

**DOCUMENT RESUME**

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**Supervision of Banks by the Federal Deposit Insurance Corporation Can Be More Efficient.** FOD-77-8; B-114831. December 22, 1977. 34 pp. + 3 appendices (22 pp.).

**Report to the Congress; by Elmer B. Staats, Comptroller General.**

**Issue Area:** Accounting and Financial Reporting (2800).

**Contact:** Field Operations Div.

**Budget Function:** Commerce and Transportation: Other Advancement and Regulation of Commerce (403).

**Organization Concerned:** Federal Deposit Insurance Corp.; General Accounting Office.

**Congressional Relevance:** Congress.

**Authority:** Banking Act of 1933.

As a result of a Congressional request that GAO review the supervisory activities of the three Federal bank regulatory agencies, GAO was granted unrestricted access to bank examination reports and related records. The Federal Deposit Insurance Corporation (FDIC) maintains public confidence in the Nation's banking system by protecting depositors and encouraging sound banking, primarily through deposit insurance and bank supervision. **Findings/Conclusions:** The deposit insurance fund presently exceeds \$7 billion and is available to meet future losses resulting from bank failures. The insurance fund is adequate to meet potential losses that might result from problem conditions known to exist in specific insured banks at the end of 1976. The financial statements in the report present fairly the financial position of FDIC as of December 31, 1975 and December 31, 1976, and the results of its operations and changes in financial position for the years then ended.

**Recommendations:** The Chairman of the FDIC should: require periodic internal audits of its Division of Bank Supervision which is responsible for the examination and supervision of banks; develop more definitive criteria for classifying those banks not appearing on the problem bank list; require more complete documentation of the decisionmaking process for classifying banks; and initiate discussions of some additional common problem areas with the other supervisory agencies. (Author/SC)

# REPORT TO THE CONGRESS

BY THE COMPTROLLER GENERAL  
OF THE UNITED STATES

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## Supervision Of Banks By The Federal Deposit Insurance Corporation Can Be More Efficient

In 1975 GAO was granted unrestricted access to bank examination reports and related records. As a result, GAO reviewed the bank supervisory process.

The Corporation continues to be an effective bank supervisor, but could be more efficient. GAO recommends that the Chairman, Federal Deposit Insurance Corporation,

- require periodic internal audits of its Division of Bank Supervision,

- develop more definitive criteria for classifying those banks in the various problem categories,

- require more complete documentation of the decisionmaking process for classifying banks, and

- initiate discussions of some additional common problem areas with the other supervisory agencies.

In GAO's opinion, the Corporation's financial statements present fairly its financial position and the results of its operation.

No. 1 of 1

## APPROVAL FOR DISTRIBUTION OF REPORT

TITLE OF REPORT: SUPERVISION OF BANKS by the FEDERAL DEPOSIT  
Insurance Corporation CAN BE MORE EFFICIENT  
~~The 1976 Audit of the FDIC Includes Review of Bank Supervisory Process~~

REQUISITION NUMBER

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## TITLE OF REPORT

The 1976 Audit of the Federal Deposit Insurance Corporation Includes Review of  
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	Attention: Ms. Ann Leshar, Room 5241 Dirksen Senate Office Building				
1	The Honorable Thomas J. McIntyre, Chairman, Subcommittee on Financial Institutions, United States Senate		X		
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COMPTROLLER GENERAL OF THE UNITED STATES  
WASHINGTON, D.C. 20548

R-114831

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

This report summarizes the results of our 1976 audit of the Federal Deposit Insurance Corporation. It is the first report to the Congress since we changed our audit from a fiscal year to a calendar year basis. For the first time, we have reviewed the Corporation's bank supervisory process, and the results of that review are also included in the report.

We made our examination pursuant to section 17(c) of the Federal Deposit Insurance Act (12 U.S.C. 1827).

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.

A handwritten signature in black ink, which appears to read "Thomas B. Atkins". The signature is written in a cursive, flowing style.

Comptroller General  
of the United States

COMPTROLLER GENERAL'S  
REPORT TO THE CONGRESS

SUPERVISION OF BANKS BY THE  
FEDERAL DEPOSIT INSURANCE  
CORPORATION CAN BE MORE  
EFFICIENT

D I G E S T

Since 1964 the Corporation has not permitted GAO access to examination reports and related records prepared on insured banks. In 1976 the Congress requested GAO to review the supervisory activities of the three Federal bank regulatory agencies. Accordingly, the agencies permitted GAO access to their bank examination and supervisory records, with the understanding that GAO would not disclose any information about specific banks, bank officers, or bank customers. GAO's report to the Congress was issued on January 31, 1977.

During the audit of the Corporation's 1976 financial statements, both the Corporation and the Comptroller of the Currency continued to grant access to these documents, thereby enabling GAO to discharge fully its audit responsibilities with regard to the Corporation's 1975 and 1976 financial statements. However, unless the Federal Reserve System adopts a position similar to that of the Corporation and the Comptroller, GAO will be unable to fulfill its responsibilities on future audits. (See p. 14.)

The Corporation maintains public confidence in the Nation's banking system by protecting depositors and encouraging sound banking. The Corporation fulfills its mission primarily through deposit insurance and bank supervision.

The deposit insurance fund presently exceeds \$7 billion and is available to meet future losses resulting from bank failures. GAO believes the insurance fund is adequate to meet potential losses

that might result from problem conditions known to exist in specific insured banks at the end of 1976. (See p. 4.)

The Corporation's Division of Bank Supervision is responsible for the examination and supervision of banks. GAO believes there is an opportunity to make the Division more efficient. GAO's review disclosed that:

- The Division is the largest organizational component with nearly 70 percent of the Corporation's resources in 1976. However, no internal audits have been conducted of its supervisory activities. (See p. 5.)
- The Division's problem bank list is an adequate tool for communicating to higher management information on those banks whose problems might financially affect the deposit insurance fund. However, there are other banks that are not reported that require more than the usual attention or require aggressive supervision. (See pp. 6 and 7.)
- The Division does not always document its decisionmaking process when classifying banks as problem or nonproblem. The lack of documentation is more serious when classifying those banks requiring aggressive supervision that are not placed on its problem bank list. (See pp. 7 to 10.)
- The Corporation, the Comptroller of the Currency, and the Federal Reserve have established the Interagency Supervisory Committee to improve the supervisory process and to resolve common problems. Although the Committee is considering several areas for study, GAO believes there are additional areas that should be addressed by the Committee, including (1) establishing uniform criteria for identifying problem banks, (2) monitoring individual problem banks, and (3) standardizing bank examination reports. (See pp. 11 and 12.)



In order for the Corporation to be a more efficient bank supervisor, GAO recommends that the Chairman, Federal Deposit Insurance Corporation,

- require periodic internal audits of its Division of Bank Supervision,
- develop more definitive criteria for classifying those banks not appearing on the problem bank list,
- require more complete documentation of the decisionmaking process for classifying banks, and
- initiate discussions of some additional common problem areas with the other supervisory agencies.

In GAO's opinion, the financial statements in this report present fairly the financial position of the Corporation as of December 31, 1976 and 1975, and the results of its operations and changes in financial position for the years then ended, in conformity with the principles and standards of accounting prescribed by the Comptroller General of the United States. (See p. 21.)

The Corporation generally agreed with GAO's recommendations. However, Corporation officials said the Division of Bank Supervision is studied almost constantly by the Board of Directors, the Chairman, and various internal study groups. GAO did not intend to imply otherwise. But, management reviews and reviews by an internal audit group can be and usually are different. An internal audit group usually focuses on a component's efficiency and effectiveness; management, on a wide variety of topics not necessarily related to performance.

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## CHAPTER 1

### INTRODUCTION

The Banking Act of 1933 created the Federal Deposit Insurance Corporation to provide stability to the Nation's banking system by protecting both private and public depositors against losses resulting from bank failures.

The Corporation insures deposits in qualified banks up to \$40,000 for each private depositor and \$100,000 for individual deposit accounts of Federal, State, and local governments. National banks chartered by the Comptroller of the Currency and State chartered banks belonging to the Federal Reserve System are automatically insured for the same limits. Other State chartered banks receive deposit insurance once the Corporation approves their application.

In carrying out its mission, the Corporation is granted power to:

- Supervise State nonmember insured banks through surveillance, examination, and enforcement activities and, indirectly, to supervise State member and national banks, primarily through surveillance.
- Serve as receiver and liquidator of closed insured banks.
- Purchase assets from, make deposits in, or extend loans to insured banks which have closed or are in danger of closing.
- Terminate a bank's deposit insurance program.
- Organize deposit insurance national banks to provide limited banking services in communities where banks have failed.
- Make loans, purchase assets, or issue a guarantee to facilitate the takeover of a failed or failing insured bank by another insured bank.

The Corporation is directed by a three-member Board of Directors. The Comptroller of the Currency serves on the Board ex officio; whereas, the other two members are appointed by the President with the advice and consent of the Senate. The directors responsible for the activities discussed in this report are listed in appendix I.

## RESERVE AND BORROWING AUTHORITY

The Corporation does not receive funds appropriated by the Congress, nor is its budget subject to congressional approval. Its operations are financed by assessing insured banks and by investing its reserves in U.S. Government obligations.

The deposit insurance fund represents the accumulated net income since the beginning of the deposit insurance program in 1933. The fund is the Corporation's basic resource for protecting depositors. Additionally, the Corporation can borrow up to \$3 billion from the U.S. Treasury if additional funds are needed. The Corporation has never exercised this borrowing authority.

The deposit insurance fund is available to meet future losses. Its balance of \$7.3 billion represents about 1 percent of the estimated insured deposits of \$628 billion in 14,823 banks at December 31, 1976. The Corporation's financial statements do not show an estimate of the liability which may occur from future failures of insured banks. Its policy is to recognize losses resulting from bank failures in the period in which the closings occur.

## SUPERVISION AND EXAMINATION OF INSURED BANKS

The Corporation, through its Division of Bank Supervision, supervises and regularly examines insured State banks that are not members of the Federal Reserve System. For calendar year 1976, the Corporation examined 7,818 of the 8,668 insured nonmember banks.

The Comptroller of the Currency and the 12 Federal Reserve banks supervise and examine national banks and State member banks, respectively. Since the Corporation has limited authority to examine national and Federal Reserve banks for insurance purposes, it relies on examinations performed by the other two Federal bank regulatory agencies.

However, the Corporation has access to and systematically reviews the other agencies' examination reports. During 1976 it reviewed 2,182 of the 4,711 reports prepared on national banks and 477 reports prepared on 98 State member banks.

