

**OVERSIGHT HEARINGS INTO THE EFFECTIVENESS  
OF FEDERAL BANK REGULATION  
(Franklin National Bank Failure)**

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**HEARINGS  
BEFORE A  
SUBCOMMITTEE OF THE  
COMMITTEE ON  
GOVERNMENT OPERATIONS  
HOUSE OF REPRESENTATIVES  
NINETY-FOURTH CONGRESS  
SECOND SESSION**

**FEBRUARY 10; MAY 25, 26; AND JUNE 1, 1976**

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<sup>1</sup> Deceased May 21, 1976.

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# OVERSIGHT HEARINGS INTO THE EFFECTIVENESS OF FEDERAL BANK REGULATION

## (Franklin National Bank Failure)

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TUESDAY, FEBRUARY 10, 1976

HOUSE OF REPRESENTATIVES,  
COMMERCE, CONSUMER,  
AND MONETARY AFFAIRS SUBCOMMITTEE  
OF THE COMMITTEE ON GOVERNMENT OPERATIONS,  
*Washington, D.C.*

The subcommittee met, pursuant to notice, at 10:05 a.m., in room 2247, Rayburn House Office Building, Hon. Benjamin S. Rosenthal (chairman of the subcommittee) presiding.

Present: Representatives Benjamin S. Rosenthal, Cardiss Collins, Elliott H. Levitas, Edward Mezvinsky, Garry Brown, Willis D. Gradison, Jr., and John N. Erlenborn.

Also present: Peter S. Barash, staff director; Robert H. Dugger, economist; Ronald A. Klempner, counsel; Eleanor M. Vanyo, assistant clerk; and Henry C. Ruempler, minority professional staff, Committee on Government Operations.

### OPENING STATEMENT OF CHAIRMAN ROSENTHAL

Mr. ROSENTHAL. The subcommittee will be in order.

The Subcommittee on Commerce, Consumer, and Monetary Affairs, pursuant to its oversight responsibilities, is continuing its investigation of the adequacy and effectiveness of Federal supervision and regulation of commercial banks. As a part of its investigation, the subcommittee is taking a close look at the way in which Federal bank regulators have handled the management and financial difficulties that confronted and eventually caused the failure of Franklin National Bank.

Today's hearing is the first of a series of hearings into the Franklin National situation. Arthur Roth, chairman of the board of Franklin National Bank until 1968 and a major stockholder, will testify today concerning the origins of the bank's problems, his knowledge of the regulatory responses to those problems, and, in his opinion, the adequacy of the banking services being offered by European-American Bank, the successor bank to Franklin National.

Mr. Roth, we are very pleased that you could be with us. You may begin your testimony.

(1)

**STATEMENT OF ARTHUR T. ROTH, FORMER CHAIRMAN OF THE  
BOARD, FRANKLIN NATIONAL BANK**

Mr. ROTH. Thank you, Mr. Chairman.

Mr. ROSENTHAL. Mr. Roth, if you have no objection, would you please stand and take this oath.

Do you solemnly swear that the testimony you are about to give this subcommittee will be the truth, the whole truth, and nothing but the truth, so help you God?

Mr. ROTH. I do.

Mr. ROSENTHAL. Thank you. You may proceed.

Mr. ROTH. Mr. Chairman, I am one banker who is glad to see this investigation of banking and the supervisory agencies. Much good can come of this. It will result in a stronger and safer banking system.

But I must warn, in taking corrective action, that we do not cause overkill. Because there has been laxity and negligence, don't set up an ICC-type of agency which will ruin banking and ruin the economy of our country. That can very easily happen.

It is the strengthening of our existing supervisory agencies that is needed. They have been lax and they have been negligent. And it is more disclosure, such as this, that is required.

Above all, I would like to say that the Federal Deposit Insurance Corporation must never, never allow a depositor in the United States to lose money. If that does occur, fear is going to set in and they are going to worry about the biggest banks in the country. So the FDIC must pursue the kind of action that they have pursued in recent months of seeing to it that the depositors are made whole.

Now I will cover these things in detail, but I would like to give some background about myself. I am 70 years of age, and I am retired. My banking career started in 1923 with Manufacturers Trust Co. as a messenger.

In 1930, I spent Thanksgiving Day, and a period of about 1 month, in the city of Toledo, Ohio, which was the hardest hit city in bank closings in the United States at that time. In that big city, there were only two small banks that were left open. I was a part of team of five that went there to help to reopen the banks in the city of Toledo.

In 1931 I was in charge of the operations of the merger of the Chatam and Phoenix National Bank with Manufacturers Trust Co.

I had activity with Manufacturers Trust Co. in the many openings of closed banks and the mergers that took place. I also had activity with them during the bank holiday.

I was the so-called efficiency expert. My job, which I did not like, was to fire people. But it was necessary at that time in order to save banks.

On April 30, 1934, I came to Franklin Square National Bank. It was a very small bank. There were five people. Their deposits were \$470,000. It was insolvent at that time.

I moved to this small bank because my wife was a country girl and was expecting our first child. So I wanted to go to the country. Also, I couldn't take the firing of people, which, as I said, was my job at Manufacturers Trust Co.

As you know, Franklin National Bank became one of the great banks of the United States, and one of the great banks of the world.

For a period of 20 years, net profits after taxes were over 20 percent on capital equity.

Mr. ROSENTHAL. What was your position with the bank during that period of time?

Mr. ROTH. I was always the chief executive officer of the bank from the very time I came with the Franklin Square National Bank. Even though my title upon entering the bank was "cashier," it was, nevertheless, chief executive officer.

Mr. ROSENTHAL. During that period of time, the assets of that bank went from what amount in what year to what amount at the time you left the bank?

Mr. ROTH. The day I entered it in 1934, the deposits were \$470,000. They were \$2 billion in 1968 when I was forced out.

Mr. ROSENTHAL. Were you also a stockholder in the bank?

Mr. ROTH. I was a large stockholder. There are 70,000 shares in the family.

At age 62, I employed a firm to search for a successor to me. It was mandatory that I retire at age 65.

Mr. ROSENTHAL. What year was that?

Mr. ROTH. That was 1967.

Mr. BROWN. Mr. Roth, may I clarify this? In 1967 you were 62, and you were required to retire at age 65. So you would have been required to retire in 1970. Is that right?

Mr. ROTH. I would have been required to retire at the end of 1970; yes. That is right.

During the time that we were searching for a successor to me, Harold Gleason pressured me constantly and said that he felt that he should be the one to succeed me. For a while, I thought perhaps this was so. But then I realized that he was not competent, and I told him that he was not competent to succeed me.

Mr. LEVITAS. Who was Gleason?

Mr. ROTH. Harold V. Gleason was the president of the bank at that particular time. And he is the one primarily responsible for the downfall of Franklin National Bank. This was through his incompetence.

I also told Gleason that there were two directors, Merkin and Hein, who were bad directors and that they should be removed from the bank. My telling Gleason he was not competent to succeed me and that two other directors were bad directors started the conspiracy to push me out of the bank. They did so in July of 1968. They did so by changing the bylaws of the bank to state that the president was the chief executive officer and the chairman of the board, which title I held, had no duties whatsoever except as a paper chairman to preside at board meetings.

I actually left the bank as paper chairman of the board in early 1970 when my name was not placed in nomination as a director.

Although I felt very strongly that Gleason was not competent, I kept silent for 2 years. And of course the earnings of the bank increased substantially in those 2 years. For example, in 1968, there were \$13,300,000; in 1969, it was \$18 million; in 1970, it was \$19,600,000. And then they started to fall off. In 1971, it was \$15,400,000 and in 1972 it was \$11,200,000.

The reason for the increase was solely the momentum that the bank had. It had nothing to do with Gleason's being in charge. He started to do the damage immediately, but it was not seen until 1971.

In November of 1971, I wrote a letter to Mr. Tisch of Loews, a director owning over 20 percent of the common stock, and said: "You must be seeing what is happening at Franklin National Bank. You are an astute businessman. The earnings of the bank are declining. You are a substantial stockholder and I am looking to you to take the necessary corrective action.

Mr. ROSENTHAL. At that time, you and your family owned 70,000 shares?

Mr. ROTH. Yes; 70,000 shares.

Mr. ROSENTHAL. How much were they worth?

Mr. ROTH. They were worth close to \$3 million.

Mr. Tisch had his attorney answer me. But of course he was on the spot. If he took more than the usual responsibility of a director, his Loews might have been declared to be a bank holding company—which he did not want to see happen. His attorney said that he was carrying out his responsibility just the same as any other director of the bank.

I received the annual report of the bank around March of 1971. This was the report for the year ending December 31, 1970. I analyzed the report. After analyzing it, I decided to write a letter to the shareholders of the bank. It was distributed at a meeting of the shareholders. And the day before the shareholders' meeting, it was mailed to all of the supervisory authorities—the Federal Reserve Board, the Federal Deposit Insurance Corporation, the State Banking Department, and the Comptroller of the Currency.

I would like to read that letter to you. It is dated April 27, 1972.

When I retired from Franklin National Bank, I resolved that because of my long influence over the bank I would not attend meetings of stockholders. However, I am shocked by what has been happening at the bank. Therefore, I have decided to write this letter to you.

The upward momentum of the bank has stopped. It is now declining and immediate drastic action is required in order to reverse this adverse trend.

The annual report shows the following: (1) A substantial reduction in earnings; (2) a heavy loan loss; (3) \$32,500,000 in tax loss carryovers, which good accounting practice dictates should not have been capitalized, but should have been charged off; (4) a similarity in some respects with the Bank of the Commonwealth of Detroit, Michigan, and their problems with regard to a heavy concentration in municipal securities and municipal deposits which now have adverse effects upon the bank's liquidity and earnings; (5) overstaffing which has caused high salary expenses accompanied by heavy occupancy and equipment costs.

This overstaffing ran to almost 1,000 employees. There was \$15 million wasted, when you consider space costs and all the other additional costs.

Mr. ROSENTHAL. Without objection, this letter, dated April 27, 1972, will be included in the record.

[The letter referred to follows:]

To: Shareholders of Franklin New York Corporation Assembled at their Annual Stockholders Meeting held at the Barbizon-Plaza Hotel, 106 Central Park South, New York, New York, on April 27, 1972.

From: Arthur T. Roth.

When I retired from Franklin National Bank, I resolved that because of my long influence over the bank, I would not attend meetings of stockholders. However, I am shocked by what has been happening at the bank. Therefore, I have decided to write this letter to you.

The upward momentum of the bank has stopped. It is now declining and immediate drastic action is required in order to reverse this adverse trend. The Annual Report shows the following:

1. A substantial reduction in earnings.
2. A heavy loan loss.
3. \$32,500,000 in tax loss carry-overs which good accounting practice dictates should not have been capitalized but should have been charged off.
4. A similarity in some respects with the Bank of the Commonwealth of Detroit, Michigan, in their problems with regard to a heavy concentration in municipal securities and deposits which now have adverse effects upon the bank's liquidity and earnings.
5. Overstaffing which has caused high salary expenses accompanied by heavy occupancy and equipment costs.

In addition to the aforesaid, there are intangible losses which have an important effect upon the successful operation of the bank. Morale is low; there is a lack of communication; there is a lack of confidence in top management; there is a lack of confidence in most of the directors and many good officers are leaving. This bank always enjoyed a very high esprit de corps which was one of its great assets. This asset no longer exists.

What is to be done? There must be an immediate change in top management. Also, there must be a change in the majority of the directors.

How is this corrective action to be accomplished? There are four general areas that we must look to for this needed corrective action:

First: The primary responsibility should rest with the Board of Directors. I have stated that a majority of the Board needs to be changed. This majority will not purge themselves nor purge management.

Second: We must also look to the banking supervisory authorities, the Office of the Comptroller of the Currency, the Federal Reserve Board and the Federal Deposit Insurance Corporation. I would hope that their action would not be unduly delayed nor that their action will be less than sufficient in nature.

Third: Mr. Laurence A. Tisch who represents Loews Corporation on the Board of Directors of the Franklin New York Corporation, which owns 20.2 percent of the outstanding voting securities of Franklin should be a prime mover for needed action. However, in order for Mr. Tisch to take action, it will be necessary for him to resign from the Board of Directors of Franklin, otherwise Loews will risk being declared a bank holding company which will be to their disadvantage. When Loews purchased this substantial interest in the bank, they assumed a responsibility to take a leadership role in the interests of the stockholders.

Fourth: Stockholder action should not be needed, as it is both costly and time consuming and will cause a great deal of adverse publicity for the bank. I am sure that the vast majority of stockholders would act for a change in management and directors if it is decided to take stockholder action.

What can be done today at the annual meeting? I believe that it is fitting and proper at this time to request that the Board of Directors agree now, at this annual meeting, to call a special meeting of the shareholders to be held three months from this date, on Thursday, July 27th, 1972. This entire special meeting should be devoted to discussing the condition of the bank at that time and the corrective action which has been taken to rectify the deficiencies. To wait a full year for another meeting of shareholders is too long.

Yours for a better Franklin,

ARTHUR T. ROTH,  
c/o Bracken and Jacoppi, Esqs.,  
194 Maine Street, East Setauket, N.Y.

Dated: April 27, 1972.

Mr. ROSENTHAL. You said this letter was sent to the Comptroller of the Currency and the Federal Reserve. To whom else, in addition to the shareholders, was it sent?

Mr. ROTH. The Federal Deposit Insurance Corporation and the State banking authorities.

Mr. ROSENTHAL. Subsequent to that, did you at any time write to the Comptroller of the Currency or the other Federal regulatory authorities?

Mr. ROTH. Yes; I did.

Mr. ROSENTHAL. Tell us about that.

Mr. ROTH. Don't you want me to cover this letter?

Mr. ROSENTHAL. We will put it in the record. I think it will be better if we go through a narrative.

Mr. ROTH. I would like to read one part of this letter, if you don't mind.

Mr. ROSENTHAL. Go ahead.

Mr. ROTH. I said:

What is to be done about this situation? The primary responsibility should rest with the Board of Directors. I have stated that the majority of the Board needs to be changed. This majority will not purge themselves nor purge management. We must look to the banking supervisory authorities—the Office of the Comptroller of the Currency, the Federal Reserve Board, and the Federal Deposit Insurance Corporation. I hope that their action would not be unduly delayed nor that their action will be less than sufficient in nature.

That is the section that I wanted to read to you. That is the warning that I gave to them. I sent it to them and it received headline publicity in the newspapers.

Mr. ROSENTHAL. Tell us what happened. Did you receive a response? Did you write a second letter? What happened?

Mr. ROTH. I received only indirect response to this letter. These were responses such as: "You are out of the bank and have been out for a couple of years. Why don't you keep your mouth shut and let them run the bank?" Reactions such as that were the responses that I received.

Mr. BROWN. Mr. Roth, the letter was sent to shareholders, with copies to the regulatory agencies. Is that correct? This was not a letter to the regulatory agencies.

Mr. ROTH. No; it was a letter to the shareholders, but it was sent to the regulatory agencies. That is right.

Mr. ROSENTHAL. Did you write to the Federal regulators at any point in time?

Mr. ROTH. I wrote directly to the regulators.

Mr. ROSENTHAL. To whom did you write and when did you write?

Mr. ROTH. I only sent copies of material to the regulators and asked them to acknowledge receipt of it. For example, a few months after this letter that went to the shareholders, Mr. Sindona bought the Loews stock from Tisch. It was at that time that I wrote a letter to Mr. Tisch and sent the copies of the letter by registered mail to the regulators.

And of course Mr. Sindona, to a large extent, is the straw that broke the camel's back. He, with his manipulation in foreign exchange, is the one that broke the camel's back and finally caused the closing and the large loss that they sustained at that time.

Mr. ROSENTHAL. Did you at any point in time have a meeting with Mr. Van Horn of the Comptroller's Office?

Mr. ROTH. Yes. If I may, I would like to refer to Mr. Sindona's letter and then I will get to that.

Mr. ROSENTHAL. You may.

Mr. ROTH. On July 18, 1972, I wrote the following letter to Mr. Tisch of Loews Corp. They had sold their 20-odd percentage of ownership of common stock to Mr. Sindona. This letter was sent by registered mail to all of the supervisory authorities. I would like to read this to you. I think it is important because of the great damage he did to the bank.

The newspapers of July 13, 1972, reported Loews Corporation, of which you are its Chief Executive Officer, the sale of 1,000,000 shares of stock of Franklin New York Corporation for \$40,000,000. The sale was to a company controlled by Michel Sindona of Milan, Italy.

Your sale of this stock may have been advisable insofar as Loews is concerned, but it raises some serious questions for the stockholders and depositors of Franklin National Bank. (1) Do you know enough about Michel Sindona to unconditionally recommend him as a person who will be good for the bank? (2) Will there be a full disclosure of his finances, his backers in detailed biographies? (3) Why would he pay \$40.00 a share for stock that is currently selling for \$32.00, having run up from \$28.00 per share apparently as a result of rumors of the sale? (4) What are his intentions regarding additional purchases and what role will he play in the operation of the bank? (5) When you sold your holdings at \$40.00 a share, did you arrange to see that other shareholders could obtain the same price? (6) Don't you think that you could have found many eminent buyers in the United States if you asked a reasonable price for the stock? Would not these prospective buyers also have offered the same deal to other stockholders? (7) Franklin has a serious problem in covering its \$32,500,000 tax loss carryover. Would not the sale and merger with a United States corporation aid in resolving this problem? (8) A bank is built on confidence. Have you considered whether or not this transaction will cause a loss of confidence in the bank?

I could ask many more pertinent questions, but this letter is now long enough. I also call your attention again to the questions I raised in my letter to stockholders, delivered at the annual meeting held on April 27, 1972.

May I hear from you in an open letter because the stockholders, depositors, and the banking fraternity will be interested in your answer.

I have written this letter because I felt a continuing responsibility to my family and many loyal stockholders, depositors, and employees that helped to build the bank from deposits of less than a million dollars to become the eighteenth largest in the nation. I only want to see good things happen to Franklin National Bank.

Mr. ROSENTHAL. To whom did you send copies?

Mr. ROTH. I sent copies to all of the supervisory agencies. I have acknowledgments from all of them—the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Comptroller of the Currency, and the State Banking Department.

Mr. ROSENTHAL. Without objection, that letter of July 18, 1972, will be included in the record.

[The letter referred to follows:]

NEW YORK, N.Y., July 18, 1972.

Mr. LAURENCE A. TISCH,  
Director, Franklin New York Corp.,  
New York, N.Y.

DEAR MR. TISCH: The newspapers of July 13, 1972, reported Loews Corp. (of which you are its Chief Executive Officer) sale of 1 million shares of stock of Franklin New York Corporation for \$40,000,000.00. The sale was to a company controlled by Michele Sindona of Milan, Italy.

Your sale of this stock may have been advisable in so far as Loews is concerned, but, it raises some serious questions for the stockholders and depositors of Franklin National Bank.

1. Do you know enough about Michele Sindona to unconditionally recommend him as a person who will be good for the bank?

2. Will there be a full disclosure of his finances, his backers, and detailed biographies?

3. Why would he pay \$40.00 a share for stock that is currently selling for \$32.00, having run up from \$28.00 per share apparently as a result of rumors of this sale?

4. What are his intentions regarding additional purchases and what role will he play in the operation of the bank?

5. When you sold your holdings at \$40.00 a share, did you arrange to see that other stockholders could obtain the same price?

6. Don't you think that you could have found many eminent buyers in the United States if you asked a reasonable price for the stock? Would not these prospective buyers also have offered the same deal to other stockholders?

7. Franklin has a serious problem in covering its \$32,500,000.00 tax loss carry over. Would not the sale and merger with a United States corporation aid in resolving this problem?

8. A bank is built on confidence. Have you considered whether or not this transaction will cause a loss of confidence in the bank?

I could ask many more pertinent questions, but this letter is now long enough. I also call your attention again to the questions I raised in my letter to Stockholders delivered at the Annual Meeting held on April 27, 1972.

May I hear from you in an open letter because the stockholders, depositors and the banking fraternity will be interested in your answer.

I have written this letter because I feel a continuing responsibility to my family and many loyal stockholders, depositors and employees who helped to build the bank from deposits of less than \$1,000,000.00 to become the 18th largest in the nation. I want only good things to happen to Franklin National Bank.

Sincerely,

ARTHUR T. ROTH.

Mr. ROSENTHAL. What happened then?

Mr. ROTH. A friend of mine said that he was Mr. Sindona's personal attorney. And he said, "I would like to have you meet Mr. Sindona even though he hates you for what you have said about him and the questions you have asked about him. But I would like to get him to know you."

So on October 25, 1972, I visited Mr. Sindona at the St. Regis in New York City. His attorney, who introduced me to him, was present.

I have a memorandum here of the topics we covered.

[The memorandum referred to follows:]

#### MEMORANDUM

October 25, 1972

Visited Sindona at Apt. 705 St. Regis. Also present Andrew Miller who arranged app't.

#### TOPICS COVERED

Sindona says can increase foreign deposits 1-2 billion  
 Will run foreign business  
 Continental Bank, Chicago, earned 55 percent total from foreign  
 Has been a partner with Continental in Bk in Europe 12 yrs  
 Sees Luftig more than Gleason  
 Luftig to spend ½ day reviewing big loans  
 Loan losses—1971—14 Mil 1972—10 Mil  
 Luftig to reduce personnel this year by 250  
 Has sold Hanover Sq for \$6 million profit with lease back  
 This profit will cover 1972 tax loss carry forward  
 Apparently has not bought any stock since Loews  
 Asked to be given year 1973 to show accomplishments  
 Believes in team play—himself running things in background  
 Watergate is his venture  
 European banks sell at 52-100 multiple  
 Avoided discussion of Gleason—Does not know well enough to evaluate yet  
 I said 3-4 times Gleason was my mistake (Boards)  
 Sindona objectives (1) stop loan losses (2) increase foreign business  
 I added (3) new top executive (4) efficient (5) esprit de corps

#### COMMENTS

Sindona is good for bank,—is straight forward—appears honest, intelligent, knows where he is going  
 Is not disturbed for paying \$40 with market \$30  
 Says will pay off in a year or so  
 Franklin has a good name in Europe  
 Apparently is not buying any new stock  
 Wants to buy a mortgage co. for bank  
 A big one—for about \$100 million cash

Mr. ROTH. Sindona said he was going to increase the foreign deposits of the bank by 1 to 2 billion dollars. That was one of the causes of the downfall of the bank. The bank went ahead and loaned these short deposits long. And when the adverse publicity hit the bank, these foreign deposits were withdrawn.

He said that he was going to run the foreign business. He said that the Continental Bank of Chicago earned 55 percent from their foreign activity and he was looking to Franklin's doing the same thing. He said he had been a partner with Continental Bank in Europe for 12 years. Now the Chairman of the Board of Continental Bank of Chicago was David Kennedy, who became the Secretary of the Treasury, and who, I believe, appointed Mr. James Smith as Comptroller of the Currency.

He said that he sees Luftig more than he sees Gleason. He said Luftig was going to reduce the personnel that year by 250. He said he sold the Hanover Square Office at a \$6 million profit on a sale-and-lease-back basis in order to cover some tax loss carryforward. He said that he believed in team play, with himself running things in the background. He said that Watergate was his venture with the Vatican. He built Watergate.

Mr. ROSENTHAL. Sindona built the Watergate building?

Mr. ROTH. Yes; he did, with the Vatican. And he created the "Watergate" in Franklin.

I said to him three or four times that Gleason was the great mistake. Every business is the length and shadow of one man, and Gleason's length and shadow is bad.

I said, "You said your objectives are to stop loan losses and to increase foreign business. I would like to add that you need a new top executive officer; you need efficiency in the bank; and you need esprit de corps, which has gone to pieces."

I received the annual report of the bank for the year of 1973. I analyzed it. I made my comments on it. I went to see Mr. Van Horn who is the Regional Director of the Comptroller of the Currency in New York. I gave him a copy of this on March 19, 1974.

Mr. ROSENTHAL. What is Mr. Van Horn's first name?

Mr. ROTH. Charles.

Mr. ROSENTHAL. Is he still with the Comptroller of the Currency?

Mr. ROTH. He is still in the same position today.

Mr. ROSENTHAL. Tell us what happened.

Mr. ROTH. I gave him this sheet which listed municipal bonds, with the size and the value of the portfolio both unsatisfactory. The amount of the trading account in size and profitability was unsatisfactory. The loss ratio of loans was unsatisfactory; the high ratio of term loans against volatile deposits was unsatisfactory; the high ratio of loans to stable funds was unsatisfactory; the amount of bank premises and equipment, unsatisfactory; tax loss carryforward, unsatisfactory; the amount of volatile deposits the bank had, unsatisfactory. The amount of high-rates-interest funds was unsatisfactory. High-rate funds, such as the certificates of deposit and Federal funds, were unsatisfactory.

Mr. ROSENTHAL. Where did you have this meeting with Mr. Van Horn?

Mr. Roth. The meeting was in his office. There was present in his office at the time his counsel, Mr. Nathans. The meeting took place in his office from 10:10 a.m. to 11:10 a.m.—1 hour.

I would like to read a few other things here and get to a very important point. The adequacy of capital funds was unsatisfactory; the retention of earnings after dividends, unsatisfactory; liquidity, unsatisfactory; profit margin, unsatisfactory. All of the trends were unsatisfactory. Morale was unsatisfactory; communication, unsatisfactory; the overall rating, unsatisfactory minus.

And I put down that the cause of this was: (1) Incompetence stemming from top management; (2) Negligence of the directors to take full remedial action; (3) The lack of full disciplinary action by the supervisory authorities.

He read it. He said:

I agree with you on everything that you have there except one point. That is what you say about the lack of disciplinary action by the supervisory authorities.

I said, "I am sorry, but that is my analysis of it and that is the way I feel about it."

He said to me:

Fortunately, I have some good news for you. You may have read in the newspaper that the bank has now employed Mr. Schreiber, who is the retired Chairman of the Board of Walter E. Heller, one of the finest finance companies in the country, and which is located in Chicago.

He said that Mr. Schreiber felt that he would completely turn the bank around by the end of the year, and that he had already made substantial progress in that direction.

He asked me whether I knew Mr. Schreiber. I said, "No."

He said, "Would you like to meet him?"

I said, "Absolutely."

He said, "Why don't you call him?"

I said, "No; you should call him."

He said, "What should I say?"

I said:

You say just what happened here today—that I gave you an analysis of the bank of everything that I found to be unsatisfactory; that you said to me that I should meet Mr. Schreiber because he would have some good news for me.

He turned to Mr. Nathans, his counsel, and said, "Do you think I should do it?"

Mr. Nathans said, "Yes; you should do it the way Mr. Roth has said."

The next day Mr. Van Horn called me and said, "I spoke to Mr. Schreiber. He would like to talk to you."

I called Schreiber on the telephone and then met with him for dinner that same night. I reviewed with Mr. Schreiber the things I felt were necessary in order to turn the bank around.

Now I have read to you from my comments with regard to my analysis of the annual statement of the bank. These were completely unsatisfactory. There is one other important thing which is written here.

I have: "What is the solution?" And I have written down: "An immediate takeover—promptly." I felt the merger was needed immediately because it was so bad.

I would like to read to you now what the Chief Executive Officer of the bank said in his annual report to the stockholders, and the way in which he painted the picture of the bank.

In 1973 Franklin crossed an important threshold so that it is now in the position to move forward in establishing itself as a major worldwide financial service institution and a leading money center banking operation. The past few years have been a period of transition for our organization. The restructuring of Franklin from a regional bank satisfying the capital markets of Long Island to a major money center institution offering a wide range of sophisticated financial services to both a national and international market has been most difficult. This transition has required redefining our market scope and revisiting our operational techniques and our management approach.

During almost any period of major change, there is uncertainty. The uncertainty which has accompanied Franklin's transitional period has been reflected in our financial performance in the last few years. To eliminate this uncertainty, we have directed our efforts to the development of a management team which could effectively respond to the challenges inherent in the banking industry, and in a broader sense, to the financial service market in the 1970's.

The design and implementation of asset and liability management techniques into our organization required restructuring of key areas of operations. The management programs which in turn focus on major profit centers, operational problems, and proper market direction are being actively developed and applied.

After thorough investigation of domestic and international markets, Franklin New York Corporation has set for itself a series of precise objectives. To obtain these objectives, specific sources and uses of capital and manpower have been identified and appropriate programs developed.

The 1973 Annual Report for Franklin National Corporation is therefore divided into sections that allow you to accurately focus not only on our present position, but our future direction as well.

My comment is, "Hogwash. Coverup." The front page of the report tells the story. It shows warm and beautiful sunshine and a nice climate. But it is a setting sun for Franklin National Bank. That is what it is.

So, I met Mr. Schreiber.

Mr. ROSENTHAL. Did you subsequently meet Mr. Smith, the Comptroller of the Currency?

Mr. ROTH. Yes; I did.

Mr. ROSENTHAL. Would you tell us when that was, the circumstances, and what happened?

Mr. BROWN. I think he wants to talk to us about his meeting with Schreiber.

Mr. ROTH. I think I ought to talk for a minute about Schreiber, and then I will get to that.

Mr. ROSENTHAL. Go ahead.

Mr. ROTH. I met Mr. Schreiber, as I said, on March 21, 1974. I was very much impressed with him. He is a doer. There is no doubt that he was largely responsible for the great things that happened at Walter E. Heller. Although it was a finance company, he was knowledgeable in the banking field because he said he made Walter E. Heller a great company by going around to the banks and saying: "What problem loans do you have? Turn them over to me and I will see that you are paid off." And he turned the loans around and made good loans out of bad loans.

I said to him:

You must shrink the size of the bank. It is a \$5 billion bank and it has no right to be. It should be \$3.5 billion. You have a lot of hot money in there in Federal funds—which is overnight money—and over \$1 billion in foreign deposits and certificates of deposit.

Mr. LEVITAS. Excuse me, Mr. Roth. Would you explain what you mean by "hot" money?

Mr. ROTH. The bank had over \$1 billion in Federal funds. All banks are required to maintain certain reserves. The members of the Federal Reserve System carry their reserves with the Federal Reserve. Others carry them with their correspondent banks. The excess money that they have over and above what is required to be kept with the Federal Reserve and correspondents are Federal funds available to be sold to banks that are short of money.

Franklin was always short of money during this period. So they bought these funds from the other banks. Now in order to buy the tremendous sums that they always had to buy, they paid one-eighth of 1 percent over the going market. That is hot money.

Mr. LEVITAS. Was this short term or long term?

Mr. ROTH. It was only overnight. The next day it had to be paid back again. It was just for 1 day that you were borrowing this money—over \$1 billion.

Mr. LEVITAS. And were they using this to lend out?

Mr. ROTH. Oh, yes. They were lending it out long. They did the same thing with certificates of deposit. They were 30, 60, and 90 days.

And then they had foreign deposits of \$1,200 million. Some of the foreign deposits were 30, 60, and 90 days. But they were loaning it out on term loans running into the years.

Mr. LEVITAS. Thank you.

Mr. ROTH. So I said, "Mr. Schreiber, you have to shrink the size of the bank to \$3.5 billion. You must stop your speculation in foreign exchange."

Do you know, I have heard that their speculation in foreign exchange at times ran \$1 billion? And they were speculating that the dollar would improve in value when it was constantly going down in value. That was \$1 billion.

