares of common stock. The Adjustable Rate Preferred Stock, Class A, in the amount of $280 million, is a cumulative issue that is callable at the option of Continental Illinois Corporation. The issuer also has the option to pay dividends on this issue in the form of additional shares of this issue or cash until the third anniversary of their original issue date.

In December, 1986, the FDIC sold 10.5 million shares of Junior Perpetual Convertible Preference Stock (52.5 million shares of common stock) to an underwriting syndicate for proceeds of $259,350,000. During 1986 the Corporation received $2,150,000 in cash dividends on the Junior Perpetual Convertible Preference Stock and $27,481,000 in cash dividends on the Adjustable Rate Preferred Stock, Class A.

5. Net Receivables from Failures of Insured Banks:

Net Receivables from failures of insured banks are as follows (in thousands):

	December 31	
	1986	1985
Depositors' claims paid	$1,829,709	$1,069,553
Depositors' claims unpaid	24,269	11,136
Assumption Transactions in a fiduciary capacity	5,637,058	3,836,002
Assets purchased in a corporate capacity	568,308	450,719
	8,059,344	5,367,410
Allowance for losses	(5,368,502)	(3,008,856)
	$2,690,842	$2,358,554

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5. Net Receivables from Failures of Insured Banks (Continued):

An analysis of the changes in the allowance for losses by account groups is as follows (in thousands):

	Depositor's claims paid	Assumption transactions in a: Fiduciary capacity	Corporate capacity	Total
1986				
Balance, January 1	$465,887	$2,154,103	$388,866	$3,008,856
Provision for insurance losses	509,261	1,851,150	(765)	2,359,646
Write-off at termination	-0-	-0-	-0-	-0-
Balance, December 31	$975,148	$4,005,253	$388,101	$5,368,502
1985				
Balance, January 1	$158,057	$1,537,398	$364,681	$2,060,136
Provision for insurance losses	307,830	617,213	24,185	949,228
Write-off at termination	-0-	(508)	-0-	(508)
Balance, December 31	$465,887	$2,154,103	$388,866	$3,008,856

6. Property and Buildings:

Property and buildings consist of (in thousands):

	December 31 1986	1985
Land	$ 4,680	$ 4,014
Office buildings	54,068	49,603
Accumulated depreciation	(7,738)	(6,453)
	$51,010	$47,164

The Corporation's 1776 F Street property is subject to notes payable totaling $6,314,000 and $9,491,000 at December 31, 1986 and 1985, respectively.

7. Liabilities Incurred in Assistance to Insured Banks:

The Corporation's outstanding principal balances on liabilities incurred in assistance to insured banks are as follows (in thousands):

	December 31 1986	1985
Federal indebtedness	$2,904,299	$3,222,905
Promissory (exchange) notes	129,809	219,847
	$3,034,108	$3,442,752

Maturities of long-term debt for each of the next five years and thereafter:

1987	1988	1989	1990	1991	1992/Thereafter
$ -0-	$ -0-	$2,937,609	$31,974	$33,281	$31,244

8. Liabilities Incurred from Failures of Insured Banks:

The Corporation's outstanding principal balances on liabilities incurred from failures of insured banks are as follows (in thousands):

	December 31 1986	1985
Federal indebtedness	$ -0-	$306,083
Notes payable	822,973	157,196
Income maintenance agreements	-0-	103,952
Depositor's claims unpaid	24,269	11,136
	$847,242	$578,367

Maturities of long-term debt for each of the next five years and thereafter:

1987	1988	1989	1990	1991	1992/Thereafter
$692,251	$5,592	$6,128	$6,722	$7,586	$104,694

Depositor's claims unpaid ($24,269) are current in nature and are not considered long-term debt.

9. Estimated Losses From Corporation Litigation:

The Corporation is involved in both its receivership and corporate capacity in numerous law suits. The merits of each case and the expected outcome have been evaluated by the Corporation's General Counsel, and, where appropriate, a contingent loss has been established. This estimated loss was $242 million in 1986. Of that amount, a $236 million legal reserve was included in the allowance for loss relating to assets acquired from assistance to an insured bank and from failed banks. The remaining $6 million is included on the financial statements as estimated losses from corporation litigation.

10. Merger Assistance Losses and Expenses: The Corporation's merger assistance losses and expenses represent (1) the original income maintenance agreement losses recorded at present value and any adjustments resulting from interest rate changes occuring in the marketplace and (2) outright assistance to merged insured banks. These amounts were $(86) million and $199 million in 1986 and 1985 respectively.

11. Provision for Insurance Losses:

An analysis of the provision for insurance losses is as follows (in thousands):

	December 31 1986	1985
Provision for insurance losses		
Net worth certificates		
Current year provision	$ -0-	$ -0-
Prior year adjustments	(62,493)	(45,985)
	(62,493)	(45,985)
Special assistance		
Current year provision	191,805	8,500
Prior year adjustments	-0-	-0-
Termination adjustments	(5,000)	-0-
	186,805	8,500
Net receivables from assistance to insured banks		
Current year provision	-0-	642,000
Prior year adjustments	390,794	-0-
	390,794	642,000
Net receivables from failures of insured banks		
Current year provision	1,854,632	433,394
Prior year adjustments	505,014	515,834
Termination adjustments	-0-	909
	2,359,646	950,137
Corporation litigations		
Current year provision	470	14,340
Prior year adjustments	(2,559)	-0-
Termination adjustments	(4,003)	-0-
	(6,092)	14,340
	$2,868,660	$1,568,992

12. Nonrecoverable Insurance Expenses:

The Corporation's nonrecoverable insurance expenses primarily represent costs associated with (1) preparing and executing the activity in payoff cases and (2) administering and liquidating the assets purchased in a corporate capacity.