In 1974 the Corporation entered into an agreement with three States to examine nonmember banks. This experimental program ended in 1976 and its results were:

- Georgia and the Corporation agreed to examine in alternating years a large portion of nonproblem banks. Each organization would independently examine banks requiring special supervisory attention and also banks with deposits exceeding \$100 million.
- Iowa and Washington discontinued the program. The Corporation, however, is discussing plans similar to Georgia's with Washington and other States.

In November 1976, the Corporation adopted a new policy concerning priorities, frequency, and scope of examination. Basically, nonmember banks with known supervisory or financial problems would be fully examined at least once every 12 months. Other nonmember banks will be examined, depending on their asset size, either on a modified or full-scale basis once every 18 months with no more than 24 months between examinations. Under the modified approach, examiners emphasize management policies and performance, asset quality, capital adequacy, liquidity, and compliance with laws and regulations.

The Corporation believes this new bank examination approach will provide a more effective utilization of its resources.

## CHAPTER 2

### AVAILABLE OPPORTUNITIES FOR MORE

#### EFFICIENT BANK SUPERVISION

The Corporation is chartered to maintain public confidence in the Nation's banking system by protecting depositors and encouraging sound banking. This has become increasingly important because:

- The Congress and the public have expressed concern about the soundness of the banking system.
- For the first time in many years an increasing number of insured banks have closed.
- The Corporation's supervisory list of problem banks has grown and now includes some large banks.

The Corporation fulfills its mission primarily through deposit insurance and bank supervision. Deposit insurance originated when the Corporation was created in 1934. The deposit insurance fund, which is available to protect depositors, exceeded \$7 billion in 1976.

From 1934 through 1976, 543 insured banks have closed because of financial difficulties. While these bank failures have raised concern, they have had little effect on the insurance fund. For example, 16 insured banks closed during 1976, the highest number in 34 years. Yet the insurance fund increased \$553 million that year even after considering loss reserves for the bank failures. According to the Corporation, for banks that failed since 1934, over 99 percent of all depositors have been paid in full or have had their funds made available to them.

We believe the deposit insurance fund is financially sound and adequate to meet potential losses that might result from problem conditions known to exist in specific insured banks at the end of 1976. Whether the insurance fund would be adequate during future periods depends on economic conditions and, therefore, is currently undeterminable.

The Division of Bank Supervision is responsible for the Corporation's supervisory process. The Division's main emphasis is the effective surveillance and supervision of those banks presenting either supervisory or financial problems. Because of the recent concern surrounding

the Nation's banking system, the Corporation's Board of Directors more than ever needs to be assured of the effectiveness with which the Division carries out its bank examination and supervisory functions. We believe there are opportunities for the Corporation to make the Division a more efficient bank supervisor. These include:

- Conducting internal audits of the Division's activities.
- Increasing management's awareness of banks not on the problem list that require aggressive supervision.
- Defining additional problems for coordination with the other bank supervisory agencies.

#### A NEED TO CONDUCT INTERNAL AUDITS OF THE DIVISION'S ACTIVITIES

The Congress has long recognized internal auditing as an important and useful management tool. The internal audit function can provide a highly valuable service to the Corporation by reviewing, appraising, and reporting on the extent and nature of internal compliance with management policies, plans, and procedures, as well as with applicable local and external regulatory requirements.

In order to improve their controls, in July 1975 the Corporation established the Office of Corporate Audits as a separate and independent operation reporting directly to the Chairman and the Board of Directors. The Office is required to conduct reviews of all financial and operational activities and to report its results and recommendations to senior management.

The Division of Bank Supervision is the largest organizational component both in terms of personnel and financial resources. In 1976 it accounted for nearly 70 percent of the Corporation's total budgeted resources. However, since it was established, the Office of Corporate Audits has not reviewed any activity within the Division of Bank Supervision. Yet in the past 2 years it has issued over 30 reports on other corporate activities.

According to agency officials, there existed an informal policy not to audit the Division's activities. They said, however, that the present policy does permit audits to be conducted.



## Conclusions and recommendations

The Division of Bank Supervision is the Corporation's largest organizational unit; however, there have not been any internal audits of its operations. Accordingly, we recommend that the Chairman, Federal Deposit Insurance Corporation, require periodic internal audits of the Division's activities. These audits will enable the Board of Directors to determine more fully how effectively the Division carries out its policies, procedures, and regulations.

## Agency comments

In commenting on this report, the Chairman stated that he was not aware of any informal policy which precluded the Division's being audited. He added that the Division may be the most studied group in the Corporation.

Regardless of whether an informal policy not to audit the Division existed, the Office of Corporate Audits has never reviewed Division activities. We did not intend to imply that the Division is not reviewed by management; but an internal audit group usually reviews a component's efficiency and effectiveness, while management reviews a wide variety of topics not necessarily related to performance.

## A NEED TO INCREASE MANAGEMENT'S AWARENESS OF BANKS NOT ON THE PROBLEM LIST THAT REQUIRE AGGRESSIVE SUPERVISION

The problem bank list is one of the principal tools the Division of Bank Supervision uses to inform the Board of Directors and senior management of those banks having problems that could affect the deposit insurance fund. Problem banks, according to the severity of their problems and financial threat to the insurance fund, are classified as serious problem-potential payoff, serious-problem, or other-problem. By definition, the first two categories clearly indicate financial involvement of the fund. Banks designated as other-problem are those in situations indicating significant weakness but having a lesser degree of vulnerability; however, these banks require more than ordinary concern and aggressive supervision. Banks classified as other-problem banks comprised about 70 percent of all problem bank designations in 1976.

The problem bank list, however, seems to place emphasis only on the financial risk to the insurance fund. There are other banks that, in the judgment of the Division,, require more than the usual attention or need aggressive supervision to prevent them from becoming a serious financial risk. Although not officially sanctioned or reported, the Division's regional offices maintain, for their own internal use, lists of nonproblem banks requiring aggressive supervision.

We believe these "near problem bank situations," or borderline cases, are almost identical to those the Division officially designates as other-problem banks. Based on our review, we found it difficult to differentiate between these banks and those formally designated other-problem. In our opinion, these banks pose some degree of financial risk to the insurance fund.

In classifying a bank as a problem or nonproblem, the Division conducts a review, at the Washington level, of all bank examination reports. Since no definitive criteria exist, the review examiners' decisions are based primarily on bank examination data, computer analysis, and personal experience.

The Computer analysis is based on 14 weighted variables which are representative of the most common deficiencies found in problem banks. Based on current examination data, all insured banks are screened for these deficiencies. Review examiners should analyze banks having such deficiencies and consider the significance of the deficiencies.

We randomly selected, on a nonstatistical basis, 75 banks that met at least 1 of the 14 deficiencies commonly found in problem banks. Of these banks, the Division classified 10 banks as problem and 65 banks as nonproblem..

From the nonproblem banks, we identified 18 near-problem bank situations. These banks had similar or as many problem characteristics as banks formally designated as other-problem and reported on the problem bank list. For example:

--Examiners rated bank management as unsatisfactory in nine cases.

--Three banks had low net capital and reserve positions based on established criteria.

--Eight banks had extremely low or negative earnings.

--Together the banks exhibited 46 additional problems, such as classified assets, overdue loans, and credit concentration.

A further review of the 65 banks showed each had some deficiencies. More importantly, five of these banks had similar and as many deficiencies as half of the above-mentioned problem banks.

Division officials have informed us that classifying problem banks is very subjective and difficult. Each bank must be treated on a case-by-case basis.

We recognize that bank classification cannot be fully objective. However, in our opinion, the Division should require the review examiner to document the reasons identified deficiencies do not warrant classifying the bank on the problem bank list. This would make the reviews more objective and reduce the number of subjective decisions now being made. For the 65 banks discussed above, the examiners could have improved documenting their decisionmaking process. The following case demonstrates the decisionmaking process. The case is typical of near-problem bank situations.

#### Case study

This bank had total assets of about \$7 million, and the examination report was dated July 1976. There were two supervisory levels of review.

#### Regional review

The regional office in its examination report rated management unsatisfactory and cited the following problems:

--Classified loans have doubled since the previous examination and now comprise 24 percent of the loan portfolio.

--Capital is deficient or inadequate due to excessive loan losses and remuneration.

--Earnings are mediocre.

--Insider loans are excessive at 90 percent of invested capital.

--Credit concentration is excessive and includes loans to owners, directors, and an affiliate.

--Excessive violation of laws persists.

--Lack of audit, uninvested cash, reciprocal accounts with an affiliate, internal control deficiencies, and other matters also deserve criticism.

Furthermore, the regional review indicated that, although the extent of deterioration possibly warranted a more severe classification, the borderline designation was assigned. Closer supervision will be accorded through more frequent examinations and 60-day progress reports.

#### Washington review:

The review examiner added that a loan to one insider is classified as substandard and the majority of loans as doubtful. The bank holds a Federal loan guarantee on the doubtful portion; however, the field examiner says loose servicing of the loan could jeopardize the guarantee. If the guarantee can be kept intact, exposure is minimal. At this time, regional supervision is sufficient. Loans include funds sold to other banks, and affiliations with two banks continue.

The computer analysis described the following deficiencies:

--Management is unsatisfactory.

--Net capital and reserves to adjusted gross assets is zero.

--Total classified assets is 102 percent of capital and reserves.

--Concentrations of credit exceed total capital and reserves.

--Credit to directors, officers, and affiliates was 120 percent of total capital and reserves.

The review examiner included four of the above deficiencies in his analysis of the examination report.

### Our comments

In summary, the Division classified the bank as non-problem. However, the problems identified in this bank were similar to those of banks appearing on the problem bank list. The review examiner did not explain the offsetting factors for the cited deficiencies that would justify classifying this as a nonproblem bank.

### Conclusions and recommendations

The problem bank list is an adequate tool for communicating to higher management those banks whose problems might financially affect the deposit insurance fund. The list could become more effective if additional definitive criteria were established for classifying banks as to their type of problem. Problem bank designations could also be more effective if documentation of the decisionmaking process were improved.

We recommend that the Chairman, Federal Deposit Insurance Corporation, improve the problem bank list report by:

- Developing more definitive criteria for classifying those banks in the various problem categories.
- Requiring bank review examiners to document more completely their reasons for classifying a bank as nonproblem.