Manufacturers Trust Company, for example, never speculated. The only time they were in foreign exchange was to take care of the needs of some of their foreign customers.

Morgan Guaranty on two occasions came into the bank and said, "You will have to stop this or else we will stop doing business with you."

This is Mr. Sindona.

Mr. BROWN. In connection with your memo here, Mr. Roth, you said, "Shrink size of bank to \$3.5 billion." What was its size at that time?

Mr. ROTH. Five billion.

I said, "You have to stop this speculation in foreign exchange. You have to reduce your loans by \$700 million to \$2 billion. Three. you have to reduce your municipal bonds by \$100 million to \$180 million. You have to reduce your other securities to \$10 million." It was around \$100 million.

"You have to reduce your trading account." They were trading for huge sums of money—as big as Chase and National City. Now "trading" is when you buy securities hoping that they are going to go up in value and then selling them again. That is trading.

Mr. BROWN. Were they not also engaging in rather risky loans to growth industries? Weren't they always—

Mr. ROTH. No. The only securities they had were the \$100 million corporate bonds, I believe. Plus a sizable amount of municipal bonds.

Mr. BROWN [continuing]. Looking for the upswing companies?

Mr. ROTH. Do you mean in their lending activities to corporations?

Mr. BROWN. Yes.

Mr. ROTH. Not so badly; no, I wouldn't say that. Their portfolio of loans on Long Island was pretty clean. Their portfolio of foreign loans, which they made at one-half of 1 percent under the going rate, I don't know about. I don't know the story there. I understand that there are losses, but that they are not really too bad. They had over \$500 million in foreign loans.

Now some of their loans outside of New York City were on the speculative side; yes. But as a whole, their loan portfolio was not bad when compared with what you see today in National City and Chase and other banks. It was not bad.

They went haywire on their lending in the last couple of years to try to increase their profits. Yes; they did that, but that was only in the last few years.

So, I said that their trading account should be reduced to \$50 million. And they had to reduce their municipal time deposits on which they were paying high rates of interest.

He agreed with me on all of these points except that he said that the loans should be reduced by \$500 million and not \$700 million.

He also made up charts on this program and presented it to the board of directors of Franklin National Bank. I understand they approved of the program.

Now I will come to my visit with Mr. Smith on April 4. When I saw Mr. Van Horn on March 19, he said to me, "Have you met our new comptroller, Mr. Smith?"

I said, "No."

He said, "I think he would welcome a visit from you when you are down in Washington."

On April 4, 1974, I was in Washington. I had made no previous appointment. When I stopped in his office, he was out. I went next door to see his first deputy, Justice Watson, whom I knew very well. I told him what Van Horn had to say and I gave him the memorandum that I discussed with Van Horn and discussed it with him too.

I also said to him:

I see an awful lot of gambling going on in banks in foreign exchange. What I don't understand is that you have no limit on the amount of gambling that can go on in foreign exchange, such as the kind of limitation you have on the amount of loans that can be made to any one borrower. In other words, you cannot loan to one borrower more than 10 percent of the capital funds of the bank. Why don't you have the same limit on speculation in foreign exchange—that it shall not exceed more than 10 percent of capital to any one country?

He said:

I am not familiar with that. I will have to get our foreign exchange man down and let you talk to him.

He telephoned, but the foreign exchange man was out for the day. It dropped there, with the exception of my talking about it with Smith.

He went in to see Smith's secretary and came back and said, "I made an appointment for you to see Smith this afternoon."

At 1:30, I went in to see Smith. I spent an hour with him. Once again, I gave him this same memorandum which I had given to Van Horn. And after I got through with that, he said, "Thank you, Mr. Roth."

I think that in the hour I spent with him, he didn't say more than 15 words.

I then spoke to him and said, "There are a lot of other things I want to talk to you about." I spoke to him about the gambling in foreign exchange by banks. I didn't mention Franklin, but I guess he knew I meant Franklin. But I meant banks generally because many were doing it. Too many of them were doing it.

I also said to him, "You know, when I was with Franklin, I thought it was kind of ridiculous to have dual examinations by banks." In other words, if a State bank that is a member of the Federal Reserve System has the State bank examiners examine the bank at the same time the Federal examiners come in, they both come in at the same time and they write up their own reports of examination.

And I said to him:

You know, that is a good thing. I used to think it was a foolish thing, but I think the wool is pulled over the eyes of the examiners too often and it will happen less often if you have dual examinations. And I would certainly recommend to you that you have another examination by another agency when a bank is on a problem list. Certainly, every 3 years all banks ought to be examined by two agencies. As a matter of fact, I would like to see it the way it is done by the Federal Reserve at the present time.

I further said to him:

I know that you are now in the course of having an accounting firm make recommendations to improve the examinations of the banks—Haskins and Sells. And I would like to give you my thoughts on what should be done to improve examinations of banks in addition to the dual examinations I just mentioned.

Mr. BROWN. Mr. Roth, may I interrupt you for a second?

Mr. ROTH. Yes.

Mr. BROWN. You mentioned that you talked with Smith about regulation of investment in foreign countries, et cetera.

Mr. ROTH. That's right.

Mr. BROWN. You said that they should have a limit such as 10 percent in each foreign country.

Mr. ROTH. That's right.

Mr. BROWN. I think you would agree, would you not, that the authority for the regulator to limit a bank's exposure to any one person to 10 percent of capital stock is a statutory provision.

Mr. ROTH. Oh, yes.

Mr. BROWN. And there is no statutory basis for a similar limitation on foreign investments. Isn't that correct?

Mr. ROTH. That is right.

Mr. BROWN. So really the regulator would have no authority to do that, would he?

Mr. ROTH. He had no authority, but it is unsound and unsafe banking practice to go beyond that. And he can raise the devil over it and he can ask that the law be changed.

Mr. BROWN. OK. But, Mr. Roth, if you were the banker and if you felt what you were doing was not unsafe and unsound, and if the

regulator, without any statutory authority, attempted to impose a restriction upon your investments, wouldn't you contest the authority to issue such a regulation?

Mr. ROTH. Someone might. But if I were a regulator, I wouldn't let the bank get away with it. I would make such a thorough examination of what was going on and I would find so many things going wrong with that kind of speculation that he wouldn't get away with it.

That is the trouble with our regulators. They don't know how to get tough when they should get tough.

Mr. ROSENTHAL. Go ahead, Mr. Roth. We break up about 12 o'clock, so I want to get your full story concerning the seven pages of this memorandum. Then everybody will have a chance to ask some questions.

Mr. ROTH. I said with regard to examinations that as soon as the bank examiners came in, I would require management to prepare their list of assets they considered to be subject to criticism, with their classifications and comments. In other words, I said that the lending offices and the bank offices should know what assets should be criticized and they should make up their own lists.

Mr. ROSENTHAL. Mr. Roth, did you conclude the Franklin matter with Mr. Smith? What did he say and what did you say? How was the matter concluded insofar as Franklin was concerned? We need to keep the record clear.

Mr. ROTH. The Franklin matter was concluded; yes. I had nothing more to say about the Franklin matter except as it involved examinations.

Mr. ROSENTHAL. Did Smith say that he would do anything or that he would not do anything? What did you ask him to do or not to do?

Mr. ROTH. Do you mean with regard to my recommendations on how to examine the banks?

Mr. ROSENTHAL. With specific reference to Franklin, how did the meeting end?

Mr. ROTH. Nothing was said. He was silent. He said about 15 words—"Thank you" and "Yes" and "Is there anything else?"

And when I got through with this, he handed my sheet with my analysis of the annual report of Franklin to me, as if to say, "Here. I am not interested."

I took it and said, "These are for you, Mr. Smith." I put them on his coffee table and left.

Mr. ROSENTHAL. Then what happened?

Mr. ROTH. I left his office.

Then I went in to see Brenton Leavitt. I said, "I would like to talk to you about the Franklin National situation. I have discussed it with the Comptroller. Also, I would like to talk to you about the Talcott matter that you have under consideration now as to whether or not you are going to allow Franklin National Bank to take over Talcott."

I gave him a memorandum of what my thoughts were with regard to the takeover of Talcott. I said that I thought Talcott should be good for Franklin New York Corp. mainly because Norman Schreiber, who ran the Walter E. Heller Co., ran one of the finest finance companies. And I thought that he could do a job with Talcott.

"However," I said, "you should not allow them to take it over unless Franklin increases its capital by \$30 million; that no pay-

ments are made to Sindona for the interest, and expenses he has had in connection with Talcott; that Franklin National Bank is to discontinue cash dividends and pay stock dividends; that Franklin National Bank is to shrink in size from \$5 billion to \$3.5 billion." In other words, this was the same kind of thing that I had told Norman Schreiber.

Mr. ROSENTHAL. When did you have this meeting with Brenton Leavitt?

Mr. ROTH. On the same day—on April 4. I might also say that I have the highest regard for him. He spoke and he discussed things with me. He was intelligent and he knew what it was all about. I am afraid I cannot say the same thing about Mr. Smith.

I said that the bank should prepare a 3-year forecast of where they are going, a balance sheet of where they are going for the next 3 years; they have to find a replacement for the chief executive officers; and that each director should sign an agreement with regard to the quarterly progress being made, which would be submitted to the Federal Reserve and the Comptroller of the Currency.

I also told Brenton Leavitt about what I said to the Comptroller about dual examinations.

And Leavitt said me, "What did the Comptroller say?"

I said, "not a single word, but I could see that he didn't like it."

And I said to Leavitt, "We are in serious times and you had better start beefing up your examination force. I am worried about what is happening in banking."

Mr. ROSENTHAL. Did you and Leavitt have anything to say about what actually should or should not be done as far as the Franklin National Bank was concerned?

Mr. ROTH. No—except that he did agree with me on all of the things I said with regard to the shrinking of the size of the bank and the actions that should be taken. He did agree with me.

Mr. ROSENTHAL. Who had the principal responsibility or the exclusive responsibility in this area?

Mr. ROTH. The Comptroller of the Currency. It is only a courtesy on the part of the Comptroller to allow the Federal Reserve to have a copy of the report of examination.

When Jim Saxon was Comptroller for a period of time, he didn't even give the reports of examination to the Federal Reserve Board.

Mr. ROSENTHAL. And the reason that Franklin is a client of the Comptroller is because Franklin was a national bank.

Mr. ROTH. That is right.

Mr. ROSENTHAL. Do they pay a fee to the Comptroller of the Currency for this relationship?

Mr. ROTH. Yes; they pay a fee. The Office of the Comptroller is self-supporting. It does not have to look to the Congress for any money to support the Office of the Comptroller of the Currency.

Mr. ROSENTHAL. Do you have any notion of how much the Franklin paid a year to the Comptroller of the Currency for this relationship?

Mr. ROTH. No, I don't recall that. But they surely did not make any money on them.

Mr. ROSENTHAL. At any time thereafter, did you have a meeting with Mr. Ed Langdon, one of the examiners for the Franklin National Bank?

Mr. ROTH. Yes. Ed Langdon is a good examiner, and Ed Lake is another very good examiner. Both of them are very competent examiners.

Mr. ROSENTHAL. By whom are they employed?

Mr. ROTH. They are employed by the Office of the Comptroller of the Currency.

Mr. ROSENTHAL. What happened at this meeting?

Mr. ROTH. This meeting with Ed Langdon occurred in the Office of the Criminal Division of the Department of Justice in New York City, which is, of course, investigating the Franklin National Bank matter.

I also discussed these kinds of things with the Department of Justice. And Ed Langdon said to me, "Well, you know, Arthur, we brought those kinds of things out in our reports, too. But down in Washington, they did otherwise."

Mr. ROSENTHAL. Did he further explain that?

Mr. ROTH. He did not.

Mr. ROSENTHAL. What did you understand him to mean by that statement?

Mr. ROTH. There are a lot of surmises. I mentioned one of them. Certainly, Smith, by his actions, was incompetent and negligent, to say the least. And Sindona had entree, I wouldn't be surprised, to Smith through David Kennedy, the former Secretary of the Treasury. That is what I surmised.

Mr. ROSENTHAL. Mr. Roth, you realize you are under oath now, don't you?

Mr. ROTH. I surmised this; that is all. I said I surmised this. It is up to you to investigate these things further.

Mr. ROSENTHAL. We will.

Mr. BROWN. What is the total content of your surmise?

Mr. ROTH. Just that. You see, we are getting now to May 12, 1974. On May 12, 1974, there was a meeting at the Federal Reserve in New York, I understand, between the Federal Reserve Board, the Comptroller of the Currency and the Federal Deposit Insurance Corporation.

Manufacturers Hanover had made an offer to buy the bank, and pay \$17 a share for the bank. I understand that the Department of Justice said that they would interpose no objection because of the condition of Franklin National Bank.

That takeover was disapproved. And the disapproval of that takeover caused great economic harm to Long Island. Unemployment went up; many businesses went bankrupt. If Manufacturers Hanover had taken over Franklin National, these things would not have occurred.

But before we get there, I have something else to say, if I may, which leads up to this crisis. May I?

Mr. ROSENTHAL. Please.

Mr. ROTH. We are in the crisis period now. I mentioned before that I had met with Schreiber on March 21 and on April 4 in Washington.

On April 29 I wrote a letter to all of the supervisory authorities, in which I once again sent my Sindona letter and the stockholders' letter. In it I said: "In your present deliberations you may have overlooked the contents of my two letters, copies of which are enclosed." I wanted to again bring to their attention that Sindona was bad. I questioned

that, and I questioned the condition of Franklin going all the way back to 1972.

Mr. ROSENTHAL. Had Sindona been a partner with David Kennedy in any matter that you know of?

Mr. ROTH. Mr. Sindona told me so.

Mr. ROSENTHAL. What did Mr. Sindona tell you about his relationship with David Kennedy?

Mr. ROTH. Well, you know that David Kennedy was a director of the Fasco Corp., which is the corporation that held the Franklin National Bank's stock. And Mr. Sindona, when I saw him, said that he had been a partner with Continental Bank in Europe for 12 years. Now David Kennedy was chairman of the board of Continental Bank.

Now we are getting to the crisis period. The real crisis occurred on Mother's Day, May 12. But let me give you some of the highlights and some of the notes I made just a few days before May 12.

I met Mr. Schreiber in his office on May 2, 1974. I made no previous appointment. I told him that he, Schreiber, should replace Gleason as chairman of the board; Sadlik should become president; and this should be done before the stockholders meeting which was supposed to take place shortly. In that way Schreiber could help to restore confidence in the bank. People had no confidence in Gleason.

Schreiber said to me, "Arthur, I can't do these kinds of things. Gleason and Merkin control the board. Numerically, I can't do anything. I am the chairman of the executive committee, but they control the board."

I said, "I am shocked that you have been brought into this bank without the control that you should have and that these people who are responsible for the unsafe and unsound banking conditions that exist are still in control. I don't understand it."

He said, "Arthur, I would suggest to you that you don't come in and see me again. I am embarrassed by your walking in like this because Gleason and others will find out about it."

On May 2, Viscardi, who is chairman of one of the great companies on Long Island, Abilities Inc., telephoned me. He said he had a \$3 million CD at Franklin. His financial adviser said, "Pull it out. Don't keep it in there for a day. Take it out."

I said to him, "He is going overboard. I wouldn't be concerned about it, Hank."

On May 6, 1974, Steven Andredda of Barron's magazine phoned me for an appointment the next day. I met him the next day, on May 7, and I made it clear three or four times that I wanted only good things to happen at Franklin. Most of my life was spent at Franklin. My family holds 70,000 shares and many of my friends and relatives are investors. I said, "Norman Schreiber can turn the bank around, but he needs to be chief executive officer with Sadlik as president. Gleason and Merkin should be out."

I warned Andredda that a bad story could do great damage to the economy of our country and have international repercussions. I told him that he should write a story to achieve corrective action and to restore confidence because of Schreiber and Sadlik. He said that he would.

I said to him, "There is no question about the solvency of the bank; there is only a problem of liquidity. The Federal Reserve and other banks will not allow anything to happen to Franklin."

I advised him to speak to the supervisory authorities. These are critical periods we are in now.

On May 8, the Financial Chronicle phoned me. I immediately asked, "What caused you to decide to write a story on Franklin?"

They answered, "The unusual release by the Federal Reserve Board with regard to the turndown of Talcott and the 2-cents-a-share earnings of Franklin which was reported."

I said to them the same things that I had said to Steven Andredda.

On May 9, I phoned Van Horn. I said, "This situation is getting to be very serious." I told him about Barron's and Financial Chronicle's telephone calls.

MR. ROSENTHAL. Mr. Van Horn was the regional administrator of the comptroller's office, wasn't he?

Mr. ROTH. That is right.

I also told him of the questions I had been asked by three or four people who had large sums of money in the bank. They said, "Is the bank safe?"

I said, "Yes; it is. Don't worry about it. I wouldn't be concerned."

The stock went off 2 points. I told Van Horn, "This thing feeds upon itself. I have been through runs of banks and I am worried about this."

Van Horn said, "Well, Mr. Smith is not concerned. He is very calm about this whole thing."

I told Van Horn that he must have Schreiber as chief executive officer and Sadlik as president.

Van Horn said, "I can't run the bank."

I said to him, "Unsafe and unsound practice is there. You have the right to ask for the removal of these people."

Van Horn said, "Yes; that is so."

I said, "You have been taken in by this fellow Gleason, I think. He is a super con man."

He said, "No, no; I know him. We know Gleason and also Smith knows him."

I said, "There are questions arising because of the Federal Reserve release on Talcott."

He said, "Well, there are many other banks that have problems around the country."

I said:

Franklin is the largest and has immediate problems and may cause national and international repercussions. You don't seem to realize this.

On May 9, Eugene Nickerson, a former Nassau County executive, called me. He said:

The head of Supermarket General that has a couple of million dollars in Franklin National is hearing rumors about Franklin. They are big depositors. Is the money safe?

I said, "Yes; it is safe. Banking cannot permit anything to happen to the Franklin National Bank. Don't worry about it."

On May 9, Viscardi called again.

On May 9, I spoke to Van Horn and related the conversations with regard to Nickerson and Viscardi and other people who had called me. He said:

Thank you. Keep me advised because you are closer to these things than I am. I would like to have you keep me advised so I can let Smith know what goes on.

I told him again that he had to get rid of Gleason and Merkin. I told him that if he did, I would make a public statement which I felt would help in restoring confidence in the bank, but that I couldn't do it as long as those two bad people were with the bank.

On May 9, Tatro and Company, a brokerage house, phoned and said that Franklin was bid at 8¾. He said, "What is the cause?"

I said, "I don't know. Maybe it is the turndown of Talcott."

On May 9, at 12:35 p.m., I phoned Van Horn about it. He said he was just on the wire with Al Hayes, president of the Federal Reserve Bank in New York, who had said that this made it an international situation. Hayes is a great banker.

At 2 o'clock in the afternoon, I telephoned M. A. Shapiro, a bank stock specialist. I said to him:

Look, Morris, you are the only one that can save this situation. You must call a meeting of the Clearing House banks tonight and request a \$100 million loan to Franklin New York Corporation, and a stand-by by the Federal Reserve Bank. You have to tell them that Schreiber should be Chief Executive Officer and Sadlik should be President, and that Gleason and Merkin have to get out.

Shapiro said, "Why me? Why should I do it?"

I said:

You know Al Hayes; you know the people down there. They all respect you. You know what the consequences are. You take fast action. Get going, Morris. It is getting too late.

He said, "OK, let me go; let me go."

Then of course you had the Mother's Day weekend when the three supervisory agencies met to decide what should be the fate of Franklin National Bank.

Manufacturers Hanover was willing to pay \$17 a share for the bank. But they turned it down. Why?

Mr. ROSENTHAL. Was this the Mother's Day weekend massacre?

Mr. ROTH. That was it all right. They massacred the people on Long Island mainly.

Mr. ROSENTHAL. And the subheading is: "Get going, Morris."

Mr. ROTH. Yes; "Get going, Morris," is right.

Now if that merger with Manufacturers Hanover had been approved, the Long Island economy would not have been critically damaged the way it was. Long Island's businesses would not have gone bankrupt the way they did. Long Island's unemployment rate would not have risen so high. The common stockholders, exclusive of Sindona, would have received about \$60 million from Manufacturers Hanover. And in addition to that, another \$80 million would have gone to debenture holders and preferred stockholders.

Yes—why, why was this turned down?

I can tell you that it smells. And it smells bad. And whoever is guilty of causing so much damage to so many people, and of causing almost an international calamity, belongs in jail.

Mr. LEVITAS. To which merger are you referring?

Mr. ROTH. The Manufacturers Hanover of May 12, 1974.

Mr. LEVITAS. Were there not two occasions when Manufacturers Hanover wanted this merger?

Mr. ROTH. Yes. They made another bid for the bank on October 8, 1974. That is a very questionable item too.

Mr. LEVITAS. But you, in your last comments, were referring to the May of 1974 merger, were you not?

Mr. ROTH. May 12, 1974.

Mr. LEVITAS. And you were not referring to the October date.

Mr. ROTH. Not to October 8; no, sir.

Mr. ROSENTHAL. Then what happened? Who turned down the merger with Manufacturers Hanover?

Mr. ROTH. I don't know. I just hear stories that it was the Comptroller. But I don't know. You will have to investigate that.

Mr. BROWN. Would you mind telling us who told you it was the Comptroller?

Mr. ROTH. Newspaper people told me. I heard it from three or four newspaper people.

Mr. BROWN. What was their source?

Mr. ROTH. I don't know. I didn't ask their source.

Mr. ROSENTHAL. This matter is being looked into by the Department of Justice right now.

Mr. ROTH. I hope so.

Mr. ROSENTHAL. It is. After the turndown of Manufacturers Hanover, what happened? Bring us up to date chronologically.

Mr. ROTH. The deposits drained out of the bank. Joe Barr came in to try to save it. He is a great guy, but it was too late to do anything.

On October 8, 1974, the Fed had loaned the bank \$1,700 million. And they asked for bids. The bids were called for at 10:30 a.m. on October 8, I understand. Manufacturers Hanover and Chemical submitted their bids. European-American asked for a delay in order to get in touch with Europe. That was until 1:30 in the afternoon.

I don't know whether you know what happens when bids are made. Almost 5 minutes before the bid is made, everybody gets on the telephone to one another and says, "What did you bid? What did you bid?"

And so it is known even before the bids are opened. That is a couple of minutes before. But here this bid was asked for at 10:30 in the morning and then it was delayed until 1:30 in the afternoon—at European-American's request.

Now you are going to ask me who told me this. And I will tell you that a number of people have told it to me. But you will have to investigate it.

European-American jacked up their bid from \$120 million to \$125 million, to beat Manufacturers Hanover at \$122 million.

Investigate it. I am telling you what I hear.

Mr. BROWN. Mr. Roth, who conducted the procedure?

Mr. ROTH. The bids, as I recall it, were under the direction of Oren Judd, a Federal judge in New York. What Oren had to do with the delay and the bidding and so forth, I have no idea. I know Oren and he is a very fine person.

Mr. BROWN. What regulatory agency is responsible?

Mr. ROTH. The Federal Deposit Insurance Corporation is responsible at this particular point. The bank was declared insolvent; they asked for bids for the bank; it was then up to Federal Deposit Insurance to accept the bids.

Mr. BROWN. But the FDIC conducts that?

Mr. ROTH. That phase of it is FDIC.

Mr. BROWN. It is totally up to FDIC, and not the Comptroller?

Mr. ROTH. That is right.

Now, here is European-American, which for weeks before have said that they were going to take over Franklin, buying Franklin. They were a \$500 million bank; and when they bought Franklin, they became \$2,500 million. A mouse was taking on the burdens of an elephant.

They knew nothing about small business loans, loans to builders, community obligations, or anything such as that. They were an international bank doing business with big accounts. And yet they were allowed to take over the bank.

If Manufacturers Hanover had taken over the bank, they would not have taken over only assets equal to the deposits, which was the requirement of the FDIC. They could have taken over a great, great many more assets and loans.

We have seen the loans in the FDIC and we know that on Long Island, almost 80 percent of them were loans that were not classified—good loans. But European-American didn't have the resources to take over anything more. When loans are with the FDIC, borrowers become tainted. People think there is something wrong that they are with the FDIC, and they can't get loans elsewhere.

Furthermore, you may have read Business Week's story of December 22, 1975, in which they quoted the bank as saying that the bank's earnings in the 2 years prior to the takeover was \$11 million and \$15 million. And then the year when they took over Franklin, they dropped to \$5 million. And last year it was \$5 million again.

They are losing money on Franklin. What happens when a bank loses money? Do they give better service? Of course not. It thinks of ways of cutting expenses and retrenching.

They didn't gain back any of the deposits they lost. The name, European-American, was against them. They knew nothing about how to run a bank on Long Island. They didn't have the management to do it. All of the good people in Franklin left.

I don't know why the FDIC ever allowed it—yes; I do; yes; I do, but you will have to check into it. National City and Chase and all of the big banks were running all over Europe establishing branches. More than half of their earnings came from international operations. The banks in Europe became upset and said, "We are letting you run all over Europe with your branches and we are not able to do the same thing in the United States. We want to have an opportunity to do the same thing in the United States."

European-American is owned by five of the largest banks in Europe—Germany, Holland, France, Belgium, and England. But they made a grave mistake.

Mr. ROSENTHAL. Who made the trade off?

Mr. ROTH. Who made the trade off? I don't follow the meaning of that.

Mr. ROSENTHAL. The implication is that somebody arranged it so that the European-American could get into this deal.

Mr. ROTH. I don't know. That is for you to investigate.

Mr. ROSENTHAL. What happened to you and your 70,000 shares?

Mr. ROTH. I still have most of it.

Mr. ROSENTHAL. How much are they worth today?

Mr. ROTH. I reported on my income tax that they were worth nothing.

Mr. ROSENTHAL. Mrs. Collins is asking how much they were worth 3 or 4 years ago.

Mr. ROTH. Three million dollars.

Mr. ROSENTHAL. So to describe you as an unhappy man is a fair statement?

Mr. ROTH. Yes—unhappy about the way things occurred here. Here was a great bank that was allowed to go down the drain—one of the greatest banks in the country. And my only purpose in being here and saying the things I am saying right now is that I want to see our banking system improved and strengthened. I don't want to see these things happen again. And you are only going to stop these kinds of things from happening by doing the kind of investigating that you are doing and the kind of talking that I am doing.

Mr. ROSENTHAL. Mrs. Collins.

Mrs. COLLINS. Mr. Roth, is it true that a Peter Shaddick was recruited by Sindona from the Bank of Montreal to head up the international department of the bank?

Mr. ROTH. That is what I understand. I only met the man once.

Mrs. COLLINS. Did you hear of any problems he encountered when he handled this responsibility?

Mr. ROTH. Yes. I heard talk that he had problems along the same lines with one of the other banks that he was with. That is right.

Mrs. COLLINS. Actually, I think you probably did all that you could to make all of the officials of the banking industry aware of what was happening. And your conclusion is that they just disregarded everything that you suggested, and that was the end of it. Is that right?

Mr. ROTH. I would say so.

Mrs. COLLINS. Thank you.

Mr. ROSENTHAL. Mr. Brown.

Mr. BROWN. Mr. Roth, you have indicated in your testimony that the turndown of Talcott was one of the crucial items as far as the soundness and the future of Franklin was concerned.

Mr. ROTH. Yes.

Mr. BROWN. For an acquisition of that nature to occur, it requires the Comptroller's approval, does it not?

Mr. ROTH. No; it is a Federal Reserve approval primarily that is required because the Federal Reserve supervises bank holding companies. It is their approval that is required.

I would think that they have discussions with the Comptroller. They should.

Mr. BROWN. So you think the Comptroller would have had some input into that?

Mr. ROTH. Oh, yes; I would say so.

Mr. BROWN. Mr. Roth, for the Comptroller to exercise his authority under the general statutory language of "unsafe and unsound banking practices," isn't his authority under that section of the law pretty much limited to refusing to grant requests of banks, such as for

branches or for acquisitions, et cetera? Isn't that about the only way he can exercise that portion of his authority?

Mr. ROTH. Pretty much so. And of course that has to be strengthened a great deal. That is one of the things that you have to do.

Mr. BROWN. So what I am saying, Mr. Roth, is that this whole list of recommendations that you discussed which should have been done, and which Mr. Schreiber apparently somewhat agreed with—to shrink the size of the bank to \$3.5 billion; to stop speculation in foreign exchange; to reduce loans to \$2 billion; to reduce municipal bonds by \$100 million to \$180 million; and on and on—were not within the purview of the statutory powers of the Comptroller. The only way the Comptroller could have used his authority to implement such recommendations was in connection with a request made by Franklin National for the approval of the Comptroller to do something. And he could say, “No; I won't grant you this authority to branch, et cetera, unless you do these things.”

Isn't that about right?

Mr. ROTH. That is right. But he can also say, “I want to see the board of directors of the bank down in my office and I am going to read the riot act to them about their unsafe and unsound banking practices.”

That used to occur in years gone by. And when you tell a board of directors of their responsibilities, that is very effective. But you have to really get tough with them.

Mr. BROWN. Who was the Comptroller on April 27, 1972?

Mr. ROTH. I don't recall who he was. I don't know whether it was Smith or not. He came in about that time, but I am not so sure.

Mr. BROWN. I think that Smith didn't come on board until some time in 1973.

Your first exhibit is the letter you first sent to the shareholders. The second exhibit is the letter you wrote to Laurence Tisch on July 18, and sent a copy by certified mail to the regulators. These were the same kinds of recommendations that you made to Schreiber later on and discussed with Smith. Did you discuss any of these with Mr. Camp who was the Comptroller at that time?

Mr. ROTH. No; I did not discuss them with Camp. But Camp may have been Comptroller at that time.

Mr. BROWN. The issues you raised about the conduct of the business of Franklin National were raised first in 1972, during a period of time when a Comptroller other than Smith was Comptroller. Is that right?

Mr. ROTH. That is right. On the other hand, it is a problem bank and it is the responsibility of a new Comptroller to look at the file.

Mr. BROWN. I just want to put this into context with respect to the time sequence.

According to your memos, apparently the first time that you advocated a takeover was in March of 1974.

Mr. ROTH. That was March 19; yes. But the Sindona letter covers the takeover. And that was before that. In the letter to Tisch, I said, “Don't you think that another American corporation could have taken it over?”

Mr. BROWN. But insofar as that recommendation is made directly to a regulatory agency, this is the first time. At the bottom of your exhibit D, you say, “Solution—a takeover promptly. On March 19, 1974,

I delivered the original of this to Mr. Van Horn and discussed items in detail."

Mr. ROTH. That's right.

Mr. BROWN. Then apparently that proposal was adopted by both Franklin National and the Comptroller in April of 1974. These things which you recommended to Schreiber were pretty much adopted. Is that not right?

Mr. ROTH. The things that I recommended to Schreiber were adopted. Yes; they tried to adopt some of them.

Mr. BROWN. And that was in April of 1974.

Mr. ROTH. But you must remember that if I could see these things in an annual report, they, when they examined a bank, saw these things long before—or should have seen them long before I did.

Mr. BROWN. Don't get me wrong, Mr. Roth. We are trying to see whether the regulatory system failed in this case, to the extent that they had the responsibility. And I think that the things that you have mentioned that were wrong with Franklin National all fall under a failure of the Congress to enact appropriate regulatory legislation. Do you not agree?

