UNITED STATES
GENERAL ACCOUNTING OFFICE

REPORT TO THE CONGRESS

Audit Of Federal Deposit Insurance Corporation For The Year Ended June 30, 1974 Limited By Agency Restriction On Access To Bank Examination Records

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

FOD-75-9 JUNE 11, 1975

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

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

This report summarizes the results of our audit of the Federal Deposit Insurance Corporation for the year ended June 30, 1974.

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

Elmer B. Staats

Comptroller General
of the United States

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COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

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D I G E S T

WHY THE AUDIT WAS MADE

The Federal Deposit Insurance Act of 1950 requires GAO to audit the Corporation.

OPINION ON FINANCIAL STATEMENTS

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

As in prior years, GAO did not have unrestricted access to bank examination reports and related documentation. Therefore, GAO could not determine

--whether bank examinations were of sufficient scope and reliability to identify all banks that should have been classified as problem banks,

--whether the Corporation had taken effective followup action on findings disclosed by bank examiners, and

--the significance of any possible adverse effects of problem banks on the Corporation's financial position

GAO believes the loss on the security sale in connection with the U.S. National Bank closing should have been recognized as an insurance loss rather than an offset against interest income. Had This been done, the assessment income credit (dividend) made available to insured banks would have been reduced by $7.6 million. (See p. 14.)

For these reasons GAO cannot express an overall opinion on the financial condition of the Corporation as shown on the accompanying financial statements for fiscal years 1973 and 1974. However, the individual amounts shown in the financial statements are fairly stated as of June 30, 1973, and June 30, 1974, and for the fiscal years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

OTHER MATTERS OF INTEREST

GAO could not fully discharge its audit responsibilities because the Corporation would not permit unrestricted access to examination reports, files, and other records related to insured banks. GAO believes that access to these records is essential because they contain facts, opinions, and recommendations of vital importance to the conduct of the Corporation's affairs.

The Corporation believes that the basic concept of confidentiality, regarding open bank data, is essential for proper supervision and functioning of banks. (See p. 4.)

On November 27, 1974, the maximum insurance for each depositor increased from $20,000 to $40,000. In addition, the individual deposit accounts of Federal, State, and local governments are now insured to a maximum of $100,000. (See p. 1.)

On October 18, 1973, the Comptroller of the Currency closed the U.S. National Bank, San Diego, California, and appointed the Corporation receiver. U.S. National Bank had over $1.2 billion in assets and approximately $932 million in deposits. According to Corporation estimates, about $461 million of these deposits were insured. The Crocker National Bank of San Francisco took over the acceptable assets and substantially all of the deposit liabilities of U.S. National; the remainder was acquired by the receiver.

On December 31, 1973, the Corporation established a $48.3 million reserve for loss in connection with this closing. Subsequent events resulted in the reserve increasing to $162 million as of June 30, 1974. The reserve for loss has been reduced to $150 million but there are indications that further increases in the loss reserve may occur. (See pp. 9 to 11.)

On October 8, 1974, the Comptroller of the Currency closed the Franklin National Bank, Brooklyn, New York, and appointed the Corporation receiver. Franklin National, which was the largest bank to close in the history of the United States, had over $3.6 billion in assets and approximately $1.4 billion in deposits. According to Corporation estimates, about $744 million of these deposits were insured.

The European-American Bank and Trust Company assumed $1.7 billion in deposits and other liabilities and purchased $1.6 billion in assets; the remainder was acquired by the Corporation. The Corporation has not established a reserve for loss because GAO was told a review and evaluation of the assets it acquired has not been completed. (See pp. 11 and 12.)

In prior audit reports to the Congress on the Corporation, GAO recommended that the Corporation reimburse the employees' compensation fund for benefit payments made after the creation of the Corporation.

The Corporation has reimbursed the employees' compensation fund for payments made during fiscal years 1962 through 1974. (See p. 21.)

The Corporation did not include all losses in computing the assessment income credit (dividend) for 1973. As a result, $7.6 million which we believe the Corporation should have retained was made available to the insured banks. (See pp. 14 and 15.)

The Corporation disagrees and believes these losses were properly excluded in computing the credit. (See pp. 15 to 20.)

AGENCY ACTIONS AND UNRESOLVED ISSUES

Both the Corporation and GAO believe that the law supports their respective positions on the access-to-records problem. Repeated efforts to resolve the matter administratively have failed.

MATTERS FOR CONSIDERATION BY THE CONGRESS

GAO recommends that the Congress amend the Federal Deposit Insurance Act to grant GAO access to examination reports, files, and other records used by the Corporation. (See p. 5.)

CHAPTER 1

INTRODUCTION

The Federal Deposit Insurance Corporation, an independent Government agency, insures deposits in qualified banks. National banks which are chartered by the Comptroller of the Currency and all State banks which are members of the Federal Reserve System are required to be insured. State banks which are not members of the Federal Reserve System may become insured upon approval of their application.

On November 27, 1974, the maximum insurance for each depositor increased from $20,000 to $40,000. In addition, the individual deposit accounts of Federal, State, and local governments are now insured to a maximum of $100,000.

The Corporation also acts, when appointed to do so, as receiver for insured banks that have been closed. On June 30, 1974, the Corporation had 26 active receivership cases.

The Corporation finances its operations from assessments against insured banks and from its investments in U.S. Government securities. The deposit insurance fund, representing the accumulated net income, totaled $5.8 billion on June 30, 1974. This amount was 1.21 percent of the insured deposits of $484.9 billion in the 14,440 insured banks on June 30, 1974. The Corporation can borrow up to $3 billion from the U.S. Treasury when, in the judgment of the Board of Directors, such funds are required for insurance purposes. The Corporation has never used this borrowing authority.

Management of the Corporation is vested in the Board of Directors, composed of (1) two members appointed by the President of the United States by and with the advice and consent of the Senate and (2) the Comptroller of the Currency. The board members are listed in appendix II. (See p. 40.)

EXAMINATION OF INSURED BANKS

The Corporation's Division of Bank Supervision consists of 104 staff members in headquarters and 1,819 staff members in 14 regional offices. This Division periodically examines insured State banks which are not members of the Federal Reserve System. Of the 8,677 insured State nonmember banks at June 30, 1974, the Corporation reported that it examined 7,505 during fiscal year 1974. As stated in chapter 2, we were denied unrestricted access to examination reports. Therefore, we are unable to evaluate the examinations performed.

On January 1, 1974, the Corporation initiated an experimental selective examination withdrawal program for examining insured State nonmember banks in Iowa, Georgia, and Washington. For selected banks in these States, the Corporation is reviewing the State banking departments' examination reports instead of performing a complete examination. The Corporation reported that it reviewed 93 such examination reports during fiscal year 1974.

The Comptroller of the Currency and the Federal Reserve banks examine national banks and State member banks, respectively. The Corporation has access to and reviews their examination reports. Of the 4,695 national banks and 1,068 State member banks at June 30, 1974, the Corporation reported that it reviewed 1,437 national bank and 365 State member bank examination reports during fiscal year 1974. We were denied unrestricted access to these examination reports. Therefore, we are unable to evaluate the examinations performed.

CHAPTER 2

CONTINUED RESTRICTION ON ACCESS TO REPORTS AND RECORDS ON BANK EXAMINATIONS

As in prior years, we could not fully discharge our audit responsibilities under the Federal Deposit Insurance Act because Corporation officials did not give us unrestricted access to examination reports, files, and other records relating to insured banks, except for the records of closed banks.