### Agency comments

The Chairman, in responding to our recommendations, stated that the criticisms contained in the report do not develop any particular deficiency in the supervision conducted by his examiners and Division Directors. Rather, the criticism is leveled more at the partial absence of statistics and documentation associated with problem banks. He concluded that these matters are essentially administrative in nature and will continue to receive their full attention. (For the Agency's full response see app. III.)

Bank examinations by the Corporation have been very subjective and thus it is difficult to ascertain how effective they have been. Our recommendations that examiners document more fully their analysis will make examinations more complete and objective. Once this has been accomplished, it can then be determined how effective Corporation examinations are.

A NEED TO COORDINATE THE RESOLUTION  
OF ADDITIONAL PROBLEMS WITH THE  
OTHER SUPERVISORY AGENCIES

Our January 31, 1977, report, "Federal Supervision of State and National Banks" (OCG-77-1), noted a potential for better cooperation between the Corporation, the Comptroller of the Currency, and the Federal Reserve to improve the effectiveness of bank supervision. To achieve this cooperation, we suggested establishing a permanent interagency working group at the operational level.

In February 1977 the three agencies, together with the Federal Home Loan Bank Board, formed the Interagency Supervisory Committee. Its members are at the directorate level, responsible for supervising insured Federal and State financial institutions. The Committee's main purpose is to establish a more formal framework among the agencies to improve the supervisory process and to resolve common problems.

As of June 3, 1977, the Committee had met on four occasions. The most significant topics receiving consideration were bank monitoring systems, a uniform approach to nonaccrual loans, a uniform agency rating system for banks, a uniform treatment of concentrations of credit, uniform consumer examination procedures, a training and compliance manual, a uniform trust department rating system, and shared national credits.

The establishment of this committee was a significant step toward a closer relationship among the three bank regulatory agencies. Interagency cooperation and coordination would also be beneficial in:

- Establishing uniform criteria for identifying problem banks. Comparisons in our bank supervision study indicated a wide disparity between the Corporation and the Comptroller of the Currency in designating national banks as problem banks. For instance, the Comptroller identified 85 national banks as problems whereas the Corporation identified only 32 of these as problems. In addition, the Corporation classified 20 national banks as problems that the Comptroller did not. Furthermore, using its own criteria, the Federal Reserve System would have designated 267 national banks as problems.

- Monitoring individual problem banks. Since national and State member banks are insured, problem designations for these banks could financially affect the Corporation's deposit insurance fund. The Corporation systematically reviews all examination reports for national and State member banks and notifies the agencies of those banks it has classified as problems. It also furnishes the agencies with quarterly problem bank lists; however, it receives only the Federal Reserve list and not the Comptroller's. Generally, the Corporation does not suggest what enforcement action should be taken or whether the responsible agency's enforcement action is adequate.
- Standardizing of bank examination reports. The Comptroller recently changed its examination report format. This has created problems for the Corporation when it desires information from the reports. It seems the agencies could work more closely together when making these types of changes in order to facilitate the exchange of data among them.

#### Conclusions and recommendations

The Corporation is to be commended for initiating action that led to establishing the Interagency Supervisory Committee. We believe the Corporation can become more effective if the common problems identified above are considered. Accordingly, we recommend that the Chairman, Federal Deposit Insurance Corporation, initiate discussions of these areas with the Interagency Supervisory Committee as soon as possible.

CHAPTER 3  
THE CORPORATION ALLOWS  
ACCESS TO ITS RECORDS

Since 1964 we have qualified our opinion on the financial statements because the Corporation restricted access to examination reports and related records prepared on insured banks. The Corporation had long disputed our access authority to these records because it believed the basic concept of confidentiality of bank data was in the public interest and essential to the proper supervision of banks and to the effective functioning of the deposit insurance program. We believed these records were necessary to evaluate the Corporation's financial operations and condition.

National banks and State member banks are insured by the Corporation but are examined by the Comptroller of the Currency and the Federal Reserve System. The Corporation cannot release its records unless approval is obtained from the two agencies.

Without unrestricted access to bank examination reports and related records, we were unable to determine (1) whether bank examinations were of sufficient scope and reliability to identify all banks that should be classified as problem banks, (2) whether the Corporation took effective followup action on bank examiners' findings, and (3) the significance of any possible adverse effects of problem banks on the Corporation's financial position.

In 1976 steps were taken to resolve the dispute. The Congress requested that we review the supervisory activities of the three Federal bank regulatory agencies. During the review all three agencies granted access to their bank examination records, provided we did not disclose any information about specific banks, bank officers, or bank customers. A spirit of cooperation existed during the review and our handling of sensitive bank examination reports received favorable comments from the regulatory agencies.

This cooperation carried forward to our 1976 audit of the Corporation's financial statements. On January 26, 1977, the Corporation's Chairman granted us unrestricted access to its records for our next three annual audits. This access specifically includes examination reports and records of open and operating State nonmember banks, with disclosure conditions similar to our previous agreement.



## EFFORT TO OBTAIN OTHER AGENCIES' RECORDS

The Corporation, however, does not have the authority to release examination data of national and State member banks. Therefore, it was requested that the Comptroller of the Currency and the Federal Reserve Board consider granting us access to their records. On May 20, 1977, the Comptroller of the Currency authorized the Corporation to provide us with examination reports of national banks for our annual audits. Formal response from the Federal Reserve Board had not been received as of August 1977; however, the Corporation indicated informally that this response would not be favorable.

The cooperation of the Corporation and the Comptroller of the Currency in attempting to administratively settle the access-to-records problem is a significant step toward resolving our longstanding dispute. However, unless the Federal Reserve System adopts a position similar to that of the Corporation and the Comptroller, we will be unable to fulfill our responsibilities on future audits.

## CHAPTER 4

### PROBLEM BANKS AND BANK FAILURES

#### PROBLEM BANKS

The financial condition of banks is monitored through the Corporation's bank examiners and the examination reports prepared by examiners of the 12 Federal Reserve banks and the Comptroller of the Currency. The following is the Corporation's comparison of problem banks and estimated insured deposits of the banks for December 31, 1976 and 1975.

	<u>Number of banks</u>		<u>Estimated insured deposits</u>	
	<u>1976</u>	<u>1975</u>	<u>1976</u>	<u>1975</u>
			(000 omitted)	
All problem banks:				
Serious problem--				
PPO (note a)	24	28	\$ 394,355	\$ 419,813
Serious problem	91	88	4,960,192	2,874,953
Other problem	<u>264</u>	<u>233</u>	<u>18,781,290</u>	<u>6,582,444</u>
Total	<u>379</u>	<u>349</u>	<u>\$24,135,837</u>	<u>\$9,877,210</u>
Nonmember:				
Serious problem--PPO	19	23	\$ 350,345	\$ 372,895
Serious problem	72	74	3,715,936	1,636,798
Other problem	<u>210</u>	<u>183</u>	<u>6,842,976</u>	<u>3,401,415</u>
Total	<u>301</u>	<u>280</u>	<u>\$10,909,257</u>	<u>\$5,411,108</u>
State member:				
Serious problem--PPO	1	-	\$ 3,767	\$ -
Serious problem	3	3	55,398	32,943
Other problem	<u>15</u>	<u>14</u>	<u>4,095,470</u>	<u>1,278,613</u>
Total	<u>19</u>	<u>17</u>	<u>\$4,154,635</u>	<u>\$1,311,556</u>
National:				
Serious problem--PPO	4	5	\$ 40,243	\$ 46,918
Serious problem	16	11	1,188,858	1,205,212
Other problem	<u>39</u>	<u>36</u>	<u>7,842,844</u>	<u>1,902,416</u>
Total	<u>59</u>	<u>52</u>	<u>\$9,071,945</u>	<u>\$3,154,546</u>

a/Potential problem payoff.

### Dynamics of problem bank list

The problem bank list included 385 banks in late 1976, its highest level in 28 years. This represented about 3 percent of all insured banks. During 1976 the Corporation removed 158 banks from the problem classification--142 because of improving conditions and 16 because of failures. Another 188 banks were added making a total of 379 problem banks at December 31, 1976, an increase of 30 over the previous year.

Although these statistics indicate the dynamics of the problem bank list, the following aging schedule provides more insight into the time it takes to resolve problems in these banks.

<u>Length of time on problem list</u>	<u>Number of banks</u>
0-6 months	30
7-12 months	91
13-18 months	82
19-24 months	77
2-3 years	62
3-5 years	27
Over 5 years	<u>10</u>
Total	<u>379</u>

### Efforts to correct problem bank situations

We previously reported to the Congress our concern about banks which are classified as problem banks for long periods of time. In that report we stated that the supervisory agencies should use their legal power more frequently when dealing with such cases. This should be particularly evident for the 10 banks on the problem list for over 5 years.

In supervising State nonmember banks, the Corporation may first attempt to correct problem situations through bank cooperation and informal supervisory methods. These informal methods include an accelerated examination program, including regular visits by examiners to update information, conferences with bank directors and the State supervisory authority, and periodic progress reports from the bank. As an intermediate enforcement measure, the Corporation's regional offices may use a letter-agreement to confirm correction programs agreed upon by the bank's board of directors.

The Corporation is now experimenting in two regions with the technique of formally notifying bank directors when the regional director recommends that their bank be designated

a problem bank. The Corporation feels supervisory changes can be made more easily if bank directors are aware of the problem status.

In 1976, the Corporation initiated 41 cease-and-desist proceedings against banks found conducting business in an unsafe or unsound manner or violating a law, rule or regulation, or written agreement. Five of these proceedings were summary cease-and-desist orders. These orders took effect when received by the banks and remained in effect until completion of the proceedings. During 1976 the Corporation terminated 24 proceedings against banks as cease-and-desist orders--21 from actions initiated in 1976 and 3 from 1975.

When a bank's financial condition is unsafe and/or unsound, the Corporation can initiate proceedings to terminate the bank's deposit insurance. The Corporation initiated eight such proceedings during 1976. State-chartering authorities closed two banks after these termination proceedings were initiated.

During 1976 the Corporation did not initiate any actions to remove an officer, director, or other person participating in bank management. Also, until 1976 the Corporation believed it had the authority to suspend officers, directors, and other persons participating in the affairs of an insured State nonmember bank who were indicted for a felony involving dishonesty or breach of trust.

However, during 1976, a Federal three-judge district court declared the statute to be "constitutionally infirm" insofar as it permits the issuance of a notice and order of suspension without affording the individual an immediate post-suspension hearing, preceded by notice of such a right, and an opportunity to be represented by counsel, to make written submissions, and to make oral argument. Feinburg v. FDIC, 420 F. Supp. 103 (D.D.C. 1976).