Mr. ROTH. I think it needs that kind of legislation; yes. That is right.

Mr. BROWN. And I think you would agree that the Comptroller really did not have the authority to do any of these things you mention, such as the limitation on foreign investments or all of the things that you have listed as unsafe or improper banking practices. Isn't that pretty much correct?

Mr. ROTH. But you did find that banks that had good management adopted many of these.

Mr. BROWN. I quite agree with you.

Mr. ROTH. And you see, the thing that is wrong with regard to the examinations of the regulatory bodies is that the one who has to be examined most of all is the chief executive officer. And they do write a report on the chief executive officer. But they never disclose that information to the board of directors. They never disclose what they think of the competency of the chief executive officer.

Mr. BROWN. Mr. Roth, do you think that everyone shares the opinion that you have expressed here today as to what went wrong with Franklin National? I don't mean that as a trick question.

I only ask that question because of the Fortune article back in October of 1974, in which it is stated:

The Franklin tale reads like a modern-dress Greek tragedy. Error begot error, and events moved inexorably to a denouement that the bank's management feared, but seemed powerless to prevent. Roth started it all by making a lot of risky loans. When the loans went bad, Roth turned to bonds. When the bonds fell in value, they could not be sold because of the loan losses. And so the bank ended up trapped with a wad of low yielding assets that had to be financed from progressively higher cost money. Meanwhile, non-interest expense was increasingly sharply because of wreckless branching and the inflation of personnel costs.

Would you care to comment on that?

Mr. ROTH. That is absolutely a lie. That story, under the byline of Alex Rose, was said to have been partly written by Erich Heinemann. Erich Heinemann was in the employ of Franklin National Bank. It was his job to get as much of Federal funds and other short-term

money as the bank needed. That was his area of responsibility, as I recall it.

So Erich Heinemann, who was brought in by Luftig, wrote a coverup story to cover up his own deficiencies and the deficiencies of those with whom he worked.

I have the answer to that. I gave it to Mr. Dugger this morning. I never sent it to Fortune magazine because I felt that it wouldn't do any good to send it to them and to dispute what they had said. But I did write it just for the record, and Mr. Dugger has the letter that I gave him this morning. And that is my answer to that.

Mr. BROWN. If you were to list on a priority basis the things that should be blamed for Franklin's failure, it would seem, according to your exhibits and your testimony, that you would first blame management. And to a certain extent, you blame the stockholders for not concurring with you in forcing the management to act differently.

Mr. ROTH. No; not at all. I don't blame the stockholders at all. No. 1, I blame the management of the bank; No. 2, I blame the directors; and No. 3, I blame the supervisory authorities.

Mr. BROWN. But with respect to the supervisory authorities, do you still feel that they had the authority to do the things that you recommended to be done as of 1972?

Mr. ROTH. I feel that if they had done what they should have done, by raising hell with the directors about their practices and what was going on and not by going in there as southern gentlemen and milque-toast and talking in a weak manner, that the directors would have seen to it that corrective action would have been taken.

Mr. BROWN. I think you suggest in your testimony that you blame Smith, the Comptroller, for not taking some action because of a relationship that existed among the parties involved. Is that not correct?

Mr. ROTH. I surmise that and other people surmise it too.

Mr. BROWN. Then why for the year or so that Mr. Camp was Comptroller did he not take any action?

Mr. ROTH. I don't know. I would have to look at the dates and at what occurred during that period of time. I don't know when Camp left there. He was a pretty good Comptroller.

Mr. BROWN. Mr. Roth, in testimony before what was then called the Subcommittee on Bank Supervision and Insurance, the St Germain subcommittee of the Banking and Currency Committee, when that subcommittee was looking into the failure of Franklin National, this issue about the potential takeover by Manufacturers Hanover was discussed. In his testimony on that matter, which was fairly thoroughly gone into by the committee, Mr. Smith said that Manufacturers Hanover lost interest in the acquisition.

But it was your position that the Comptroller turned it down.

Mr. ROTH. That is right. That is how I understand it.

Mr. BROWN. But your understanding comes from talking with newspaper people and so on.

Mr. ROTH. That is right.

Mr. BROWN. If there were to be a takeover by Manufacturers Hanover at that time, that would have required shareholder approval. Would it not, unless the Comptroller exercised his extraordinary au-

thority to waive shareholder voice in that transaction? Is that not right?

Mr. ROTH. That is right.

Mr. BROWN. Is that a very usual thing for the Comptroller to do?

Mr. ROTH. No; it is not. It is an unusual thing, but it has been happening recently.

Mr. BROWN. With Mr. Sindona's owning the amount of stock that he did in Franklin National, do you think that Smith could have gotten shareholder approval of that takeover?

I think it was Smith's position, in view of the way in which the discussions had gone in the three agencies, the Fed, the FDIC, and the Comptroller, that he couldn't have gotten shareholder approval and that, therefore, if the takeover were to take place, he would have to exercise that authority. And when Manufacturers Hanover knew that he would have to exercise that kind of authority, it is then that they lost interest. Does that sound plausible?

Mr. ROTH. It could be. But I don't know whether they knew what a precarious situation Franklin National Bank was in. They should have acted then and there. That is where I see the negligence.

Mr. BROWN. But that is where we have a bit of a problem. The question is what authority did they have. And that gets into the general scope of this subcommittee's activities.

Mr. ROTH. That is right.

Mr. BROWN. You obviously feel that if the authority does not exist, the regulatory authority should be given greater authority than they presently have in these different areas.

Mr. ROTH. Absolutely.

Mr. BROWN. And you feel this both with respect to foreign investment limitations and with respect to the recommendations which you made with respect to Franklin National as being applied to all institutions. Is that right?

Mr. ROTH. That is right.

Mr. BROWN. And I think that you will agree that if the authority is there, it is fuzzy at best. Is that not right?

Mr. ROTH. Yes; it is very fuzzy. That is true.

Mr. BROWN. So legislation should be enacted to make this authority clear.

Mr. ROTH. That is right.

Mr. BROWN. I think you said in your opening remarks that you hoped we wouldn't throw the baby out with the bathwater—or words to that effect.

Mr. ROTH. Absolutely.

Mr. BROWN. There is much discussion in the other committee about having one regulatory agency.

Mr. ROTH. I would be very much concerned about that. I think that it might become a regulatory agency such as some of the other regulatory agencies that we have. I mentioned the ICC before. That could do immense damage to the banking system and to the economy of our country. I would be very fearful of that.

The Comptroller's Office has to be reorganized. The laws have to be strengthened to give the Federal Reserve and the FDIC and the Comptroller more authority in the case of problem banks and how to deal

with them. But I would still leave the Office of the Comptroller of the Currency the way it is, as well as the others. And I would get into dual examinations, as I recommended, too. And I would have more dis-closure with regard to the examinations. Also, your oversight committee has to do what it is doing now more often.

Mr. BROWN. I couldn't agree with you more.

Mr. Roth, you talk about dual examinations. As far as State-chartered banks, we do have dual examinations now.

Mr. ROTH. Yes; we do.

Mr. BROWN. And with the examinations that I have come in contact with some time back, they don't always appear at the same time. Often they are separate and independent examinations.

Mr. ROTH. Yes.

Mr. BROWN. Do you think that that second look is a good thing? I guess you do think so.

Mr. ROTH. Absolutely. I surely do.

Mr. BROWN. Are you saying that there should be a second Federal regulatory look at them?

Mr. ROTH. We have the State Banking Department; we have the Federal Reserve; we have the FDIC; and we have the Comptroller now. All are doing examinations. I say that there should be dual examinations of all banks of whatever combination you may want to use of those.

In the case of the national banks, it is only the Comptroller's Office.

Mr. BROWN. And you are saying that if it is a national bank, it should be examined by the FDIC and by the Comptroller or by the Federal Reserve?

Mr. ROTH. Yes.

Mr. BROWN. My time has expired. Thank you, very much.

Mr. ROSENTHAL. Mr. Levitas.

Mr. LEVITAS. Thank you, Mr. Chairman.

I'd like to try to clear up this chronology again, Mr. Roth. Mr. Brown suggested that the first communication you had with the regulatory agencies may have occurred in 1973. Did you send copies of your April and July 1972 letters to FDIC and the Comptroller of the Currency?

Mr. ROTH. I surely did.

Mr. LEVITAS. So they would have had this information brought to their attention early in 1972.

Mr. ROTH. And you should have seen the newspapers at that time. All of the newspapers carried big stories about this. They could not have missed it.

Mr. LEVITAS. Who hired Harold Gleason as president of the Franklin National Bank?

Mr. ROTH. I hired him originally as our public relations officer.

Mr. LEVITAS. How long had he worked for you before you came to the conclusion that he was incompetent?

Mr. ROTH. When I started to seek someone to replace me as president, when I became 62 years of age and had to retire at 65, I thought we ought to get someone in for a couple of years so I could sit by his side to see how he was doing. I initially did not think of Gleason, but he brought himself forward constantly and pressured me and the directors that he was the one that was competent to succeed me.

I left that question open and kept on looking for an officer to succeed me. Finally, when he pressured me so much, I said, "You are not competent enough to succeed me."

Mr. LEVITAS. When was the Franklin Bank first designated or considered as a bank needing special attention by the regulatory agencies? Do you know?

Mr. ROTH. I think it occurred on two or three occasions. Sometimes there were minor matters that needed some corrective action.

Mr. LEVITAS. I am referring specifically to the last time before the final collapse.

Mr. ROTH. I would not know that.

Mr. LEVITAS. You don't know whether it occurred when you first called this matter to their attention in 1972?

Mr. ROTH. No. I don't have any information on that.

Mr. LEVITAS. The concern toward which this committee is properly directing its attention is why didn't the regulatory agencies identify Franklin as a problem early enough to take sufficient corrective actions to avoid its failure. We were told at an earlier hearing that if the regulators had looked at the traditional ratios that they look at in designating banks as problem banks that they would not have discovered the inherent weakness in Franklin that led to its ultimate collapse other than, as you have indicated, management. Can you shed any light on why the regulators did not identify Franklin as a problem bank in time and take the necessary steps to avoid the ultimate failure?

Mr. ROTH. No; I can't. After all, when I wrote my letter on April 27, 1972, I indicated that it was a problem bank—if you read between the lines. It was a very strong letter. I don't know whether they had Franklin down as a problem bank at that time or not; but, certainly I did.

Mr. LEVITAS. And you had recently been the chief executive officer of that bank.

Mr. ROTH. Absolutely.

Mr. LEVITAS. In that connection, Mr. Roth—and this will be a subjective evaluation on your part—did you, in your various dealings with the regulatory officials, both in New York City and here, and with Mr. Schreiber and some others, get the feeling at any time that you were being humored or patronized by them?

You were a person who had been forced out as chief executive officer. You obviously had a great deal of animosity toward the people responsible—a feeling that you had done a good job and that nobody, or certainly none of these people, could follow in your footsteps.

Did you feel that these people were merely listening to you as a disgruntled former chief executive of this organization and not really paying attention to what you were saying?

Mr. ROTH. I think that to an extent that is true. But I tried to be very specific in what I found wrong in the bank. I was specific in stating what corrective action had to be taken. I did not speak in generalities.

But I think what you say is true.

Mr. LEVITAS. In answer to Mr. Brown's question of whether you felt there had been a failure of Congress to enact sufficient legislation to deal with corrective regulatory steps, you said, "Yes." I am inclined to agree with you in that regard.

But you are not also suggesting, are you, that if the existing regulating authorities saw that a bank was heading for a collapse that they would stand by and do nothing? There are things that they could do. For example, suppose they found that the management of the bank was corrupt or so incompetent as to constitute gross negligence on the part of the board to keep the management in. Isn't there something that the existing regulators could do under their existing authority? Or would they just have to stand by and see a bank collapse?

Mr. ROTH. I don't know what there is in the law. If they are corrupt or if a man has been indicted or something like that, certainly they can ask that he be removed. They can go to the board of directors and ask that he be removed.

Now I don't know whether the law is specific in saying that they have to remove such a man or not. I don't recall anything in the law with respect to that.

Regulators should regulate as tough regulators. They can't be weak about these situations.

Mr. LEVITAS. Let me get back to that question because I think it is an extremely important question in our committee's evaluating the significance, if you will, of the existing regulatory agencies.

What should a bank regulator do under existing authority when he finds the type of situation that you have outlined to him, including incompetent management, including speculative dealings with depositors' money, including a decline in profits and the incurring of losses, and when this has gone on over a period of time and the bank is headed for an inevitable collapse? What should and could an examiner, a regulatory agency, do about such a situation at the present time?

Mr. ROTH. All he could do is meet with the board of directors. He should have them go down to Washington to meet with the Comptroller of the Currency and tell them the facts. He should tell them that they are headed for trouble and that it is the responsibility of the board of directors to take the necessary corrective action. He should tell them that if they don't do it, they are going to have examiners in there looking over their shoulders constantly. He should tell them that they are going to be subject to lawsuits, the chances are, and that they had better take this corrective action and do it immediately.

Mr. LEVITAS. To your knowledge, did the Comptroller of the Currency, Mr. Smith or any of his predecessors, do that with respect to the Franklin Bank from 1972 on?

Mr. ROTH. I understand that Mr. Van Horn did meet with the board of directors of the bank after each examination. But you have to know Mr. Van Horn. He is a southern gentleman.

Mr. LEVITAS. Southern gentlemen can be mean sometimes.

Mr. ROTH. But you know the kind of southern gentleman that I mean—a real southern gentleman.

Mr. ROSENTHAL. I understand, but he doesn't. Mr. Levitas is from Atlanta, Ga.

Mr. ROTH. He is not strong. He doesn't pound the table. He doesn't warn them of what they are headed for.

Mr. LEVITAS. I understand that in October 1972, you wrote Dr. Arthur Burns, the Chairman of the Federal Reserve, making certain recommendations to him relative to the problems that you foresaw in the regulatory process during an expanding economy. Did you write such letter?

Mr. ROTH. Yes; I did.

Mr. LEVITAS. I would like to ask that this be made a part of the record.

Mr. ROSENTHAL. Without objection.

[The letter referred to follows:]

BANK OF SUFFOLK COUNTY,  
Stony Brook, N.Y., October 13, 1972.

DR. ARTHUR F. BURNS,  
Chairman, Federal Reserve Board,  
Washington, D.C.

DEAR DR. BURNS: Permit me first to introduce myself. I am the retired Chairman of the Board of the Franklin National Bank, New York City. I sat next to you at the Economics Seminar at Long Island University (of which I am a Trustee) about four or five years ago. We have a mutual friend in Dr. R. Gordon Hoxie.

Today's New York Times quotes you giving a "jawboning" warning to banks and other lending institutions on interest rates. I agree with you. But I advocate that much more should be done promptly than "jawboning."

A period of economic expansion is always accompanied by a heavy increase in speculation and overexpansion. Speculation and overexpansion feed the fires of inflation. When the boom recedes it is speculation and overexpansion that leads in bankruptcies and loan losses in banking.

Therefore,

1. Banks must exercise credit restraints,
2. The bank examiners, in times of economic expansion, should list or classify loans made for purposes of speculation and overexpansion,
3. The 100 largest banks, in particular, should be told that the welfare of their country is more important than higher earnings.

During the last period of economic expansion the banks used Eurodollars and foreign deposits to finance a great deal of speculation and overexpansion. The supply of these funds negated the efforts of the Federal Reserve. The prime rate borrower was able to obtain loans. Also, the temptation was engaged in to make loans at rates up to 15 percent to high risk borrowers.

The money going to prime and high risk borrowers often left those borrowers rated in between with credit unavailable or available at high rates.

Therefore,

4. The use of Eurodollars and foreign funds should be controlled,
5. The maximum rate of interest should be set at 3% over prime.

I hope my comments will be of help.

Cordially,

ARTHUR T. ROTH,  
Chairman of the Board.

Mr. LEVITAS. What response, if any, did you receive from Mr. Burns?

Mr. ROTH. I received just an acknowledgement. That is all.

Mr. LEVITAS. Were there no comments on the points that you made?

Mr. ROTH. No comments. And I might add that the things that I said in this letter really occurred. This was in 1972.

I said:

A period of economic expansion is always accompanied by a heavy increase in speculation and over-expansion. Speculation and over-expansion feed the fires of inflation. When the boom recedes, this speculation and over-expansion leaves bankruptcies and loan losses in banking.

And that is what is occurring right now.

Mr. LEVITAS. I was looking at that in the letter. I thought perhaps you could do as well as Jean Dixon has in some of her predictions.

Let me ask a question that ties in with this. Do you feel that during periods of economic expansion that the bank examiners are less careful and prudent in their examination process than they are during periods of recession—that when things are going up, they may be a little more lax?

Mr. ROTH. Yes; of course they are. But they should remember what may happen later on. And the trouble with a lot of our regulators and other people is that they are not practical bankers. They do not have the years of experience necessary to know all of the things that have happened in the past, such as bank failures and troubles of that sort. I wrote this from my experience of a period of 50 years in banking.

Mr. LEVITAS. Was Mr. Sindona or his company an owner of a sufficient amount of stock in Franklin New York to constitute it as a holding company?

Mr. ROTH. Definitely, in my opinion; yes.

Mr. LEVITAS. If that is true, did it not render it subject to the jurisdiction of the Federal Reserve Board and Dr. Arthur Burns?

Mr. ROTH. That is right; it would have.

Mr. LEVITAS. In the process of Mr. Sindona's company becoming a bank holding company, would it have been appropriate for the Federal Reserve Board to investigate the people who controlled that bank holding company as to their backgrounds, their character, and their prior dealings? Would that have been done by the Federal Reserve Board?

Mr. ROTH. Yes; it would have been. That is what I had in mind when I wrote the letter and sent it to the Federal Reserve.

Mr. LEVITAS. But they did not do that?

Mr. ROTH. I don't know. I don't know what investigating they did.

Mr. LEVITAS. Do you know whether the Sindona operation was regulated as a bank holding company?

Mr. ROTH. It was not.

Mr. LEVITAS. Then presumably the investigations of the type that I refer to were not performed.

Mr. ROTH. They may have been performed and maybe they thought that it didn't come under their jurisdiction as a bank holding company.

Mr. BROWN. Will the gentleman yield?

Mr. LEVITAS. Yes.

Mr. BROWN. Of course there was the one-bank holding company exemption for some time.

Mr. ROTH. That is right.

Mr. BROWN. My memory is foggy as to when that law ending the one-bank holding company exemption became effective.

A member of the staff says that became effective in 1970.

Isn't that why Tisch decided to dispose of it?

Mr. ROTH. Oh, yes. The Federal Reserve was investigating it. I think he was fearful that Loews Inc. would have been declared to be a bank holding company.

I think also, after writing my letter as I did, that he was smart enough to get rid of the stock. But he got rid of it to the wrong person.

Mr. LEVITAS. Didn't Mr. Sindona then become the bank holding company—or his company?

Mr. ROTH. I don't think the Fasco Corp. was declared to be a bank holding company by the Federal Reserve. I don't know, but I don't believe so.

Mr. LEVITAS. Should it have been?

Mr. ROTH. Yes; I say that it should have been.

Mr. LEVITAS. If it had been, then there could have been the opportunity for investigation into the background, character, and prior experience of the people involved.

Mr. ROTH. Any time anybody buys 20 percent of the stock of an important bank, and a bank that has problems, that person should definitely be investigated. That should be done whether or not the law requires it.

Mr. LEVITAS. Let me ask one last question which calls upon your experience as a banker for many years. This committee, along with other committees of the Congress, is trying to discharge its constitutional duty in the investigation and oversight of the bank regulatory system. It is being said that we are undermining confidence in the banking system by raising questions and that we may be creating problems rather than leading to their solution. Do you, based on your experience of many years as a successful banker, have any thoughts on that?

Mr. ROTH. Yes. I think a lot of people feel that way about it. But the very fact that the Federal Deposit Insurance for quite a number of years now has not allowed any depositor to lose any money has restored confidence. But once the FDIC allows any money to be lost at any time from now on, I am afraid of what may happen. So I am thinking that we have to do things with the FDIC to increase the amount of insurance. It wouldn't cost them any more. Maybe instead of \$40,000, it should be increased to \$500,000 or so. After all, this increase is primarily going to help small banks. So why not do it. The cost is no more to the FDIC because they have adopted a very sound policy of selling the bank to competitors and seeing to it that nobody loses any money.

Mr. LEVITAS. Do you think that hearings of this type are good for the banking industry and for the public?

Mr. ROTH. Thank goodness we are having this hearing. Yes, it is going to be very, very good. It is going to have a salutary effect. But as I have said, if we had an overall supervisory group, as has been recommended by the Reuss committee, I see great damage not only to banking, but to the economy of our country.

I would want you to continue doing the things you are doing today and to get into it in great detail. The public has confidence only because no money has been lost. But you have to do something about FDIC insurance, as I see it, and see to it that the depositors don't lose money.

Mr. LEVITAS. I believe I am correct in saying that after some of the banks were named recently in press reports and listed as problem banks and so forth that the market impact on the price of their shares was not negative. I think some of them even increased.

Mr. ROTH. That is right.

Mr. LEVITAS. That proves that the public pays pretty close attention to what they read, for the most part. Thank you very much, Mr. Roth.

Mr. ROSENTHAL. Before I turn it over to Mr. Gradison, I have two questions which I want the record to show.

What was the change, either plus or minus, in the number of branches that Franklin had before Franklin went under and now that European-American has out on Long Island? Do you know?

Mr. ROTH. On Long Island, they didn't close any branches, to my recollection. In New York City, they only closed a limited number of four or five, as I recall.

Mr. ROSENTHAL. What was the total stockholder loss as a result of Franklin's problems?

Mr. ROTH. There were 4,600,000 shares which were, you might say, at \$30 or \$40 a share. So it is \$125 to \$175 million. And I don't know what will happen to the preferred stockholders and the debenture holders. There is another \$60 or \$70 million there. But I think they are going to be paid in full.

I question whether the common stockholders will get anything out of it, but I think everyone else will be paid. And there will be no loss to the Federal Deposit Insurance.

Mr. ROSENTHAL. Mr. Gradison.

Mr. LEVITAS. Will the gentleman yield?

Mr. GRADISON. Yes.

Mr. LEVITAS. For the purpose of completing the record, I ask unanimous consent that the letter which Mr. Roth drafted to send to Fortune magazine, but did not send, dated October 17, 1974, be made a part of the record.

Mr. ROSENTHAL. Without objection, it will be a part of the record.

Mr. BROWN. In order to make it complete, the article should also be included.

Mr. ROSENTHAL. We will put both of them in.

[The information referred to follows:]

[From Fortune magazine, October 1974]

#### WHAT REALLY WENT WRONG AT FRANKLIN NATIONAL

THE DEBACLE THAT SHOOK THE U.S. BANKING SYSTEM WASN'T CAUSED BY THOSE WELL-PUBLICIZED FOREIGN-EXCHANGE LOSSES—THE REAL PROBLEM WENT DEEPER: FRANKLIN'S MANAGERS DIDN'T KNOW HOW TO RUN A BIG-LEAGUE BANK

(By Sanford Rose)

The nation's financial system is facing its gravest crisis since the Bank Holiday of 1933. The crisis is one of confidence. The public has become increasingly worried about the solvency of even the most profitable banks. In the past few months, bank-stock prices have fallen far more rapidly than the stock market as a whole—which is saying plenty. The prices of bank stocks are now lower in relation to earnings and book value than they were on Friday, March 3, 1933, the day before the Bank Holiday. Says Morris Schapiro, the dean of American bank analysts: "We don't have a bank holiday yet, but we already have a bank-holiday stock market."

The weakening of public confidence in the banks is traceable, to a considerable extent, to the well-publicized misadventures of the Franklin National Bank of New York. In May, Franklin National, then the twentieth-largest bank in the U.S., with deposits of close to \$3 billion, canceled its second-quarter dividend and announced foreign-exchange losses in the neighborhood of \$40 million. Many people believed that Franklin, which had been a weak-earning bank for years, would be promptly liquidated by the regulatory authorities and its deposits assumed by a stronger banking institution. Instead, Franklin retained a precarious hold on life during the subsequent months. Aided by a massive loan from the Federal Reserve, the bank was able to meet deposit withdrawals that exceeded \$1.5 billion by September.

Franklin's miseries have affected public confidence in two ways. First, the spectacle of a major bank being propped up for months was itself rather unnerving. In addition, the particular ailment that most people associate with Franklin—foreign-exchange losses—seems to have afflicted a fair number of other banks recently. Several small European banks had large foreign-exchange

losses and subsequently failed. It seemed reasonable, then, to wonder whether Franklin's problems might be typical of the banking industry.

The answer happens to be no. To be sure, many banks speculate in foreign exchange. But no U.S. bank speculated as heavily or as recklessly as did Franklin. Most banks can make money in much less risky ways. Franklin could not; it is now clear that the bank *had* to speculate in foreign exchange because it could earn virtually nothing on normal operations. Not counting foreign-exchange transactions, Franklin made just about \$5 billion in 1973. That amounted to about one-tenth of 1 percent of the bank's assets. The average U.S. bank made more than eight times as much on assets during 1973.

The details of Franklin's foreign-exchange operations are lurid enough—as we shall see—but the real story of the bank's downfall has to do with normal banking deteriorating rapidly after the middle of 1973. Data available to *Fortune* indicate that the bank lost money on a pre-tax basis from July through September of 1973—not counting foreign exchange. Indeed, were it not for a phony foreign-exchange profit in September, 1973, Franklin might have been forced to cancel its third-quarter dividend—an action that would have terrified its creditors and probably triggered the inevitable crisis eight months earlier. Operating profits reappeared briefly in late 1973. But from February through April, 1974, the bank continued to lose money. And during April its controller's office projected losses of between \$5 million and \$7 million for the entire second quarter.

Although the total operating shortfall does not equal the foreign-exchange loss—now estimated at about \$46 million—it is much more significant. A foreign-exchange loss, even a series of losses, constitutes an extraordinary event. On the other hand, persistent operating deficits betoken fundamental rot. The plain fact is that Franklin could not manage the spread between the yield on loans and bonds and the cost of investable funds, personnel, and occupancy. If Franklin had not received massive assistance from the Federal Reserve, the bank would have been forced to shut its doors sometime in 1974 even if it hadn't lost a dollar in foreign exchange.

The statement seems almost incredible. Most Americans assume banks don't fail unless there is fraud, and that large banks just don't fail at all. Why couldn't Franklin make money doing what other banks do?

#### *Perils of a one-man show*

An answer begins with the dearth of professional-caliber management at the bank. It has been run amateurishly for decades. In the 1950's and early 1960's Franklin enjoyed two advantages not given to many other banking institutions. It was located in one of the fastest-growing market areas of the country, Long Island. And it was insulated from serious competition by branching restrictions placed on New York City banks. Embosomed in the soft plush of this uniquely favorable environment, Franklin saw no need to professionalize its management.

Even if it had perceived the need, it is doubtful that anything would have been done about it. The bank was headed in those years by Arthur Roth, a hard-driving autocrat whose favorite homily is "every organization is but the shadow of one man." Roth ran Franklin as a one-man show, surrounding himself with malleable subordinates who had no particular aptitude for banking.

One of these was Harold Gleason, a good public-relations man and a smooth and persuasive talker. Gleason was Roth's faithful subordinate for about a dozen years. Ultimately, though, the two fell out after Roth told Gleason that he didn't measure up and would never be chief executive. Of Gleason, Roth now says bitterly: "I treated him like a son. Little did I imagine that the man was just a faker, an egotistical incompetent."

Another of Roth's protégés was John Sadlik, who eventually became the bank's chief financial officer. Sadlik's knowledge of the finer points of finance has always been somewhat sketchy. He would generally approve an investment if its yield was at least one percentage point above the bank's average cost of money. That might sound reasonable to nonbankers. But in a period when demand and savings deposits are declining, average cost can understate the true cost of financing asset growth.

During late 1973, for example, nearly every asset acquired by Franklin had to be financed by borrowings in the money market at rates of between 9 and 11 percent. This *marginal cost* was about 2 to 4 percent above the average cost of Franklin's funds, which, of course, included low-cost demand deposits and pass-

book-savings accounts. Clinging to the one-percent-above-average standard, Sadlik and others approved the acquisition of many assets on which the bank inevitably lost money.

*Waving aside the balance sheet*

Despite managerial shortcomings, Roth was able to propel Franklin forward at a frantic pace during the bank's golden age. From 1950 to 1962 Franklin's assets grew from \$78 million to over \$1 billion. Earnings averaged between 15 and 20 percent of stockholders' equity.

Roth and his epigones could not dispense money fast enough in those early years. The flavor of the bank's lending operations was recalled recently by Roger Elton, a banker who later joined Franklin and rose to become executive vice president. Said Elton: "In the early 1950's, the Long Island contractor who built my house needed \$25,000. He went to Franklin and they gave him the money before he even showed them his balance sheet. When he produced the statement, they waved it aside."

Clearly, Roth was not averse to risk. Indeed, he often stated that he was willing to take loan losses equal to twice those of the average bank, provided he could earn 0.75 to 1.25 percentage points above the national average on his loan portfolio. But there were years in which loan losses reached three to five times the average.

During the late 1950's and early 1960's, some of the losses grew out of loans made by Franklin in anticipation of public offerings. Small businessmen would come into the bank with letters from underwriters promising to help them raise funds in the capital markets. Franklin would provide the interim financing. But after the stockmarket collapse of 1962, many of these offerings had to be withdrawn, and a lot of borrowers defaulted. At about the same time, the apartment boom in the metropolitan New York area collapsed, and a number of Franklin's real-estate equity loans went sour.

The alarming rise in loan losses helped change Roth's mind about the kind of assets Franklin should be acquiring. In the early 1960's, the emphasis shifted from loans to municipal bonds. The bank more than doubled the size of its securities portfolio, loading up on 3 to 4 percent Long Island school-district bonds. In buying municipals, Franklin acquired what looked like attractive tax-free assets, while at the same time ingratiating itself with town treasurers, whose deposits—both demand and time—came pouring into the bank.

But Roth overdid it. He bought so many municipals that in later years the bank was stuck with far more of them than were justified by its tax position. Franklin hasn't paid any federal income taxes for most of the last decade. Instead, largely because of its municipal bonds and the slow growth of its taxable revenues, the bank started accumulating a tax-loss carry-forward, which it carried on its balance sheet as an asset.

Without taxable income, it is no fun owning a lot of low-yielding tax-exempt bonds. At the time of the crisis last May, Franklin held close to \$300 million in municipal bonds with an average yield of only 4 percent. That yield was about three to 3.5 percentage points below the bank's average cost of money and about seven percentage points below its marginal cost. Just comparing average yield with average cost, the bank was losing about \$10 million a year on its municipal-bond holdings.

Most other banks would have shed this albatross a long time ago, even if that meant taking sizable capital losses on the sale of bonds. And there were times in the past when the capital penalty would not have been too onerous. Says Harold Kurtz, a former Franklin vice president: "As late as 1968, we could have disposed of many of those bonds without hurting ourselves too much. But by then our loan losses were so high that we could not afford to take additional losses in the bond account."