Access to the records of the Corporation's Division of Bank Supervision is essential to a meaningful audit. The Division employs 76 percent of the Corporation's total personnel, and the Division's efforts and reports are an essential part of the Corporation's operations. The reports on insured banks contain facts, opinions, and recommendations of vital importance to the conduct of the Corporation's affairs. Without unrestricted access to these reports and the supporting documentation, we cannot evaluate important information affecting the Corporation's financial operations and condition.

The Corporation's financial condition is related to the financial condition of the banks it insures. As the closings of the U.S. National Bank of San Diego and the Franklin National Bank demonstrated (see pp. 9 to 12), large bank failures have a major impact on the Corporation. Without unrestricted access to the bank examination reports and related information, the General Accounting Office cannot evaluate all information affecting financial operations in order to advise the Congress of the Corporation's financial condition.

Previously, the majority of problem banks had not required a financial outlay by the Corporation because potential problems were identified and appropriate corrective actions were taken. On the other hand, certain banks failed shortly after appearing on the problem list, apparently because the condition of the banks had deteriorated beyond the point where corrective action was feasible. Therefore, early identification of potential problems appears to minimize the possibility of subsequent bank failures. Accordingly, we require access to all open bank records--problem and nonproblem--to evaluate the Corporation's efforts in examining and supervising insured banks.

Because of the Corporation-imposed restrictions, we could not determine (1) whether bank examinations were of sufficient scope and reliability to identify all the 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 effects of problem banks on the Corporation's financial position.

The Corporation believes that the basic concept of confidentiality of bank data is, in the public interest, essential to the proper supervision of banks, and essential to the effective functioning of the deposit insurance program.

The positions of GAO and the Corporation on this matter are set forth in detail in our report to the Congress, "Audit of the Federal Deposit Insurance Corporation, Year Ended June 30, 1964" (B-114831, February 28, 1966). Some of the basic issues are restated in our report to the Congress, "Audit of Federal Deposit Insurance Corporation for the Year Ended June 30, 1972, Limited by Agency Restriction on Access to Bank Examination Records" (B-114831, April 23, 1973) and in our report with the same title for the year ended June 30, 1973 (B-114831, May 23, 1974).

In the Corporation's comments of March 31, 1975, on our 1974 report, the Chairman stated that, in reference to the positions discussed in the previous reports the Corporation's views, "which have been expressed fully, have not changed."

Both the Corporation and GAO believe the present law supports their respective positions. Repeated efforts to resolve this matter administratively have been unsuccessful.

MATTERS FOR CONSIDERATION BY THE CONGRESS

To more effectively carry out our audit responsibility, we recommend that the Congress amend the Federal Deposit Insurance Act to clarify our authority to have access to examination reports, files, and other records of the Corporation, the Federal Reserve banks, and the Comptroller of the Currency.

For this purpose the third sentence of section 17(b) of the act (12 U.S.C. 1827(b)) should be amended to read as follows:

> "The representatives of the General Accounting Office shall have access to all books, accounts, records, reports, files, and all other papers, things, or property belonging to or in use by the Corporation pertaining to its <u>accounts and operations</u> and necessary to facilitate the audit, <u>including bank examination reports and related records</u>, and they shall be afforded full facilities for verifying transactions with the balances or securities held by depositaries, fiscal agents, and custodians." (Underscoring denotes the change required.)

CHAPTER 3

PROBLEM BANKS AND BANK FAILURES

PROBLEM BANKS

The Corporation classifies problem banks as serious problem-potential payoffs, serious problems, and other problems. A "serious problem-potential payoff bank" is one considered to have at least a 50-percent chance of requiring financial assistance from the Corporation in the near future. A "serious problem bank" is one which threatens ultimately to involve the Corporation in a financial outlay unless a drastic change can be made. An "other problem bank" is one which is less vulnerable but requires aggressive supervision.

The Corporation's estimate of the number of problem banks and the estimated insured deposits at June 30, 1974 and 1973, are shown below.

	Number of banks		Estimated insured deposits	
	June 30, 1974	June 30, 1973	June 30, 1974	June 30, 1973
			(000 omitted)	
Serious problem-potential payoff banks:				
State nonmember	6	2	$ 49,998	$ 16,474
State member	2	1	10,986	8,095
National	3	2	1,175,732	449,991
Total	11	5	1,236,716	474,560
Serious problem banks:				
State nonmember	32	16	672,970	124,366
State member	-	3	-	103,511
National	6	5	128,197	56,760
Total	38	24	801,167	284,637
Other problem banks:				
State nonmember	85	101	975,831	1,409,665
State member	8	9	820,834	833,534
National	10	20	482,006	201,548
Total	103	130	2,278,671	2,444,747
Total	152	159	$4,316,554	$3,203,944

During fiscal year 1974, the Corporation removed 100 banks from the problem-bank classification--97 because of improvements in bank management and/or financial condition and 3 because of bank failure--and added 93 other banks, making a total of 152 problem banks at June 30, 1974.

To correct problem conditions at an insured bank, the Corporation and the appropriate bank regulatory body--the Comptroller of the Currency, the Federal Reserve Board, or the State banking authority--attempt to obtain the bank management's cooperation. When corrective action cannot be obtained by this method, the Corporation is authorized to take corrective measures, subject to certain protective standards and procedures. Under this authority the Corporation, during fiscal year 1974, issued seven cease-and-desist orders to, and initiated two additional proceedings against, insured state nonmember banks engaged in unsafe and unsound practices. Moreover, four orders of suspension and one notice of intention to remove bank officials were approved.

When unsafe and unsound practices persist, the Corporation is authorized to initiate proceedings which may result in terminating the bank's deposit insurance coverage. The Corporation initiated one such proceeding during fiscal year 1974.

When an insured bank is in danger of closing, the Corporation is authorized to make loans to the bank when its continued operation is essential to provide adequate banking service to the community. Under this authority the Corporation had $37 million in outstanding loans as of June 30, 1974.

BANK FAILURES

During fiscal years 1970-74, 24 insured banks failed, as shown below.

Fiscal year	Number of Insured Banks Which Failed: State Nonmember	State Member	National	Total
1970	5	-	2	7
1971	7	-	1	8
1972	2	-	1	3
1973	2	-	1	3
1974	1	-	2	3
Total	17	-	7	24

The Comptroller of the Currency can declare a national bank insolvent and the State banking authorities can declare a State bank insolvent. In these cases, the Corporation is appointed receiver for closed national banks and accepts appointment as receiver for closed insured State banks when requested by the State authorities. The principal methods the Corporation has used to protect the depositors of these banks has been (1) directly paying off insured deposits or (2) assisting other banks in purchasing the assets and assuming the liabilities of the closed bank. This latter method, which is referred to as a deposit assumption, can be authorized whenever, in the judgment of the Corporation's Board of Directors, it will reduce the risk or avert a threatened loss to the Corporation. During fiscal years 1970-74, the Corporation made 14 payoffs and authorized 10 deposit assumptions.