The Corporation is authorized to provide assistance to an operating insured bank experiencing financial difficulty, provided the bank's continued operations are essential to the community. These loans totaled \$37 million as of December 31, 1976, unchanged from calendar year 1975.

#### BANK FAILURES

Sixteen banks failed during 1976. Insured deposits totaled \$576 million, surpassed only by insured deposits of failed banks in 1973 and 1974. The Corporation estimates a

potential loss of \$15.3 million for these 16 banks as of December 31, 1976. The names and status of the failed banks and those that failed through mid-1977 are:

<u>Bank</u>	<u>Date closed</u>	<u>Estimated insured deposits</u>	<u>Estimated loss to the Corporation</u>	<u>Status</u>
(000 omitted)				
<u>1976 Failures</u>				
Bank of Bloomfield Bloomfield, New Jersey	1/10/76	\$ 23,695	\$ 1,830	Acquired by First National Bank, New Jersey
Bank of Woodmoor Woodmoor, Colorado	1/12/76	3,079	305	Acquired by El Paso County Bank
Hamilton National Bank of Chattanooga Chattanooga, Tenn.	2/16/76	202,237	-	Acquired by First Tennessee National Bank
South Texas Bank Houston, Texas	2/25/76	6,876	257	Acquired by South Loop National Bank
First State Bank of Northern California San Leandr Calif.	5/21/76	38,509	-	Acquired by Lloyds Bank California
Northeast Bank of Houston, Houston, Texas	6/03/76	10,999	86	Acquired by First City Bank--North-east N.A.
First State Bank of Hudson Co., Jersey City, New Jersey	6/14/76	13,439	2,400	Acquired by New Jersey Bank, N.A.
Coronado National Bank Denver, Colorado	6/25/76	2,606	200	93 percent of insured deposits have been paid
Mt. Zion Deposit Bank Mount Zion, Kentucky	6/25/76	554	250	96 percent of insured deposits have been paid
Citizens State Bank Carrizo Springs, Texas	6/29/76	13,764	3,100	54 percent of insured deposits have been paid
New Boston Bank & Trust Co., Boston, Massachusetts	9/14/76	5,142	720	Acquired by Capital Bank & Trust Co.

<u>Bank</u>	<u>Date closed</u>	<u>Estimated insured deposits</u>	<u>Estimated loss to the Corporation</u>	<u>Status</u>
(000 omitted)				
American Bank & Trust Co., N.Y., N.Y	9/15/76	\$ 84,991	\$ -	Acquired by Bank Leumi Trust Co. of New York
Hamilton Bank & Trust Co., Atlanta, Georgia	10/08/76	20,485	1,000	Acquired by National Bank of Georgia
Centennial Bank Philadelphia, Pennsylvania	10/20/76	9,541	335	Acquired by Lincoln Bank
First State Bank & Trust Co., Rio Grande City, Texas	11/19/76	10,841	825	Acquired by First National Bank of Rio Grande City
International City Bank & Trust Co., New Orleans, Louisiana	12/03/76	129,092	4,000	Acquired by the Bank of New Orleans and Trust Co.
<u>1977 Failures</u>				
First State Bank Foss, Oklahoma	3/11/77	1,560	160	Acquired by Washita State Bank
Monroe Bank & Trust Co., Monore, Connecticut	3/28/77	2,624	-	Acquired by North American Bank & Trust Co.
First Augusta Bank & Trust Co., Augusta, Georgia	5/20/77	15,549	-	Acquired by First National Bank of Atlanta

Of the 1976 closed banks, 13 were State nonmember banks, 2 were national banks, and 1 was a State member bank. Since 1972, 40 banks have failed--29 State nonmember, 8 national, and 3 State member banks.

From January 1 through June 30, 1977, three additional State nonmember banks failed. These banks had estimated insured deposits of about \$20 million, and potential losses to the Corporation estimated at \$160,000.

#### Methods used to protect depositors

Banks are declared insolvent by their chartering authorities--the Comptroller of the Currency for national banks and State banking authorities for State banks. The Corporation is appointed receiver for closed national banks

and it accepts appointment as receiver for State banks when requested to do so by their chartering authorities and when authorized or permitted by State law.

The Corporation uses two principal methods to protect depositors of a failed bank.

- It assists another insured bank to absorb the failed or failing bank deposits.

- It pays insured deposits of the closed and liquidated bank.

The Corporation is authorized to assist financially in a deposit assumption when its Board of Directors finds such action will reduce the risk or avert a threatened loss. The deposit assumption method also provides full protection of depositors' accounts for amounts in excess of insurance limits authorized by section 11(a) of the Federal Deposit Insurance Act. For these reasons the Corporation has in recent years encouraged the deposit assumption methods as often as possible.

## CHAPTER 5

### SCOPE OF EXAMINATION AND OPINION

#### ON FINANCIAL STATEMENTS

We have examined the statement of financial condition of the Federal Deposit Insurance Corporation as of December 31, 1976, and the related statements of income and the deposit insurance fund, changes in financial position, and analysis of the deposit insurance fund for the year then ended. Our examination was made in accordance with generally accepted auditing standards and included such tests of the accounting records and such other auditing procedures as we considered necessary. We previously examined and reported on the Corporation's financial statement for the year ended December 31, 1975.

During the year, the Corporation's Office of Corporate Audits issued reports on various financial and operational activities of the Corporation. To the extent possible, we used the work of the internal auditors, thereby reducing the scope of our audit.

In our opinion, the accompanying financial statements (schs. 1 through 4) present fairly the financial position of the Corporation at December 31, 1976 and 1975, and the results of its operations and changes in financial position for the years then ended, in conformity with the principles and standards of accounting prescribed by the Comptroller General of the United States.



## **FINANCIAL STATEMENTS**

FEDERAL DEPOSIT INSURANCE CORPORATION  
COMPARATIVE STATEMENT OF FINANCIAL CONDITION

(In thousands)

<u>ASSETS</u>	<u>Calendar year ended December 31,</u>	
	<u>1976</u>	<u>1975</u>
CASH	\$ 22,860	\$ 17,359
U.S. GOVERNMENT OBLIGATIONS (notes 2 and 3)	6,760,229	6,472,294
ASSETS ACQUIRED IN FAILURES OF INSURED BANKS:		
Depositors claims paid	\$ 62,598	\$ 65,686
Depositors claims unpaid	1,280	900
Equity in assets ac- quired (note 4)	1,664,321	1,790,443
Assets purchased outright	35,160	4,477
	<u>1,763,359</u>	<u>1,861,506</u>
Less reserve for losses	<u>240,601</u>	<u>213,150</u>
Notes purchased:		
Principal (note 4)	200,500	163,000
Accrued interest	<u>4,127</u>	<u>3,518</u>
	204,627	166,518
ASSISTANCE TO OPERATING INSURED BANKS:		
Principal (note 5)	37,000	37,000
Accrued interest	<u>7</u>	<u>1</u>
	37,007	37,001
MISCELLANEOUS ASSETS	1,869	1,645
LAND AND OFFICE BUILDING LESS DEPRECIATION ON BUILDING (note 2)	<u>6,553</u>	<u>6,688</u>
TOTAL ASSETS (note 1)	<u>\$8,555,903</u>	<u>\$8,349,861</u>

The notes following schedule 4 are an integral part of these statements.

# SCHEDULE 1

# SCHEDULE 1

LIABILITIES AND THE DEPOSIT INSURANCE FUND	Calendar year ended December 31,	
	1976	1975
ACCOUNTS PAYABLE AND ACCRUED LIABILITIES	\$ 3,927	\$ 4,053
EARNEST MONEY, ESCROW FUNDS, AND COLLECTIONS HELD FOR OTHERS	3,963	2,137
ACCRUED ANNUAL LEAVE	3,791	3,359
DUE INSURED BANKS:		
Net assessment income credits		
Available 7-1-1976	\$ 0	\$ 362,428
Available 7-1-1977	379,595	0
Other	<u>27,185</u>	<u>1,098</u>
	406,780	363,526
LIABILITIES INCURRED IN FAILURES OF INSURED BANKS:		
F.R.B. indebtedness (note 6)		
Principal	650,000	1,125,000
Accrued interest	<u>198,846</u>	<u>134,847</u>
Other notes payable (note 6)		
Principal	18,691	0
Depositors claims unpaid	1,280	900
DEPOSIT INSURANCE FUND, NET INCOME ACCUMULATED SINCE THE BEGINNING OF THE CORPORATION (sch. 2)	<u>7,268,625</u>	<u>6,716,039</u>
TOTAL LIABILITIES AND DEPOSIT INSURANCE FUND (notes 1, 2, and 7)	<u>\$8,555,903</u>	<u>\$8,349,861</u>

FEDERAL DEPOSIT INSURANCE CORPORATIONCOMPARATIVE STATEMENT OF INCOMEAND THE DEPOSIT INSURANCE FUND

(In thousands)

	Calendar year ended December 31,	
	<u>1976</u>	<u>1975</u>
<b>REVENUES:</b>		
Assessments earned (note 2)	\$ 676,065	\$ 641,233
Interest on U.S. Government securities	444,691	390,558
Amortization and discounts earned, net (note 2)	4,995	3,752
Net profit on sales of U.S. Government securities	0	45
Interest earned on notes receivable	17,697	15,720
Other income	<u>1,001</u>	<u>304</u>
<b>TOTAL REVENUES</b>	<u>1,144,457</u>	<u>1,051,612</u>
<b>EXPENSES, LOSSES, AND ASSESSMENTS</b>		
<b>CREDITS:</b>		
Assessment credits returned to banks	379,565	362,304
Provision for insurance losses	28,001	27,619
Administrative and operating expenses	74,649	67,688
Nonrecoverable insurance expense	3,861	2,152
Net loss on sales of U.S. Government securities	<u>105,595</u>	<u>0</u>
<b>TOTAL EXPENSES</b>	<u>591,871</u>	<u>459,763</u>
<b>NET INCOME--Addition to the deposit insurance fund</b>	552,586	591,849
<b>DEPOSIT INSURANCE FUND--January 1</b>	<u>6,716,039</u>	<u>6,124,190</u>
<b>DEPOSIT INSURANCE FUND--December 31</b>	<u>\$7,268,625</u>	<u>\$6,716,039</u>

The notes following schedule 4 are an integral part of these statements.