Ironically, Franklin's oversized municipal-bond portfolio eventually resulted in the loss of its public deposits. Because Franklin had bought so many municipals in the early and mid-1960's, it was out of the market by the end of the decade. Predictably, the officials of Long Island communities did not at that point dwell on the bank's earlier heavy purchases; instead, they just seemed irritated that Franklin, a local bank, was not now picking up its share of the increase in municipal debt. So they began moving their deposits out of the bank and into competitive institutions like Security National.

### *He couldn't find "21"*

By the early 1960's the wall that separated Queens from the rest of Long Island had begun to crumble. The New York City banks had been given the right to branch into Nassau County. Commercial and savings banks alike began pushing into the new territory, poaching on Roth's once inviolate preserve. Roth mapped a counterstrategy. He would go to New York.

Many believe that the decision to enter New York was Roth's most egregious blunder. The bank did not have the ability to compete in the New York market. Says Mike Merkin, the eighty-year-old vice chairman of Franklin: "What business had Roth coming to New York? He didn't even know the way to '21.'"

The move to New York need not have been a mistake however. Meadowbrook National Bank—now the National Bank of North America—came from Long Island to New York and managed fairly well. It was the way Roth entered New York that hurt him.

First he tried to buy a New York bank, the Federation Bank & Trust. He could not get Federation right away, at least not on terms that satisfied him. Not being one to wait, Roth started branching into the city in 1964. And he arrived traveling first class. Says Jerome Twomey, a former executive vice president at Franklin: "Roth came to New York building monuments—impressive and very costly structures." The move to New York enormously inflated the bank's occupancy expense.

A newcomer to New York City, Franklin could not hope for the choicest bank credits; it had to content itself with shards. The bank fought for small participations in major loans syndicated by the larger New York banks. If the bank won a place in these syndicates at all, it was often because it lacked the nerve to ask for decent compensating balances—i.e., non-interest-bearing funds that must be kept on deposit at all times. Says David Dowd, a former Franklin vice president: "I went directly from Irving Trust to Franklin in the mid-Sixties. At Irving we had a piece of the Woolworth account and we got a compensating balance of between 20 and 30 percent. At Franklin we would not have dared to ask for more than 10 percent. We knew we couldn't get it."

Finding it both difficult and unprofitable to attract national customers, Franklin began to concentrate on a somewhat specialized clientele. The bank soon acquired a reputation as a primary lender to "growth companies"—which usually turned out to mean companies that were promoting their stocks heavily. Says Twomey, who was responsible for a part of the business: "To be perfectly frank, in those years nearly every company that was written up in the *Wall Street Journal* for unusual accounting practices became our customer."

Although this was high-risk business, Franklin did not earn especially high rates. The bank was so committed to rapid growth that its loan officers often shaved rates in order to show volume and remain members in good standing of a go-go shop. When they did reach for yield, it was sometimes in exotic and unproductive forms. For example, a number of loan officers took "shadow warrants," i.e., they included clauses in the loan agreement providing for additional interest payments if the price of the borrower's stock rose above a certain figure. Ordinarily, the stock did not go up enough, and Franklin was left holding a risky loan with a modest yield.

### *Triumph of a generous man*

In 1967, Franklin finally merged with the Federation Bank & Trust. Roth got the Federation, but in turn the Federation got him. Allying himself with the new directors on Franklin's board, Gleason managed to supplant Roth as chief executive in 1968, and finally pushed him off the board altogether in 1970. Roth retired to the role of gadfly, stinging management, and particularly Gleason, in angry letters to the shareholders.

With Gleason enthroned as chief executive, the bank's fortunes began a serious further declension. An easy-going and generous man, Gleason lacked the disposition to control personnel expenses, and they soared. Under Gleason's guiding hand, the number of employees increased sharply, salaries and bonuses rose, and expense accounts became much more lavish. From 1968 to 1970, the bank's salary expense increased by 50 percent.

At about the same time, Franklin's earnings began to suffer alarmingly from a change in the accounting procedures governing loan losses. Before 1969 banks did not have to show loan losses on their income statements. Instead of reducing reported earnings, the losses were a below-the-line deduction from reserves, in

effect a direct charge to capital. Beginning in 1969, however, the supervisory agencies insisted that banks put at least a portion of their losses onto their income statements.

Banks that did not wish to take the full yearly loss against income could choose one of two moving-average procedures. They could compute the ratio of net losses to average loans during the five years ending in the current year (initially 1969), apply that ratio to all current loans, and reduce income by the resulting figure. Alternatively, they could decide that the ratio to be used would be net losses to average loans for 1969-73, or as much of the period as had been completed.

Since Franklin had had a miserable loan-loss experience in the mid-1960's, and a good performance in 1969, it elected the second alternative. That worked out tolerably well until 1971, when losses were horrendous. And with only two other years represented in the average, the 1971 losses had a terrific impact on income; they socked it for a dizzying \$7.2 million.

By the early 1970's, Franklin was beginning to show signs of terminal illness. The fall in interest rates from mid-1970 to 1972 reduced loan yields, but the bank's interest expenses did not fall commensurately, in part because the cost of passbook savings—a sizable chunk of Franklin's deposits—remained relatively stable.

Franklin's miseries in this period can be summarized by a comparison of its 1972 operating results with those of a representative group of peer banks—that is, banks of similar deposit size and roughly similar deposit composition. According to unpublished Federal Reserve data, Franklin had a net return in 1972 of less than three-quarters of a cent per dollar of investable funds, i.e., deposits and borrowed money. Its peers made more than twice that. Franklin paid more for its money than its peers, and it earned less on its bread and butter, commercial loans, on both a gross and a net basis. Moreover, by 1972 the bank had become almost unbelievably inefficient. Expenses per dollar of commercial-loan volume totaled 50 percent more than at banks of comparable size.

#### *New faces of the 1970's*

Since the late 1960's Laurence A. Tisch, head of Loews Corp., had been quietly buying up Franklin stock. By 1971 he had accumulated a controlling 20 percent, and in mid-1972 he became alarmed at what was happening to his investment. Tisch decided on a major rescue effort. He reached into Bankers Trust and persuaded Paul Luftig, the highly respected head of Bankers' metropolitan division, to come aboard as Franklin's president.

An energetic and ambitious man in his early forties, Luftig took the job in May, 1972—fully expecting to succeed Gleason as chief executive officer within a matter of weeks. But in July Tisch undercut Luftig by selling nearly all his stock to Michele Sindona, the Italian financier.

Sindona's reasons for buying into the bank remain an enigma, as do many of Sindona's moves. He apparently did not research the acquisition very thoroughly, however; shortly after he bought the bank, he confessed to a reporter that he had never heard of Arthur Roth. When the two men finally met later in 1972, Roth, still a substantial Franklin shareholder, asked Sindona what he was going to do about earnings. Sindona replied: "Don't worry. I'm going to make most of my money in foreign exchange. That's the way I do it in my Italian banks."

Meanwhile, Gleason had been reprieved. He began to cultivate Sindona, traveling to Italy every second weekend for "talks"; he also took Italian lessons. Luftig was isolated, in effect a lame-duck president. Still, he held on tenaciously. He had a five-year contract and he was determined to make a serious effort to get things organized.

Early in 1973, another new face appeared in the top management ranks. Peter Shaddick was recruited by Sindona from the Bank of Montreal to head up the international department. Although Shaddick entered the bank with the title of senior executive vice president, it was clear from the beginning that he intended to function as a sort of co-president. It was also clear that he was going to run the international department as a bank within a bank. He scorned Franklin's internal auditors and requested his own auditing group. Shaddick was a tiger; and since he was Sindona's man, no one messed with him.

#### *The scandal in real estate*

While Shaddick busied himself with his palatinate, Luftig tried to cut operating costs. He fired some people, although probably not as many as he should have. Overall, Luftig was able to slow down the rate of increase in operating

costs, but he was never able to reduce costs absolutely. One of the main reasons was occupancy expense, which increased substantially following the move to 450 Park Avenue in November, 1972.

The bank's real-estate situation had become nothing short of scandalous. Luftig found that Franklin didn't really need about 25 percent of the space it was paying for. In some cases the bank was renting space far above market prices. And at the same time it was charging *less* than market price for the space it subleased to others.

One problem was that the bank had no effective supervision over small leases. In an uncharacteristic effort to save a few pennies on legal fees, the bank had a policy of allowing the other party's lawyer to draw up small leases. The terms of these leases were naturally unfavorable to the bank.

The real-estate problem was aggravated by Franklin's sale-leaseback arrangements. The bank had a continuing, desperate need to show taxable income in order to avoid wasting a portion of its tax-loss carry-forward. In several years, to avoid this waste, Franklin sold a large amount of property and simultaneously leased it back. The bank booked a capital gain, which it used to offset the ordinary income losses of previous years. Unfortunately, these transactions also inflated rental costs: the bank's lease payments exceeded the property taxes it would have paid had it continued to own the buildings.

### *Gambling on leverage*

Finding it impossible to reduce expenses, Luftig made a procrustean adjustment in his thinking. If the bank's expenses could not be cut down to a level appropriate to its asset size, asset size would have to be expanded. In late 1972 Luftig began borrowing money in order to finance a major expansion of the bank's lending activity. By increasing the bank's already substantial leverage—i.e., the ratio of assets to equity capital—Luftig hoped to raise earnings per share despite the burden of outsize expenses and the handicap of an anemic profit margin. At the time, this seemed a reasonable step, given the bank's predicament. Yet it proved disastrous.

In the first eight months of 1973, Franklin's domestically financed loans grew by nearly 25 percent. But the bank had the bad luck to be expanding its assets in a period when bank lending rates were artificially depressed by Federal Reserve pressure. For a considerable part of 1973, the prime rate remained three-quarters to a full percentage point below the level it would have reached if the Fed had not been trying to hold it down.

Meanwhile, bank borrowing rates were not placed under comparable pressure. The rate on certificates of deposit remained relatively free to rise. The rate on federal funds—the reserve balances that banks borrow from other banks—was artificially held down only until about April, then was more or less allowed to move up.

The behavior of federal funds, which Franklin borrowed heavily, was a special problem. The rate on federal funds eventually rose to higher levels than it otherwise would have precisely because the prime rate was being contained. A bargain prime increases the demand for credit. As more loans are extended, demand deposits also increase, raising the level of required reserves. In turn, the scramble for reserves puts upward pressure on the funds rate. Hence any bank that financed itself with a large amount of federal funds during 1973 faced extraordinary pressure in earnings. At Franklin, profit margins virtually evaporated. At times during the year the bank put assets on its books at a negative earnings spread—i.e., the yield on the asset was less than the cost of financing it.

If Franklin had been able to finance its asset growth by expanding core deposits—demand and passbook-savings money—it would undoubtedly have prospered. Franklin's average monthly prime rate rose from 6 to about 10 percent during 1973. The cost of its demand deposits totaled only about 2¼ percent and the cost of passbook savings averaged just over 4 percent. But Franklin's demand deposits were actually falling in this period. Passbook savings were also eroding, as savers moved their money into Treasury bills and other money-market instruments. That left Franklin scrambling for funds in the money market, where rates kept rising.

Banks normally strive to hold on to at least enough cheap core money to finance their fixed-rate assets—e.g., bonds, mortgages, consumer loans, and some commercial loans. That way, even if interest rates rise, they are guaranteed a positive earnings spread on a part of the total portfolio. But once the size of the fixed-rate portfolio exceeds the amount of core funds, a bank can end up financing rate-insensitive assets with highly rate-sensitive liabilities.

And that was what happened to Franklin. At the beginning of 1973, the bank's core money just about equaled its fixed-rate portfolio. But during 1973, while the core money eroded, fixed-rate assets increased. At the end of the year the bank was going to the money market for about \$500 million to finance the part of its fixed-rate portfolio that was no longer covered by its core deposits. It was also borrowing \$1.2 billion to finance its fluctuating-rate loans—i.e., those tied to movements of the prime rate. It made a little money on the spread between the yield and the cost of these loans, but not as much as it lost on the fixed-rate portfolio. On balance, Franklin was losing money on its \$1.7 billion in borrowed funds. Luftig's gamble on capital leverage had backfired.

#### *Mired in federal funds*

Having become dependent on borrowed funds in a period of rising rates, Franklin might still have effected some substantial economies by lengthening the maturity structure of its borrowings. There were days during 1973 when the bank was borrowing over \$1 billion—about 25 percent of total liabilities—in the form of one-day federal funds. At midyear the federal-funds figure was running about \$750 million, at a cost of about 8¼ percent. The cost of six-month certificates of deposit was approximately the same. If Franklin had locked up \$750 million in six-month money just past midyear, it would not have had to borrow some \$930 million in federal funds, at a cost of about 10 percent, during December, 1973. Franklin would have saved about \$1 million in interest costs for that one month alone.

But at midyear, 1973, Franklin's management expected interest rates to fall dramatically. And why lock up a lot of expensive money when day-to-day funds would soon be available at much lower rates?

While the bank was playing Russian roulette with its debt structure, it was passing up opportunities to increase the return on its assets. Franklin's overall yield on assets was badly depressed by its huge fixed-rate portfolio, which constituted about half of all domestic earning assets. But even the variable-rate portion of Franklin's portfolio was outrageously underpriced. Loans that other banks made at the prime rate plus 2 percent could be obtained from Franklin at prime plus ½ or 1 percent.

There was nothing irrevocable about these prices. About 45 percent of Franklin's domestic-loan portfolio—over \$900 million—matured every three months. The figure includes all the bank's ninety-day discounted loans as well as over \$500 million in other loans. The bank could have raised its rates on these maturing assets to competitive levels; alternatively, it could have turned away the business. Eventually, Franklin did some of each, but not soon enough to raise earnings in 1973.

#### *Earning less on more*

Shaddick was not doing much better abroad. It is true that foreign assets nearly doubled during 1973; by year-end they exceeded a billion dollars, about a quarter of the bank's total earning assets. The only trouble with this growth is that it was totally unprofitable. At the end of 1973 the international department was actually earning fewer dollars on its \$1-billion portfolio than it had earned on \$600 million the previous December. Profit margins abroad—i.e., the difference between interest earned and interest paid as a proportion of assets—had fallen from about a half cent per dollar of assets in the middle of 1973 to one-tenth of a cent at the end of the year. Adding in the cost of running the overseas branches, Franklin was plainly losing money abroad.

Shaddick's problems mirrored those of the rest of the bank. He was borrowing too short and lending too long, at rates of ½ percent to ⅝ percent over his cost of funds. As the cost of day-to-day Eurodollars crept up, margins fell and disaster threatened. Like Luftig, Shaddick had guessed wrong on interest-rate movements.

In July, 1973, Luftig left on vacation, still convinced that interest rates would soon peak. While on vacation, he telephoned William Hitchborn, the con-

troller, to ask how the bank was doing. Hitchborn, who worked for John Sadlik, told him not to worry—the bank was having a banner month. Luftig returned to find that the bank had lost nearly \$700,000 in July, the worst month in history. Hitchborn had badly miscalculated.

In the latter half of 1973, a deepening sense of gloom pervaded the bank. Luftig now realized that he had to reduce assets, not increase them. Jolted by the Hitchborn incident and others like it, he demanded better and more comprehensive financial data. Luftig also tried to fire Sadlik, but Gleason intervened to save him.

By late summer, the mood in the bank was approaching panic. The third-quarter dividend looked shaky, and this in turn could have jeopardized a plan of Sindona's to help the bank. He had been pushing a merger between Franklin and Talcott National, a factoring and finance company that he also controlled. Since Talcott had profits, Franklin would find a use for its tax-loss carry-forward. But if Franklin omitted its third-quarter dividend, the merger would be in trouble.

Suddenly, as if by magic, earnings appeared. Franklin recorded a \$2-million profit in foreign exchange during September. Sometime during the month, it is now known, Franklin's foreign-exchange department received a call from a member of senior management. The traders were instructed to arrange off-setting currency transactions with a Swiss bank called Amincor. Franklin bought four or five separate currencies from Amincor and soon thereafter resold them to the Swiss bank at a \$2-million profit.

But it was later established that the currencies in question had not risen sufficiently in the interim to produce a \$2-million gain. The exchange rates placed on the contracts were plainly phony, rigged by agreement with Amincor to guarantee Franklin's profit. At the time, however, no questions were raised. The bank received a check for \$2 million from Amincor. The check was addressed to P. R. Shaddick. Buttressed by the bogus foreign-exchange profit, Franklin declared its dividend.

During the waning months of 1973, interest rates fell slightly from their September peak, and operating results improved. The bank's earnings were now so sensitive to the movements of the federal-funds rate that a decline of less than a percentage point in October sufficed to raise its gross interest differential by close to \$2 million. In November Shaddick added to the good news by coming up with some sizable additional foreign-exchange profits. These appear to have been legitimate.

Beginning in the fourth quarter of 1973, Franklin began gambling heavily in the bond market. Management was convinced that the slight easing of interest rates presaged a sharp further decline. And so the bank authorized its securities department to go long in five- to ten-year government and federal agency bonds. J. Michael Carter, the head of the securities department, ended up buying much more than he was authorized to buy. From late in 1973 until March, 1974, Franklin's bond holdings rose by about \$200 million. The yields on these bonds averaged between 7 and 8 percent, which was two to three percentage points less than the cost of the money used to purchase them. Unless interest rates fell substantially in 1974, the bank was obviously headed for further sizable operating deficits.

#### *Once more with Amincor*

By early 1974, the bank was almost a complete hostage to the vagaries of the federal-funds rate. When the rate fell in January, the bank remained marginally profitable. When it started to rise strongly in April, the bank's monthly operating deficit soared to \$3 million.

Well aware of the bank's precarious operating position, Shaddick redoubled his efforts to make extraordinary gains in foreign exchange. There were profits of \$3.8 million in January, but losses of \$2.5 million in February. By March it was time for another Amincor deal. On March 28, the bank arranged a transaction in

future foreign exchange (currencies bought and sold for future delivery), and these netted a phony unrealized profit of another \$2 million. As a result, a prospective March foreign-exchange loss of \$1 million was converted into a \$1-million profit. The following month, Shaddick cracked up under the strain and spent two weeks in a hospital.

By April, Luftig was spending about half his time on the telephone trying to persuade other banks to continue selling Franklin federal funds. Morgan, then Franklin's major correspondent bank, had stopped selling it funds in the fall of 1973. Now Bank of America was cutting back its allotment, from \$50 million to \$30 million. Gradually, as word spread through the banking business that Franklin might fail, a growing number of banks either reduced or suspended sales.

Despite enormous difficulties, Franklin was still able to buy more than \$500 million a day in federal funds during the first week of May. But it was clear that, within a short period of time, the bank would simply be unable to finance itself. Given the continued high level of the federal-funds rate, the bank was sure to continue losing money throughout the second quarter. By the end of the quarter, it would very probably face a massive run on its deposits.

#### *Lurching toward merger*

On May 6, Luftig told the bank's executive committee that Franklin had to be merged. By the end of the day the committee voted unanimously to authorize him to seek a merger. Luftig informed the Federal Reserve of the bank's predicament on the following day and started talks immediately with John McGillicuddy, president of Manufacturers Hanover. McGillicuddy liked the idea of a merger, but he had some conditions. He wanted antitrust clearance from the Justice Department. He wanted a guarantee that he would not have to bring any of Franklin's top executives into Manufacturers' senior management. In addition, McGillicuddy had a record of earnings growth at Manufacturers that he cherished. If he took on Franklin's losses, the record would surely be tarnished. And so some form of subsidy from the Federal Deposit Insurance Corporation would be required.

During the week of May 6, progress was made on at least two of the three issues raised by McGillicuddy. The Fed agreed to intercede with the Justice Department on the antitrust issue. And Franklin's executive committee agreed to the personnel condition. There was, moreover, some reason to expect a favorable response from the FDIC. It had provided a subsidy to the Crocker National Bank when it absorbed U.S. National in October, 1973. It would probably do the same in this case. In any event, on Friday Luftig called McGillicuddy and said: "I think we've got a deal." But then a bombshell exploded.

During the week, Franklin's top management had been getting intimations that the bank had suffered additional foreign-exchange losses—losses not recorded on the bank's books. But it wasn't until Friday night, May 10, that some idea of the magnitude of the losses emerged. That night Luftig apprehensively passed the news to Manufacturers that Franklin had apparently sustained a huge loss in foreign-exchange trading. To his relief, Manufacturers indicated that it was still willing to negotiate. On the weekend teams from both banks sat down to work out merger arrangements.

But on Sunday, May 12, Sindona moved to quash the effort. He managed to set up a remarkable high-level meeting at the Federal Reserve Bank of New York with representatives of the Fed, the Securities and Exchange Commission, and the Comptroller of the Currency. Representing Franklin were Sindona; his personal lawyer, Randolph Guthrie, of Mudge Rose Guthrie & Alexander; Carlo Bordoni, a close Sindona associate who was also a member of Franklin's board; Harold Gleason; and the bank's public-relations man, Arthur Perfall. Of this group, the only one who could conceivably claim a nodding acquaintance with Franklin's operating problems was Gleason.

Sindona had excluded from the meeting all the bank's top operating executives. And while he brought along his own personal lawyer, he did not invite the bank's longtime law firm, Kaye, Scholer, Fierman, Hays & Handler. It is little

wonder, then, that the regulatory authorities received a badly garbled account of the bank's situation at the meeting. What is puzzling is that the regulators accepted this account without too much question.

After pondering the condition of the bank, regulators approved a Sindona plan to salvage Franklin by raising \$50 million in additional capital from the bank's shareholders. Then a most astounding press release was prepared. The release, which was distributed by the Federal Reserve as well as by Franklin, implied that the entire \$39-million or \$40-million foreign exchange loss had occurred during the second quarter; whereas at least \$14 million had plainly occurred during the first quarter. The release also stated that Franklin believed it was insured "for a substantial portion of the loss." Some of the bank's top executives knew that it wasn't true. In fact, Kaye, Scholer had just reported that the bank was probably not insured for any part of the loss.

The release further stated that the Comptroller of the Currency had assured the Federal Reserve that Franklin was a solvent institution and therefore eligible for loans at the Fed's discount window. It is hard to see how the Comptroller could have offered any such assurances. When Luftig was informed by telephone of the contents of the release, he called in Edward Lake, the bank examiner from the Comptroller's office who had been assigned to the Franklin account. Asked Luftig: "Are we solvent?" Replied Lake: "No."

#### *A special kind of insolvency*

Considering only its liquidation value, Franklin was obviously insolvent on May 12. It could be argued that, in one sense, most other banks were also insolvent. After years of rising interest rates, the market value of their bond portfolios and their fixed-rate loans is appreciably below their liabilities.

But most other banks are going concerns that earn profits and pay dividends; it is reasonable to ignore their technical insolvency. Franklin was not at all a going concern on May 12. The bank had no prospects of making money then or in the foreseeable future.

The bank had no very good way of dealing with its central problem: its dependence on fixed-rate assets. As of May 12, Franklin had about \$1.6 billion in fixed-rate assets—\$900 million in bonds and another \$700 million in loans. The bank had unrealized depreciation of about \$100 billion in the bond account alone. If Franklin had tried to cut its fixed-rate portfolio to manageable proportions, it would have had to take huge losses—in addition, that is, to its operating losses and those already sustained on foreign-exchange transactions. Sindona's plan for a \$50-million capital increase would not have helped much.

It is, in fact, hard to see what merit the regulators saw in Sindona's rescue plan. Why didn't they reject it and push hard to get Franklin merged with Manufacturers? With any encouragement from the regulators, a merger would have been speedily arranged. Manufacturers would have quietly assumed Franklin's deposit obligations, and there would have been no mass withdrawals. Franklin's troubles would not have remained in the headlines for many months.

#### *Luftig calls his lawyer*

After the session at the Fed broke up, Gleason returned for an emergency meeting of Franklin's executive committee later that evening. He confirmed that merger talks were suspended. Then Luftig told Gleason that his press release was inaccurate. Gleason said nothing, except that certain management changes would be discussed the next day. Whereupon Gleason left the meeting and Luftig called his lawyer.

The following day, Shaddick resigned and Luftig was fired. Gleason was named president as well as chairman. Five weeks later, on June 20, the bank revised that press release. It raised the figure for foreign-exchange losses from about \$39 million to \$45.8 million and assigned \$26.7 million of this amount to the first quarter. The second release said that the first-quarter loss had resulted from falsified or unauthorized foreign-exchange contracts.

There is still very little known about those mysterious foreign-exchange transactions. At the end of June, however, it was learned that Sindona had had previous dealings with the Amincor Bank of Switzerland and had used the bank in his acquisition of Interphoto Corp. in 1970. Moreover, Carlo Bordoni, who continued on Franklin's board until late June, 1974, had also seen service on Amincor's board from the 1969 to early 1973.

Sources in the SEC now confirm that the \$4 million in foreign-exchange profits realized in September, 1973, and in March, 1974, was the result of self-dealing transactions. But what about the huge losses? Did they result from legitimate gambles that did not pay off? Or did Sindona give up on his attempt to prop up the bank after the two Amincor incidents? Did he instead decide that, since Franklin was in any case lost, it was now time to recoup his \$40-million stock investment by sticking the bank with some foreign-exchange losses? Both the FBI and the SEC are still pursuing the answers.

To be sure, some of the circumstances surrounding the foreign-exchange losses are highly suspicious. A big chunk of these losses was attributable to a single trader, Donald Emrich, who had been hired by Shaddick in July, 1973. He was scarcely what one would call a topflight candidate for a trading job. He had previously been fired by Continental Illinois for the precise offense he committed at Franklin—unauthorized trading in foreign exchange. Before that he had been fired from Marine Midland Bank for irregularities pertaining to petty cash.

Perhaps Shaddick did not bother to inquire closely into Emrich's background. And since Shaddick was a law unto himself at Franklin, perhaps nobody bothered to check up on his choice. But there are other possibilities too. Shaddick himself had previously worked at Continental Illinois and many contacts in the foreign-exchange department. It is conceivable that Shaddick may have known all about Emrich and decided that he might be just the right man to have around.

It is also conceivable that the foreign-exchange losses were simply the result of some desperate gambles. There is no doubt that, during much of the second half of 1973 and early 1974, Shaddick was putting enormous pressure on the foreign-exchange department to show profits. In that sort of atmosphere, a trader like Emrich might conceivably have felt justified in taking some fairly wild gambles—and then hiding the results from management if they proved unfavorable.

### *Barr goes shopping*

On the same day that the bank revised its figures on foreign exchange, Gleason resigned as chairman and president, turning over both jobs to Joseph Barr, a former Secretary of the Treasury in the Johnson Administration. Barr spent most of his time attempting to sell the bank. He asked bank analyst Morris Schapiro to try to persuade would-be foreign and out-of-state acquirers that it was worthwhile paying a substantial premium to get a foot into the New York market.

Schapiro and Barr shopped around for buyers during the rest of June. But as Franklin continued to lose deposits, live prospects became increasingly scarce. Finally, on July 2, the Comptroller of the Currency asked Frank Wille, Chairman of the FDIC, to try to arrange a government-assisted purchase of Franklin. For the last three months Wille has been trying to dispose of Franklin by offering what amounts to a huge subsidy. Under one plan, the FDIC would assume all of Franklin's debt to the Federal Reserve.

As this article went to press, the best guess about Franklin's fate was that it would disappear as an independent banking entity sometime in late September or October. There is a plan to preserve Franklin as a purely Long Island bank, but, in mid-September, the regulators did not seem convinced that the plan was viable. It seems likely that Franklin's assets will shortly be auctioned off to one or more big banks. Wille will then have done essentially what Luftig tried to do four to five months earlier: merge Franklin into a stronger institution. In the interim, Franklin will have lost a minimum of 50 percent of its deposits,

its stockholders will have lost most, if not all, of their investment, and the country's financial system will have received its worst scare since the Depression.

The Franklin tale reads a modern-dress Greek tragedy. Error begat error, and events moved inexorably to a denouement that the bank's management feared, but seemed powerless to prevent. Roth started it all by making a lot of risky loans. When the loans went bad, Roth turned to bonds. When the bonds fell in value, they could not be sold because of the loan losses. And so the bank ended up trapped with a wad of low-yielding assets that had to be financed with progressively higher-cost money. Meanwhile, non-interest expense was increasing sharply because of reckless branching and the inflation of personnel costs.

By 1972 the only way to raise earnings to tolerable levels was by vastly increasing capital leverage. But there never was a more inopportune time to leverage a bank than in late 1972 and 1973. The cost of borrowed money increased much more rapidly than the return on assets. Profit margins were nearly obliterated, and the stage was set for a final desperate gamble. Hoping for a drop in interest rates, the bank bought still more bonds. But interest rates rose even higher. By then the bank was mortally wounded. The foreign-exchange losses were merely the proverbial coup de grace.

In one respect, certainly, Franklin's problems were not at all typical of U.S. banking. Just about every big-league bank in the country has had better management. But in another respect, Franklin does fairly represent a powerful new current in the banking industry: a zeal for endless growth is shared by many other banks, including some big ones. It might ultimately prove to be a problem for some of them too.

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AFTER WRITING THIS LETTER, I DECIDED TO KEEP IT AS MY RECORD OF THE ANSWER  
AND NOT TO MAIL IT

OCTOBER 17, 1974.

FORTUNE MAGAZINE,  
*Time & Life Building,*  
New York, N.Y.

GENTLEMEN: "The Inside Story of What Really Went Wrong at Franklin National Bank" obviously represents a good deal of research and explains many of the management and financial problems that led to the collapse of that institution. In general, the article's judgments are supported by verifiable fact; but in several places, opinions are given for which there is neither factual basis nor balancing judgments and which mar an otherwise interesting piece of reporting.

In an article as long as yours, there are inevitable errors. Thus, the anecdote about Franklin lending a builder \$25,000 in 1950 without a financial statement turns out to be inaccurate. I checked with Roger Elton, the source given, and his recollection is that the loan was made by Pat Clifford. A financial statement was, indeed, demanded and produced.

The opinion of Jerry Twomey that we entered the New York market "building monuments, impressive and very costly structures," is given without any caveats or criticisms; actually, there are countervailing opinions and facts. Those buildings are functional, beautiful and, because of their unique design, perennial advertisements for the bank's special character. The land could not be bought for anything close to what we paid, nor the buildings constructed today for twice their original cost. They were so valuable that later management was able to realize important profits from their sale when forced to increase profits. It is indeed unfortunate that their destructive financial policies pushed them to this extremity.

There are several more serious lapses in your story which might mislead the reader unfamiliar with all of the facts, partly because it collapses time in a confusing way when it apportion blame for the bank's downfall. It raises a very important question for any interested executive: Where, in time, does executive responsibility begin and end?

Franklin went under in October 1974. I was forced out as chief executive officer in July 1968, more than six years earlier, and left the bank entirely in March 1970, four and one-half years before it collapsed.

When I was forced out, the bank was in excellent condition by any objective test:

- Bottom line earnings were 50 percent above (as a percentage of common stockholders' equity) those of other large New York banks.
- Loans were demonstrably healthy (losses were 2 cents a share in 1969).
- Liquidity and capital position were good and getting better.
- Municipal obligations (one-third short-term) were a good source of profit.

I might add that we had no foreign currency transactions nor foreign loans, both of which your article accurately identifies as sources of grave trouble in later years.

To support my statements, I enclose a page from Morris Schapiro's Bank Stock Quarterly for March 1970, which gives a rather complete record of Franklin's earnings, loan charge-offs, etc., during 1960-69, the period of Franklin's entrance into the New York market with all the attendant start-up expenses. These facts alone would destroy your statement that Franklin's entrance into New York was my "most egregious blunder."