Methods of Protecting Depositors and the Corporation's Estimated Losses as of June 30, 1974

Fiscal year	Payoff: Number	Payoff: Estimated loss (000 omitted)	Deposit assumption: Number	Deposit assumption: Estimated loss (000 omitted)	Total: Number	Total: Estimated loss (000 omitted)
1970	4	$ 855	3	$ -	7	$ 855
1971	4	9,250	4	400	8	9,650
1972	3	2,150	-	-	3	2,150
1973	2	350	1	300	3	650
1974	1	2,000	2	162,200	3	164,200
	14	$14,605	10	$162,900	24	$177,505

The Corporation estimated that, for the three banks which failed during fiscal year 1974, the insured deposits totaled about $477.1 million and that its losses at June 30, 1974, were about $164.2 million.

Bank	Date closed	Estimated insured deposits	Estimated loss to Corporation
		(000 omitted)	
First State Bank, Vernon, Texas	7-16-73	$ 9,955	$ 2,000
First National Bank of Eldora, Eldora, Iowa	10- 5-73	6,168	200
U.S. National Bank of San Diego, San Diego, California	10-18-73	461,000	162,000
		$477,123	$164,200

The Corporation in discharging its insurance indemnity liability for the three banks had paid, as of June 30, 1974, 99.9 percent of the insured deposits in the First State Bank. The Corporation also facilitated the acquisition of the First National Bank of Eldora and the U.S. National Bank of San Diego by other insured banks. On October 8, 1973, Second National Bank of Eldora acquired First National Bank. The acquisition of U.S. National Bank is described in the following section.

Closing of U.S. National Bank of San Diego

On October 18, 1973, the Comptroller of the Currency closed the U.S. National Bank, San Diego, California, and appointed the Corporation receiver. On the same day, the Crocker National Bank of San Francisco assumed substantially all the deposit liabilities and purchased the closed bank's acceptable assets. At the time of its closing, U.S. National had over $1,200 million in assets and approximately $932 million in deposits. About $461 million (49 percent) of the deposits were insured. In consummating the deposit assumption, the Corporation:

1. As receiver, accepted the $89.5 million purchase premium bid by Crocker National Bank.

2. As receiver, purchased the U.S. National's unacceptable assets having a total book value of $412 million.

3. Paid the Crocker National Bank $130 million for the difference between the acceptable assets and the liabilities assumed and paid the Federal Reserve Bank of San Francisco $30 million as consideration for releasing assets pledged by U.S. National.

4. As receiver, assumed liabilities of $117 million and the $49 million capital account of the closed bank.

5. Purchased a $50 million 7-1/2-percent note from the Crocker National Corporation to provide Crocker National Bank with additional capital.

On December 31, 1973, the Corporation established a $48.3 million reserve for loss in connection with this closing.

As of June 30, 1974, the Corporation had spent $318 million in connection with U.S. National's closing. This is an increase of $158 million since the deposit assumption occurred. The receiver has paid Crocker an additional $101 million for assets subsequently found to be unacceptable. The receiver also paid $49.9 million to holders of letters of credit and $7.6 million for other assets relating to the closing.

As a result of these transactions and a reappraisal of assets and liabilities previously acquired, the Corporation, as of June 30, 1974, increased the reserve for loss to $162 million. On February 3, 1975, the Corporation's Division of Liquidation recommended that the reserve for loss be increased to $178 million. After reviewing the recommendation, the Board of Directors reduced the established reserve from $162 million to $150 million.

This reserve may be understated because of a class suit filed on behalf of all creditors of U.S. National whose claims were not assumed by Crocker. The plaintiff is seeking to void the deposit assumption agreement because it allegedly created illegal preferences. The suit was dismissed in District Court but was appealed to the 9th Circuit which sent the case back to the District Court for trial on its merits. A subsequent decision adverse to the Corporation would have a considerable monetary impact.

Closing of Franklin National Bank

On October 8, 1974, the Comptroller of the Currency closed the Franklin National Bank, Brooklyn, New York, and appointed the Corporation receiver. On the same day, European-American Bank and Trust Company, an insured New York State-chartered bank, assumed $1,704 million of deposits and other liabilities and purchased $1,579 million of the closed bank's assets. The assuming bank's purchase premium bid of $125 million was the highest of the four bids received. The other bids were submitted by Manufacturers Hanover Trust Company, Chemical Bank, and First National City Bank.

Franklin National was the largest bank to close in United States history with book value assets of $3,662 million and deposits of approximately $1,440 million. Of those deposits, the Corporation estimates that $744 million was insured.

In its corporate capacity the Corporation purchased $2,083 million of Franklin's assets and assumed Franklin's $1,723 million debt to the Federal Reserve Bank of New York. The debt repayment will be completed at the end of 3 years through liquidating the purchased assets, with the Corporation making up any shortfall. The Corporation has also purchased a $100 million capital note from European-American Bank and Trust Company to provide additional capital.

Corporation officials advised us that a reserve for loss relating to the Franklin National Bank closing has not been established. The reason given was that the Corporation is reviewing and evaluating the assets it acquired. Until this evaluation is completed, these officials told us, the

Corporation will not be in a position to determine the amount of loss, if any, which it will sustain.

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The Corporation's records show that the bank failures in the last several years had resulted from various combinations of unsound and deceptive practices in operations, including misuse of bank funds by bank officers, directors, and owners; substandard loans and excessive appraisals of collateral; unwarranted loans in which bank officials, directors, and owners had personal financial interests; loans in excess of the limits prescribed by law; broker-solicited funds in certificates of deposit and related, unwarranted out-of-territory lending; inadequate capital; unsatisfactory management; and defalcations.

Estimated liability for future bank failures

The Corporation's financial statements do not show an estimate of the liability which the Corporation will incur from future failures of insured banks. The Corporation recognizes losses resulting from bank failures in the period in which they are incurred. This policy is contrary to generally accepted accounting principles which advocate matching expenses to the periods in which the revenues are recognized.

This matter was discussed in earlier GAO reports on financial operations of the Corporation.

AGENCY COMMENTS

In the Corporation's March 31, 1975, comments on our 1974 report, the Chairman said a computation of an estimated liability for future bank failures would be impossible. The Chairman stated:

> "At any point in time, it would be coincidental if we had knowledge of future bank failures. Even if we felt that an individual bank might represent a potential future failure, it would be impossible for us to make accurate estimates of the Corporation's liability in such a case. Any such eventual losses and contingent liability would depend upon factors which

could not be assessed until or after a given bank actually failed.

"Accordingly, we do not believe it would be good accounting practice nor possible for us to carry on our books estimates of liabilities which could result from developments which have not occurred during the accounting period involved; or which may not happen at all in the future accounting periods. In those circumstances, we must disagree with your proposals in this connection and believe that both pragmatic and accounting considerations would support our view. In effect, there is no actuarial basis for computing or accounting for our contingent liabilities in future closed bank situations. We cannot know which, if any insured banks will fail at some future time and, therefore, we have no basis for computing a contingent liability in those unidentifiable future cases. Thus, we believe your proposed comments on this issue are not valid."

Estimates by their nature cannot be accurate, only reasonable. Since 1934 at least one bank has closed each year, resulting in a financial outlay by the Corporation. Therefore, we believe that any financial statement the Corporation issues which does not reveal a reasonable estimate of liabilities resulting from future bank closings does not fully reveal the Corporation's financial position.

The estimated liability, in our opinion, can be derived from (1) past bank failures and (2) the banks on the Corporation's problem list. The Corporation defines a "serious problem-potential payoff bank" as one considered to have at least a 50-percent chance of requiring financial assistance from the Corporation in the near future. The Corporation defines a "serious problem bank" as one which threatens ultimately to involve the Corporation in a financial outlay unless a drastic change can be made. Accordingly, we believe the Corporation can and should show on its financial statements an estimate of the liability which it will incur because of future bank failures.