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

	Calendar year ended December 31,	
	<u>1976</u>	<u>1975</u>
RESOURCES WERE PROVIDED FROM:		
Operations		
Net deposit insurance assessments	\$ 296,500	\$ 278,929
Interest on		
U.S. Government obligations	444,699	390,558
Interest on notes receivable	17,697	15,720
Other income	1,001	304
	<u>759,897</u>	<u>685,511</u>
Less:		
Administrative and operating expenses, net of depreciation	74,714	67,552
Nonrecoverable insurance expenses	3,861	2,152
	<u>78,575</u>	<u>69,704</u>
Resources provided from operations	681,322	615,807
Maturity and sale of		
U.S. Government obligations,		
less \$105,595 net loss in 1976		
and including \$45 gain in 1975	2,606,985	1,723,976
Collections received on assets		
acquired in receivership and		
deposit assumption transactions,		
excluding \$475,000 in 1976 and		
\$598,472 in 1975 in Franklin		
National Bank liquidation		
collections applied directly		
to the reduction of the F.R.B.		
indebtedness	362,579	135,383
Increase in assessment credits due		
banks and other liabilities	<u>45,386</u>	<u>73,708</u>
Total resources provided	<u>\$3,696,272</u>	<u>\$2,548,874</u>
RESOURCES WERE APPLIED TO:		
Purchase of U.S. Government obligations	\$2,971,611	\$2,211,895
Acquisition of assets in		
receivership and deposit		
assumption transactions,		
excluding \$82,690 in 1976 and		
and \$104,556 in 1975		
representing the increase in		
accrued interest on the F.R.B.		
indebtedness and other notes		
payable	695,027	323,124
Increase in accrued interest on		
securities (note a)	23,909	14,336
Increase in miscellaneous assets	224	1,017
Increase (decrease) in cash	<u>5,501</u>	<u>(1,498)</u>
Total resources applied	<u>\$3,696,272</u>	<u>\$2,548,874</u>

The notes following schedule 4 are an integral part of these statements.

FEDERAL DEPOSIT INSURANCE CORPORATIONANALYSIS OF DEPOSIT INSURANCE FUND

(In thousands)

	From inception to December 31, <u>1976</u>	<u>1975</u>
<b>INCOME:</b>		
Insurance assessments	\$8,771,776	\$8,095,711
Less net assessment income credits	<u>4,435,813</u>	<u>4,056,248</u>
Net insurance assessments	<u>4,335,963</u>	<u>4,039,463</u>
Income from U.S. Government securities	3,975,473	3,631,374
Other operating income (principally interest and allowable return from deposit insurance assumption and receivership cases)	<u>59,235</u>	<u>40,537</u>
Total income	<u>8,370,671</u>	<u>7,711,374</u>
<b>EXPENSES AND LOSSES:</b>		
Administrative and operating expenses	735,471	660,622
Deposit insurance losses and expenses	286,013	254,151
Interest paid to the Secretary of the Treasury on retired capital stock	<u>80,562</u>	<u>80,562</u>
Total expenses and losses	<u>1,102,046</u>	<u>995,335</u>
<b>DEPOSIT INSURANCE FUND, NET INCOME ACCUMULATED SINCE INCEPTION</b>	<u><u>\$7,268,625</u></u>	<u><u>\$6,716,039</u></u>

The notes following schedule 4 are an integral part of these statements.

FEDERAL DEPOSIT INSURANCE CORPORATION

NOTES TO THE FINANCIAL STATEMENTS

DECEMBER 31, 1976 AND 1975

1. These financial statements:

- (a) Do not include accountability for the assets and liabilities of the 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 the courts, supervisory authorities, and others as required.
- (b) Includes transactions in unaudited collection and disbursement reports from liquidators of Franklin National Bank, Northeast Bank of Houston, The Hamilton Bank and Trust Company, and Centennial Bank, of Philadelphia, for the month of December 1976. Also included were transactions reflected in unaudited collection and disbursement reports from the liquidator of Franklin National Bank for the last quarter of 1975.

2. Summary of accounting policies:

- (a) U.S. Government obligations--Securities are shown at amortized cost which is the purchase price of the securities less the amortized premium or plus the accreted discount. Such amortization and accretion are computed on a daily straight-line basis from the date of acquisition to the date of maturity.

	<u>1976</u>	<u>1975</u>
	( thousands )	
U.S Government Securities:		
Securities at amortized cost	\$6,630,116	\$6,366,090
Accrued interest receivable	<u>130,113</u>	<u>106,204</u>
Total	<u>\$6,760,229</u>	<u>\$6,472,294</u>

- (b) Deposit insurance assessments--The Corporation assesses insured banks at the rate of 1/12 of 1 percent per year on the bank's average deposit liability less certain exclusions and deductions. Assessments are due in advance for a 6-month period and credited to income when earned each month. Each July 1, 66-2/3 percent of the Corporation's net assessment income for the prior calendar year is made available to insured banks as a prorated credit against the current assessments due.
- (c) Depreciation--The office building is depreciated on the straight-line basis over a 50-year estimated life. The cost of furniture, fixtures, and equipment is expensed at time of acquisition.
- (d) Reclassifications--Certain reclassifications have been made in the 1975 financial statements to conform to the presentation used in 1976.
- (e) Estimated liability for future bank failures: It is the policy of the Corporation to establish a reserve for loss at the time a bank fails. The reserve is reviewed on a 6-month basis and adjusted, as required, based on more current financial information. The Corporation does not provide an estimated liability for future bank closings because such estimates are impossible to make since such eventual losses and contingent liability would depend upon factors which could not be assessed until or after a given bank actually failed. The Corporation's deposit insurance fund is available for future loss contingencies.

3. U.S. Government obligations--Investment in securities at December 31, 1976 and 1975, is as follows:

	<u>1976</u>	<u>1975</u>
	(thousands)	
Purchase price	\$6,629,974	\$6,358,006
Amortized cost	6,630,116	6,366,090
Market value	6,759,509	6,481,692

4. Assets acquired in receivership and deposit assumption transactions.

- (a) Equity in assets acquired under agreements with insured banks totaled \$1,664 million and \$1,790



million at December 31, 1976 and 1975, respectively. Of these totals approximately \$849 million for 1976 and \$1,125 million for 1975 represent equity in assets acquired as a result of the closing of Franklin National Bank on October 8, 1974.

- (b) Notes purchased to facilitate deposit assumptions--The Corporation's outstanding notes receivable, purchased to facilitate deposit assumptions and mergers of closed insured banks under section 13(e) of the Federal Deposit Insurance Act are:

	<u>1976</u>	<u>1975</u>
Crocker National Corporation	\$ 50,000,000	\$ 50,000,000
European-American Bank and Trust Company	100,000,000	100,000,000
Clearing Bank	1,500,000	1,500,000
Marine National Exchange Bank of Milwaukee	2,500,000	3,500,000
First Tennessee National Corporation	16,000,000	-
First Tennessee National Bank	8,000,000	-
Bank Leumi Trust Company of New York	10,000,000	-
Southeast Banking Corporation	5,000,000	-
New Orleans Bancshares, Inc.	7,500,000	-
Southern Bancorporation, Inc.	<u>-</u>	<u>8,000,000</u>
	<u>\$200,500,000</u>	<u>\$163,000,000</u>

5. Assistance to operating insured banks--As of December 31, 1976 and 1975, the Corporation had two outstanding notes receivable purchased under authority of section 13(c) of the Federal Deposit Insurance Act; one for Bank of the Commonwealth with a principal balance on the note of \$35.5 million and the other for Unity Bank and Trust Company with a principal balance of \$1.5 million.

- (a) Bank of the Commonwealth--Maturity dates of the Bank of the Commonwealth notes were extended in 1976 from 1977 to 1982-87. In addition to changing the basis of computing interest from a fixed rate to a formula related to net income, the new terms provide for a prepayment incentive discount. As a condition of the extension and modification agreement, the bank agreed to a recapitalization plan which was in progress but not fully completed at yearend.
- (b) Unity Bank and Trust Company--On December 27, 1976, the Federal Deposit Insurance Corporation announced that its Board of Directors had agreed to extend until June 30, 1982, the \$1.5 million capital note of Unity Bank and Trust Company, Boston, Massachusetts, which matured on December 31, 1976. Payment of principal and interest on the note will be in accordance with the terms of the amended note.

6. Liabilities incurred in receivership and deposit assumption transactions:

- (a) Federal Reserve Bank of New York indebtedness--As of December 31, 1976 and 1975, the principal outstanding balance due the Federal Reserve Bank of New York was \$650 million and \$1,125 million, respectively. Accrued interest payable to the bank of \$199 million represents interest for 817 days since inception at the rate of 7.52 percent simple interest per annum on the unpaid principal balance, after deducting \$5 million for certain out-of-pocket expenses incurred by the Corporation as provided in the agreement of sale.
- (b) Other notes payable--This amount represents the unpaid principal on the Corporation's unsecured notes designated "5.775% Series A Notes due January 1, 1983" and "5.775% Series B Notes due January 1, 1990" as set forth in the consents, exchange agreement, and agreements of release and satisfaction related to the sale of Franklin Buildings, Inc. to European-American Bank & Trust Company.

7. Contingent liabilities

- (a) Savings certificates, 8.5 percent growth and savings certificates, 8.5 percent income--In accordance with the indemnification agreement between

the Corporation and The Bank of New Orleans and Trust Company, the Corporation agreed to indemnify the bank, by paying to the bank on a monthly basis, an amount equal to the difference between the interest accrued on the outstanding principal and interest balances on certain specified savings certificates (referred to collectively as the "wild card indebtedness") and the interest that would accrue during the month at the Treasury bill rate.

- (b) Southern Bancorporation note receivable--On December 9, 1976, Southern Bancorporation repaid in full the \$8 million note that the Corporation had purchased on September 24, 1974. Southern Bancorporation financed this transaction by obtaining a loan from First Union National Bank of North Carolina. To induce FUNB to enter into the loan agreement, the FDIC agreed to guarantee the payment of 75 percent of the principal amount of the loan on the terms and conditions set forth in the guarantee agreement.
- (c) Legal actions--Total recovery sought as a result of legal actions against the FDIC as a receiver or liquidator of a closed insured bank and against the FDIC in its corporate capacity which were pending as of December 31, 1976 and 1975, totaled \$393 million and \$1,942 million, respectively. In the opinion of the FDIC's Office of General Counsel, these actions may result in recoveries totaling \$20 million for 1976 and \$17 million for 1975 against the FDIC. These estimated potential losses have been taken into consideration upon establishing and or amending the reserve for losses.