Franklin's healthy condition, after we left the "soft plush of our uniquely favorable environment" and entered banking's toughest market, New York City, was achieved by those "malleable subordinates who had no aptitude for banking." This, it seems to me, is where your article departs seriously from reality and damages, as well, the reputations of a number of competent executives. It compounds this error by singling out John Sadlik for malignment. Sadlik was, and is, a knowledgeable and prudent banker (retained by the perceptive people who took over Franklin and changed its name), whose knowledge of the fine points of finance cannot seriously be questioned by anyone informed in this area. If Franklin management had listened to Sadlik—his memoranda to management bear this out—the bank would be a living and profitable institution today.

The article's analysis of Franklin's problems with municipal bonds is a model of unjustified conclusions drawn from inaccurate evidence. The facts are simple. The municipals we held when I left were profitable to the bank. One-third of these were short-term (maturing in twelve months or less). (Forty-two million dollars worth of long-term municipals came with the acquisition of the Federation Bank.)

No bank, no business, is static. Management is supposed to make investments in anticipation of economic conditions; when conditions change, they're supposed to anticipate the changes, or, at the very least, to react swiftly when changes are perceived. Franklin's feckless management did neither. They increased their investments in longer term municipals after I left. They became speculators in foreign exchange. They borrowed huge amounts overnight and loaned it out long. They sought and obtained equally huge short-term high-interest-rate foreign deposits and loaned it long term. They built up their officers and personnel one-third more than required. They lacked leadership. The bank was badly mismanaged.

There is no point in elucidating all the "egregious errors" in your article—the ones above are the most serious.

One point the article does not make is that all criticisms it contains are hindsight. From my evaluation of the personnel that forced me out of the bank, I was certain in 1970 that they would do badly. But I decided to say nothing in public for two years to give management a chance to prove their astuteness.

When it became obvious, however, that my privately held predictions were coming disastrously true, in November 1971 I issued the first of three letters warning of impending calamity. In April 1972 and again on July 18, 1972, I wrote detailed letters of warning and gave copies to the press, which published much of the material. Copies were also sent by registered mail to the Comptroller of the Currency, the Federal Reserve Board, and the Federal Deposit Insurance Corporation.

There was then still time to force Franklin management to correct its errors or to step down in favor of competent people. This was not done, and the result makes sad reading.

Franklin has now been reborn as The European-American Bank and Trust Company. I shall do all I can to help it to again become the great bank it was in years gone by.

Whatever harm your article has done to the reputations of those not responsible for Franklin's downfall cannot be mended.

ARTHUR T. ROTH.

NET OPERATING EARNINGS AND THE BOTTOM LINE, PER SHARE 1960-69 (AFTER APPLICABLE TAXES)

Year	Common shares	Operating earnings	Actual net loan charge-offs (recoveries)	Percent of average loans	Net operating earnings	Cash dividends declared	Payout (percent)	Net securities losses (gains) and net sundry debits (credits)			Bottom line (net income)	Common stockholders equity		
								Total	Securities	Sundry		Average	Net operating earnings (percent)	Bottom line (percent)
Franklin New York Corp.:														
1969	4,570,067	\$4.11	\$0.02	0.007	\$4.09	\$1.44	35.2	\$0.20	\$0.20		\$3.89	\$22.51	18.2	17.3
1968	4,298,193	3.63	.51	.177	3.12	1.51	48.4	.03	.03		3.09	20.69	15.1	14.9
1967	3,981,454	3.39	.85	.308	2.54	1.00	39.4	.15	.15		2.39	18.65	13.6	12.8
1966	3,981,454	3.09	1.68	.655	1.41	.98	69.5	.18	.18		1.23	17.03	8.3	7.2
1965	3,981,454	2.51	.98	.465	1.53	.95	62.1				1.53	16.06	9.5	5.5
1964	3,981,454	2.34	.33	.195	2.01	.93	46.3	.18	.18		1.83	15.68	12.8	11.7
1963	3,981,454	2.46	.68	.476	1.78	.90	50.6	.12	.12		1.66	15.22	11.7	10.9
1962	3,981,454	2.46	.17	.125	2.29	.88	38.4	(.15)	(.15)		2.44	14.31	16.0	17.1
1961	3,981,454	2.36	.02	.021	2.34	.85	35.3	.08	.08		2.26	13.18	17.8	17.1
1960	3,950,245	2.25	.07	.068	2.18	.20	9.2	(.73)	(.73)		2.91	11.06	19.7	26.3
Average				.249										14.5
Charter New York Corp.:														
1969	6,914,696	3.88	.20	.048	3.68	1.97	53.5	.33	.33		3.35	34.23	10.8	9.8
1968	6,914,696	3.89	.19	.057	3.70	1.74	47.0	.88	.88		2.82	32.93	11.2	8.6
1967	6,914,696	3.48	.14	.115	3.34	1.61	48.2	(.01)	(.01)		3.35	31.89	10.5	10.5
1966	6,914,696	3.05	.10	.087	2.95	1.60	54.2	.44	.44		2.51	30.45	9.7	8.2
1965	6,914,696	2.65	.09	.032	2.56	1.48	57.8	.20	.20		2.36	29.16	8.8	8.1
1964	5,858,300	3.04	.06	.024	2.98	1.56	52.3	.10	.10		2.88	29.76	10.0	9.7
1963	5,858,300	2.90	.04	.016	2.86	1.54	53.8	(.06)	.06	(\$0.12)	2.92	28.49	10.0	10.2
1962	5,858,300	2.83	.02	.010	2.81	1.51	53.7	(.17)	(.17)		2.98	27.37	10.3	10.9
1961	5,858,300	2.80	.21	.114	2.59	1.48	57.1	(.30)	(.30)		2.89	26.27	9.9	11.0
1960	5,858,300	3.11	.07	.042	3.04	1.45	47.7	.09	.09		2.95	25.05	12.1	11.8
Average				.054										9.9

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NET OPERATING EARNINGS AND THE BOTTOM LINE, PER SHARE 1960-69 (AFTER APPLICABLE TAXES)—Continued

Year	Common shares	Operating earnings	Actual net loan charge-offs (recoveries)	percent of average loans	Net operating earnings	Cash dividends declared	Payout (percent)	Net securities losses (gains) and net sundry debits (credits)			Bottom line (net income)	Common stockholders equity		
								Total	Securities	Sundry		Average	Net operating earnings (percent)	Bottom line (percent)
<b>Chase Manhattan Corp.:</b>														
1969	31, 878, 666	\$3. 74	\$0. 13	0. 038	\$3. 61	\$1. 75	48. 5	0. 67	0. 67	-----	\$2. 94	\$32. 33	11. 2	9. 1
1968	31, 428, 333	3. 8	. 13	. 041	3. 67	1. 56	42. 5	. 55	. 60	(. 05)	3. 12	31. 37	11. 7	9. 9
1967	31, 426, 997	3. 35	. 13	. 043	3. 22	1. 46	45. 3	(. 17)	(. 10)	(. 07)	3. 39	29. 77	10. 8	11. 4
1966	31, 426, 997	3. 14	. 17	. 060	2. 97	1. 32	44. 4	. 50	. 51	(. 01)	2. 47	28. 46	10. 4	8. 7
1965	31, 26, 997	2. 93	. 05	. 023	2. 88	1. 33	46. 2	(. 08)	(. 01)	(. 07)	2. 96	27. 58	10. 4	10. 7
1964	31, 426, 997	2. 68	. 18	. 040	2. 60	1. 27	48. 8	. 23	. 12	. 11	2. 37	26. 82	9. 7	8. 8
1963	31, 426, 997	2. 47	. 23	. 138	2. 24	1. 15	51. 3	(. 21)	(. 28)	. 07	2. 45	25. 82	8. 7	9. 5
1962	31, 426, 997	2. 30	. 02	. 015	2. 28	1. 15	50. 4	(. 54)	(. 53)	(. 01)	2. 82	24. 35	9. 4	11. 6
1961	31, 426, 997	2. 25	. 06	. 042	2. 19	1. 10	50. 2	(. 43)	(. 24)	(. 19)	2. 62	22. 90	9. 6	11. 4
1960	31, 426, 997	2. 37	. 03	. 022	2. 34	1. 02	43. 6	. 34	. 37	(. 03)	2. 00	21. 80	10. 7	9. 2
Average				. 046									10. 0	
<b>Chemical New York Corp.:</b>														
1969	13, 408, 967	5. 28	. 06	. 015	5. 22	2. 60	49. 8	. 66	. 66	-----	4. 56	43. 86	11. 9	10. 4
1968	13, 207, 128	5. 10	(. 04)	(. 010)	5. 14	2. 45	47. 7	. 82	. 82	-----	4. 32	42. 35	12. 1	10. 2
1967	13, 140, 344	4. 65	. 17	. 044	4. 48	2. 20	49. 1	. 12	. 15	(. 03)	4. 36	41. 05	10. 9	10. 6
1966	13, 139, 049	4. 14	. 32	. 103	3. 82	2. 10	55. 0	1. 14	1. 13	. 01	2. 68	40. 22	9. 5	6. 9
1965	13, 139, 049	4. 01	. 17	. 053	3. 84	2. 10	54. 7	(. 04)	(. 04)	-----	3. 88	39. 25	9. 8	9. 7
1964	13, 138, 384	3. 88	. 06	. 027	3. 82	1. 87	49. 0	. 16	. 09	(. 07)	3. 66	38. 14	10. 0	9. 6
1963	12, 840, 885	3. 53	. 11	. 052	3. 42	1. 84	53. 8	. 15	. 16	(. 01)	3. 27	36. 94	9. 3	8. 9
1962	12, 714, 885	3. 60	. 06	. 029	3. 54	1. 83	51. 7	(. 23)	(. 21)	(. 02)	3. 77	35. 51	10. 0	10. 6
1961	12, 714, 885	3. 45	(. 02)	(. 009)	3. 47	1. 73	49. 9	(. 10)	(. 08)	(. 02)	3. 57	33. 85	10. 3	10. 5
1960	12, 714, 885	3. 22	. 26	. 150	2. 96	1. 60	54. 1	(. 64)	(. 61)	(. 03)	3. 60	32. 16	9. 2	11. 2
Average				. 045									9. 8	
<b>First National City Corp.:</b>														
1969	27, 035, 196	5. 04	. 20	. 044	4. 84	2. 30	47. 5	. 54	. 41	. 13	4. 30	42. 72	11. 3	10. 1
1968	26, 813, 473	4. 66	. 17	. 044	4. 49	2. 10	46. 8	. 38	. 42	(. 04)	4. 11	41. 21	10. 9	10. 0
1967	26, 705, 064	4. 22	. 18	. 052	4. 04	1. 90	47. 0	. 20	. 20	-----	3. 84	39. 75	10. 2	9. 7
1966	26, 648, 871	3. 94	. 23	. 070	3. 71	1. 75	47. 2	. 26	. 20	. 06	3. 45	38. 36	9. 7	9. 0
1965	26, 639, 838	3. 52	. 20	. 069	3. 32	1. 69	48. 2	. 21	(. 01)	. 22	3. 11	37. 15	8. 9	8. 4
1964	26, 616, 912	3. 26	(. 01)	(. 004)	3. 27	1. 53	46. 8	. 08	. 04	. 04	3. 19	35. 93	9. 1	8. 9
1963	26, 601, 980	2. 89	. 06	. 030	2. 83	1. 47	51. 9	(. 18)	(. 19)	. 01	3. 01	34. 65	8. 2	8. 7
1962	26, 601, 980	2. 79	. 14	. 081	2. 65	1. 44	54. 3	. 28	. 09	. 19	2. 37	33. 57	7. 9	7. 1
1961	26, 497, 940	2. 75	. 26	. 164	2. 49	1. 41	56. 6	(. 46)	(. 51)	. 05	2. 95	32. 30	7. 7	9. 1
1960	26, 497, 940	2. 80	. 65	. 397	2. 15	1. 39	64. 7	. 13	. 10	. 03	2. 02	30. 84	7. 0	6. 5
Average				. 094									8. 7	

## FRANKLIN NATIONAL BANK STATEMENT OF CONDITION

	June 30		
	Sept. 30, 1968 (millions)	1968 (thousands)	1967 (thousands)
<b>Resources:</b>			
Cash and due from banks .....	\$218	\$216, 257	\$236, 352
U.S. Government obligations .....	400	365, 247	276, 444
Municipal obligations .....	404	390, 971	459, 691
Federal agency obligations .....	36	40, 150	34, 757
Other securities .....	18	17, 265	23, 161
<b>Total securities</b> .....	<b>860</b>	<b>813, 633</b>	<b>794, 053</b>
Federal funds sold .....	147	19, 303	93, 015
Loans .....	1, 256	1, 241, 306	1, 172, 874
Less—Reserve for loans .....	20	20, 158	20, 000
<b>Net loans</b> .....	<b>1, 236</b>	<b>1, 221, 148</b>	<b>1, 152, 874</b>
Bank premises and equipment .....	46	47, 243	40, 985
Customers' liability on acceptances .....	23	26, 823	24, 607
Accrued interest receivable .....	19	16, 154	12, 765
Other resources .....	10	10, 826	4, 719
<b>Bank premises and other resources</b> .....	<b>100</b>	<b>101, 046</b>	<b>83, 076</b>
<b>Total resources</b> .....	<b>2, 561</b>	<b>2, 371, 387</b>	<b>2, 359, 370</b>
<b>Liabilities:</b>			
<b>Deposits:</b>			
Demand .....	800	755, 185	704, 300
Time .....	1, 252	1, 149, 875	1, 243, 140
<b>Total deposits</b> .....	<b>2, 053</b>	<b>1, 905, 060</b>	<b>1, 947, 440</b>
Securities sold under agreement to repurchase .....	16	110, 134	29, 065
Federal funds purchased .....	241	93, 070	151, 180
Mortgages payable .....	25	25, 781	26, 422
Acceptances outstanding .....	23	27, 459	25, 150
Unearned income .....	17	16, 853	15, 777
Accrued interest, taxes and other liabilities .....	13	24, 182	17, 399
Dividends payable .....		2, 098	
<b>Total other liabilities</b> .....	<b>54</b>	<b>70, 592</b>	<b>58, 326</b>
<b>Total liabilities</b> .....	<b>2, 390</b>	<b>2, 204, 637</b>	<b>2, 212, 433</b>
<b>Capital funds:</b>			
Capital debentures (4¼ percent—due 1988) .....	30	30, 000	30, 000
<b>Equity capital:</b>			
Preferred stock (\$4.60—\$100 par) .....	20	20, 000	20, 000
Convertible preferred stock (\$2.45—\$25 par) .....	20.5	20, 523	20, 523
Common stock (\$5 par) .....	22.7	22, 751	19, 907
Surplus .....	65	65, 000	50, 000
Undivided profits .....	13	8, 476	6, 507
<b>Total capital funds</b> .....	<b>1, 71.2</b>	<b>166, 750</b>	<b>146, 937</b>
<b>Total liabilities and capital funds</b> .....	<b>2, 561</b>	<b>2, 371, 387</b>	<b>2, 359, 370</b>

## FRANKLIN NATIONAL BANK STATEMENT OF EARNINGS

	9 mo ending Sept. 30, 1968 (millions)	6 mo ending June 30,	
		1968 (thousands)	1967 (thousands)
<b>Operating income:</b>			
Interest and fees on loans.....	70	\$44,888	\$37,167
Income on U.S. governments, municipal and other securities.....	30	20,115	14,088
Service charges on deposit accounts.....	3.6	2,443	1,922
Other income.....	3.8	2,535	1,825
<b>Total operating income.....</b>	<b>107</b>	<b>69,981</b>	<b>55,002</b>
<b>Operating expenses:</b>			
<b>Staff expenses:</b>			
Salaries.....	15.5	10,059	6,929
Profit sharing, pension and other employee benefits.....	2.5	1,665	1,027
<b>Total.....</b>	<b>18</b>	<b>11,724</b>	<b>7,956</b>
<b>Interest expense:</b>			
On deposits.....	46	30,896	26,287
On borrowed money.....	11	6,726	3,518
<b>Total.....</b>	<b>57</b>	<b>37,622</b>	<b>29,805</b>
Net occupancy costs—bank premises.....	4.8	3,139	2,695
Equipment, stationery, telephone and postage.....	4.8	3,132	2,827
Advertising and business development.....	1.5	1,028	1,406
Other expenses.....	3.8	2,522	1,633
<b>Total operating expenses.....</b>	<b>90.4</b>	<b>59,167</b>	<b>46,322</b>
<b>Operating earnings:</b>			
Operating earnings before income taxes.....	17.4	10,814	8,680
Income taxes applicable to operating earnings.....	3.5	1,816	1,253
<b>Net operating earnings.....</b>	<b>13.9</b>	<b>8,998</b>	<b>7,427</b>
Per share of common stock outstanding (4,043,953—1968 average and 3,981,450—1967) after deducting preferred dividends of \$1,466,000 in 1968 and \$460,000 in 1967.....	2.78	1.86	1.75
<b>Nonoperating (additions) or deduction, net of tax:</b>			
Security (profits) or losses.....	.136	205	426
Transfer to reserve for loans to restore losses.....			431
Other deductions.....		65	48
<b>Total nonoperating deductions.....</b>	<b>.139</b>	<b>270</b>	<b>905</b>
<b>Transferred to undivided profits.....</b>	<b>13.755</b>	<b>8,728</b>	<b>6,522</b>

## STATEMENT OF CHANGES IN CAPITAL ACCOUNTS

Balance, beginning of year.....	148.2	\$148,244	\$120,796
<b>Add:</b>			
Transferred from statement of earnings.....	13.7	8,728	6,522
Issuance of convertible preferred stock.....			20,523
From merger federation bank & trust co.....			1,522
Issuance of additional common stock.....	15.0	15,043	
<b>Total.....</b>	<b>177.0</b>	<b>172,015</b>	<b>149,363</b>
<b>Less:</b>			
Cash dividends on common stock.....	3.5	3,555	1,966
Cash dividends on preferred stock.....	.7	537	460
Cash dividends on convertible preferred stock.....	1.5	1,173	
<b>Total deductions.....</b>	<b>5.7</b>	<b>5,265</b>	<b>2,426</b>
<b>Balance, end of period.....</b>	<b>171.3</b>	<b>166,750</b>	<b>146,937</b>

Mr. ROSENTHAL, Mr. Gradison.

Mr. GRADISON. Thank you, Mr. Chairman.

At this point, Mr. Chairman, I would ask to put into the record the lead editorial from today's Wall Street Journal, entitled "Bored by the Bank Flap."

Mr. ROSENTHAL. May I take a look at it? I have not seen it.

Without objection, it will be included in the record.

[The article referred to follows:]

[From the Wall Street Journal, Feb. 10, 1976]

## REVIEW &amp; OUTLOOK—BORED BY THE BANK FLAP

"I hold in my hand a list of 28 American banks that are in trouble through having made bad loans," says one of the great liberal newspapers of the land. "I hold in my hand a list of umpteen other banks that have made risky loans to X, Y and Z," says another of the great liberal newspapers of the land. Congressional committees hold investigations. Presidential candidates fulminate. Bank reform legislation is drawn up to deal with the situation.

Until now, we have not commented on this latest sport. Frankly, we've been bored by it. The "troubled bank" story is last year's story and the story of 1974, when it really looked dicey as to whether the banks had sufficient capital to get through the squeeze. (See for example, "Bank Soundness" in these columns, November 24, 1974.) The reason the liberals in Congress and on the great liberal newspapers of the land were not then wringing their hands is not hard to recall. They were then worried about the faltering economy and were exhorting the banks to make bad loans.

The banks, you'll recall, were told they had to be socially responsible. The liberal commentators fumed that banks were actually refusing to lend money to "red-lined" neighborhoods. The New York banks were being vilified and picketed for their hesitation in buying Mayor Beame's municipal bonds and tax-anticipation notes. House Banking Chairman Henry Reuss, for gosh sakes, was pushing credit allocation legislation that would have required the banks to make loans to suit his tastes. Mass transit projects seemed to be the favorite idea. Wouldn't it be swell if everyone had a Metro like Washington, D.C.?

At the same time, you must recall, the liberals were screaming at Arthur Burns to gun the money supply faster. In the current sport, which The Economist of London calls "Bashing at the American Banks," there has not been one word in all the newspaper stories and all the congressional testimony that makes the connection between an increase in the money supply and bad bank loans to X, Y and Z. Members of the congressional banking committees, if not the great liberal newspapers of the land, are supposed to know of this connection:

1. The Fed increases the money supply by monetizing debt, i.e., buying interest-bearing bonds from the banks with printing-press money.
2. The banks have more cash as a result.
3. The supply of good customers wanting to finance profitable projects has not increased.
4. The banks are losing money by sitting on cash.
5. They make loans to riskier customers.
6. They form Real Estate Investment Trusts.
7. They throw money at anyone who doesn't look like an out-and-out burglar.
8. A Go-Go Era is born.
9. Roaring inflation develops, followed by 10. Collapse.

It is thus deliciously clear why the liberals have had to wait until recovery seems to be underway before they decide to talk about a year-old story. By now, we are all supposed to have forgotten their prescriptions when the banks really were in trouble, so they can piously proclaim how much more prudent they would have been than those reckless bankers.

The liberals are still after Arthur Burns to gun the money supply. But they want the banking laws reformed so that for every bank lending officer there is a government bank regulator, who will be wise and prudent in seeing to it that monetized debt goes, not into those awful REITs, but into socially desirable projects, like big MAC bonds and New York State TANs.

We're bored by it all. It's too transparent. The liberals have learned a thing or two in the last few years, but so have we all. When Mr. Reuss tried to ram his credit allocation legislation through the veto-proof Democratic Congress last year he was almost laughed off Capitol Hill. He's not going to do any better with a phony hoorah about troubled banks and a "moderate" approach to bank reform.

We don't need any new banking laws and regulations. Bank lending officers and loan committees don't need bank examiners at their elbows to tell them X is socially desirable and Y is not. The important thing is that Arthur Burns doesn't forget what he's learned and start pumping out printing-press cash. With or without further "reform," the banks will be as sound as a dollar.

Mr. GRADISON. This editorial makes the point that whatever problems we have had with regard to banks and bank regulations will be made worse if we move in the direction of encouraging overexpansion of bank loans during periods of expansion of the economy. This is the point you made.

It also makes the point that one of the most dangerous things that can be done with regard to the quality of bank loans would be for the Congress to step in, as some of the leaders of the Congress have advocated, and regulate who should be able to borrow money in the United States. This was a proposal which only lost by one vote in the Banking Committee last year. It was, in other words, that the Government should regulate the allocation of credit among all borrowers and lenders in the country.

Mr. ROTH. I don't go for allocation of credit, but I do go for something that I asked the Federal Reserve to send out on April 4, 1974. I would like to read that to you.

I was very much concerned about the Federal Reserve's inability to restrain the inflationary trends to the extent that they hoped that they could. They tried to do it almost entirely by jacking up interest rates so that they became so high that they bankrupted many concerns around the country.

I asked to see Arthur Burns on April 4, 1974. He was at the White House, so I saw Governor Wallich. I thought I knew him, but I found that I didn't know him.

I said:

I have written a short letter that I think you ought to consider sending out to all of the banks in the country because I see that your efforts are not bearing fruit the way they should.

This simple letter said:

The Federal Reserve's efforts to restrain inflation could be aided by the cooperation of banks in restraining their lending activities. Loans for speculative purposes and for over-expansion and those that feed the fires of inflation in particular should be most carefully examined. At a time when loan demands are heavy, many banks have inadequate ratios of capital and loans are being made using short-term funds which could create liquidity problems. Please fill in and return in the next ten days your loans, the amount of your capital funds ratio, and your loans to regular deposits—

Mr. GRADISON. Mr. Roth, may I interrupt because of the shortage of time?

Mr. ROTH. Yes.

Mr. GRADISON. I am aware that the Fed did send out a commentary not unlike this as an outgrowth of the recommendations of the Advisory Committee.

Mr. ROTH. Five months later. That is right. But I met one of the members of the Advisory Committee when they had a meeting on that same day. He said, "What are you doing here, Arthur?"

I told him.

He said:

Ridiculous, ridiculous. Banking is a competitive business.

This is the same thing that Wallich said to me.

I said:

It is a quasi-public business and we have a public responsibility. That responsibility has to do with the fact that we cannot allow this inflation to get out of hand because we are making so many loans.

He said:

Oh, we are going to take care of that by increasing the discount rate.

I said:

That is ridiculous.

Mr. GRADISON. Mr. Roth, the first general area I would like to explore with you has to do with whether the regulatory agencies were picking up the problems of Franklin and reflecting them back to the management and directors for action.

According to testimony taken last July before Mr. St Germain's subcommittee, on page 753, Mr. St Germain said:

The examination report of March 1972 to May 1972 contained a volume of criticized loans then of 74 percent of gross capital funds—plus notations by examiners. I quote: "An intolerably high volume of loans subject to adverse comments. Suggest strong corrective measures."

Then the examination of November 1973 to March 1974 volume of criticized loans contained 111 percent of gross capital funds. The notation by the examiner is alarming.

Now this gives me the impression that the examiners were picking up these problems. Once these are found, are they not made available to the management and to the board of directors of the subject bank?

Mr. ROTH. Absolutely. And the board of directors has to record it in the minutes and it has to be discussed and submitted to all of the entire board of directors. That is right.

Mr. GRADISON. Is it your impression then that the problems of Franklin were being picked up on a reasonably current basis as part of the examination process?

Mr. ROTH. I think the examiners did a competent job. I know Ed Langdon and I know Ed Lake. I know they are very competent examiners.

Mr. GRADISON. Mr. Roth, much of your opening statement was based upon the events of May, 1974, and leading up to the Mother's Day events which you described earlier. In a symposium of the American Bar Association, held in Montreal, Joseph Barr commented upon that period. Now he, of course, had earlier been Secretary of the Treasury and, as you indicated, was called in, perhaps too late, to save Franklin.

But my understanding is that he stated at the Montreal symposium that all three Federal banking agencies performed very well during the Franklin crisis of 1974. How do you feel about that?

Mr. ROTH. The Federal Reserve, of course, was supplying all of the money that was needed. They did try to take corrective action—as much as they could—but it was too late. They had gone too far by then. They did the best they could, I would say.

Mr. GRADISON. My impression, from what you said before, was that you didn't think they performed very well with regard to the way in which they reacted to the Manufacturers Hanover bid, the time they took to resolve the problem, and the decision that was made with regard to the ultimate takeover by European-American.

Mr. ROTH. I didn't have those things in minds when I said that. The Federal Reserve supplied the money that was needed; yes, they did.

Mr. GRADISON. I yield such time as I may have remaining to Mr. Brown.

Mr. BROWN. I was interested in your comment about Joe Barr. I remember Joe Barr too, of course.

Joe Barr took over the chairmanship in June of 1974.

Mr. ROTH. That is right.

Mr. BROWN. At that point in time, he thought there was a chance of saving it. And I don't think that anybody thinks that Joe Barr wasn't qualified to make that observation.

Mr. ROTH. Oh, no; oh, no.

Mr. BROWN. But he did think there was a chance of saving it.

Mr. ROTH. That is right.

Mr. BROWN. He thought that it could be carried along with some Federal assistance and a merger worked out where there wouldn't be the kind of loss that eventually occurred.

Mr. ROTH. That is right.

Mr. BROWN. So even as late as June of 1974, there was a pretty competent individual who thought it could be saved. Is that right?

Mr. ROTH. Yes. And I think that at about the same time I wrote an article that appeared in the Journal of Commerce in New York outlining a plan that I felt would save Franklin National Bank too. That is right.

Mr. BROWN. I think that Joe at that time said that there was more than \$2 billion in good collateral, against which the bank could borrow \$1.5 billion from the Federal Reserve. A further estimate was made that a financial run would total approximately \$400 million and still leave a narrow margin of \$200 million to \$300 million.

Mr. ROTH. Yes. But in talking to Joe, I said to him, "Look, you have to clean house here and get rid of this fellow Gleason and of Merkin."

He said, "I can't do it."

I said, "Why can't you do it?"

He said, "Because the directors are in control."

Mr. BROWN. But you see, Mr. Roth, that is what bothers me. You want the shareholders to be completely exonerated from any responsibility in this area. Who elects directors?

Mr. ROTH. Sure, the shareholders do. But you know how the directors of any corporation are elected. It is up to the chief executive officer to say who he would like to have and then the balance of the directors go along with him.

Mr. BROWN. Nonetheless it is the duty of the shareholders as owners to hold the management accountable for the well-being of the corporation.

Mr. ROTH. That is right.

Mr. BROWN. That is where the buck stops, doesn't it?

Mr. ROTH. Well, but you have to have a dissident stockholder who is going to spend all of the money that is necessary to rally support on his side in order to overthrow a director and put a new director in. That is a very costly procedure.

I said in my letter that this could be done, but that it would be damaging to the bank and very costly and should not have to be done.

Mr. BROWN. But that is where I have a difficult time comprehending what you would have done. We have already established that the regulatory authority does not have the power to do the specific things that you recommended. The people who could do those things were the management and the directors through the management.

Mr. ROTH. The examiners have the authority to come in and talk to the directors and lay the cards on the table and pound the table and tell them of what disasters they are heading for. They can tell

them about the unsafe and unsound banking practices. It has been done over the years, and has been done successfully. But you need that kind of a tough guy.

Mr. BROWN. But you were a pretty tough guy. You tried to work on shareholders and everybody else and you couldn't affect those directors.

Mr. ROTH. No; I never tried to work on the shareholders. I told the shareholders the facts. I said I was not going to do these things as far as the shareholders were concerned.

Mr. BROWN. I have no further questions.

Mr. ROSENTHAL. Thank you very much, Mr. Roth, for this very informative testimony which you have given. I want you to be assured that this subcommittee will continue this investigation no matter where it may go. The subcommittee stands adjourned.

[Whereupon, at 12:10 p.m., the subcommittee adjourned, to reconvene subject to the call of the Chair.]



# OVERSIGHT HEARINGS INTO THE EFFECTIVENESS OF FEDERAL BANK REGULATION (Franklin National Bank Failure)

TUESDAY, MAY 25, 1976

HOUSE OF REPRESENTATIVES,  
COMMERCE, CONSUMER,  
AND MONETARY AFFAIRS SUBCOMMITTEE  
OF THE COMMITTEE ON GOVERNMENT OPERATIONS,  
*Washington, D.C.*

The subcommittee met, pursuant to notice, at 10 a.m., in room 2247, Rayburn House Office Building, Hon. Benjamin S. Rosenthal (chairman of the subcommittee) presiding.

Present: Representatives Benjamin S. Rosenthal, Robert F. Drinan, Elliott H. Levitas, David W. Evans, and Willis D. Gradison, Jr.

Also present: Peter S. Barash, staff director; Robert H. Dugger, economist; Ronald Klempner, counsel; Doris Faye Taylor, clerk; and Henry C. Ruempler, minority professional staff, Committee on Government Operations.

Mr. ROSENTHAL. The subcommittee will be in order.