CHAPTER 4

OVERPAYMENT OF DIVIDENDS

TO INSURED BANKS

Under section 7 of the Federal Deposit Insurance Act (12 U.S.C. 1817), the Corporation assesses insured banks at a rate one-twelfth of 1 percent per year on the banks' average deposit liability less certain items. At the end of each calendar year, the Corporation computes its net assessment income, which is the total of the assessments less operating costs and expenses, increases in reserve for insurance losses, and sustained insurance losses. The Corporation includes in reserve for insurance losses the difference between its cash outlays and the expected recoveries in deposit assumptions and/or direct payoffs. Deposit assumptions and direct payoffs are explained in chapter 3 (p. 8.) Also included in the losses are all other expenses relating to bank closings, such as salaries and travel of Corporation personnel directly involved in the closings. After the net assessment income is computed, 66 and two-thirds percent is made available to the insured banks in the form of a prorated credit (dividend) against future assessments and 33 and one-third percent is retained by the Corporation. The purpose of this provision is to have the assessment income cover the Corporation's operating expenses and insurance losses each year.

The Corporation sustained a loss on security sales in conjunction with the U.S. National Bank closing. This loss was not accounted for in the computation of the 1973 assessment credit as were other expenses related to bank closings. Thereby, over $7 million, which, in our opinion, the Corporation should have retained, was made available as a credit (dividend) against the assessments due from the insured banks. The details follow.

In October 1973 the Corporation made a $210 million cash outlay to facilitate the Crocker National Bank's purchase and assumption of the closed U.S. National Bank. To raise the required funds the Corporation sold some of its investments in Government securities at an $11 million loss. In accounting for this loss, the $11 million was offset against interest income. The Corporation's position is that this loss was not an operating expense or an insurance loss; therefore, it was not included in the computation of the assessment credit.

Before the U.S. National Bank closing, the Corporation considered the alternatives available to protect the insured depositors. From these alternatives the Corporation determined that a deposit assumption would (1) reduce its overall loss from the bank closing and (2) protect the depositors of the closed bank. The securities were sold to provide the funds required to consummate the deposit assumption. Therefore, we believe that the resulting loss on the security sale should be recognized as an insurance loss. For this reason, we believe the $11 million loss should have been included in the computation of the assessment credit. Had this loss been included in the computation, the credit would have been reduced by $7.6 million.

AGENCY COMMENTS

In the Corporation's March 31, 1975, comments on our report, the Chairman addressed at some length the issue concerning the sale of securities during fiscal year 1974, and whether the loss on such sale should have been considered in the Corporation's assessment credit computation for calendar year 1973. The Chairman stated that:

> "* * * the losses taken by the Corporation in the sale of certain securities were a conscious aspect of the Corporation's portfolio management and were neither forced by nor more than indirectly involved in the USNB [U.S. National Bank] failure, except that they occurred in the same general timeframe."

The documentation we reviewed in connection with the sale of the securities indicated that they were sold to provide the funds required by the U.S. National Bank's closing. Moreover, the Corporation's Financial Audits Branch's report for the period involved stated that these sales were necessary to obtain funds in connection with the October 1973 U.S. National Bank's closing.

The Chairman added that:

"We were aware in the early summer of 1973 that we might very well have to make substantial disbursements in connection with the eventual resolution of the USNB situation. Two options were readily available:

"(1) We could simply accummulate or hold funds in the form of Certificates of Indebtedness * * *. While our funds remain in this instrument, our yield represents the prior month's average of the 91-day Treasury bill rate. This rate can be volatile, so it is our normal practice - except in very heavy income periods - not to accumulate and carry large balances in Certificates of Indebtedness. Instead, when such balances take on substantial proportions, it is our policy to reinvest those funds in intermediate-term securities providing guaranteed stable yield for some period of time. In fact, on May 31, 1973, we held $289 million of Certificates of Indebtedness, knowing then of the possibility of later developments in San Diego.

"(2) The second option suggested that we continue to reinvest Certificates funds during the summer of 1973 in the interests of assured yield, notwithstanding the probable requirement that large sums might be necessary in connection with the USNB failure. This meant that - when the USNB requirements were made known - we would stand ready to liquidate selected parts of our portfolio in order to produce those funds. This is the essential purpose of the deposit insurance fund."

The Chairman continued that:

"We chose the latter option, in the interests of assuring average yield, rather than to hold or pile up funds in our Certificates of Indebtedness."

According to the Chairman, the stated practice is for the Corporation to not normally carry large balances in Certificates of Indebtedness. However, our analysis of these investments shows that the balance increased from $289.0 million in May 1973 to $776.7 million in February 1975. Moreover, the average balance in these investments for the year ending February 1975 was about $485 million.

The Chairman further stated that:

"* * * we decided not to accumulate Certificates during the summer of 1973 and reinvested those funds. When it then came time to liquidate certain securities for possible use in the USNB situation, we went further and asked Treasury to see if it could dispose of certain long-term issues which were having the effect of dragging down our average yield. These long-term securities had been purchased by the Corporation many years before and we had debated for a considerable period the wisdom of liquidating them in the long-term interest of our average yield."

During our review of the Corporation's investment activities for fiscal year 1974, we found that not only were low yield securities sold but also security issues with relatively high yield. The following table summarizes the sales transactions:

Securities Sold by the Corporation

Security	Book value sold	Balance 6-30-74	Gain or loss (-)	Yield to cost rates
	(millions)			
6% notes	$ 3.0	$210.6	-0.1	6.07
7% notes	22.5	166.1	- .0	7.06
6-1/2% notes	18.7	191.1	- .2	6.53
7-3/4% notes	67.3	294.1	2.2	7.98
6% notes	33.5	598.1	-1.1	6.03
6-1/4% notes	32.7	522.5	-1.4	5.99
6-3/8% bonds	1.5	329.9	- .1	6.24
3-1/2% bonds	10.0	157.9	-2.5	3.82
3% bonds	15.0	6.0	-3.5	3.08
3-1/2% bonds	19.9	81.8	-4.6	3.58
4-1/8% bonds	51.7	-	- .2	4.43

Our review also disclosed that several security issues with yield ratios of less than 4.25 percent were part of the investment portfolio and none of these securities were sold.

The Chairman also stated that:

> "* * * the USNB failure simply served as a catalyst in pursuing an investment course which we had been considering for some time and one which the Corporation even now is considering in greater magnitude."

The Corporation has not sold any more securities since October 1973.

The Chairman continued that:

> "* * * [the] Treasury was unable to sell large volumes of these securities but, on those for which it could find buyers, the market price produced book value losses for the Corporation. We were quite willing to take those losses on the grounds that our continuing possession of those issues was of little use to the Corporation, given present-day yields, and that similar sums reinvested at the rates available would recoup these losses in some six to eight years."

During our review, we discussed the sale with Corporation officials and also with appropriate Treasury Department officials. They were unable to provide us with any analyses concerning which issues should be sold.

The Chairman continued that the sale and the securities involved were verbally arranged with the Treasury Department. He stated that:

> "* * * You will also note that the next paragraph of the authorization indicates that it was in keeping with verbal arrangements made by the Controller of this Corporation with Mr. Carlock. Those verbal arrangements requested Mr. Carlock to see what his people could do to get rid of some portion of our long-term securities. This was an after-the-fact authorization in that we had determined verbally that

Treasury could only dispose of parts of our holdings of these particular long-term issues during September, resulting in book value losses which we expected."