## **APPENDIXES**

MEMBERSHIP OF THE BOARD OF DIRECTORS

	<u>Tenure of office</u>	
	<u>From</u>	<u>To</u>
George A. LeMaistre, Chairman (note a)	Aug. 1973	Present
Robert Bloom, Acting Comptroller of the Currency (note b)	July 1976	Present

• One position is currently vacant

a/Robert E. Barnett served as Chairman from March 1976 through May 1977. Frank Wille was Chairman from April 1970 through March 1976.

b/James E. Smith, as Comptroller of the Currency, served as an ex officio member of the Board from July 1973 to July 1976.



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

B-114831

SEP 02 1976

The Honorable Robert E. Barnett  
Chairman, Board of Directors  
Federal Deposit Insurance Corporation

Dear Mr. Barnett:

We have examined the financial statements of the Federal Deposit Insurance Corporation for the year ended December 31, 1975. Our audit, required by the Federal Deposit Insurance Act (12 U.S.C. 1827), was made in accordance with generally accepted auditing standards and, with the exception of bank examination reports, included such tests of the accounting records and other auditing procedures as we considered necessary. In our examination we relied, to the extent possible, on the work of the Corporation's Financial Audit Branch.

This report is submitted according to the agreement reached between the General Accounting Office and the Corporation on September 24, 1975. This audit completes the transition required to change the audit cycle from a fiscal year to a calendar year. The report will be included as an appendix to our report to the Congress on the examination of the calendar year 1976 financial statements.

The financial statements do not show an estimate of the liability which the Corporation may incur because of future bank failures.

As in prior audits, we could not fully discharge our audit responsibilities under the Federal Deposit Insurance Act because we did not have unrestricted access to examination reports, files, and other records relating to insured banks except for the records of closed banks. Therefore, we could not determine (1) whether bank examinations were of sufficient scope and reliability to identify all banks that should have been classified as problem banks, (2) whether the Corporation had taken effective followup action on bank examiners' findings, and (3) the significance of any possible adverse effect of problem banks on the Corporation's financial position.

For these reasons we cannot express an overall opinion on the accompanying financial statements for calendar year

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1975. However, in our opinion, the individual amounts shown in the financial statements are fairly stated as of December 31, 1975, and for the year then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

As you know, we have been granted access to the bank examination reports of the Corporation, as well as the Federal Reserve Board and the Comptroller of the Currency, for purposes of responding to a congressional request for a study of the effectiveness of Federal bank supervision. This study is separate from our review of the financial statements of the Corporation. It is estimated that this study will be completed in December 1976.

We have recommended in prior reports to the Congress that, to more effectively carry out our audit responsibility, the Federal Deposit Insurance Act be amended to clarify our authority to have access to all examination reports, files, and other records of the Corporation. Our position on this matter remains unchanged.

Sincerely yours,



ACTING Comptroller General  
of the United States

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FINANCIAL STATEMENTS

## SCHEDULE 1

FEDERAL DEPOSIT INSURANCE CORPORATIONCOMPARATIVE STATEMENT OF FINANCIAL CONDITIONDECEMBER 31, 1975, AND DECEMBER 31, 1974

	<u>December 31, 1975</u>		<u>December 31, 1974</u>	
	<u>(000 omitted)</u>			
<b>ASSETS</b>				
CASH		\$ 17,359		\$ 18,857
<b>U.S. GOVERNMENT SECURITIES:</b>				
Securities at amortized cost (notes 1 and 4)	\$6,366,090		\$5,874,374	
Accrued interest receivable	<u>106,204</u>	6,472,294	<u>91,868</u>	5,966,242
<b>ASSETS ACQUIRED IN RECEIVER-SHIP AND DEPOSIT ASSUMPTION TRANSACTIONS:</b>				
Subrogated claims of depositors against closed insured banks	65,686		53,644	
Net insured balances of depositors in closed insured banks to be subrogated when paid, see related liability	900		903	
Equity in assets acquired under agreements with insured banks (note 5)	1,790,443		2,113,341	
Corporation purchases	<u>4,477</u>		<u>4,609</u>	
	1,861,506		2,172,497	
Less reserves for losses	<u>213,150</u>	1,648,356	<u>185,743</u>	1,986,754
Notes purchased to facilitate deposit assumption:				
Principal (note 6)	163,000		158,000	
Accrued interest receivable	<u>3,518</u>	166,518	<u>3,445</u>	161,445
<b>ASSISTANCE TO OPERATING INSURED BANKS:</b>				
Principal (note 7)	37,000		37,000	
Accrued interest receivable	<u>1</u>	37,001	<u>1</u>	37,001
<b>LAND AND OFFICE BUILDING, less depreciation on building (note 1)</b>				
	6,688		6,824	
<b>MISCELLANEOUS ASSETS</b>	<u>1,645</u>		<u>628</u>	
Total assets (note 2)	\$8,349,861		\$8,177,751	

The notes following schedule 4 are an integral part of this statement.

## APPENDIX II

## APPENDIX II

## SCHEDULE 1

	<u>December 31, 1975</u>	<u>December 31, 1974</u>
	<u>(000 omitted)</u>	
<b>LIABILITIES AND DEPOSIT INSURANCE FUND</b>		
<b>ACCOUNTS PAYABLE AND ACCRUED LIABILITIES</b>	\$ 4,053	\$ 4,494
<b>EARNEST MONEY, ESCROW FUNDS AND COLLECTIONS HELD FOR OTHERS</b>	2,137	1,630
<b>ACCRUED ANNUAL LEAVE OF EMPLOYEES</b>	3,359	2,979
<b>DUE INSURED BANKS:</b>		
Net assessment income credits:		
Available July 1, 1975		\$ 285,433
Available July 1, 1976	\$ 362,428	
Other	<u>1,098</u>	<u>4,831</u>
	303,526	290,264
<b>LIABILITIES INCURRED IN RECEIVERSHIP AND DEPOSIT ASSUMPTION TRANSACTIONS:</b>		
Federal Reserve Bank of New York indebtedness:		
Notes payable	1,125,000	1,723,000
Accrued interest payable (note 8)	<u>134,847</u>	<u>30,291</u>
	1,259,847	1,753,291
<b>NET INSURED BALANCE OF DEPOSIT- TORS IN CLOSED INSURED BANKS--</b>		
See related asset	<u>900</u>	<u>903</u>
Total liabilities (notes 2 and 3)	1,633,822	2,053,561
<b>DEPOSIT INSURANCE FUND, net income accumulated since inception (sch. 2)</b>	<u>6,716,039</u>	<u>6,124,190</u>
Total liabilities and deposit in- surance fund	<u>\$8,349,861</u>	<u>\$8,177,751</u>

## SCHEDULE 2

## SCHEDULE 2

FEDERAL DEPOSIT INSURANCE CORPORATIONCOMPARATIVE STATEMENT OF INCOME AND DEPOSIT INSURANCE FUNDCALENDAR YEARS ENDED DECEMBER 31, 1975, AND DECEMBER 31, 1974

	<u>1975</u>		<u>1974</u>
	(000 omitted)		
<b>INCOME:</b>			
Deposit insurance assessments:			
Assessments earned during the year (note 1)	\$640,915		\$587,322
Less net assessment income credits to insured banks	<u>362,304</u>	\$ 278,611	<u>285,420</u>
Adjustments of assessments earned in prior years		<u>318</u>	<u>44</u>
		278,929	301,946
Net income from U.S. Government securities	394,355		357,648
Less adjustment to securities income--prior years (note 9)	<u>-</u>	394,355	<u>186</u>
Interest on capital notes		15,720	-
Other income		<u>304</u>	<u>8,634</u>
Total income	<u>689,308</u>		<u>668,042</u>
<b>EXPENSES AND LOSSES:</b>			
Administrative and operating expenses		67,688	59,214
Provision for insurance losses:			
Applicable to banks assisted in the current year	32,577		5,625
Adjustments applicable to banks assisted in prior years	<u>-4,958</u>	27,619	<u>92,238</u>
Nonrecoverable insurance expenses incurred to protect depositors--net		<u>2,152</u>	<u>2,111</u>
Total expenses and losses		<u>97,459</u>	<u>159,188</u>
<b>NET INCOME--ADDITION TO THE DEPOSIT INSURANCE FUND FOR THE YEAR</b>		591,849	508,854
<b>DEPOSIT INSURANCE FUND, at the beginning of the year</b>	<u>6,124,190</u>		<u>5,615,336</u>
<b>DEPOSIT INSURANCE FUND, at the end of the year--net income accumulated since inception</b>	<u>\$6,716,039</u>		<u>\$6,124,190</u>

The notes following schedule 4 are an integral part of this statement.

## SCHEDULE 3

## SCHEDULE 3

FEDERAL DEPOSIT INSURANCE CORPORATIONSTATEMENT OF CHANGES IN FINANCIAL POSITIONCALENDAR YEAR ENDED DECEMBER 31, 1975

	<u>Amount</u>
	(000 omitted)
<b>FUNDS PROVIDED BY:</b>	
Net deposit insurance assessments	\$ 278,929
Income from U.S. Government securities, less amortized net discounts	390,558
Maturities and sales of U.S. Government securities, including exchanges of long-term securities	1,723,976
Collections on assets acquired in receivership and deposit assumption transactions	733,855
Increase in assessment credits due banks	73,262
Income from capital notes	<u>15,720</u>
Total funds provided	<u>\$3,216,300</u>
<b>FUNDS APPLIED TO:</b>	
Administrative, operating and insurance expenses less miscellaneous credits	69,400
Acquisitions of assets in receivership and deposit assumption transactions	921,596
Purchase of U.S. Government securities, including exchanges of long-term securities	2,211,895
Net change in other assets and liabilities	<u>13,409</u>
Total funds applied	<u>\$3,216,300</u>

**ANALYSIS OF NET CHANGE IN OTHER ASSETS AND LIABILITIES**

	<u>1975</u>	<u>1974</u>	<u>Increase or decrease (-)</u>
<b>Assets:</b>			
Cash	\$ 17,359	\$ 18,857	\$-1,498
Accrued interest receivable	106,204	91,868	14,336
Other assets	<u>1,645</u>	<u>628</u>	<u>1,017</u>
	<u>125,208</u>	<u>111,353</u>	<u>13,855</u>
<b>Less liabilities:</b>			
Accounts payable	4,053	4,494	441
Collections held for others	2,137	1,630	-507
Accrued annual leave	<u>3,359</u>	<u>2,979</u>	<u>-380</u>
	<u>9,549</u>	<u>9,103</u>	<u>-446</u>
Net change in other assets and liabilities	<u>\$115,659</u>	<u>\$102,250</u>	<u>\$13,409</u>

The notes following schedule 4 are an integral part of this statement.