Today, the Commerce, Consumer, and Monetary Affairs Subcommittee continues its oversight review of the effectiveness of Federal regulation of commercial banks. Earlier this year, the subcommittee heard testimony from Arthur Roth, former chairman of the board of Franklin National Bank, about the problems of Franklin National and the efficacy of Federal regulation of the bank. Our hearings this week and next will explore the findings and implications of a 3-month subcommittee investigation of the Comptroller of the Currency's examination and supervision of Franklin.

The hearings represent the first in-depth and direct review by Congress of the efficiency of the Comptroller's examination and supervision of a major money market national bank. While other interested committees have inquired into the circumstances surrounding the Federal Reserve's loan of \$1.9 billion to Franklin after May 1974 and the declaration of its insolvency in October 1974, this subcommittee will be examining the crucial regulatory actions from 1969 until May 1974 which failed to halt Franklin's slide into insolvency.

Many of the problems which caused Franklin to be declared insolvent only 1½ years ago are presently being experienced by some of our large national banks. These are: excessive "criticized" loans for real estate construction and development projects, real estate investment trusts, oceangoing tankers and underdeveloped countries; large portions of liabilities are from costly and volatile, interest sensitive

sources; inadequate capitalization; unwarranted involvement in speculative areas, such as foreign exchange trading; rapid expansion of branch offices, lending areas and other business activities without a commensurate improvement in management's ability to cope with the added responsibilities; and, high operating expenses, in part attributable to costly investment in new and expensive headquarter facilities.

The manner in which the Comptroller's office identified and supervised Franklin's problems will provide us with a valuable point of reference in evaluating the effectiveness of present-day regulation. That is why today's hearing will also focus on the Comptroller's regulation of the First National Bank of East Islip, N. Y., a small ongoing bank in the same region as Franklin National.

We will attempt to determine what similarities and differences exist between the effectiveness of the Comptroller's past supervision of Franklin and present supervision of East Islip. Our study of the relationship between the Comptroller's office and the First National Bank of East Islip will also examine the manner in which the Comptroller forces compliance with accurate disclosure of a bank's affairs in proxy statements, annual reports, and other public pronouncements.

Today's witnesses will be Messrs. C. Thomas Metz and Henry Hoppler, subcommittee investigators, who have studied the Comptroller's regulation of Franklin National Bank and have interviewed numerous examiners and other personnel of the Federal banking agencies involved in the affairs of Franklin. They will also testify on the results of their investigation.

The second witness for today will be Aaron B. Donner, a former director of First National Bank of East Islip. Mr. Donner will testify about the bank's lending practices and the Comptroller's response to those practices.

On Wednesday, the subcommittee will hear testimony from Mr. Dennis Weatherstone, senior vice president of Morgan Guaranty Trust Co. and an expert in international and foreign exchange operations, who will testify about his bank's reaction to Franklin National's foreign exchange activities, the effect of those activities on Franklin, and the reaction of the Federal regulatory agencies when he discussed these activities with them prior to May 1974.

On Tuesday, June 1, the subcommittee will hear testimony from Mr. James E. Smith, Comptroller of the Currency; Charles Van Horn, Regional Administrator of National Banks for the Second National Bank Region; and Mr. John Fleming, National Bank Examiner.

Mr. Hoppler and Mr. Metz, you have a prepared statement. Why don't you begin.

**STATEMENT OF HENRY L. HOPPLER AND C. THOMAS METZ, SUBCOMMITTEE STAFF INVESTIGATORS, ON DETAIL FROM THE GENERAL ACCOUNTING OFFICE**

Mr. HOPPLER. Mr. Chairman, at this time we would like to read portions of our prepared statement and we would like our prepared statement to be entered into the record.

Mr. ROSENTHAL. Without objection, the whole statement shall be included as a part of the record.

**Mr. HOPPLER.** Mr. Chairman and members of the subcommittee, for the past 4 months, we have been working as staff investigators for the Commerce, Consumer, and Monetary Affairs Subcommittee to assist in its oversight investigation of the Office of the Comptroller of the Currency. Our efforts combined with those of the subcommittee's regular staff have been directed toward determining the adequacy and effectiveness of the Comptroller's examination and supervision of Franklin National Bank, the subject of today's hearing. Our review focused on the years 1969-74. The Comptroller of the Currency from 1969 to July 1973 was Mr. William Camp, now deceased. The present Comptroller, James Smith, took office in July 1973. The New York regional administrator since 1969 has been Mr. Charles Van Horn.

Our evaluation of the Office of the Comptroller of the Currency's examination and supervision of Franklin National Bank is based on (1) an analysis of Franklin National Bank's examination reports and related files in the Washington headquarters and New York regional office of the OCC; (2) a review of OCC operating manuals, examination procedures, and documents; (3) discussions with OCC officials in Washington and New York; (4) a review of an October 1974 draft report on Franklin by Haskins and Sells, a well-known management consulting firm; and (5) a review of the May 30, 1975, report on the operations of the Office of the Comptroller by Haskins and Sells. We did not examine the accounting records of Franklin and, therefore, are unable to comment on the accuracy of the financial data included in the examination reports.

Franklin National Bank was declared insolvent by the Comptroller of the Currency on October 8, 1974. However, as our testimony will indicate, Franklin had serious problems which were identified in its examination reports as early as 1969, and may have been insolvent as early as May 1974.

National bank examinations are designed to determine the condition and performance of banks, the quality of their operations, the capacity of their management, and the degree of compliance with Federal laws. Without such an audit and review process, an adequate system of national bank supervision and Federal law enforcement would be impossible.

Mr. Chairman, our 3-month review in behalf of the subcommittee of the Comptroller's examination and supervisory processes as they were applied to Franklin National Bank leads us to the following conclusions:

One, OCC enforcement and compliance documents do not clearly establish the division of responsibility and authority among examiners, regional administrators, and Washington officials to require a bank to take corrective actions on problems identified during examinations. As a consequence, there exists among the OCC staff a difference of opinion as to who has the responsibility and authority to require such corrective action.

Two, the management and portfolio problems that plagued Franklin since the late sixties and led to its eventual failure in 1974 were amply documented by national bank examiners over a 5-year period. We found that OCC failed to utilize fully its supervisory options to correct the problems identified by examiners. For example:

Though OCC representatives frequently discussed examiner findings with senior bank officials and received numerous promises that corrective actions would be taken, subsequent examinations did not indicate substantive improvements.

Despite constant critical examination reports, the OCC allowed Franklin to open 17 branches in New York and 1 branch in London between 1969 and 1973. Denial of these branches could have been used effectively to discipline Franklin.

It was not until February 1974, only 3 months before the beginning of massive Federal Reserve support, that the OCC took aggressive supervisory actions to force Franklin to correct problems which had been repeatedly identified by examiners since 1969.

Three, though examiners generally identified Franklin's problems, we found two notable exceptions:

First, in February 1973, OCC examiners failed to include in their report a \$50 million instance of balance sheet "window dressing" which resulted in an overstatement of the bank's resources.

Second, in June 1973, during a 1-day check of the bank's foreign exchange profit and loss statements, the OCC examiner apparently did not verify the foreign exchange rates used in preparing these schedules. We believe that had he verified these rates, the OCC would have become aware in June 1973 of Franklin's misrepresentations of foreign exchange profits rather than almost a year later in May 1974.

Though examiners generally identified Franklin's problems, the critical comments found scattered throughout the examination reports frequently did not get recorded on page 2 of the report, "Comments on Matters Requiring Attention." Page 2 is important because it is on that page that examiners are supposed to itemize areas of concern. Noninclusion may suggest to bank officers and directors that a problem is not important. For example, in the 1970, 1971, 1972, and 1973 reports, capital was regarded as inadequate and criticized. However, capital was not itemized on page 2 until 1973.

#### FREQUENCY

Mr. Metz. The National Bank Act, U.S.C. 481, requires the Comptroller of the Currency to examine every national bank twice in each calendar year. The Comptroller, at his discretion, however, may waive one examination or examine a bank more frequently, if necessary. The waiver of one examination cannot be exercised more frequently than once during any 2-calendar-year period.

During the 1969-1974 period, nine reports of examinations were prepared on Franklin. Six of the nine reports were "regular" and three were "special visitations." Table 1 shows the starting and closing dates and the man-days used on each examination.

#### RATINGS

Examination reports contain comments by the examiner concerning the following categories: Condition of bank; management; earnings; capital; internal controls and audit procedures; and future prospects. The comments include a descriptive word rating, such as excellent, good, fair, poor, et cetera, for each category. Table 2 presents the rating in each of these categories.

The descriptive word ratings reveal that Franklin's overall condition was only fair and its capital was borderline in 1969. By 1972, its condition was unsatisfactory; its management only fair; its earnings poor; and its capital inadequate.

At the completion of each regular examination, Franklin was further rated in three categories: capital position, quality of assets, and management. A composite or group rating of Franklin was also made. Capital position is rated from 1 to 4, with 1 being adequate, based on such factors as management, liquidity, earnings, et cetera. Quality of assets is rated from A to D, A being good, based on the ratio of classified and speculative assets to gross capital. Management is rated S, strong or competent; F, fair; or P, poor, incompetent or integrity questioned. The composite or group rating is from 1 to 4, 1 being a sound institution, based on consideration of all ratings.

Ratings were made by the regional administrator, although in 1972 the composite rating was revised downward in OCC/Washington. Table 3 shows Franklin's rating at each regular examination.

Franklin's composite rating declined from 2 to 3 in 1970, and remained a 3 through early 1974. OCC procedures provide that banks having a composite rating of 3 or 4 require special attention. OCC Deputy Comptroller John Gwin, who was responsible for the New York region, informed Comptroller William Camp in March 1971 that Franklin was in need of close supervision. The New York regional administrator at that time was Mr. Charles Van Horn.

#### SUPERVISORY OPTIONS AND ENFORCEMENT FOLLOWUP

In testimony before this subcommittee on January 20, 1976, the Deputy Comptroller of the Currency, Robert Bloom, identified supervisory methods available to the OCC for correcting deficiencies in banks identified as requiring special supervisory attention. He stated that special supervision begins with the examiner's comments on matters requiring attention in the examination report. Next, the regional administrator can request a bank's board of directors and executive management to institute corrective measures, request monthly progress reports, and conduct frequent visitations and examinations. OCC/Washington personnel can be involved in any of these aspects. Additionally, OCC can withhold approval on applications for various corporate changes, such as opening a new branch or approving investments in banking premises. Other actions include initiation of cease and desist proceedings, certification to the Federal Reserve for removal of a bank official or criminal referral to the Department of Justice. Though Mr. Bloom failed to enumerate it, the OCC also had the authority to publish all or part of Franklin's examination reports.

The OCC did not fully utilize its options, and what actions it did take clearly were not adequate for the purpose of getting Franklin to work out its problems.

#### EXAMINER COMMENTS

The examiner's conclusions regarding aspects of a bank's affairs that should be brought to the attention of the Comptroller and the bank's directors are found on page 2 of the examination report. Our review of these comments reveals several important instances in which strong

examiner criticisms found elsewhere in the Franklin examination reports were not included on page 2. This is a problem because non-inclusion may suggest to bank officers and directors that a problem is not important.

Nevertheless, even the problems cited on page 2 were not always effectively dealt with by Franklin's management. Succeeding examination reports evidenced no significant improvement in some of the problems cited on page 2 during 1969 to 1973.

#### CREATIVE MEASURES

After each examination report was completed, the OCC regional administrator and the examiner-in-charge met with Franklin's board of directors to discuss the condition of the bank. The regional administrator, Mr. Charles Van Horn, told us in a recent interview that requests to the board to take corrective actions should have been made at these meetings and that these requests should be reflected in OCC memoranda of these meetings.

These memoranda indicate that only after the 1970 examination was a request made for corrective action. This request was simply "to keep us—the OCC/New York office—currently informed with respect to alleviating criticisms." The bank gave assurances that monthly progress reports on criticized loans were to continue to be forwarded.

#### EXAMINATIONS AND VISITATIONS

Despite the steadily deteriorating condition of Franklin from 1969 through 1973, the frequency of examinations was not increased. Even the three examinations every 2 calendar years, required by law, were not conducted from 1969 through 1971.

Special 1-day visitations were made in February 1973, June 1973, and February 1974 to review Franklin's foreign exchange operations.

#### APPLICATION APPROVALS

Applications for new branch offices of a national bank require approval by the Comptroller. In practice, when an application is considered, it is circulated to examiners in the region, regional administrators, Director of the Bank Organization Division and Deputy Comptroller for recommendations and comments. Comments are also requested from the State banking department. In the Franklin case, all reports by these individuals were reviewed and provided the basis for the final decision by the Comptroller. Table 4 shows the domestic branches approved and opened and disapproved through December 31, 1973.

From 1969 to year end 1973, Franklin received approval from the Comptroller and opened 17 new branches. Eleven of the branches were approved at a time when the condition of the bank was rated as only fair, and its capital as borderline. One branch was approved despite a condition rating of unsatisfactory and a capital rating of inadequate.

Similarly, despite critical examination findings, OCC/Washington did not object in March 1971 to the Federal Reserve's Board of Governors' approval of Franklin's London branch application.

In order to perform full banking services in England, a bank must be formally recognized by the Bank of England. In October 1972, the Bank of England wrote the OCC asking if there were any problems with Franklin that would prevent recognition—“\* \* \* our basic principle is that we only recognize in London those banks which are in good standing in their own markets, with their competitors and with their authorities.” The OCC Director of International Operations, Robert Mullin, recommended the Bank of England recognize Franklin’s London branch.

#### OTHER ENFORCEMENT OPTIONS

We found no evidence that the OCC threatened to initiate cease and desist proceedings or publish portions of Franklin’s examination reports, sought to remove an officer or director of Franklin, or attempted to make a criminal referral to the Justice Department prior to May 1974.

In short, the OCC failed to utilize fully its available enforcement powers to correct deficiencies in the Franklin bank.

#### SOLVENCY AND EXAMINATION REPORT FINDINGS

According to the Comptroller’s Handbook of Examination Procedures, the examiner is responsible for determining if a bank is solvent, both in having collectable assets sufficient to pay depositors and other creditors and in its ability to meet maturing and usual demands. The examination report includes a question as to whether a bank is solvent in both respects.

In 1969 to 1972, the examiner answered “yes” to this question. In the November 1973 report, he referred to the narrative comments on the condition of the bank, which stated: “\* \* \* The bank has not been able to meet the day-to-day requirements placed upon it in the ordinary conduct of its business and simultaneously sustain its overly ambitious growth program without the heavy and continuous use of borrowings, particularly in the Federal funds market.” The May 1974 visitation report stated: “Bank condition remains hazardous and bank is only able to meet its day-to-day requirements through the assistance of the Federal Reserve Bank.”

In October 1974, the Comptroller of the Currency declared Franklin to be insolvent. The affidavit cited certain statistical data to show that Franklin’s equity capital would be reduced from \$175 million to \$19 million because of losses, doubtful assets and securities depreciation. According to the affidavit, the remaining equity capital would undoubtedly be eliminated by the discount factor involved in the sale of sufficient loans to pay off Franklin’s obligation to the Federal Reserve Bank of New York.

The affidavit further stated that the Comptroller is not required to wait until the losses he finds in a bank’s assets are actually charged against the bank’s book equity capital. The Comptroller’s duty is to determine when a bank has reached the point that it will not be able to meet obligations to its depositors in the near future. According to the affidavit, Franklin would have reached that point many months before without the aid of the Federal Reserve Bank of New York.

Thus, while Franklin did not actually become insolvent, its solvency was due only to Federal Reserve Bank funds borrowed on a daily basis from May 10 to October 8, 1974.

#### CONDITION OF THE BANK

According to the Comptroller's handbook, the major factor used in determining the rating of a bank's condition is the amount of low quality, questionable, and unsound assets owned by a bank in relationship to the reasonable loss eliminating capacity afforded by its capital structure. If the amount of such assets is excessive in relationship to the capital structure's reasonable loss eliminating capacity, the bank's condition is poor regardless of any other factors. Franklin's condition was rated "fair" in 1969; "poor" in 1970; "fair" in 1971 and March 1972; "unsatisfactory" in December 1972; and "extremely poor" in 1973.

#### QUALITY OF LOANS

Mr. HOPPLER. The main factor critically commented on in Franklin's examination reports was the quality of its loan portfolio and the resulting impact of liquidity. Loans are assigned a classification based on the examiner's best judgment concerning the degree of risk and the likelihood of orderly liquidation. Loans can be classified "substandard", "doubtful", or "loss". Substandard loans must have a positive and well-defined weakness that jeopardizes the liquidation of the debt. A doubtful loan has all of the weaknesses inherent in an asset classified substandard and its collection or liquidation in full is highly questionable. Loans classified "loss" are considered uncollectable and of such little value that their continuance as active assets of the bank is not warranted. These three categories make up "total classified loans".

Additionally, loans may be listed as "other loans especially mentioned." Such loans must constitute undue or unwarranted credit risks, but not to a point justifying classification in the above categories. "Total criticized loans" consist of total classified loans plus other loans especially mentioned.

According to the Haskins and Sells Franklin report, as early as the 1964 examination, the examiners commented that classified and criticized loans were very high in relation to total loans and to Franklin's total capital. Table 5 shows the ratio of total criticized loans to gross capital as cited in the 1970-73 examination reports and examiner comments made.

In every examination report from 1969 on, the quality of the loan portfolio was cited as a "matter requiring attention," frequently as the most important problem. Each report also stated that Franklin's management was deeply concerned about asset quality.

Loan quality was discussed at the meetings with Franklin's board of directors after each examination. However, we found no evidence of the regional administrator's requesting a definitive commitment from the board of directors and executive management to institute appropriate corrective measures to its lending policies until directed to do so by the Comptroller of the Currency in February 1974.

## LIQUIDITY

Set forth below are the examiner's comments on Franklin's liquidity in the six regular examination reports. As you can see, the 1969 report said "very low liquidity." The 1970, 1971, and 1972 reports used the term "marginal" to describe liquidity. The 1973 report used the term "hazardous."

Despite the seriousness of these comments, and particularly the 1973 comment calling the bank's liquidity position "hazardous," only in the 1969 examination report was liquidity cited on page 2 as a "matter requiring attention." That report recommended management continue their efforts to improve liquidity and noted that liquidity improved by the close of the examination. The report did not specifically identify the efforts taken by management, but OCC files showed that in October 1969 Franklin sent the regional administrator a copy of a plan to improve liquidity through a loan restraint program.

In analyzing the 1969 report, the Assistant Chief National Bank Examiner in OCC/Washington commented that liquidity management was inadequate as evidenced by the sharp growth in loan accounts during a period when deposits were declining. It was his opinion that Franklin's liquidity position should be followed closely. According to the regional administrator, the bank submitted monthly liquidity reports.

Except, however, for the Assistant Chief National Bank Examiner's comments concerning the 1969 report, we found no indications that Franklin's marginal liquidity was the subject of discussions within the Comptroller's office until early 1974 when Regional Administrator Van Horn informed a Deputy Comptroller that virtually the entire investment portfolio was pledged and, therefore, it offered no liquidity protection. The Comptroller's handbook states that when an examiner determines a bank's liquidity position to be inadequate or marginal, he should also determine the bank's plans to achieve and maintain its liquidity at a level commensurate with accepted industry standards. The examiners found Franklin's liquidity to be "marginal" in 1970, 1971, and 1972; and "hazardous" in 1973. Nevertheless, we found no evidence that the examiners or OCC officials made the required determination of Franklin's plans to improve its liquidity.

## INVESTMENT SECURITIES

According to the Comptroller's handbook, a suitable investment account should be of a type quickly convertible into cash.

The six regular examination reports stated that Franklin's overall bond account was of good quality and diversification; however, the amount of bond depreciation as a percentage of adjusted capital funds was considered high or disproportionate. Maturities were considered long in most reports.

A measure of the quality of a bank's investment account is the ability of a bank's investment account to absorb the depreciation which would have to be taken on the investments should a bank have to liquidate its assets to meet other demands. Also, as a general rule, maturities should be reasonably spaced with a fair preponderance in short- and medium-term obligations.

Table 6 shows the estimated depreciation on Franklin's investment account and the percentage of investments with maturities over 5 years.

Evidence in the files indicate that bond depreciation was referred to in board of directors' meetings following the 1969, 1970, 1971, and March 1972 examinations. The length of maturities was discussed with the board after the 1970 and 1971 reports. However, there is no evidence that Franklin was urged to take action to reduce bond depreciation or shorten maturities. Likewise, there was no evidence that either depreciation or maturities received any special attention within the OCC.

#### MANAGEMENT

Mr. METZ. According to the Comptroller's handbook, the OCC must be provided with a clear evaluation of management. The name of the individual or individuals of primary importance in management, or who dominate policies to any extent, must be stated, and a concise estimate made of their ability.

In the five examinations during 1969-72, the examiners characterized the chief executive officer as basically a public relations man attempting to build a competent management team.

In the September 1969 examination report, OCC examiners rated Franklin's management as "Good." Most of the senior management team received favorable comments and the other officers were noted to be performing satisfactorily with a good young nucleus developing. The directors were reported to be kept well-informed and exercised reasonable and independent supervision.

OCC examiners rated Franklin's management only "Fair" in the 1970, 1971, and 1972 reports.

In the March 1972 report, the examiner began to criticize senior management. He noted that the head of the International Division was basically uninformed of the serious deficiencies in that area because of a breakdown in communications prompted by a lack of adequate supervision. The leadership in two other divisions were also criticized for lack of aggressiveness and not providing adequate management direction and control. Weaknesses in senior management were reported to be compounded by a serious lack of middle management personnel, especially in the lending area.

In the December 1972 report, the examiner rated the management as "Fair." But he commented on "considerable changes in senior management between examinations," including a new president and senior vice president of the International Department. He also commented that the new personnel "have not been with the bank long enough to demonstrate whether they can develop into a competent team and provide the management depth this bank so badly needs." He noted that Michele Sindona, a well-known Italian financier, had recently purchased 21.7 percent interest in the common stock of the Franklin New York Holding Co., the bank's parent corporation, and that management believed this action would lead to substantial growth in Franklin's international activities.

In the November 1973 report, OCC rated management as "Poor." The chief executive officer was still described as "basically public-relations oriented." The president of the bank and the head of one department were criticized for poor management. Additionally, the report stated:

The extent of turnover in both the senior and junior management groups in recent years has been staggering. Numerous inept lending officers were let go; however, the bank also lost several competent officers due to the turmoil of the senior management level. Morale in the entire organization is at an all time low and the bank lacks strength and experience at the middle management level. Top management continues to seek outside help, but, in view of the bank's reputation in the industry, is finding it exceedingly difficult locating suitable candidates. There are indications that management is over-reacting in various problem areas, and that the bank is being run by crisis. With the tempest and turmoil involved, this examiner has serious reservations whether or not the bank will ever develop a competent management team.

While the November examination was in process, the examiner-in-charge informed officials of the Federal Reserve Bank of New York that he believed the senior executive vice president was, in fact, the chief executive officer operating Franklin in accordance with Mr. Sindona's wishes and that the bank had serious management problems.

Although the examination reports identified major personnel changes which took place in the bank between 1969 and 1973, the significance of these changes was not explained. Therefore, OCC was not provided with a clear, concise evaluation of Franklin's management as required by the handbook.

#### EARNINGS

According to the Comptroller's handbook, satisfactory earnings and profits are not only necessary to, but indicative of a sound, well-managed bank. The ratings of Franklin's earnings went from "Good" in 1969, to "Fair" in 1970 and 1971, "Marginal" in March 1972, and "Poor" in December 1972 and 1973. Table 7 shows the net operating income of Franklin as discussed in each examination report.

Despite the declining ratings, Franklin's earnings were not cited on page 2 as a "matter requiring attention" in any of the examination reports. The evidence available to us indicates that earnings were discussed with the bank's board of directors only after the 1971 examination.

#### CAPITAL

According to the Comptroller's handbook, when an increase in a bank's capital is believed to be necessary, the examiner should so state in the confidential section of the report. The regional administrator will then initiate such action as deemed necessary. The examiner should not make specific recommendations as to the amount of new capital a bank should raise unless the matter has first been cleared with their regional administrator.

Franklin's capital position was rated "borderline" in the 1969 and "inadequate" in the 1970-73 examination reports. The file indicates that capital adequacy was nevertheless discussed at meetings with the bank's board after each examination from 1970 to 1973; and after the 1970 examination the file indicates that Mr. Van Horn "suggested that consideration be given, in due course, to an appropriate increase of capital funds." There is no indication, however, that Franklin was requested to increase its capital until the Comptroller of the Currency requested, in February 1974, a definite program for adjusting the imbalance between Franklin's capital and the size of its operations.

## INTERNATIONAL

In addition to its domestic activities, Franklin conducted an international banking business through its International Division located in New York City, branches in London and Nassau and representative offices in Singapore and Mexico City. Table 8 shows the growth in Franklin's foreign exchange transactions from 1969 through 1974.

Franklin's foreign exchange transactions volume grew from \$13.6 million in September 1969 to \$19.0 million in May 1971, and to \$3.7 billion in November 1973. In 1969, 1970, and 1971 examination reports, the examiner commented on this growth pattern and stated Franklin's need to develop a system which would provide adequate controls and reliable information to management.

OCC began its next examination on March 6, 1972, and found that the division's operations were in chaos and ". . . internal controls are virtually nonexistent." The examiner-in-charge reported the problems to the bank's chief executive officer and requested corrective action.

Meanwhile, because of the seriousness of these deficiencies, the regional administrator contacted the OCC Director of International Operations and requested that he meet with Franklin's officers to discuss these matters. OCC's Director of International Operations visited New York, reviewed the problems with the examiners and the bank's officials, and was assured that corrective actions were being initiated.

In letters dated May 15 and June 9, 1972, Franklin's executive vice president sent the OCC Director of International Operations evidence that actions were being taken by the bank to correct the problems noted in the March examination report.

In response to the June letter, the OCC Director replied that he was fully satisfied with the bank's foreign exchange operations as reported and that all segments of the operations appeared to be operating efficiently. We were informed by the director that OCC's examiners did not conduct an onsite verification that these actions were being taken, but relied on the newly established operating procedures and the bank's copies of documents implementing these procedures.

The December 11, 1972, examination report noted that the bank had substantially improved its international accounting procedures since the last examination; however, the head trader had been replaced twice and the department still had internal control deficiencies such as the absence of trading limits.

OCC completed the international portion of the November 1973 examination about the end of December. According to the report, foreign exchange trading had increased to \$3.8 billion resulting in a profit of about \$7.5 million. The examiner cautioned senior management on the risks of large open positions and gaps, the large volume of trading, and the rumors concerning other banks closing their lines with Franklin. He added that if "the currency markets had reacted contrary to the expected," Franklin's \$7.5 million profit could have ended up as a loss. The report rated the condition, management, and future prospects of the International Division as "good."

At the board meeting following the November 1973 examination, the directors were advised that the foreign exchange position was extremely heavy and that consideration should be given to establishing

guidelines for keeping the foreign exchange position within more reasonable bounds.

On Friday, May 3, 1974, the bank was advised by the London branch that the National Westminster Bank had objected to the volume of the bank's sterling clearings through its account. Senior officials of the bank conducted an investigation which resulted in a trader admitting that he had entered contracts which he had not recorded. On May 14, the OCC Director of International Operations called for a special examination of the foreign exchange activities as of May 10, 1974. The examination found that the total losses of the department due to the use of false exchange rates and unrecorded contracts were over \$43 million compared to the bank's earlier loss examination of \$609,000 for the same period. As a result, OCC made criminal referrals to the U.S. Attorney General with the result that several of the bank's officials were convicted of conspiracy and fraud.

Though the OCC's supervision of Franklin's international activities was more stringent than its oversight of the bank's domestic operations, as we indicated at the outset of our testimony, there are at least two notable exceptions.

First, on February 1, 1973, an OCC Deputy Comptroller asked the New York regional office to determine if the bank was engaging in some apparent "window dressing." The OCC Director of International Operations advised the Deputy Comptroller that, according to the international examiner in New York, there had been a \$50 million "window dressing" transaction between Franklin and the Banco De Roma. The examiner had further stated that when he had completed the international portion of the examination, he would state his views on this window-dressing transaction on page 2 of the report. The director stated that he would fully support the examiner's criticism.

The December 1972 report did not contain any reference to the window-dressing transaction. The examiner-in-charge stated that the regional administrator and the international examiner discussed the problem and decided not to include it in the report. The regional administrator informed us that he did not recall any such meeting and stated that if he did instruct the examiner to delete it from his report, he would not have done so without first discussing it with the Deputy Comptroller. We were unable to determine precisely why the window-dressing transaction was not included in the report.

The second instance occurred on June 13, 1973, when the New York regional administrator sent the same international examiner into the bank to conduct a 1-day check of its foreign exchange operation. In a letter to the regional administrator, the examiner noted that all position limits had been canceled and, although the volume of foreign exchange transactions and positions had increased, the bank had not taken any undue risk in its foreign exchange trading. He stated that all internal control procedures seem to be well observed and a new internal auditor had been put into the department to oversee its activities.

Apparently the examiner did not verify the exchange rates in his review of the international department's profit and loss statements. If he had, we believe he would have discovered that Franklin officials were misrepresenting the profitability of their foreign exchange operations. Actual foreign exchange losses amounting to \$43 million were

discovered during the May 10, 1974, special examination mentioned earlier.

#### OPERATING PROCEDURES AND GUIDELINES

Our review shows that OCC documents do not clearly identify the responsibilities and authority of examiners, regional administrators, and Washington officials to require a bank to take corrective actions on problems identified in the examination reports. As a result, there exists within OCC a difference of opinion as to who has the responsibility and authority to require a bank to take corrective actions to problems identified during examinations.

We were informed by the examiners-in-charge of the 1969-74 Franklin examinations that they do not believe they have the authority or responsibility to require a bank to take corrective actions. The examiners view their responsibility as verifying the accuracy of a bank's records, evaluating the adequacy of management, and reporting their findings to the regional office. According to the examiners, the regional administrator and OCC/Washington have responsibility for enforcement actions.

The duties of the regional administrator are set forth in various documents, such as the OCC's directory, examining circulars, and other office memoranda. However, the regional administrator stated that these documents are not sufficiently clear in identifying his enforcement authority and responsibility.

At OCC/Washington, the former First Deputy Comptroller told us that he believed both the examiner and the regional administrator, as duly authorized representatives of the Comptroller, had the authority and responsibility to require Franklin to take those actions which were finally taken by the Comptroller in February 1974; that is, Franklin was required to submit a statement of the names of the bank's officers and their responsibilities; a plan to reduce all forms of borrowing; a clearly defined loan policy; the bank's future program in foreign exchange; and a plan to improve the bank's capital.

In a subsequent discussion with the Regional Administrator Charles Van Horn, he advised us that he or the examiner could have requested Franklin's officials to submit the same written plans requested by the Comptroller.

#### HASKINS AND SELLS REPORT

In May 1974, the Comptroller and Haskins and Sells entered into a contract calling for a study of all functions and related activities of the OCC.

The Haskins and Sells report issued May 30, 1975, recommended the development of a written statement of policies and decision guidelines to insure a greater delegation of decisionmaking authority within the OCC. These guidelines ". . . should clearly describe the authorities and responsibility assigned to each of the managerial persons employed within the OCC. They should describe the nature of the information to be compiled under the supervision of the person assigned to each function, the extent to which the information compiled should be verified or reconciled with other data, and the person or persons to whom the information should be sent. The guidelines should also define the conditions under which decisions could be made at various levels of authority."