During our review we were unable to obtain any documentation pertaining to specific securities that were to be sold to raise the funds needed for the U.S. National Bank closing. Our review of the Treasury Department's correspondence for the Corporation's securities activity disclosed several documents relating to the sale but not in any specific nature. In fact, the telegram from the Treasury to the President of the Federal Reserve Bank of New York authorizing the sale did not mention specific security issues but rather stated that specified amounts of any U.S. Treasury securities held in account for the Corporation should be sold at the highest price obtainable.

The Treasury official added that his office was not in a position to advise the Corporation what to sell because the Treasury did not have the necessary information on current book value.

In conclusion the Chairman stated that:

"The thrust of these operations is that we decided to pursue an investment policy during the summer of 1973 which represented our view of the best interests of the Corporation in terms of our portfolio management. The USNB situation was simply a partial catalyst in the sense that we knew we would need funds sooner or later. The losses we chose to take on the disposition of a relatively small portion of our long-term issues were the culmination of portfolio discussions having a considerable history. These disposals and losses were not caused by USNB and could have been avoided completely had we chosen other investment policy alternatives. Meantime, the basic investment policy issue remains: that is, whether we should take further book value losses in order eventually to improve our average yield.

"In view of the foregoing, we believe our assessment credit was computed properly and that no adjustments are necessary with respect to the 1975 credit."

We continue to believe that the loss on the sale of securities should have been included in the computation of the assessment credit. If it had been included, the credit would have been reduced by $7.6 million.

CHAPTER 5

STATUS OF EARLIER RECOMMENDATIONS

In our earlier audit reports, we recommended that the Federal Deposit Insurance Act be amended to require the Corporation to reimburse the employees' compensation fund for benefit payments made from that fund on account of the Corporation's employees for all periods after the creation of the Corporation.

In his March 4, 1974, letter, the Chairman said that:

> "For several years, based upon somewhat institutional views and prior interpretations, the Corporation has supported GAO's recommendation that the Federal Deposit Insurance Act be amended * * * [to] reimburse the employees' compensation fund for benefit payments made after the creation of the Corporation.
>
> "In the past year we have reviewed and researched these situations carefully. On the basis of discussions with individuals in GAO and in the Civil Service Commission, * * *.
>
> "* * * we have concluded that we can find a legal basis, notwithstanding earlier interpretations, for reimbursing the employees' compensation fund for benefit payments made after the creation of the Corporation and more recently. The latter conclusion will permit us to repay any compensation benefits which have inured to our employees and will also permit us to pay such costs in the future."

Accordingly, the Corporation reimbursed the employees' compensation fund $195,149 for payments made during fiscal years 1962 through 1974.

CHAPTER 6

SCOPE OF AUDIT AND

OPINION ON FINANCIAL STATEMENTS

SCOPE OF AUDIT

We have examined the statement of financial condition of the Federal Deposit Insurance Corporation as of June 30, 1973, and June 30, 1974, the related statements of income and deposit insurance fund for the years then ended and of changes in financial position for the year ended June 30, 1974, and the statement of analysis of the deposit insurance fund from the fund's inception. Our examination was made in accordance with generally accepted auditing standards and, with the exception concerning review of bank examination reports and related data which is discussed in chapter 2 (see p. 3), included such tests of the accounting records and such other auditing procedures as we considered necessary.

During fiscal year 1974 the Corporation's Financial Audits Branch completed 11 reports on various aspects of the Corporation's operations. We relied as far as possible on the work of the internal auditors in our review.

OPINION ON FINANCIAL STATEMENTS

The Corporation prepared the financial statements in this report. These financial statements do not show an estimate of the liability which the Corporation will incur because of future bank closings.

Because we did not have unrestricted access to examination reports and related documentation on insured banks (see p. 4), 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.

As discussed in chapter 4, page 14, we believe the loss on the security sale in connection with the U.S. National Bank closing should have been recognized as an insurance loss rather than an offset against interest income.

For these reasons we cannot express an overall opinion on the accompanying financial statements for fiscal years 1973 and 1974. However, the individual amounts shown in the financial statements are fairly stated as of June 30, 1973, and June 30, 1974, and for the fiscal years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

SCHEDULE 1

FEDERAL DEPOSIT INSURANCE CORPORATION

COMPARATIVE STATEMENT OF FINANCIAL CONDITION

JUNE 30, 1974 AND JUNE 30, 1973

	June 30, 1974 (000 omitted)		June 30, 1973	
ASSETS				
CASH		$ 6,121		$ 7,372
U.S. GOVERNMENT SECURITIES:				
Securities at amortized cost (note a)	$5,851,592		$5,632,899	
Accrued interest receivable	87,935	5,939,527	82,094	5,714,993
ASSETS ACQUIRED IN RECEIVERSHIP AND DEPOSIT ASSUMPTION TRANSACTIONS:				
Subrogated claims of depositors against closed insured banks	$ 60,013		$ 75,045	
Net insured balances of depositors in closed insured banks, to be subrogated when paid, see related liability	778		1,137	
Equity in assets acquired under agreements with insured banks (note b)	327,659		28,100	
Corporation purchases	4,699		4,964	
	$ 393,149		$ 109,246	
Less reserves for losses (note c)	192,031	201,118	40,586	68,660
Note purchased to facilitate deposit assumption				
Principal (note d)	50,000		- 0 -	
Accrued interest receivable	935	50,935		- 0 -
ASSISTANCE TO OPERATING INSURED BANKS				
Principal	$ 37,000		$ 37,000	
Accrued interest receivable	487	37,487	487	37,487
LAND AND OFFICE BUILDING, less depreciation on building		6,891		7,026
MISCELLANEOUS ASSETS		685		957
Total Assets		$6,242,764		$5,836,495

Note (a) The securities had a face value of $5,860,812,000 cost of $5,832,859,000, and market value of $5,388,724,000 at June 30, 1974.

(b) Equity in assets acquired under agreements with insured banks increased by $299,559,000 during fiscal year 1974. Included in this net increase is $306,375,000 in connection with the closing of U.S. National Bank. Net decreases in this account amounted to $6,816,000 during fiscal year 1974.

(c) Includes $162,000,000 provision for loss in connection with the closing of U.S. National Bank. Not included in this provision for loss is the potential liability of a class action suit filed against the Receiver, the Corporation and Crocker National Bank as discussed in footnote 3.

(d) This note was purchased by the Corporation to facilitate the purchase of certain assets and the assumption of certain deposit and other liabilities of U.S. National Bank, San Diego, California by Crocker National Bank, San Francisco, California. The Corporation purchased the promissory note from Crocker National Corporation, a Delaware Corporation, on October 22, 1973, in the amount of $50,000,000. This note matures five years from the date of execution. Interest is 7½ per cent per annum payable quarterly.

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

The opinion of the General Accounting Office on these statements appears on page 22.