## SCHEDULE 4

## SCHEDULE 4

FEDERAL DEPOSIT INSURANCE CORPORATIONANALYSIS OF DEPOSIT INSURANCE FUNDFROM INCEPTION TO DECEMBER 31, 1975

	<u>Amount</u>
	(000 omitted)
<b>INCOME:</b>	
Insurance assessments	\$8,095,711
Less net assessment income credits	<u>4,056,248</u>
Net insurance assessments	<u>4,039,463</u>
Income from U.S. Government securities	3,631,374
Other operating income (principally interest and allowable return from deposit insurance assumption and receivership cases)	<u>40,537</u>
Total income	<u>7,711,374</u>
<b>EXPENSE AND LOSSES:</b>	
Administrative and operating expenses	660,622
Deposit insurance losses and expenses	254,151
Interest paid to the Secretary of the Treasury on retired capital stock	<u>80,562</u>
Total expenses and losses	<u>995,335</u>
DEPOSIT INSURANCE FUND, NET INCOME ACCUMULATED SINCE INCEPTION	<u>\$6,716,039</u>

The notes following schedule 4 are an integral part of this statement.

FEDERAL DEPOSIT INSURANCE CORPORATIONFOOTNOTES TO THE FINANCIAL STATEMENTSDECEMBER 31, 19751. ACCOUNTING POLICIES

Securities--U.S. Government securities are presented at amortized cost which is the purchase price of the securities less the amortized premium or plus the amortized discount. As of December 31, 1975, amortized premiums amounted to \$6,488,858 and amortized discounts \$13,763,390. Premiums and discounts are amortized on a daily straight-line basis from the date of acquisition to the date of maturity. Net income from U.S. Government securities represents the total of interest income earned less premium plus discount amortization for the year.

Deposit insurance assessments--The Corporation assesses insured banks at the rate of 1/12 of 1 percent each year on the bank's average deposit liability less certain amortized exclusions and deductions. Assessments are due in advance for a 6-month period and credited to income when earned each month. Sixty-six and two-thirds percent of the Corporation's net assessment income for the prior calendar year is made available each July 1 to insured banks in the form of a prorated credit against the current assessments due.

Depreciation--The office building is depreciated on a straight-line basis at the rate of 2 percent each year over a 50-year estimated life. Furniture, fixtures, and equipment are fully depreciated at the time of acquisition.

## 2. These statements:

- a. Do not include accountability for the assets and liabilities of the closed insured banks for which the Corporation acts as receiver or liquidating agent.
- b. Include transactions reflected in unaudited collection and disbursement reports from the liquidator of Franklin National Bank for the last quarter of 1975.

3. Legal actions pending against the Corporation on December 31, 1975, involved an estimated potential liability of \$1,942 million. In the opinion of the Corporation's General Counsel, these actions, arising essentially from litigation involving closed bank activities, may result in recoveries against the Corporation of \$17 million. This estimated loss has been provided for in these statements.
4. The securities had a face value of \$6,376,176,500, a cost of \$6,358,006,191, and a market value of \$6,481,691,963 at December 31, 1975.
5. Equity in assets acquired under agreements with insured banks totaled \$1.790 billion. Of this total approximately \$1.125 billion represents equity in assets acquired as a result of the closing of Franklin National Bank on October 8, 1974.
6. Notes purchased to facilitate deposit assumption:
 

Crocker National Corporation, San Francisco, California	\$ 50,000,000
Southern Bancorporation, Inc., Greenville, South Carolina	8,000,000
European-American Bank and Trust Co., New York, New York	100,000,000
Clearing Bank, Chicago, Illinois	1,500,000
Marine National Exchange Bank, Milwaukee, Wisconsin	<u>3,500,000</u>
	<u>\$163,000,000</u>
7. Assistance to operating insured banks:
 

Bank of the Commonwealth, Detroit, Michigan	\$35,500,000
Unity Bank and Trust Company, Boston, Massachusetts	<u>1,500,000</u>
	<u>\$37,000,000</u>
8. Accrued interest payable of \$134.8 million represents interest for 450 days at the rate of 7.52 percent simple interest per annum on the unpaid principal amount due on Franklin National Bank's indebtedness to the Federal Reserve Bank of New York. This amount is subject to adjustment for certain out-of-pocket expenses the Corporation incurred as provided for in the Agreement of Sale.





FEDERAL DEPOSIT INSURANCE CORPORATION, Washington D C 20429

OFFICE OF THE CHAIRMAN

October 28, 1977

Mr. S.D. McElyea, Director  
Field Operations Division  
U.S. General Accounting Office  
Washington, DC 20548

Dear Mr. McElyea:

This is in response to your letter of September 12, 1977, with which you enclosed copies of your proposed draft report to the Congress on your 1976 audit of the Corporation's financial statements and of its bank supervisory process.

Needless to say, we are glad to have an audit report which is not conditioned by a cover qualification. At the same time, we are not at all happy to note that GAO plans to place on the cover of its report several unilateral comments which can certainly mislead an uninformed reader.

The first of those comments recommends that I require periodic internal audits (presumably, operational audits) to be conducted of the activities of the Division of Bank Supervision. This recommendation suggests that such audits will enable the Board of Directors to more fully determine how effectively the Division carries out its policies, procedures, and regulations. In leading up to this recommendation, your report states that there exists an informal policy not to audit the Division's activities but that present policy does permit audits to be conducted.

Insofar as I can discover, no informal policy has existed which would prevent operational audits of the Division of Bank Supervision. We created an Office of Corporate Audits because we believe in the concept of internal auditing.

At the same time, our Division of Bank Supervision may be the most studied function in the Corporation. Its policies, procedures, and regulations are and have been under almost constant study by the Board of Directors, by the Chairman, and by various internal study groups. One such review was completed not long ago and another comprehensive study of most aspects of the supervisory process is just getting under way. In that context, there is no formal or informal impediment to an internal audit even though it is difficult to perceive that such an audit could add materially to the Board's day-to-day knowledge of the Division's operations.

In any case, the appearance of this GAO recommendation on the cover of your audit report implies to the uninformed that the Corporation is overlooking or

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simply omitting periodic internal audits of its Division of Bank Supervision. The fact is, however, that if the Division receives very much more attention as to its policies, procedures, and regulations, it will have great difficulty in keeping up with its very large operating responsibilities.

By the same token, you have selected three additional recommendations for inclusion on the cover of your report which, if adopted, presumably would make the Corporation a more effective bank supervisor. We have no particular difficulty with studying or even implementing these and other recommendations in part or in whole. We are not at all sure, however, that there is any need for such recommendations to appear unilaterally on the cover of your audit report. The Corporation has been operating for forty-five years and, during that time, its supervisory policies and processes have evolved out of much trial and error and a great deal of operating experience. Its supervisory responsibilities are perhaps its most important function and, coupled with the dynamic growth of the banking industry, require that the Corporation examine and re-examine its procedures almost constantly. Improvement and fine-tuning of the regulatory process are almost the primary requirements of the Division of Bank Supervision.

Thus, with respect to suggestions for improvement, there is nearly always available some history of discussion or examination of the particular suggestion. When you place several of your recommendations on the cover of your report, however, very little justice is done to the relevant responses which flow from the Corporation's continuing study, review and experience. Fundamentally, therefore, notwithstanding some possible public relations benefit, we urge that GAO not use the cover of its audit report to highlight unilateral recommendations which can be the basis for substantial discussion or response.

Elsewhere, there appears to be an error on page 26 of your draft report. In that instance, the report cites a potential loss of \$11.8 million in connection with the sixteen banks which failed in 1976. Our records and a tape run on the amounts shown in the table on pages 27 and 28 indicate that the potential loss would be \$15.3 million.

Our remaining comments as to your draft report are directed to your review of some aspects of the bank supervisory process. We recognize the fact that this process can be improved, as it has been continually through the life of the Corporation, but we must reiterate that there are sometimes several sides to individual aspects of the improvements proposed. These additional comments follow the chapter and page numbering sequence of your draft:

(See GAO note.)

1. Chapter 1, page 1 - (a) The first item in the third full paragraph on this page states that the Corporation is granted power to "Supervise insured banks through surveillance, examination, and enforcement activities." While the Corporation has power to supervise insured banks in the manner stated in your draft, those powers are circumscribed

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.

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with respect to National banks and State banks which are members of the Federal Reserve System. In point of fact, the Corporation directly supervises State nonmember insured banks and indirectly performs surveillance of the condition and posture of National banks and State banks which are members of the Federal Reserve System. As we pointed out in our comments to your 1975 study of the Federal supervision of State and National banks, Appendix III - 9, the legislative history of the Federal Deposit Insurance Act of 1950 quite clearly indicates that the intent of Congress was to limit FDIC's authority to examine State member and National banks. House Report Number 3049 of the 81st Congress (2d Sess. 1 and 4) states in relevant part that the Corporation's special examination authority over State member and National banks is to be utilized only in the cases where, in the judgment of the Board of Directors after a review of the Federal Reserve's or Comptroller of the Currency's examination reports, there are indications that the bank may be a problem or that it is in a condition likely to result in loss to the deposit insurance fund of the Corporation.

We pointed out further that, unless otherwise directed by Congress, the FDIC is constrained to exercise its examination authority in accordance with the aforementioned statement of Congressional intent. In addition, under Sections 8(b) and 8(e) of the Federal Deposit Insurance Act (12 U.S.C. §§ 1818(b) and (e)), the Corporation has no authority either to take cease and desist action against National and State member banks or to remove officers or directors of such banks. We suggest, therefore, that the statement as to the power of the Corporation to supervise insured banks quoted above be amended to read as follows: "Supervise State nonmember insured banks through surveillance, examination, and enforcement activities and indirectly supervise State member and National banks, primarily through surveillance."

(b) We feel that in listing the powers granted to the Corporation on pages 1 and 2 of Chapter 1 of your draft, you should add the power of the Corporation to facilitate the takeover of an insured bank by another insured bank when the first insured bank is in danger of closing or has closed. We suggest accordingly that the following be added to your list on pages 1 and 2: "make loans, purchase assets, or issue a guarantee to facilitate the takeover of a failed or failing insured bank by another insured bank."