We were advised that OCC has begun preparing job position descriptions for its employees, apparently in an effort to implement the recommendation.

That concludes our statement, Mr. Chairman.

Mr. ROSENTHAL. Thank you very much. I want to commend both of you for a first-rate and very thorough review.

We shall forgo questions at this time because the statement shall be included in the record. But we shall hold you available for further discussion subsequent to the testimony of the Comptroller.

We thank you both very much.

[Messrs. Hopper's and Metz' prepared statement follows:]

PREPARED STATEMENT OF HENRY L. HOPPLER AND C. THOMAS METZ,  
SUBCOMMITTEE STAFF INVESTIGATORS, ON DETAIL FROM THE GENERAL  
ACCOUNTING OFFICE

Mr. Chairman and Members of the Subcommittee:

For the past 4 months, we have been working as staff investigators for the Commerce, Consumer and Monetary Affairs Subcommittee to assist in its oversight investigation of the Office of the Comptroller of the Currency. Our efforts combined with those of the subcommittee's regular staff have been directed toward determining the adequacy and effectiveness of the Comptroller's examination and supervision of Franklin National Bank, the subject of today's hearing. Our review focused on the years 1969-1974. The Comptroller of the Currency from 1969 to July 1973, was Mr. William Camp, now deceased. The present Comptroller James Smith took office in July 1973. The New York regional administrator since 1969 has been Mr. Charles Van Horn.

Our evaluation of the Office of the Comptroller of the Currency's (OCC) examination and supervision of Franklin National Bank is based on (1) an analysis of Franklin National Bank's examination reports and related files in the Washington headquarters and New York regional office of the OCC; (2) a review of OCC operating manuals, examination procedures and documents; (3) discussions with OCC officials in Washington and New York; (4) a review of an October 1974 draft report on Franklin by Haskins and Sells, a well-known management consulting firm; and (5) a review of the May 30, 1975, report on the operations of the Office of the Comptroller by Haskins and Sells. We did not examine the accounting records of Franklin and, therefore, are unable to comment on the accuracy of the financial data included in the examination reports.

Franklin National Bank was declared insolvent by the Comptroller of the Currency on October 8, 1974. However, as our testimony will indicate, Franklin had serious problems which were identified in its examination reports as early as 1969, and may have been insolvent as early as May 1974.

National bank examinations are designed to determine the condition and performance of banks, the quality of their operations, the capacity of their management and the degree of compliance with Federal laws. Without such an audit and review process, an adequate system of national bank supervision and Federal law enforcement would be impossible.

Mr. Chairman, our 3-month review in behalf of the subcommittee of the Comptroller's examination and supervisory processes as they were applied to Franklin National Bank leads us to the following conclusions:

- (1) OCC enforcement and compliance documents do not clearly establish the division of responsibility and authority, among examiners, regional administrators and Washington officials, to require a bank to take corrective actions on problems identified during examinations. As a consequence, there exists among the OCC staff a difference of opinion as to who has the responsibility and authority to require such corrective action.
- (2) The management and portfolio problems that plagued Franklin since the late 1960's and led to its eventual failure in 1974, were amply documented by national bank examiners over a 5-year period. We found that the OCC failed to utilize fully its supervisory options to correct the problems identified by examiners. For example:
  - Though OCC representatives frequently discussed examiner findings with senior bank officials and received numerous promises that corrective actions would be taken, subsequent examinations did not indicate substantive improvements.
  - Despite constant critical examination reports, the OCC allowed Franklin to open 17 branches in New York and one branch in London between 1969-1973. Denial of these branches could have been used effectively to discipline Franklin.
  - It was not until February 1974, only 3 months before the beginning of massive Federal Reserve support, that the OCC took aggressive supervisory actions to force Franklin to correct problems which had been repeatedly identified by examiners since 1969.
- (3) Though examiners generally identified Franklin's problems, we found two notable exceptions:
  - First, in February 1973, OCC examiners failed to include in their report a \$50-million instance of balance sheet "window dressing" which resulted in an overstatement of the bank's resources.
  - Second, in June 1973, during a 1-day "check" of the bank's foreign exchange profit and loss statements, the OCC examiner apparently did not verify the foreign exchange rates used in preparing these schedules. We believe that, had he verified these rates, the OCC would have become aware in June 1973 of Franklin's misrepresentations of foreign exchange profits rather than almost a year later in May 1974.

- (4) Though examiners generally identified Franklin's problems, the critical comments found scattered throughout the examination reports frequently did not get recorded on page 2 of the report, "Comments on Matters Requiring Attention." Page 2 is important because it is on that page that examiners are supposed to itemize areas of concern. Non-inclusion may suggest to bank officers and directors that a problem is not important. For example, in the 1970, 1971, 1972 and 1973 reports, capital was regarded as inadequate and criticized. However, capital was not itemized on page 2 until 1973.

EXAMINATIONSFrequency

12. U.S.C. 481 requires the Comptroller of the Currency to examine every national bank twice in each calendar year. The Comptroller, at his discretion, however, may waive one examination or examine a bank more frequently, if necessary. The waiver of one examination cannot be exercised more frequently than once during any two calendar year period.

During the 1969-1974 period, nine reports of examinations were prepared on Franklin. Six of the nine reports were "regular" and three were "special visitations." Regular examinations were made as of September 29, 1969, August 31, 1970, May 17, 1971, March 6, 1972, December 11, 1972 and November 14, 1973. Special visitations were made as of May 10, May 14 and August 14, 1974. The first of these visitations related to foreign exchange activities and the second two were to obtain current evaluations of loan portfolio and investment account quality.

While the examinations took from 1 week to almost 4 months to complete, the bank's financial data are verified as of the commencement date of the examination. Table 1 shows the starting and closing dates and man-days used on each examination.

On three other occasions, February 1973, June 1973 and February 1974, the regional administrator sent examiners into the bank to obtain data on certain aspects of Franklin's international operations.

Ratings

Examination reports contain comments by the examiner concerning the following categories: (1) Condition of Bank; (2) Management; (3) Earnings; (4) Capital; (5) Internal Controls and Audit Procedures; and (6) Future Prospects. The comments include a descriptive work rating (Excellent, Good, Fair, Poor, etc.) for each category. Table 2 presents the rating in each of these categories.

The descriptive word ratings reveal that Franklin's overall condition was only Fair and its capital was Borderline in 1969. By 1972 its condition was Unsatisfactory, its management only Fair, its earnings Poor, and its capital Inadequate.

At the completion of each regular examination, Franklin was further rated in three categories: (1) Capital Position, (2) Quality of Assets and (3) Management. A Composite or Group rating of Franklin was also made. Capital position is rated from 1 to 4 (1 being adequate) based on such factors as management, liquidity, earnings, etc. Quality of assets is rated from A to D

(A being good) based on the ratio of classified and speculative assets to gross capital. Management is rated S (strong or competent) F (fair), or P (Poor, incompetent or integrity questioned). The Composite or Group rating is from 1 to 4 (1 being a sound institution) based on consideration of all ratings.

Ratings were made by the regional administrator, although in 1972 the composite rating was revised downward in OCC/Washington. Table 3 shows Franklin's ratings at each regular examination.

Franklin's Composite rating declined from 2 to 3 in 1970, and remained a 3 through early 1974. OCC procedures provide that banks having a Composite rating of 3 or 4 require special attention. OCC Deputy Comptroller John Gwin, who was responsible for the New York region, informed Comptroller William Camp in March 1971 that Franklin was in need of close supervision. The New York Regional Administrator at that time was Mr. Charles Van Horn.

#### ENFORCEMENT FOLLOW-UP

##### Supervisory Options

In testimony before this subcommittee on January 20, 1976, the Deputy Comptroller of the Currency, Robert Bloom, identified supervisory methods available to the OCC for correcting deficiencies in banks identified as requiring special supervisory attention. He stated that special supervision begins with the examiner's comments on matters requiring attention in the examination report. Next, the regional administrator can request a bank's board of directors and executive management to institute corrective measures, request monthly progress reports and conduct frequent visitations and examinations. OCC/Washington personnel can be involved in any of these aspects. Additionally, OCC can withhold approval on applications for various corporate changes, such as opening a new branch or approving investments in banking premises. Other actions include initiation of cease and desist proceedings, certification to the Federal Reserve for removal of a bank official or criminal referral to the Department of Justice. Though Mr. Bloom failed to enumerate it, the OCC also had the authority to publish all or part of Franklin's examination reports.

The OCC did not fully utilize its options, and what actions it did take clearly were not adequate for the purpose of getting Franklin to work out its problems.

Examiner Comments

The examiner's conclusions regarding aspects of a bank's affairs that should be brought to the attention of the Comptroller and the bank's directors are found on page 2 of the examination report. Our review of these comments reveals several important instances in which strong examiner criticisms found elsewhere in the Franklin examination reports were not included on page 2. This is a problem because non-inclusion may suggest to bank officers and directors that a problem is not important.

Nevertheless, even the problems cited on page 2 were not always effectively dealt with by Franklin's management. Succeeding examination reports evidenced no significant improvement in some of the problems cited on page 2 during 1969-1973.

Corrective Measures

After each examination report was completed, the OCC regional administrator and the examiner-in-charge met with Franklin's board of directors to discuss the condition of the bank. The regional administrator, Mr. Charles Van Horn, told us in a recent interview that requests to the board to take corrective actions should have been made at these meetings and that these requests should be reflected in OCC memoranda of these meetings.

These memoranda indicate that only after the 1970 examination was a request made for corrective action. This request was simply "to keep us [OCC/New York] currently informed with respect to alleviating criticisms."

Examinations and Visitations

Despite the steadily deteriorating condition of Franklin from 1969 through 1973, the frequency of examinations was not increased. Even the three examinations every two calendar years, required by law, were not conducted from 1969 through 1971.

Special 1-day visitations were made in February 1973, June 1973 and February 1974 to review Franklin's foreign exchange operations.

Application Approvals

Applications for new branch offices of a national bank require approval by the Comptroller. In practice, when an application is considered, it is circulated to examiners in the region, regional administrators, Director of the Bank Organization Division and Deputy Comptroller for recommendations and comments. Comments are also requested from the State banking department. In the Franklin case, all reports by these individuals were reviewed and provided the basis for the final decision by the Comptroller. Table 4 shows the domestic branches approved (and opened) and disapproved through December 31, 1973.

From 1969 to year end 1973, Franklin received approval from the Comptroller and opened 17 new branches. Eleven of the branches were approved at a time when the condition of the bank was rated as only Fair and its capital as Borderline. One branch was approved despite a condition rating of Unsatisfactory and a capital rating of Inadequate.

Similarly, despite critical examination findings, OCC/Washington did not object in February 1971, to the Federal Reserve's Board of Governors' approval of Franklin's London branch application.

In order to perform full banking services in England, a bank must be formally recognized by the Bank of England. In October 1972, the Bank of England wrote the OCC asking if there were any problems with Franklin that would prevent recognition; "...our basic principle is that we only recognize in London those banks which are in good standing in their own markets, with their competitors and with their authorities." The OCC Director of International Operations Robert Mullin recommended the Bank of England recognize Franklin's London branch.

#### Other Enforcement Options

We found no evidence that the OCC threatened to initiate cease and desist proceedings or publish portions of Franklin's examination reports, sought to remove an officer or director of Franklin, or attempted to make a criminal referral to the Justice Department before May 1974.

In short, the OCC failed to utilize fully its available enforcement powers to correct deficiencies in the Franklin bank.

### EXAMINATION REPORT FINDINGS

#### Solvency

According to the Comptroller's Handbook of Examination Procedures, the examiner is responsible for determining if a bank is solvent, both in having collectable assets sufficient to pay depositors and other creditors and in its ability to meet maturing and usual demands. The examination report includes a question as to whether a bank is solvent in both respects.

In 1969 to 1972 the examiner answered "yes" to this question. In the November 1973 report, he referred to the narrative comments on the condition of the bank, which stated "...The bank has not been able to meet the day-to-day requirements placed upon it in the ordinary conduct of its business and simultaneously sustain its overly ambitious growth program without the heavy and continuous use of borrowings, particularly in the Federal funds market."

The May 1974 visitation report stated: "Bank condition remains hazardous and bank is only able to meet its day-to-day requirements through the assistance of the Federal Reserve Bank."

In October 1974 the Comptroller of the Currency declared Franklin to be insolvent. The affidavit cited certain statistical data to show that Franklin's equity capital would be reduced from \$175 million to \$19 million because of losses, doubtful assets and securities depreciation. According to the affidavit, the remaining equity capital would undoubtedly be eliminated by the discount factor involved in the sale of sufficient loans to pay off Franklin's obligation to the Federal Reserve Bank of New York.

The affidavit further stated that the Comptroller is not required to wait until the losses he finds in a bank's assets are actually charged against the bank's book equity capital. The Comptroller's duty is to determine when a bank has reached the point that it will not be able to meet obligations to its depositors in the near future. According to the affidavit, Franklin would have reached that point many months before without the aid of the Federal Reserve Bank of New York.

Thus, while Franklin did not actually become insolvent, its solvency was due only to Federal Reserve Bank funds borrowed on a daily basis from May 10 to October 8, 1974.

#### Condition of the Bank

According to the Comptroller's Handbook, the major factor used in determining the rating of a bank's condition is the amount of low quality, questionable, and unsound assets owned by a bank in relationship to the reasonable loss eliminating capacity afforded by its capital structure. If the amount of such assets is excessive in relationship to the capital structure's reasonable loss eliminating capacity, the bank's condition is poor regardless of any other factors. Franklin's condition was rated "Fair" in 1969, "Poor" in 1970, "Fair" in 1971 and March 1972, "Unsatisfactory" in December 1972 and "Extremely Poor" in 1973.

#### Quality of Loans

The main factor critically commented on in Franklin's examination reports was the quality of its loan portfolio and the resulting impact on liquidity. Loans are assigned a classification based on the examiner's best judgment concerning the degree of risk and the likelihood of orderly liquidation. Loans can be classified "substandard", "doubtful", or "loss". Substandard loans must have a positive and well-defined weakness that jeopardizes the liquidation of the debt. A doubtful loan has all of the weaknesses inherent in an asset classified

substandard and its collection or liquidation in full is highly questionable. Loans classified "loss" are considered uncollectable and of such little value that their continuance as active assets of the bank is not warranted. These three categories make up "total classified loans."

Additionally, loans may be listed as "other loans especially mentioned." Such loans must constitute undue or unwarranted credit risks, but not to a point justifying classification in the above categories. "Total criticized loans" consist of total classified loans plus other loans especially mentioned.

According to the Haskins and Sells Franklin report, as early as the 1964 examination the examiners commented that classified and criticized loans were very high in relation to total loans and to Franklin's total capital. Table 5 shows the ratio of total criticized loans to gross capital as cited in the 1970-1973 examination reports and comments made.

In every examination report from 1969 on, the quality of the loan portfolio was cited as a "matter requiring attention," frequently as the most important problem. Each report also stated that Franklin's management was deeply concerned about asset quality.

Loan quality was discussed at the meetings with Franklin's board of directors after each examination. However, we found no evidence of the regional administrator requesting a definitive commitment from the board of directors and executive management to institute appropriate corrective measures to its lending policies until directed to do so by the Comptroller of the Currency in February 1974.

#### Liquidity

Set forth below are the examiner's comments on Franklin's liquidity in the six regular examination reports.

<u>Examination</u>	<u>Comments</u>
9/29/69	"...very low liquidity. This is the main area of concern at this examination."
8/31/70	"...marginal due to the heavy volume of problem loans."
5/17/71	"...marginal due to the heavy volume of problem loans currently reflected."
3/6/72	"...marginal due to the heavy volume of problem loans currently reflected."
12/11/72	"...marginal due to the heavily loaned position, volume of problem credits, unused commitments and the need for consistent large borrowings."
11/14/73	"Bank's liquidity position is considered hazardous by the examiner..."

Despite the seriousness of these comments, and particularly the 1973 comment calling the bank's liquidity position "hazardous," only in the 1969 examination report was liquidity cited on page 2 as a "matter requiring attention." That report recommended management continue their efforts to improve liquidity and noted that liquidity improved by the close of the examination. The report did not specifically identify the efforts taken by management, but OCC files showed that in October 1969 Franklin sent the regional administrator a copy of a plan to improve liquidity through a loan restraint program.

In analyzing the 1969 report, the Assistant Chief National Bank Examiner commented that liquidity management was inadequate as evidenced by the sharp growth in loan accounts during a period when deposits were declining. It was his opinion that Franklin's liquidity position should be followed closely. According to the regional administrator, the bank submitted monthly liquidity reports.

Except for the Assistant Chief National Bank Examiner's comments concerning the 1969 report, we found no indications that Franklin's marginal liquidity was the subject of discussions within the Comptroller's office until early 1974, when Regional Administrator Van Horn informed a Deputy Comptroller that virtually the entire investment portfolio was pledged and, therefore, it offered no liquidity protection. The Comptroller's Handbook states that, when an examiner determines a bank's liquidity position to be inadequate or marginal, he should also determine the bank's plans to achieve and maintain its liquidity at a level commensurate with accepted industry standards. The examiners found Franklin's liquidity to be "marginal" in 1970, 1971 and 1972 and "hazardous" in 1973. Nevertheless, we found no evidence that the examiners or OCC officials made the required determination of Franklin's plans to improve its liquidity.

#### Investment Securities

According to the Comptroller's Handbook, a suitable investment account should be of a type quickly convertible into cash.

The six regular examination reports stated that Franklin's overall bond account was of good quality and diversification; however, the amount of bond depreciation as a percentage of adjusted capital funds was considered high or disproportionate. Maturities were considered long in most reports.

A measure of the quality of a bank's investment account is the ability of the bank to absorb the depreciation which would have to be taken on the investments should a bank have to liquidate its assets to meet other demands. Also,

as a general rule, maturities should be reasonably spaced with a fair preponderance in short- and medium-term obligations.

Table 6 shows the estimated depreciation on Franklin's investment account and the percent of investments with maturities over 5 years.

Evidence in the files indicate that bond depreciation was referred to in board of directors' meetings following the 1969, 1970, 1971 and March 1972 examinations. The length of maturities was discussed with the board after the 1970 and 1971 reports. However, there is no evidence that Franklin was urged to take action to reduce bond depreciation or shorten maturities. Likewise, there was no evidence that either depreciation or maturities received any special attention within the OCC.

#### Management

According to the Comptroller's Handbook, the OCC must be provided with a clear evaluation of management. The name of the individual or individuals of primary importance in management, or who dominate policies to any extent, must be stated, and a concise estimate made of their ability.

In the five examinations during 1969-1972, the examiners characterized the chief executive officer as basically a public relations man attempting to build a competent management team.

In the September 1969 examination report, OCC examiners rated Franklin's management as "Good." Most of the senior management team received favorable comments and the other officers were noted to be performing satisfactorily with a good young nucleus developing. The directors were reported to be kept well-informed and exercised reasonable and independent supervision.

OCC examiners rated Franklin's management only "Fair" in the 1970, 1971, and 1972 reports.

In the March 1972 report, the examiner began to criticize senior management. He noted that the head of the International Division was basically uninformed of the serious deficiencies in that area because of a breakdown in communications prompted by a lack of adequate supervision. The leadership in two other divisions were also criticized for lack of aggressiveness and not providing adequate management direction and control. Weaknesses in senior management were reported to be compounded by a serious lack of middle management personnel, especially in the lending area.

In the December 1972 report, the examiner rated the management as "Fair." But he commented on "considerable changes in senior management between examinations", including a new president and senior vice president of the International Department.

He also commented that the new personnel "have not been with the bank long enough to demonstrate whether they can develop into a competent team and provide the management depth this bank so badly needs." He noted that Michele Sindona, a well-known Italian financier, had recently purchased 21.7 percent interest in the common stock of the Franklin New York Holding Company (the bank's parent corporation), and that management believed this action would lead to substantial growth in Franklin's international activities.

In the November 1973 report, OCC rated management as "Poor." The chief executive officer was still described as "basically public-relations oriented." The president of the bank and the head of one department were criticized for poor management. Additionally, the report stated:

"The extent of turnover in both the senior and junior management groups in recent years has been staggering. Numerous inept lending officers were let go; however, the bank also lost several competent officers due to the turmoil on the senior management level. Morale in the entire organization is at an all time low and the bank lacks strength and experience at the middle management level. Top management continues to seek outside help, but, in view of the bank's reputation in the industry, is finding it exceedingly difficult locating suitable candidates. There are indications that management is over-reacting in various problem areas, and that the bank is being run by crisis. With the tempest and turmoil involved, this examiner has serious reservations whether or not the bank will ever develop a competent management team."

While the November examination was in process, the examiner-in-charge informed officials of the Federal Reserve Bank of New York that he believed the senior executive vice president was, in fact, the chief executive officer, operating Franklin in accordance with Mr. Sindona's wishes and that the bank had serious management problems.

Although the examination reports identified major personnel changes which took place in the bank between 1969-1973, the significance of these changes was not explained. Therefore OCC was not provided with a clear, concise evaluation of Franklin's management as required by the Handbook.

#### Earnings

According to the Comptroller's Handbook, satisfactory earnings and profits are not only necessary to, but indicative of, a sound, well-managed bank. The ratings of Franklin's earnings went from "Good" in 1969, to "Fair" in 1970 and 1971, "Marginal" in March 1972 and "Poor" in December 1972 and 1973. Table 7 shows the net operating income of Franklin as discussed in each examination report.

Despite the declining ratings, Franklin's earnings were not cited on page 2 as a "matter requiring attention" in any of the examination reports. The evidence available to us indicates that earnings were discussed with the bank's board of directors only after the 1971 examination.

#### Capital

According to the Comptroller's Handbook, when an increase in a bank's capital is believed to be necessary, the examiner should so state in the confidential section of the report. The regional administrator will then initiate such action as deemed necessary. The examiner should not make specific recommendations as to the amount of new capital a bank should raise unless the matter has first been cleared with their regional administrator.

Franklin's capital position was rated "borderline" in the 1969 and "inadequate" in the 1970-1973 examination reports. No examiner, however, specifically stated an increase in capital was necessary.

Franklin's capital position was not cited on page 2 as a "matter requiring attention" until the 1973 examination report. The file indicates that capital adequacy was nevertheless discussed at meetings with the bank's board after each examination from 1970 to 1973; and after the 1970 examination the file indicates that Van Horn "suggested that consideration be given, in due course, to an appropriate increase of the capital funds." There is no indication, however, that Franklin was requested to increase its capital until the Comptroller of the Currency requested, in February 1974, a definite program for adjusting the imbalance between Franklin's capital and the size of its operations.

#### International

In addition to its domestic activities, Franklin conducted an international banking business through its International Division located in New York City, branches in London and Nassau and representative offices in Singapore and Mexico City. Table 8 shows the growth in Franklin's foreign exchange transactions from 1969 through 1974.

Franklin's foreign exchange transactions volume grew from \$13.6 million in September 1969, to \$19.0 million in May 1971, and to \$3.7 billion in November 1973. In 1969, 1970 and 1971 examination reports, the examiner commented on this growth pattern and stated Franklin's need to develop a system which would provide adequate controls and reliable information to management.

OCC began its next examination on March 6, 1972, and found that the division's operations were in chaos and "...internal controls are virtually non-existent."

The examiner-in-charge reported the problems to the bank's chief executive officer and requested corrective action.

Meanwhile, because of the seriousness of these deficiencies, the regional administrator contacted the OCC Director of International Operations and requested that he meet with Franklin's officers to discuss these matters. OCC's Director of International Operations visited New York, reviewed the problems with the examiners and the bank's officials and was assured that corrective actions were being initiated.

In letters dated May 15 and June 9, 1972, Franklin's executive vice president sent the OCC Director of International Operations evidence that actions were being taken by the bank to correct the problems noted in the March examination report.

In response to the June letter, the OCC Director replied that he was fully satisfied with the bank's foreign exchange operations as reported and that all segments of the operations appeared to be operating efficiently. We were informed by the director that OCC's examiners did not conduct an on-site verification that these actions were being taken, but relied on the newly established operating procedures and the bank's copies of documents implementing these procedures.

The December 11, 1972, examination report noted that the bank had substantially improved its international accounting procedures since the last examination; however, the head trader had been replaced twice and the department still had internal control deficiencies such as the absence of trading limits.

OCC completed the international portion of the November 1973 examination about the end of December. According to the report, foreign exchange trading had increased to \$3.8 billion resulting in a profit of about \$7.5 million. The examiner cautioned senior management on the risks of large open positions and gaps, the large volume of trading and the rumors concerning other banks closing their lines with Franklin. He added that if "the currency markets had reacted contrary to the expected," Franklin's \$7.5 million profit could have ended up as a loss. The report rated the condition, management and future prospects of the International Division as "Good."

At the board meeting following the November 1973 examination, the directors were advised that the foreign exchange position was extremely heavy and that consideration should be given to establishing guidelines for keeping the foreign exchange position within more reasonable bounds.

On Friday, May 3, 1974, the bank was advised by the London Branch that the National Westminster Bank had objected to the volume of the bank's sterling clearings through its account. Senior officials of the bank conducted an investigation which resulted in a trader admitting that he had entered contracts which he had not recorded. On May 14 the OCC Director of International Operations called for a special examination of the foreign exchange activities as of May 10, 1974. The examination found that the total losses of the department due to the use of false exchange rates and unrecorded contracts were over \$43 million compared to the bank's earlier loss estimation of \$609,000 for the same period. As a result, OCC made criminal referrals to the U.S. Attorney General with the result that several of the bank's officials were convicted of conspiracy and fraud.

Though the OCC's supervision of Franklin's international activities was more stringent than its oversight of the bank's domestic operations, as we indicated at the outset of our testimony, there are at least two notable exceptions.

First, on February 1, 1973, an OCC Deputy Comptroller asked the New York regional office to determine if the bank was engaging in some apparent "window dressing." The OCC Director of International Operations advised the Deputy Comptroller that, according to the international examiner in New York, there had been a \$50-million "window dressing" transaction between Franklin and the Banco De Roma (\$50 million due to and due from Banco De Roma, all in U.S. dollars, and all with same maturity dates and rates of interest). The examiner had further stated that when he had completed the international portion of the examination (December 11, 1972), he would state his views on this window-dressing transaction on page 2 of the report. The director stated that he would fully support the examiner's criticism.

The December 1972 report did not contain any reference to the window-dressing transaction. The examiner-in-charge stated that the regional administrator and the international examiner discussed the problem and decided not to include it in the report. The regional administrator informed us that he did not recall any such meeting and stated that if he did instruct the examiner to delete it from his report, he would not have done so without first discussing it with the Deputy Comptroller. We were unable to determine precisely why the window-dressing transaction was not included in the report.

The second instance occurred on June 13, 1973, when the New York regional administrator sent the same international examiner into the bank to conduct

a 1-day check of its foreign exchange operation. In a letter to the regional administrator, the examiner noted that all position limits had been cancelled and, although the volume of foreign exchange transactions and positions had increased, the bank had not taken any undue risk in its foreign exchange trading. He stated that all internal control procedures seem to be well-observed and a new internal auditor had been put into the department to oversee its activities.

Apparently the examiner did not verify the exchange rates in his review of the international department's profit and loss statements. If he had, we believe he would have discovered that Franklin officials were misrepresenting the profitability of their foreign exchange operations. Actual foreign exchange losses amounting to \$43 million were discovered during the May 10, 1974, special examination mentioned earlier.

#### OPERATING PROCEDURES AND GUIDELINES

Our review shows that OCC documents do not clearly identify the responsibilities and authority of examiners, regional administrators and Washington officials to require a bank to take corrective actions on problems identified in the examination reports. As a result, there exists within OCC a difference of opinion as to who has the responsibility and authority to require a bank to take corrective action to problems identified during examinations.

We were informed by the examiners-in-charge of the 1969-1974 Franklin examinations that they do not believe they have the authority or responsibility to require a bank to take correction actions. The examiners view their responsibility as verifying the accuracy of a bank's records, evaluating the adequacy of management and reporting their findings to the regional office. According to the examiners, the regional administrator and OCC/Washington have responsibility for enforcement actions.

The duties of the regional administrator are set forth in various documents, such as the OCC's Directory, examining circulars and other office memoranda. However, the regional administrator stated that these documents are not sufficiently clear in identifying his enforcement authority and responsibility.

At OCC/Washington, the former First Deputy Comptroller told us that he believed both the examiner and the regional administrator, as duly authorized representatives of the Comptroller, had the authority and responsibility to require Franklin to take those actions which were finally taken by the Comptroller

in February 1974; that is, Franklin was required to submit (1) a statement of the names of the bank's officers and their responsibilities; (2) a plan to reduce all forms of borrowing; (3) a clearly defined loan policy; (4) the bank's future program in foreign exchange; and (5) plan to improve the bank's capital.

In a subsequent discussion with the Regional Administrator, Charles Van Horn, he advised us that he or the examiner could have requested Franklin's officials to submit the same written plans requested by the Comptroller.

Haskins and Sells Report

In May 1974, the Comptroller and Haskins and Sells entered into a contract calling for a study of all functions and related activities of the OCC.

The Haskins and Sells report issued May 30, 1975, recommended the development of a written statement of policies and decision guidelines to ensure a greater delegation of decision-making authority within the OCC. These guidelines

"...should clearly describe the authorities and responsibility assigned to each of the managerial persons employed within the OCC. They should describe the nature of the information to be compiled under the supervision of the person assigned to each function, the extent to which the information compiled should be verified or reconciled with other data, and the person or persons to whom the information should be sent. The guidelines should also define the conditions under which decisions could be made at various levels of authority."

We were advised that OCC has begun preparing job position descriptions for its employees, apparently in an effort to implement the recommendation.

TABLE 1  
EXAMINATION DATA

<u>COMMENCED</u>	<u>TYPE</u>	<u>CLOSED</u>	<u>MAN-DAYS</u>
9/29/69	Regular	12/24/69	2,175
8/31/70	Regular	12/24/70	2,594
5/17/71	Regular	8/6/71	1,749
3/6/72	Regular	5/23/72	1,603
12/11/72	Regular	3/2/73	1,454
11/14/73	Regular	3/8/74	1,486
5/13/74	Special	5/21/74	--
5/14/74	Special	5/20/74	--
8/14/74	Special	8/27/74	--

TABLE 2  
EXAMINATION DESCRIPTIVE WORD RATINGS

	<u>9/29/69</u>	<u>8/31/70</u>	<u>5/17/71</u>	<u>3/6/72</u>	<u>12/11/72</u>	<u>11/14/73</u>	<u>11/14/73</u> <u>International</u> <u>Department</u>
Condition of the Bank	Fair	Poor	Fair	Fair	Unsatis.	Extremely Poor	Good
Management	Good	Fair	Fair	Fair	Fair	Poor	Good
Earnings	Good	Fair	Fair	Marginal	Poor	Poor	--
Capital	Border-line	Inade-quate	Inade-quate	Inade-quate	Inade-quate	Inade-quate	--
Internal Controls	Adequate	Adequate	Adequate	Weak	Generally Adequate	Adequate	--
Future Prospects	Good	Good	Good	Fair	Good	Fair	Good

TABLE 3

CATEGORY AND COMPOSITE RATINGS  
OF  
FRANKLIN NATIONAL BANK

<u>Date of Examination</u>	<u>Capital Position</u>	<u>Quality of Assets</u>	<u>Management</u>	<u>Composite Rating</u>
9/29/69	2	B	F	2
8/31/70	2	C	F	3
5/17/71	2	C	F	3
3/6/72	2	C	F	3 <sup>a</sup>
12/11/72	2	C	F	3 <sup>a</sup>
11/14/73	2	D	F	3

<sup>a</sup>Rating revised from 2 to 3.