13. Assessment Credits Due Insured Banks:

Contingent upon a legislatively specified ratio of the Corporation's Deposit Insurance Fund to estimated insured bank deposits, the Corporation credits a legislatively authorized percentage (currently 60 percent) of its net assessment income to insured banks. This credit is distributed, pro-rata, to each insured bank as a reduction of the following year's assessment. Net assessment income is determined by gross assessments less administrative operating expenses and expenses and losses related to insurance operations. Certain income, expense, and credit amounts do not correspond to amounts reported on the financial statements because of adjustments to prior years' assessment credits not affecting the 1986 and 1985 assessment credit computational amounts.

The Garn-St Germain Depository Institutions Act of 1982 amended Section 7(d)(1) of the Federal Deposit Insurance Act and authorized the Corporation to include certain lending costs in the computation of the net assessment income. The lending costs are the amounts by which the amount of interest earned on each loan made by the Corporation under Section 13 of the Federal Deposit Insurance Act after January 1, 1982, is less than the amount of interest the Corporation would have earned for the calendar year if interest had been paid on the loans at a rate equal to the average current value of funds to the U.S. Treasury for the calendar year.

The computation of net assessment income credits for calendar year 1986 and 1985 are as follows (in thousands):

Net Assessment Income Credit Computation - Calendar Year 1986

Computation:		
Gross assessment income - C.Y. 1986		$1,578,200
Less: Carry-over of net expenses and losses from C.Y. 1985	$1,113,954	
Administrative operating expenses	180,267	
Merger assistance losses and expenses less amortization and accretion	(99,746)	
Provision for insurance losses	2,867,960	
Nonrecoverable insurance expenses	36,783	
Lending costs	3,061	4,102,279
Excess of losses and expenses over gross assessment income		2,524,079
Assessment credit adjustment - prior years		65,280
Net excess of losses and expenses over gross assessment income - C.Y. 1986		$2,589,359

13. Assessment Credits Due Insured Banks (Continued):

Net Assessment Income Credit Computation - Calendar Year 1985

Computation:		
Gross assessment income - C.Y. 1985		$1,432,381
Less: Carry-over of net expenses and losses from C.Y. 1984	$ 599,601	
Administrative operating expenses	179,209	
Merger assistance losses and expenses less amortization and accretion.	194,700	
Provision for insurance losses	1,568,385	
Nonrecoverable insurance expenses	4,956	
Lending costs	145	2,546,996
Excess of losses and expenses over gross assessment income		1,114,615
Assessment credit adjustment - prior years		(661)
Net excess of losses and expenses over gross assessment income - C.Y. 1985		$1,113,954

14. Lease Commitments:

Rent for office premises charged to administrative operating and liquidation overhead expenses were $27,914,000 (1986) and $22,605,000 (1985). Minimum rentals for each of the next five years and for subsequent years thereafter are as follows (in thousands):

1987	1988	1989	1990	1991	1992/Thereafter
$26,278	$17,693	$12,031	$10,737	$10,480	$46,319

Most office premise lease agreements provide for increase in basic rentals resulting from increased property taxes and maintenance expense.

15. Pension Plan and Accrued Annual Leave:

All of the Corporation's permanent employees are covered by the Civil Service Retirement System. Total Corporation (employer) matching contributions to the Civil Service Retirement System for all permanent employees were approximately $9,662,000 and $8,356,000 for the calendar years ending December 31, 1986 and 1985, respectively.

Although the Corporation funds a portion of pension benefits under the Civil Service Retirement System relating to its permanent employees and makes the necessary payroll withholdings from them, the Corporation does not account for the assets of the Civil Service Retirement System nor does it have actuarial data with respect to accumulated plan benefits or the unfunded liability relative to its permanent employees. These amounts are reported by the Office of Personnel Management (OPM) for the Retirement System and are not allocated to the individual employers. The OPM also accounts for all health and life insurance programs for retired Corporation permanent employees.

The Corporation's liability to employees for accrued annual leave is approximately $10,445,000 and $8,571,000 at December 31, 1986 and 1985, respectively.

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16. Commitments and Contingencies:

The Corporation insures total deposits of about $1.6 trillion in over 14,000 insured commercial banks. The Corporation does not estimate the contingent liability for either the potential assistance to insured banks that the regulatory process has identified as distressed or other insured banks that are financially weak but have not yet been identified by the regulatory process. Rather, as described in Note 1, Allowance for Loss, the Corporation does establish an allowance for loss when assistance is granted or a bank is closed. The allowance for loss on the financial statements includes all banks which were assisted or failed through 1986. The Corporation believes that it is impossible to estimate a contingent liability with any reasonable certainty. The Corporation's entire Deposit Insurance Fund and borrowing authority are available for any assistance or closing activity.

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