SCHEDULE 1

		June 30, 1974		June 30, 1973
		(000 omitted)		
LIABILITIES AND DEPOSIT INSURANCE FUND				
ACCOUNTS PAYABLE AND ACCRUED LIABILITIES		$ 7,001		$ 3,798
EARNEST MONEY, ESCROW FUNDS AND COLLECTIONS HELD FOR OTHERS		1,178		1,099
ACCRUED ANNUAL LEAVE OF EMPLOYEES		3,435		3,259
DUE INSURED BANKS:				
Net assessment income credits:				
Available July 1, 1973	$ - 0 -		$280,247	
Available July 1, 1974	282,878		153,869	
Available July 1, 1975 (Estimated)	101,970			
Other	127	384,975	80	434,196
NET INSURED BALANCES OF DEPOSITORS IN CLOSED INSURED BANKS--See related asset		778		1,137
Total Liabilities		$ 397,367		$ 443,489
DEPOSIT INSURANCE FUND, net income accumulated since inception (Sch. 2)		5,845,397		5,393,006
Total Liabilities and Deposit Insurance Fund		$6,242,764		$ 5,836,495

SCHEDULE 2

FEDERAL DEPOSIT INSURANCE CORPORATION

COMPARATIVE STATEMENT OF INCOME AND DEPOSIT INSURANCE FUND

FISCAL YEARS ENDED JUNE 30, 1974 AND JUNE 30, 1973

	Fiscal Year 1974 (000 omitted)		Fiscal Year 1973	
INCOME:				
Deposit insurance assessments:				
Assessments earned during the year	$556,650		$499,853	
Less net assessment income credits to insured banks -- estimated	231,386	$ 325,264	298,824	$ 201,029
Adjustments of assessments earned in prior years		103		91
		$ 325,367		$ 201,120
Net income from U. S. Government securities		331,239		299,713
Other Income		5,376		2,408
Total Income		$ 661,982		$ 503,241
EXPENSES AND LOSSES:				
Administrative and operating expenses		$ 56,868		$ 51,300
Provision for insurance losses:				
Applicable to banks assisted in the current fiscal year (note e)	$164,200		$ 6,000	
Adjustments applicable to banks assisted in prior years	-12,755	151,445	-6,630	-630
Nonrecoverable insurance expenses incurred to protect depositors--net		1,278		985
Total expenses and losses		$ 209,591		$ 51,655
NET INCOME--ADDITION TO THE DEPOSIT INSURANCE FUND FOR THE YEAR		$ 452,391		$ 451,586
DEPOSIT INSURANCE FUND, at the beginning of the year		5,393,006		4,941,420
DEPOSIT INSURANCE FUND, at the end of the year--net income accumulated since inception		$5,845,397		$5,393,006

Note (e) Includes $162,000,000 provision for loss in connection with the closing of U.S. National Bank. Not included in this provision for loss is the potential liability of a class action suit filed against the Receiver, the Corporation and Crocker National Bank as discussed in footnote 3.

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

The opinion of the General Accounting Office on these statements appears on page 22.

 SCHEDULE 3

FEDERAL DEPOSIT INSURANCE CORPORATION

STATEMENT OF CHANGES IN FINANCIAL POSITION

FISCAL YEAR ENDED JUNE 30, 1974

	Amount (In Thousands)
FUNDS PROVIDED BY:	
Net deposit insurance assessments	$ 325,367
Income from U.S. Government securities, less amortized net discounts	333,963
Maturities and sales of U.S. Government securities, including exchanges of long term securities	1,609,056
Collections on assets acquired in receivership and deposit assumption transactions	51,495
Total funds provided	2,319,881
FUNDS APPLIED TO:	
Administrative, operating and insurance expenses, less miscellaneous credits	$ 52,633
Acquisitions of assets in receivership and deposit assumption transactions	335,757
Purchase of U.S. Government securities, including exchanges of long term securities	1,830,474
Purchase of note to facilitate deposit assumption	50,000
Total funds applied	2,268,864
NET CHANGE IN OTHER ASSETS AND LIABILITIES	$ 51,017

ANALYSIS OF NET CHANGE IN OTHER ASSETS AND LIABILITIES

Assets	1974	1973	Increase (Decrease)
Cash	$ 6,121	$ 7,372	$(1,251)
Accrued interest receivable	89,357	82,581	6,776
Other assets	685	957	(272)
	96,163	90,910	5,253
Less Liabilities			
Accounts payable	7,001	3,798	(3,203)
Collections held for others	1,178	1,099	(79)
Accrued annual leave	3,435	3,259	(176)
Due insured banks	384,975	434,197	49,222
	396,589	442,353	45,764
Net change in other assets and liabilities	$ 300,426	$ 351,443	$ 51,017

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

The opinion of the General Accounting Office on these statements appears on page 22.

 SCHEDULE 4

FEDERAL DEPOSIT INSURANCE CORPORATION

ANALYSIS OF DEPOSIT INSURANCE FUND

FROM INCEPTION TO JUNE 30, 1974

	Amount (In Thousands)
INCOME:	
Insurance assessments	$7,153,533
Less net assessment income credits	3,509,794
Net insurance assessments	$3,643,739
Income from U.S. Government securities	3,055,683
Other operating income (principally interest and allowable return from deposit insurance assumption and receivership cases)	18,817
Total income	$6,718,239
EXPENSES AND LOSSES:	
Administrative and operating expenses	$ 563,201
Deposit insurance losses and expenses	229,079
Interest paid to the Secretary of the Treasury on retired capital stock	80,562
Total expenses and losses	$ 872,842
DEPOSIT INSURANCE FUND, NET INCOME ACCUMULATED SINCE INCEPTION	$5,845,397

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

The opinion of the General Accounting Office on these statements appears on page 22.

FEDERAL DEPOSIT INSURANCE CORPORATION

FOOTNOTES TO THE FINANCIAL STATEMENTS

JUNE 30, 1974

1. 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 June 30, 1974 amortized premiums amounted to $3,655,000 and amortized discounts $22,388,000. Premiums and discounts are amortized on a straight-line basis from the first month after acquisition to the month 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 per 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 per year over a 50-year estimated life. Furniture, fixtures, and equipment are fully depreciated at the time of acquisition.

2. These statements do not include accountability for the assets liabilities of the closed insured banks for which the Corporation acts as receiver or liquidating agent.

3. Legal actions pending against the Corporation on June 30, 1974, involved an estimated potential liability of $264 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 $12 million. This estimated loss has been provided for in these statements.

Not included in this estimated loss is the potential liability of a class action suit filed in behalf of all creditors of U.S. National Bank, San Diego, California whose claims were not assumed by Crocker National Bank, San Francisco, California. Since no class has yet been certified, it is impossible to accurately forecast the amount of any liability which might eventually result from this litigation. However, a decision adverse to the Corporation would have considerable monetary impact.

GAO NOTES TO FINANCIAL STATEMENTS

1. On October 8, 1974, the Comptroller of the Currency closed the Franklin National Bank, Brooklyn, New York, and appointed the Corporation receiver. On the same day, European-American Bank and Trust Company, an insured New York State-chartered bank, assumed $1,704 million of deposit and other liabilities and purchased $1,579 million of the closed bank's assets. At the time of the closing, Franklin National Bank had assets of $3,662 million, total deposits of approximately $1,440 million, and insured deposits of $744 million.

   The transactions relating to this deposit assumption occurred after June 30, 1974, and therefore are not accounted for in these financial statements. To consummate the deposit assumption, the Corporation:

   a. Accepted, as an offset against European-American's purchase price, the $125 million purchase premium bid by European-American Bank and Trust Company.

   b. Purchased, in its corporate capacity, $2,083 million of Franklin's assets.

   c. Assumed Franklin's $1,723 million debt to the Federal Reserve Bank of New York. The debt will be repaid at the end of 3 years through liquidating the purchased assets, with any shortfall to be paid by the Corporation.

   d. Purchased a $100 million note from European American Bank and Trust Company to provide additional capital.