2. Chapter 1, page 3 - The second sentence of the third full paragraph on this page states: "Although the Corporation has authority to examine any bank for insurance purposes, it relies on the examination performed by the other two Federal bank regulatory agencies." For the reasons set forth in our comment #1 above, we disagree with the connotation to be inferred from the statement that the Corporation has authority to examine any bank for insurance purposes. Your statement risks misleading, especially in light of the clear legislative history of our examination powers described above, which indicates that the Congress did not want the Corporation to exercise examination authority with respect to National and Federal Reserve member banks, except under limited circumstances.

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3. Chapter 2 - The comments to follow cover the general thrust of the chapter, namely the handling of "problem" and "near problem" banks. Additional detailed comments will be made with respect to certain specific portions of Chapter 2.

We note incidentally that a distinction must be drawn throughout this discussion between those banks posing supervisory problems and those which, because of their condition, pose financial risk to the Corporation. The latter generally are listed as problem banks and your draft report assumes - and it is a fact - that senior management of the Corporation, including the Board of Directors, is knowledgeable of the banks on the problem bank list.

Your draft report indicates that FDIC management should have an awareness of banks not on the problem list but which require aggressive supervision. The draft report seems to suggest that the FDIC create or formalize what might be termed a "borderline" list. Some regions now maintain on an unofficial basis what might be called such a list. On the other hand, we do not perceive either the utility or wisdom of maintaining a continuing, formal "borderline" list of banks which pose supervisory - but not financial - problems to the Corporation. Partly, this is because there will always be some banks which fall in the "near problem" but not quite "problem" area. In many of those cases, reasonable men may disagree.

Our experience, however, is that we can rely on the regional directors to be well aware of and to handle adequately the varying and often temporary supervisory problems in their regions. Moreover, examination reports are reviewed in both the regional offices and Washington office and comments are made in the file and on the form 96 which summarize the posture of the bank as set forth in those examination reports. We believe these comments and records are evidence that virtually all banks posing special supervisory problems to the Corporation are receiving proper and adequate supervisory attention.

Notwithstanding the foregoing, we also believe that there is some merit to the thought that senior management of the Corporation could benefit from an even greater awareness of the general condition of the banking industry to the extent it can be measured by banks representing various supervisory problems. In that sense, our recently adopted General Memorandum No. 1 allows for modified examinations in certain circumstances. One of the situations where a modified examination is not permitted is where the bank represents a supervisory or financial problem to the Corporation. Accordingly, we will institute a procedure whereby our regional directors will report to Washington on a quarterly basis the number of banks in their regions which do not qualify for a modified examination and the reason or reasons therefor. The overview of these quarterly reports should provide senior management of the Corporation with additional awareness of the continuing range of supervisory problems faced by our regional offices and the Corporation.

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Additionally, on or about November 1, 1977, the Corporation's Integrated Monitoring System (IMS) will go into effect. The IMS is a computer-based system which, among other things, utilizes certain basic tests for analyzing the condition and trends of commercial banks under the direct supervision of the Corporation. The computer-based analysis will be performed initially in the regional offices and, in the event a commercial bank fails one or more of the tests, a report analyzing the situation will have to be completed in the regional office and subsequently reviewed in the Washington office. Another integral part of the system is a so-called Annual Review which will also be performed in the region. As a result of the Annual Review, a report setting forth the analysis performed and any unsafe or unsound trends or characteristics of the bank will be provided in an Annual Review Memorandum which will be prepared in the region and again reviewed in the Washington office. Accordingly, the Integrated Monitoring System will serve as another vehicle for bringing to the attention of senior management in the Corporation, and particularly in the Division of Bank Supervision, banks posing not only financial risks to the Corporation but also presenting supervisory problems.

Your draft report also indicates GAO found that some banks with characteristics similar to those of problem banks were not placed on the problem bank list and that the reasons for not listing them were not always clearly documented. While we are certain that our staff is aware of the need to document what may sometimes represent judgmental decisions, we will nevertheless remind both regional and Washington office personnel who review examination reports of the need for relevant documentation.

The draft report also suggests the need for definitive criteria in determining whether a bank belongs on the problem list. In our comments to the GAO study of the Federal supervision of State and National Banks, Appendix III - 42-43, we set forth our reasons why mechanical formulae cannot be applied universally to determine whether or not an operating bank warrants FDIC problem status. We pointed out that a problem bank designation should only be imposed on a case by case basis after a comprehensive, in-depth analysis of the entire bank involved.

We also stated in our comments the major elements of a bank requiring analysis and evaluation; namely, asset quality and liquidity, the margin of capital protection, the degree of stability or volatility in the bank's liability structure, the character and ability of its management, the bank's earning performance, and its adherence to applicable laws and regulations. To the extent that any definitive numerical criteria exist, it is generally known that a bank with a very low adjusted capital ratio or a net capital ratio approaching less than zero is most likely to be listed as a problem bank. We continue to believe, however, that the decision to place a bank on a problem list is dependent on several variables and ultimately involves a professional judgment. Nevertheless, our efforts to refine criteria and heighten objectivity will continue.

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On pages 10 and 11 of Chapter 2 of the draft report, there seems to be undue emphasis on the so-called computer analysis of 14 weighted variables utilized by the Corporation. These 14 weighted variables are a tool which was developed as an early attempt at some kind or type of warning system within the Division of Bank Supervision of the Corporation. The tool does serve a use but we would be less than candid if we did not indicate its utility is limited. Furthermore, it should be noted that some of the deficiencies which show up in the course of utilizing these 14 weighted variables may indicate not present but potential future problems, such as the one involving classifications amounting to 40% of capital. There are others that overlap, for example: a bank with a large volume of overdue loans is also likely to have a high amount of classified assets and therefore adjusted capital is likely to be low. The draft report seems to add up the number of deficiencies as if that total number has meaning. The 14 weighted variables are only meaningful if the items are looked at and analyzed individually. Thus, it is virtually meaningless to take the position that, because a bank has four or six deficiencies, it is in a worse (or better for that matter) condition than a bank with one or two deficiencies. It depends upon the type of deficiencies found and how they affect that individual bank.

Our overall comment on the GAO review of the problem bank situation and its general handling by the Corporation is that the criticisms contained in the draft report do not develop any particular deficiency in the supervision conducted by our examiners and Regional Directors. The criticism, if any, is leveled more at the partial absence of statistics and documentation associated with problem banks. These matters are essentially administrative in nature and will continue to receive our full attention.

4. Chapter 2, page 15 - In the second full paragraph of page 15, there is a discussion of the Interagency Supervisory Committee which we believe is either not completely accurate or not complete. It is indicated in that paragraph that as of June 3, 1977 the committee had met on five occasions. In fact, the committee had met on four occasions, viz. on March 4, April 5, May 5 and June 3, 1977. In addition, the paragraph indicates that the Interagency Supervisory Committee had no definitive accomplishments, as of the June 3, 1977 date, and that one of the more significant topics under consideration is Shared National Credits. As we indicated in our comments to your 1975 study on bank supervision (Appendix IV-41), FDIC was participating in Shared National Credits in 1976 and, at the Interagency Supervisory Committee meeting of May 5, 1977, we reaffirmed our participation in that program. Furthermore, a Country Exposure Report Form and instructions were agreed to by the three agencies and sent to insured commercial banks of \$300 million or more (except in the case of State member banks where only those of \$1 billion or more were surveyed) in July. The concept, form and instructions were agreed to by the three agencies on or before the June 3, 1977 date. The purposes of the form and survey, which will be used on an ongoing basis, are

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to get more complete information on United States commercial banks' foreign lending, to help evaluate country risk, and to identify concentrations of credit in the foreign and international banking field.

Additionally, in June 1977 an interagency course was given on consumer matters and attended by representatives from all three agencies at the FDIC Training Center. Instructors from all three agencies participated in the training of those in attendance. Each of the topics listed in your draft report has been the subject of considerable work by the three agencies (except, of course, shared national credits, which is under way) and, while there is more to be done, a solution and final position on each is close to completion. Finally, in addition to those topics mentioned on page 15 of your draft report, we suggest that the following major topics are also under consideration and are being worked on by the Interagency Supervisory Committee; namely, a uniform approach to nonaccrual loans, a uniform treatment of concentrations of credit, and a uniform trust department rating system. We suggest that at least the second full paragraph on page 15 be rewritten to include the factual material set forth here.

5. Chapter 4, page 25 - The first full paragraph on page 25 states that the Corporation can initiate proceedings to terminate a bank's deposit insurance when its financial condition "continues" to be unsafe and/or unsound. The Financial Institutions Supervisory Act of 1966 amended the enforcement authority of the Federal Bank Regulatory Agencies and, in the course of so doing, amended Section 8(a) of the Federal Deposit Insurance Act by, among other things, deleting the word "continued." Accordingly, it is no longer necessary to prove that the condition, practice or violation has continued, or is continuing for a period of time, in order for the Corporation to initiate proceedings to terminate a bank's deposit insurance. We suggest, therefore, that the word "continues" in the first line of the first full paragraph on page 25 of your draft report be deleted.

6. Chapter 4, page 25 - The last sentence of the last full paragraph on page 25 indicates that the method by which the Corporation will seek to correct constitutional defects in Section 8(g) of the Federal Deposit Insurance Act, will be to propose legislation to correct those defects. However, another method which the Corporation is pursuing to attempt to correct the procedural "due process" problem of Section 8(g) is the issuance of procedural regulations to, among other things, afford the individual an administrative hearing. We suggest also, therefore, that the last sentence of the full paragraph on page 25 be amended as follows: Delete the period and add the following language "or issue procedural regulations to correct the procedural 'due process' problem."

7. Chapter 4, page 29 - The second sentence in the first paragraph under the heading "Methods used to protect depositors" states only that the Corporation accepts appointments as receiver for State banks when requested by the chartering

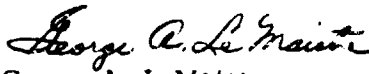
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authority. In the case of the failure of a State bank, under Section 11(e) of the Federal Deposit Insurance Act (12 U.S.C. 1821(e)), the Corporation may accept such appointment only where it is authorized to act as a receiver under State law. It is suggested that the second sentence of the first paragraph under the aforementioned heading on page 25 be amended, as follows: Delete the period and add the following language "and is authorized or permitted by State law."

We appreciate this opportunity to comment on your draft report and trust it will be possible for you to make the changes suggested or to include our comments in the final report.

Sincerely,

  
George A. LeMaitre  
Chairman