   Corporation officials told us that a reserve for loss relating to the Franklin National Bank closing has not been established. The reason given was that the Corporation is reviewing and evaluating the assets it acquired. These officials told us that until this evaluation is completed, the Corporation will not be in a position to determine the amount of loss, if any, which it will sustain.

2. A class action suit on behalf of California bank customers has been filed in the U.S. District Court for the Central District of California against most major California banks and others. The suit is seeking $8 billion in treble damages for an alleged conspiracy to fix prices for banking services. The Corporation is involved only as receiver of the U.S. National Bank and

is negotiating to be voluntarily dismissed from this suit.

The Corporation's General Counsel advised us that the plaintiff's chances for success are extremely unlikely. In view of an earlier legal decision concerning actual notice which should be given to all parties to a class action (presumably to all persons who have borrowed from banks throughout the State of California), the plaintiff apparently cannot sustain such an action.

In the Corporation's opinion, the treble damage claim appears wholly unsupported by any allegation in the complaint. Moreover, the Corporation's General Counsel advised us that if the class action should be successful, the law states that only actual damages can be recovered from a receiver. If the judgment is against the receiver, the plaintiff is only entitled to a pro rata share of the receivership assets.

Their General Counsel believes the receivership will not suffer any loss whatsoever from this suit; therefore, the Corporation has not established any reserve for loss.

FEDERAL DEPOSIT INSURANCE CORPORATION Washington, D.C. 20429

OFFICE OF THE CHAIRMAN

March 31, 1975

Mr. H. L. Krieger, Regional Manager
Attention: Mr. J.E. Thornton
U.S. General Accounting Office
803 West Broad Street
Falls Church, Virginia 22046

Dear Mr. Krieger:

This is in response to your recent letter with which you enclosed copies of your draft report to the Congress on the audit of this Corporation for the year ended June 30, 1974.

We were glad to be able to meet with members of your staff to discuss some of the issues and we appreciate this opportunity to review your draft and offer our comments.

As your report noted, the Corporation has indicated its views on several occasions in connection with your desire to have unrestricted access to bank examination reports and related documents. In the past and particularly on February 9, 1973, in commenting on your 1972 audit report, we have outlined our position on this issue at considerable length. Last year, in responding to your proposed 1973 audit report, I quoted at some length the substance of my February 9th letter.

In that context, I should like to refer to that past correspondence and to indicate that our views, which have been expressed fully, have not changed.

In the same sense, we note your reiterated comment on page 1, under the heading "Opinion on Financial Statements", to the effect that the Corporation's financial statements do not show an estimate of the liability which the Corporation will incur because of future bank failures. This statement and additional comments on this subject also appear on pages 24 and 31 of the draft report.

As we noted last year, it is our view that such estimates are impossible. At any point in time, it would be coincidental if we had knowledge of

Mr. H. L. Krieger
U.S. General Accounting Office March 31,1975

future bank failures. Even if we felt that an individual bank might represent a potential future failure, it would be impossible for us to make accurate estimates of the Corporation's liability in such a case. Any such eventual losses and contingent liability would depend upon factors which could not be assessed until or after a given bank actually failed.

Accordingly, we do not believe it would be good accounting practice nor possible for us to carry on our books estimates of liabilities which could result from developments which have not occurred during the accounting period involved; or which may not happen at all in future accounting periods. In those circumstances, we must disagree with your proposals in this connection and believe that both pragmatic and accounting considerations would support our view. In effect, there is no actuarial basis for computing or accounting for our contingent liabilities in future closed bank situations. We cannot know which, if any, insured banks will fail at some future time and, therefore, we have no basis for computing a contingent liability in those unidentifiable future cases. Thus, we believe your proposed comments on this issue are not valid.

On pages 5, 25, 26, and 27, your draft report also indicated that the Corporation did not account for all losses in computing the assessment credit for 1973 and that, because it did not take into consideration certain losses on the sale of securities - which you related to the failure of the United States National Bank of San Diego - the Corporation should recover $7.6 million from insured banks by reducing the next credit to banks. Incidentally, we believe this understates somewhat the figure which actually would be involved.

In fact, however, the losses taken by the Corporation in the sale of certain securities were a conscious aspect of the Corporation's portfolio management and were neither forced by nor more than indirectly involved in the USNB failure, except that they occurred in the same general time-frame.

We were aware in the early summer of 1973 that we might very well have to make substantial disbursements in connection with the eventual resolution of the USNB situation. Two options were readily available:

(1) We could simply accumulate or hold funds in the form of Certificates of Indebtedness, an instrument arranged for us by the Treasury Department and into which the Corporation's newest receipts

Mr. H.L. Krieger
U.S. General Accounting Office
March 31, 1975

have been invested in recent years. While our funds remain in this instrument, our yield represents the prior month's average of the 91-day Treasury bill rate. This rate can be volatile, so it is our normal practice - except in very heavy income periods - not to accumulate and carry large balances in Certificates of Indebtedness. Instead, when such balances take on substantial proportions, it is our policy to reinvest those funds in intermediate-term securities providing guaranteed stable yield for some period of time. In fact, on May 31, 1973, we held $289 million of Certificates of Indebtedness, knowing then of the possibility of later developments in San Diego.

(2) The second option suggested that we continue to reinvest Certificates funds during the summer of 1973 in the interests of assured yield, notwithstanding the probable requirement that large sums might be necessary in connection with the USNB failure. This meant that - when the USNB requirements were made known - we would stand ready to liquidate selected parts of our portfolio in order to produce those funds. This is the essential purpose of the deposit insurance fund.

We chose the latter option, in the interests of assuring average yield, rather than to hold or pile up funds in our Certificates of Indebtedness. Incidentally, inasmuch as all the items in our portfolio can be liquidated upon call to the Treasury, I would have had still another option: that is, we could have asked Treasury to liquidate only securities which would have shown a profit in the then-market. Thus, had we chosen to accumulate Certificates or had we liquidated only items which would show a profit, the issue you pointed up would never have been raised.

In any case, we decided not to accumulate Certificates during the summer of 1973 and reinvested those funds. When it then came time to liquidate certain securities for possible use in the USNB situation, we went further and asked Treasury to see if it could dispose of certain long-term issues which were having the effect of dragging down our average yield. These long-term securities had been purchased by the Corporation many years before and we had debated for a considerable period the wisdom of liquidating them in the long-term interest of our average yield. Because these securities were of special interest only to certain kinds of buyers, they could not be sold without accounting for book value losses.

Mr. H. L. Krieger
U.S. General Accounting Office March 31, 1975

As it developed, Treasury was unable to sell large volumes of these securities but, on those for which it could find buyers, the market price produced book value losses for the Corporation. We were quite willing to take those losses on the grounds that our continuing possession of those issues was of little use to the Corporation, given present-day yields, and that similar sums reinvested at the rates available would recoup these losses in some six to eight years.

Thus, the USNB failure simply served as a catalyst in pursuing an investment course which we had been considering for some time and one which the Corporation even now is considering in greater magnitude. We continue to hold more than $500 million of long-term securities, purchased many years ago, which prevent us from maximizing the yield on our total portfolio, a policy we set in motion eight or nine years ago. In order to pursue this investment policy, however, which has nearly doubled our average yield, there is no way to avoid additional book value losses if we dispose of long-term issues; although the reinvestment of the proceeds from any such loss sales will recoup these losses over a period of time and, thereafter, will find the Corporation's average portfolio yield further improved.

Because it would be time-consuming to reconstruct each aspect of the Corporation's investment operations during the summer of 1973, I am enclosing two copies of correspondence which serve as examples of the processes described above. On July 27, 1973, we authorized Treasury to roll over certain maturing securities which we held. In the same authorization, we further authorized Treasury to acquire up to $100 million face amount of issues maturing in the 3-7 year range and having the best yields available. These were to be financed through the redemption of that amount of Certificates of Indebtedness in the interest of obtaining guaranteed yield for some period of time. As I noted, we could have held those and other Certificates during the summer and simply accumulated them in an amount adequate to meet any eventual requirement for USNB. By August 31, 1973, however, through reinvestment during the summer, we had reduced our holdings of Certificates to some $112 million.

I am also enclosing correspondence to Fiscal Assistant Secretary Carlock dated September 28, 1973. Its purpose was to authorize Treasury to dispose of more than $200 million book value of selected items in our portfolio. The proceeds, added to the $112 million of Certificates we still held, were intended to produce substantially more

Mr. H. L. Krieger
U.S. General Accounting Office
March 31, 1975

than the $300 million which it was concluded during September might be needed in San Diego. In part, the overage reflected our desire to unload as many long-term issues as possible in pursuit of an investment decision having nothing to do with USNB. Absent specific figures back in June, this merely culminated investment conclusions we had reached in the interests of yield before the San Diego situation ever became definitive.

You will note that this correspondence refers to $25 million worth of three of the long-term issues I mentioned above -- the following month, incidentally, Treasury was able to sell another $20 million. You will also note that the next paragraph of the authorization indicates that it was in keeping with verbal arrangements made by the Controller of this Corporation with Mr. Carlock. Those verbal arrangements requested Mr. Carlock to see what his people could do to get rid of some portion of our long-term securities. This was an after-the-fact authorization in that we had determined verbally that Treasury could only dispose of parts of our holdings of these particular long-term issues during September, resulting in book value losses which we expected.

As you are aware, the Corporation cannot buy or sell securities unilaterally in an amount more than $100,000. Any transaction in a larger amount must be approved by Treasury, notwithstanding the fact that the Corporation can select or recommend particular issues with Treasury's acquiescence. In this instance, we simply asked Treasury to have its people dispose of a marketable selection of issues, with particular emphasis on the sale of some of our long-term holdings. Without any reference to San Diego, we were willing to take some book value losses in order to dispose of any part of our long-term holdings; although we could have just as easily requested Treasury to sell only issues which would show a book profit.

I am using the examples noted above because we would have time-consuming difficulty in retracing all of our investments, reinvestments, and portfolio changes during this period. When the time came, we had arranged to have available something more than $300 million for possible use in the USNB situation. It turned out, however, that only some $210 million was needed. Thus, in spite of the liquidation we chose to make, our yield continued on well over $100 million of these accumulated funds which we later reinvested. To allocate the flow of these investments, liquidations, and reinvestments - or which portions might be chargeable to San Diego - would be nearly impossible except in the broadest terms.

Mr. H. L. Krieger
U.S. General Accounting Office

March 31, 1975

The thrust of these operations is that we decided to pursue an investment policy during the summer of 1973 which represented our view of the best interests of the Corporation in terms of our portfolio management. The USNB situation was simply a partial catalyst in the sense that we knew we would need funds sooner or later. The losses we chose to take on the disposition of a relatively small portion of our long-term issues were the culmination of portfolio discussions having a considerable history. These disposals and losses were not caused by USNB and could have been avoided completely had we chosen other investment policy alternatives. Meantime, the basic investment policy issue remains: that is, whether we should take further book value losses in order eventually to improve our average yield.

In view of the foregoing, we believe our assessment credit was computed properly and that no adjustments are necessary with respect to the 1975 credit.

Beyond these points, we are enclosing a draft of your proposed report which we have marked to reflect the views of a number of our people whose responsibilities are involved. Basically, these are semantic suggestions to reflect accuracy.

We trust these comments will be useful as you complete your audit report. To the extent that our editorial suggestions pose any problem, we shall be glad to discuss them. If you feel such discussion would be helpful, please communicate with Mr. Edward F. Phelps, Jr., Controller of the Corporation, at 389-4481.

Sincerely,

Frank Wille

Frank Wille
Chairman

Enclosures

AHT/rc
cc:
Chairman Wille
Mr. Phelps
Mr. Roderick
Mr. Teichler
Mr. Goodman
Mr. Selke
Day File
Reading File

JUL 31 1973

MEMORANDUM TO: Mr. Alan R. Miller
Executive Secretary

SUBJECT: Security Transactions

Pursuant to Resolution No. 21360, adopted by the Board of Directors on May 28, 1964, I authorized the Secretary of the Treasury on July 27, 1973, to purchase $110,000,000 in 7-3/4% Treasury Notes of Series B-1977 dated August 15, 1970, due August 15, 1977, and $75,546,000 in 7-1/2% Treasury Bonds of 1988-93 dated August 15, 1973, due August 15, 1993. These acquisitions will be financed through an exchange of the following securities presently owned by this Corporation:

4% Bonds of 1973 due 08-15-73	$180,546,000
8-1/8% Notes - Series "B" due 08-15-73	5,000,000

Additionally, and as part of this same authorization, I authorized the Treasury to acquire up to $100,000,000 face amount of issues maturing in a 3 - 7 year range and having the best yields available. This authorization, which supersedes the outstanding balance of our May 1, 1973 authority, is to be financed through the redemption of a like amount of Treasury Certificates of Indebtedness.

Frank Wille
Chairman

AHT/rc
cc:
Chairman Wille
Director LeMaistre
Mr. Phelps
Mr. Teichler
Mr. Selke
Mr. Goodman
Mr. Roderick

September 28, 1973

Honorable John K. Carlock
Fiscal Assistant Secretary
Department of the Treasury
Washington, D. C.

Dear Mr. Carlock:

This will authorize you to sell, at the best prices obtainable, the following U. S. Treasury Securities held for the account of this Corporation:

Security	Face Amount
3 1/2% UST BONDS 2/15/90	$10,000,000
3 1/2% UST BONDS 11/15/98	10,000,000
3% UST BONDS 2/15/95	5,000,000
7% UST NOTES 11/15/75	22,500,000
6 1/2% UST NOTES 5/15/76	14,500,000
7 3/4% UST NOTES 8/15/77	67,500,000
6% UST NOTES 11/15/78	33,500,000
6 1/4% UST NOTES 8/15/79	31,900,000
6 3/8 % UST NOTES 2/15/82	1,500,000
6% UST NOTES 5/15/75	3,000,000

The foregoing authorization is in keeping with verbal arrangements made by the Controller of this Corporation with representatives of your office on September 20, 1973.

Sincerely,

(Signed) Wille

Frank Wille
Chairman

MEMBERSHIP

OF THE

BOARD OF DIRECTORS

	Tenure of office	
	From	To
Frank Wille, Chairman	March 1970	Present
James E. Smith, Comptroller of the Currency (note a)	July 1973	Present
George A. LeMaistre (note b)	Aug. 1973	Present

[a] Justin T. Watson was the Acting Comptroller from March 1973 to July 1973.

[b] This position on the board was vacant from February 1973 to August 1973.

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