TABLE 4  
FRANKLIN NATIONAL BANK  
LIST OF BRANCHES OPENED OR DISAPPROVED  
JANUARY 1, 1970 to DECEMBER 31, 1973

DATE BRANCH APPROVED OR DISAPPROVED	RATING OF BANK AT DATE OF LAST COMPLETED EXAMINATION		RECOMMENDATION FOR APPROVAL BY <sup>1</sup>			
	CONDITION	CAPITAL	REGIONAL EXAMINER	REGIONAL ADMINISTRATOR	DIRECTOR BANK ORGANIZATION DIVISION	DEPUTY COMPTROLLER OF CURRENCY
9-14-64	Fair	Adequate	F	F	F	F
5-24-67	Fair	Inadequate	U	U <sup>2</sup>	F	F
1-30-68	Fair	Inadequate	F	F	F	F
5-27-68	Fair	Inadequate	F	F	U	F
2-4-69	Fair	Strengthened	F	F	F	F
4-7-69	Fair	Strengthened	F	F	F	F
5-5-69	Fair	Strengthened	F	F	F	F
7-10-69	Fair	Strengthened	F	F	F	F
11-5-69	Fair	Strengthened	F	F	F	F
1-13-70	Fair	Borderline	F	F	F	F
1-22-70	Fair	Borderline	F	F	F	F
2-16-70	Fair	Borderline	F	F	F	F
2-18-70	Fair	Borderline	U	F	U	F
3-11-70	Fair	Borderline	F	F	F	F
4-16-70	Fair	Borderline	F	F	F	F
6-10-70	Fair	Borderline	F	F	U	F
6-22-70	Fair	Borderline	U	F	F	F
8-4-70	Fair	Borderline	F	F	F	F
8-31-70	Fair	Borderline	F	F	F	F
11-4-70	Fair	Borderline	F	F	F	F
3-27-73	Unsatisfactory	Inadequate	F	F	F	F
BRANCHES DISAPPROVED						
2-27-70	Fair	Borderline	F	F	U	U
4-1-70	Fair	Borderline	U	F	U	U
11-9-70	Fair	Borderline	U	F	U	U
2-19-71	Poor	Inadequate	F	U	U	U

<sup>1</sup> - F - Favorable; U - Unfavorable  
<sup>2</sup> - Deputy Regional Administrator

TABLE 5

	<u>Total Criticized Loans to Gross Capital Funds</u>	<u>Comments</u>
8/31/70	109%	Increased substantially
5/17/71	92%	Slight improvement; unprecedented increase in volume of doubtful and loss
3/6/72	82%	Remains in deteriorated state; improvement wholly due to capital increase
12/11/72	74%	Remains extremely high
11/14/73	111%	Marked deterioration; classified loans increasing 32% and special mention up 78%

TABLE 6

INVESTMENT ACCOUNT  
ESTIMATED DEPRECIATION

<u>Examination</u>	<u>Bond Depreciation (millions of dollars)</u>	<u>Depreciation as Percent of Adjusted Capital</u>	<u>Length of Maturities Over 5 Years</u>
9/29/69	\$ 107.2	52%	68%
8/31/70	109.0	52%	63%
5/17/71	62.9	31%	56%
3/ 6/72	58.9	24%	58%
12/11/72	55.3	23%	75%
11/14/73	58.3	25.6%	77%
5/14/74	110.3	-	82%
8/14/74	127.4	-	82%

TABLE 7

NET OPERATING INCOME

<u>Examination</u>	<u>Year</u>	<u>Net Operating Income</u>
9/29/69	1968	\$24,636,000
	1969 Est	26,750,000
8/31/70	1969	27,602,000
5/17/71	1970	26,493,000
	1971 Est	37,000,000
3/6/72	1970	26,500,000
	1971	15,800,000
	1972 Est	22,200,000
12/11/72	1971	15,800,000
	1972	10,950,000
11/14/73	1972	10,950,000
	1973	11,568,000

TABLE 8

FOREIGN EXCHANGE GROWTH

<u>Date of Examination</u>	<u>Total Foreign Exchange Bought and Sold (million)</u>
9-29-69	\$ 13.6
8-31-70	10.7
5-17-71	19.0
3-6-72	422.4
12-11-72	1,375.2
11-14-73	3,760.7
5-14-74	3,332.6
8-14-74	1,900.2

Mr. ROSENTHAL. The next witness is Mr. Aaron B. Donner, former director of First National Bank of East Islip, Long Island, N.Y.

Mr. Donner, you have no objection to being sworn and testifying under oath, do you?

**STATEMENT OF AARON B. DONNER, FORMER DIRECTOR, FIRST NATIONAL BANK OF EAST ISLIP, LONG ISLAND, N.Y.**

Mr. DONNER. No, sir.

Mr. ROSENTHAL. Would you please stand and raise your right hand. Do you swear to tell the whole truth and nothing but the truth, so help you God?

Mr. DONNER. I do, sir.

Mr. ROSENTHAL. We will proceed. Mr. Donner, you are here today, as I understand it, to testify regarding a number of matters concerning the First National Bank of East Islip. Included in these matters are matters you learned of during your tenure as a director of the First National Bank of East Islip.

I am advising you that you are directed to testify to all matters within your knowledge regarding the First National Bank of East Islip, this being a committee of Congress specifically directed to investigate all matters relating to bank regulations in the United States.

Mr. DONNER. I understand, Mr. Chairman.

Mr. ROSENTHAL. Are you ready?

Mr. DONNER. Yes, sir.

Mr. ROSENTHAL. Would you state your name and occupation?

Mr. DONNER. Mr. Chairman, my name is Aaron Donner. I am a lawyer with a law office in Bay Shore, N.Y. I have been a lawyer since 1952.

Mr. ROSENTHAL. For the record, include your address.

Mr. DONNER. My address is 2115 Union Boulevard, Bay Shore, N.Y.

Mr. ROSENTHAL. Do you have a prepared statement?

Mr. DONNER. No, sir; I do not. I have some notes from which I am prepared to testify.

Mr. ROSENTHAL. You may proceed and then we will question after that.

Mr. DONNER. All right. In about January of 1974, our firm was consulted by a Walter Lang, who was a former director and an attorney for the First National Bank of East Islip, in connection with certain litigation involving the First National Bank of East Islip.

In the course of the representation of Mr. Lang, we also met and were retained by other individuals who were substantial stockholders of the First National Bank of East Islip and who expressed a concern and a desire to commence a stockholders' derivative action involving the First National Bank of East Islip. Our firm was retained to represent them.

During the course of that representation, we gained certain information. So many things happened simultaneously that I do not want to express that there is a sequential order. But I will relate the ones that I think are particularly pertinent to your committee.

The first item that we reached, which was almost rushed upon us, was the annual election for the board of directors.

Mr. ROSENTHAL. Were you ever a director of the First National Bank of East Islip?

Mr. DONNER. Yes; I was. That was later on, sir.

Mr. ROSENTHAL. Go ahead.

Mr. DONNER. In connection with that, there was a feeling among certain stockholders that the proxy statement for that election to be held in February of 1974 contained inaccurate or misleading statements.

With reference to trying to hold off this election and trying to have the Comptroller of the Currency withdraw his approval of the proxy statement, Mr. Lang and I made an appointment, through a Mr. Jacobson, who was a counsel in the Office of the Comptroller of the Currency, to see a gentleman who was, according to my recollection, a Mr. Gwin. He was presented to us as a Deputy Comptroller.

We met with him on February 27, 1974, in his office in Washington. In that meeting, we related certain specifics in which we thought the proxy statement was inaccurate as far as certain matters which were to be the subject of this election.

At this point, I will digress. We did not realize it at the time, but the items that we complained of that were inaccurate in the proxy statement had been the subject of the Comptroller's comment in his examinations preceding February 1974. One of the items that we complained of in the proxy statement of 1974 that was inadequately disclosed was the fact that there were loans in excess of the statutory limit by the bank. And these loans were in trouble. We thought that these items should be presented in the proxy statement.

As a matter of fact, as I have been advised, in April of 1972, the Comptroller of Currency's report regarding the bank stated:

A review of the report discloses that total criticized loans represent 113 percent of gross capital funds; past due obligations are heavy at 8.6 percent; 13 percent of total loans lack adequate credit data; the bank has not established limits or proper controls on its indirect lines of credit, some of which have reached unwarranted levels; three loans in excess of the bank's legal lending limit are presently outstanding, including the Crest Affiliates Line in which there appears to be substantial losses; and the bank's capital is considered inadequate in relation to the risks taken and the volume of business transacted."

So in other words, when we went to Washington in 1974 to see the Deputy Comptroller of the Currency, presumptively, if he did not have them available, he certainly did have access to his own reports.

The report went on to consider other items. We contended also that there were loans made to members of the board of directors. Again, I am trying to be objective in saying that some of these items are the subject of litigation and will be decided by another forum. But I am saying that these items were raised in the Comptroller's reports prior to our visit to Washington.

To end this particular episode, Mr. Gwin listened to us patiently and politely declined to participate in any manner in this particular problem. He contended, and he was in part correct, that this was a fight between stockholders and that the Comptroller was not going to participate in it.

Our thrust, mind you, was not the question of his taking sides, but whether or not a proxy statement was an accurate reflection of substantial matters of condition relating to the bank's affairs.

The next pertinent part of this, and to bring you up in seriatim, is that the action proceeded; the action is still pending. There were numerous motions and resolutions which, unless the committee wants to hear about them, I will not go into.

Mr. ROSENTHAL. We are not interested in the private litigation. As you know, it is the mission of this committee to review and oversight the efficiency and operation of the Office of the Comptroller of the Currency. We are keenly interested in anything pertinent to that.

Mr. DONNER. As a part of the 1972 report of the Comptroller of the Currency, I am advised by someone else, although I do not have direct access to this report myself, that this report contained the following language:

The Directors will either remove that portion of the Crest Affiliates Line presently considered loss (\$464,776) on or before June 9, 1972, or furnish this Office with a written guarantee of this portion signed jointly and severally by the entire Board with the understanding that the loss portion will be removed within six months.

This was in the 1972 statement.

At a later time, in the latter part of November of 1975, I was a candidate and became elected to the board of directors of the First National Bank of East Islip. At some time in January or February of 1975, the Comptroller's report for 1974 became available. This was read by the members of the board of directors.

I do not have a written copy of it, and I call the committee's attention to the fact that the procedure is that there is only one copy of the report which is available to be read by the members of the board of directors. There is no circulation of this report. The report must be read at the bank without notes. So I am going by recollection.

But this report contained substantially the same recommendation in 1974 that was expressed here in 1972—in effect that there were loans in excess of the statutory limit, requiring them to take the subject action as outlined here by the board of directors.

I was concerned about the existence of these items. In January or February of 1975, I commenced telephoning respective counsel in the Comptroller's Office. I do not know the substance of these conversations, but I spoke to three gentlemen—a Mr. Sorrino, a Mr. Rosten, and a Mr. Klein. Substantially, as a result of those conversations, I asked them "What is the effect of your report?"

Their reply was that the Comptroller's report is an administrative determination. It requires action by the bank. It is not just an advisory opinion.

I asked them, "What is the usual procedure?"

They said:

First of all, on these reports, we direct a written reply to each one of the items which we raise as requiring response. And such an item as this, in effect raising a question of a statutory violation of—I can't remember the section of 12 United States Code—requires substantial action.

I said, "What if nothing is done?"

They said, "We will take action."

I said, "What action can you take?"

They outlined a whole number of possibilities that could be taken by the Comptroller's Office.

Anyway, to come to the point, when the matter was considered by the board of directors, the majority of the board substantially stated in

writing what their reply was. And I will emphasize that I was a minority on the board; I was not coinciding with the majority. The reply was that they would decline to take action as requested by the Comptroller of the Currency.

Upon further query by myself of the counsel who was present, I said, "Can you take a response such as this to the Comptroller of the Currency?"

He said, "We have always done it that way. We have Washington counsel who specialize in these matters and they have advised us that this is what will happen."

I said, "What does the Comptroller of the Currency do when you respond in such a manner?"

They said, "Nothing."

Mr. ROSENTHAL. Did you ask the name of the Washington counsel?

Mr. DONNER. No, sir. Or if I did know the name, it escapes me at the moment.

Mr. ROSENTHAL. Have you learned the name since then?

Mr. DONNER. No, sir. And apparently they were correct. Nothing did happen. I called the Comptroller's office, I think, one more time and asked about it.

The reply was, "Well, when we get the report, we will do something."

But nothing happened and it did not seem fruitful to continue telephoning. And substantially with regard to my experience with the Comptroller's office, that would seem to summarize my own direct contact with it.

Mr. ROSENTHAL. What else did you want to tell us about your experience with the bank since you were a director, or prior thereto, about its relationship with the Comptroller of the Currency?

Mr. DONNER. Again, passing on the question of what parties contend in lawsuits, I was impressed by the fact—and I must admit that as a lawyer, it is almost a naive statement to make—that I thought the function of the Comptroller of the Currency was that that agency, as most Government agencies are, was one where an individual would have some sort of access or recourse, whether as a depositor or as a stockholder, to the institution of a federally chartered bank.

Apparently, it is not a device to which the public, through an attorney or otherwise, has any access or recourse for complaint.

As a matter of fact, as I have examined it a little more closely, the Comptroller's office seems to be one of those anomalous agencies that exists only in relation to banks and does not exist in relation to other agencies of Government.

I gather, as I later learned, that the Comptroller's office is not funded by Congress so it has no direct congressional controls.

If I may digress, I was impressed when I first went to Washington in 1974 that the Comptroller's office had become the subject of the SEC regulations. And I, having at least a reading familiarity with the SEC regulations, thought that the SEC always erred on the side of full disclosure and that the public or persons dealing with it would be fully apprised of the nature of what they were dealing with. And I assumed that this obligation would be even greater with a federally chartered or licensed agency.

Instead, once again, the cloak of secrecy regarding the findings of the Comptroller's office, the apparent lack of responsiveness to individual complaints, in my limited experience, would seem to belie that

which the public expects from other Federal agencies in the classic role of protecting the public interest.

Mr. ROSENTHAL. Are you still a director of the bank?

Mr. DONNER. No, sir; I have resigned.

Mr. ROSENTHAL. Very briefly, how would you characterize your experience with the Comptroller's office?

Mr. DONNER. In one word, I would say frustrating.

Mr. ROSENTHAL. Were some of the loans of the First National Bank of East Islip that were in excess of its limits made to insiders at the bank?

Mr. DONNER. No, sir. There were two separate questions presented: One was loans to excessive limits and the other was one which was characterized as insider's loans.

Mr. ROSENTHAL. How about loans to officers or directors of the bank?

Mr. DONNER. I am trying to choose my words carefully because, again, some of this is the subject of litigation. I might present one side and somebody else might legitimately dispute it. I have been advised by other people who were involved and I am quoting other people, but at the time these loans were made—which, mind you, in the context of as small a bank as this, are very large loans, with \$200,000 for 20 years at 7.5 percent to one director and \$100,000 for 20 years at 7.5 percent to another—there was a question as to whether or not the directors, at the time the loans were made, were also functioning as officers of the bank; and, therefore, would come within the prohibition of being executive officers.

Again, I have been advised that Mr. Van Horn discussed this matter with the directors involved and in effect counseled them of what they would have to do to relieve themselves of the requirement of being executive officers so they would not fall within the prohibition of an insider's loan to executive officers.

Mr. ROSENTHAL. Did they follow through with that advice?

Mr. DONNER. Yes, sir; they did follow through with that advice. But of course that was after the loan was made.

Mr. ROSENTHAL. Were those the only loans to directors that you were aware of during your tenure of office?

Mr. DONNER. That is correct.

Mr. ROSENTHAL. Mr. Evans, do you have any questions?

Mr. EVANS. I have none at this moment.

Mr. ROSENTHAL. Thank you very, very much.

Is Mr. Greene here? Do you want to testify?

#### STATEMENT OF THEODORE J. GREENE, ATTORNEY

Mr. GREENE. Yes, Mr. Chairman.

Mr. DONNER. May I remain here?

Mr. ROSENTHAL. Is he a friend of yours?

Mr. DONNER. He is the adversary—in the friendly sense of the word, I would say.

Mr. ROSENTHAL. You may stay where you are seated, Mr. Donner.

As I understand it, Mr. Greene, you represent some of the parties and interests to the litigation that we have just been discussing. I take it that you have never been a director or officer of a bank.

Mr. GREENE. That is correct, sir; but, the first part of your statement is incorrect. We are special counsel to the bank. The individual directors and officers are represented by another firm as special counsel. The reason for the split in representation is because of a potential conflict of interest between defendants.

Mr. ROSENTHAL. Just for the record, I will defer taking your testimony under oath simply because you were not an officer or director of a bank. You do not feel any compulsion to take the oath and I do not feel any compulsion to ask you to.

Mr. GREENE. Very well, sir.

Mr. ROSENTHAL. You may proceed to tell us what you want.

Mr. GREENE. My name is Theodore J. Greene. My firm has offices at 425 Park Avenue, New York. I am an attorney.

As I noted, my firm is special counsel to the First National Bank of East Islip. We were retained in the first instance upon the occasion of the suit by plaintiffs represented by Mr. Donner's law firm, to attempt to enjoin the 1974 annual meeting.

I am here in the nature of a rebuttal witness. I would, therefore, like to mention only a few points that I think perhaps Mr. Donner was in some possible error.

No. 1, I think Mr. Donner's notion of the function and responsibilities of the Comptroller's Office is rather off base. It is, of course, the principal regulating agency of all national banks.

Mr. ROSENTHAL. I want you to have an opportunity to explain your position, but we will not become mediators between two lawyers to an ongoing litigation. We cannot resolve it.

I am interested in learning of any facts or knowledge—and I will take circumstantial knowledge—or any experience that anybody has in dealing with the Comptroller of the Currency. Our mandate from the Congress is the oversight and review of the efficiency of the operation of the Office of the Comptroller of the Currency.

So if you have anything you want to tell us which sheds light on that area, we would be very grateful to you.

Mr. GREENE. Very good, Mr. Chairman.

I would say that as counsel for three separate national banks, including East Islip, each of whom is in the New York City metropolitan area, and each of which is a small or community-sized bank, that the report of the Comptroller's Office issued on the occasion of an examination of their national bank examiners is treated almost as the equivalent of marching orders. When the recommendations are set forth on page 2 of the examiner's report, while the recommendations are couched in polite and almost diplomatic language, the boards of the banks that I have represented have always considered them to be mandates of things that had to be done. And, to the best of my knowledge and experience, these suggestions have always been complied with.

Now, in the specific instance of the First National Bank of East Islip, we have a legal question of whether certain loans exceeded the lending limit that was permitted to the bank. The loans were charged off as directed by the Comptroller's Office. And I might say parenthetically that there was a very full and complete disclosure of these loans in an earlier proxy statement, which Mr. Donner did not mention.

Now it is up to the appropriate forum, which in this case will be the U.S. District Court of the Eastern District of New York, to deter-

mine in due course, upon the conclusion of the litigation which is now pending, whether these loans indeed exceeded the lending limit.

Mr. ROSENTHAL. I have before me a letter dated June 1, 1972, from the Regional Administrator of National Banks, the Second National Bank Region, addressed to the Board of Directors of the First National Bank of East Islip. Do you have a copy of that letter?

Mr. GREENE. I do not, but I believe I have seen the letter to which you are referring. I suspect that it is an exhibit in the litigation.

Mr. ROSENTHAL. I suppose so. I will read the letter to you. It says:

Attached is the report of examination of the bank, made on April 24, 1972, by National Bank Examiner Royal B. Dunham, Jr.

A review of the report discloses that total criticized loans represent 113 percent of gross capital funds; past due obligations are heavy at 8.6 percent; 13 percent of total loans lack adequate credit data; the bank has not established limits or proper controls on its indirect lines of credit, some of which have reached unwarranted levels; three loans in excess of the bank's legal lending limit are presently outstanding, including the Crest Affiliates Line in which there appears to be substantial losses; and the bank's capital is considered inadequate in relation to the risks taken and the volume of business transacted.

Confirming our discussions at the Board meeting held on May 9, 1972, attended by National Bank Examiner Royal B. Dunham, Jr., Regional Counsel Wallace S. Nathan, Bank's Counsel Walter F. Lang, Jr., all Board members, and the undersigned, it was understood that:

Prompt corrective attention would be given to each of the loans criticized in the report of examination;

Current and satisfactory credit information would be maintained on all loans;

Controls would be established over all indirect paper and such paper would receive closer supervision by the Board;

Prompt attention would be given to rectifying each of the loans in excess of the limits prescribed by 12 U.S.C. 84;

A program for the raising of at least \$1.3 million in capital funds would be formulated on or before July 9, 1972, and efforts would be made to have these funds in the bank on or before September 9, 1972;

The Directors will either remove that portion of the Crest Affiliates Line presently considered loss (\$464,776) on or before June 9, 1972, or furnish this office with a written guarantee of this portion signed jointly and severally by the entire Board with the understanding that the loss portion will be removed within six months;

Consideration would be given to improving the supervision of the loan account through the expansion of the senior lending staff of the bank;

The bank will be kept on our list for more frequent examinations and periodic visitations until the adverse trend in the affairs of the bank is reversed.

It is signed:

Very truly yours, Gerald H. Lipkin, Deputy Regional Administrator of National Banks."

My question to you, sir, is: Do you have any personal knowledge as to whether any of these directions were met and, if so, when and how?

Mr. GREENE. I do. I believe that virtually all of those requirements were met in full or at least in substantial part.

Additional capital was raised; the bank, over a period of approximately 2 years, brought in new and experienced high-level officers; tighter controls or new controls were implemented with regard to credit analysis, control of books, records, and the like. The proof of the pudding was, if I may, that the bank, after sustaining these very substantial losses—and I am not about to try to minimize the losses—has been able to turn itself around and showed a very handsome profit last year. And in the first 4 months of this year, it is continuing to show a very nice profit.

Mr. ROSENTHAL. I appreciate that. With regard to the requirement that prompt attention would be given to rectifying each of the loans in excess of the limits prescribed by § 12 U.S.C. 84, what was done?

Mr. GREENE. In the first instance, approximately \$450,000 of those loans was charged off. In the second instance, the bank then and thereafter continued to attempt to collect every single penny of those loans.

The borrower was in the business of constructing what are called modular homes. These are prefabricated units which are put onto a site in a substantially completed form. The bank lent these moneys under two assumptions: First, that the modular homes would be delivered only because there had been a signed contract with a third-party purchaser; and second, that an agency of the Federal Government had a commitment to give a permanent first mortgage.

Mr. ROSENTHAL. Had loans been made in excess of the limits prescribed by the code?

Mr. GREENE. The Comptroller has taken that point of view and the plaintiffs in the litigation have taken that point of view. The bank and the directors have taken a contrary point of view. So the courts will determine this point.

Mr. ROSENTHAL. You either complied with this or you did not. What is the answer?

Mr. GREENE. Compliance was made by charging off the amount indicated—over \$400,000. Compliance was also done in that the bank undertook its best efforts to try to collect these loans. And the bank took title to 50 of the properties and attempted to sell them.

Mr. ROSENTHAL. Don't get me involved into the litigation. Has the Comptroller deemed that to be compliance?

Mr. GREENE. I don't know that the Comptroller has taken any further position as to its characterization of the loans as having been illegal in the first instance.

Mr. ROSENTHAL. Then your answer is "no"?

Mr. GREENE. To my knowledge, the Comptroller has said nothing further as regards the characterization of the loans.

Mr. ROSENTHAL. His mandate to the bank, dated June 1, 1972, has yet to be met?

Mr. GREENE. No, Mr. Chairman; I do not think that is correct.

Mr. ROSENTHAL. Either you complied or you didn't comply.

Mr. GREENE. The board of directors was advised to do two things.

Mr. ROSENTHAL. Counsel, you cannot try the lawsuit here. Incidentally, I think we ought to put on the record another factor.

The fact is that former Mayor Wagner called me yesterday and asked me to provide an opportunity for you to appear here today. He is your law partner.

Mr. GREENE. That is correct.

Mr. ROSENTHAL. This committee wanted to cooperate in that regard. And only because it is equitable and fair, we afforded you an opportunity to rebut anything Mr. Donner had to say.

The distinction between you and Mr. Donner is that Mr. Donner not only was a lawyer, but he was a member of the board of directors and can personally testify to the facts in the case. You, as I understand it, can only tell us what you want to tell us in your position as counsel to some of the parties and/or the bank. Isn't that correct?

Mr. GREENE. I can tell you of the personal knowledge I have which is gained from conversations with the bank's officers and directors and the examinations of the books and records. So if that is considered derivative knowledge, then that is what it is.

Mr. ROSENTHAL. You well know that that is what it is.

Again, I must repeat, we are only interested in the performance of the Comptroller of the Currency, and not necessarily to the skill of the counsel to the litigants.

Mr. GREENE. Mr. Chairman, with all due respect, I think perhaps you are missing the point on the Comptroller's directive as regards the so-called illegal loans. The Comptroller directed that they be charged off; they were charged off.

Mr. ROSENTHAL. You say one thing but Mr. Donner shakes his head. Has the Comptroller ever sent the bank a letter saying that the loans in excess of the limit have been cleared to their satisfaction? Can you tell me that?

Mr. GREENE. No; they have never sent such a directive.

Mr. ROSENTHAL. Then the answer to that is "no." In view of the fact that your response to that was "no," has the Comptroller ever pursued that matter any further? Or, how has the Comptroller pursued it?

Mr. GREENE. The Comptroller is fully aware of the litigation because we have made reports and delivered copies of the pleadings and other documents to them at their request.

I want to stress that inasmuch as the loans have been charged off—now that is historical fact—the consequences that may flow from illegality of the loan, if that is the court's determination, can only occur in the future. I do not know what further thing the Comptroller or any governmental agency can do after the loan has been charged off.

There is a remedy, of course, for the plaintiffs. They may obtain a recovery.

Mr. ROSENTHAL. I am not interested in the plaintiffs or the courts or you or anybody else. I am only interested in whether the Comptroller followed up his direction in the letter of June 1, 1972. And the only conclusion I can draw is that the answer is "no."

Mr. GREENE. The Comptroller certainly is aware that the loans were charged off.

Mr. ROSENTHAL. How do you know that? How can you testify to that?

Mr. GREENE. Because the reports are filed with the Comptroller's office and the annual reports indicate that.

More recently, a form F-2, which is a rather comprehensive financial statement, was filed. And the Comptroller receives it.

Mr. ROSENTHAL. Why did you want to appear here today to testify?

Mr. GREENE. I was concerned that Mr. Donner might make statements concerning The First National Bank of East Islip which were inaccurate. I was specifically concerned because there was a newspaper item in the New York Daily News last Friday which coupled The First National Bank of East Islip with the Franklin National. Any casual reader of that article, having read about Franklin, a failed, defunct bank, and then reading what was said about East Islip could very easily draw the conclusion that East Islip was about to go under. And that is just not the fact.

I had no idea how well reported this meeting would be or what would be said.

Mr. ROSENTHAL. I do want to state for the record that the fact that we are inquiring into two different banks on the same day is purely coincidental. It is merely logistical timing of when we can hold these hearings. Perhaps we should have held the hearing with regard to this bank on another day, and that problem with the newspaper story in the New York Daily News would not have occurred.

On June 1, 1972, they also said that the directors will either remove that position of the Crest Affiliates Line presently considered loss—\$464,776—on or before June 9, 1972, or furnish this office with a written guarantee of this portion signed jointly and severally by the entire board with the understanding that the loss portion will be removed within 6 months. Did either of those take place?

Mr. GREENE. Yes; the first of the alternatives was what happened.

Mr. ROSENTHAL. How did they do that?

Mr. GREENE. It was a chargeoff. It appears as a loss; it reduces the capital position if other profits are not adequate to cover it.

Mr. ROSENTHAL. Did you ever receive a letter of any memorandum from the Comptroller saying that they were generally satisfied with what had taken place in response to this letter of June 1?

Mr. GREENE. To the best of my knowledge, the Comptroller does not send out that type of letter, ever. They just tell you what to do, and they follow through to make sure it is done. If it has not been done, they remind you that it is to be done. If you have done it, it is history.

Mr. ROSENTHAL. They never send you a letter when you have complied?

Mr. GREENE. They do not give out pats on the back for having done what you are told to do.

Mr. ROSENTHAL. Now you said that there is a question of whether section 12 U.S.C. 84 was complied with or not because that is a matter for litigation.

Of course, Mr. Smith will testify to what his procedures were. And the only reason we are examining this bank is that it is one way for us to find out whether or not the Comptroller did in fact live up to what Mr. Smith will tell us, presumably, is policy.

But from your knowledge and experience, when the Comptroller of the Currency sends a letter indicating things to be done, do they never send you a followup letter of your having done it or not having done it?

Mr. GREENE. When the letter comes in to do things, as I have said, in my experience with three banks, the letter is the equivalent of marching orders. This means that the board does it.

Now some things cannot be done in 1 day. Some things can be done only within a period of several months.

The president is required to send a letter to the Comptroller's Office reciting that the comments on page 2 of the report were read to the full board; and, to set forth in considerable detail all of the corrective measures that will be taken by the bank; and, to report any of the corrective measures that have theretofore been taken. This is standard operating procedure, in my experience.

Mr. ROSENTHAL. Did the board or the president ever respond to this letter of the Comptroller, dated June 1, 1972?

Mr. GREENE. I have no personal knowledge about that. That was before my time.

Mr. ROSENTHAL. But that is a key element in this inquiry.

Mr. GREENE. I can speculate, for whatever it is worth, that there was compliance.

Mr. ROSENTHAL. Don't speculate. Did you bring with you a file that would have this material in it?

Mr. GREENE. No. I was unaware that that letter would be so important in these hearings. I brought certain things with me, but not that.

Mr. ROSENTHAL. Do you know the name of the special counsel to whom Mr. Donner referred that the bank hired here in Washington?

Mr. GREENE. This is the first time I have ever heard that the bank had done it.

Mr. ROSENTHAL. Mr. Donner, when was the special counsel hired?

Mr. DONNER. We have special counsel Mr. Greene who was hired in connection with the litigation. I do not know whether there is other special counsel who would counsel them in matters relating to the Comptroller's Office. I have no knowledge of that.

Mr. ROSENTHAL. Do you know, Mr. Greene?

Mr. GREENE. I have never heard before about other special counsel. In addition to counseling them on this litigation, my firm has been retained to counsel them generally with respect to compliance with the Comptroller's regulations and other matters pertaining to national banks.

I would have guessed that I was their special counsel.

Mr. ROSENTHAL. Have you formerly been associated with the Comptroller of the Currency?

Mr. GREENE. No, sir.

Mr. ROSENTHAL. Has any member of your firm ever been employed by or associated with the Comptroller of the Currency?

Mr. GREENE. No, sir.

Mr. ROSENTHAL. Has any member of your firm ever been associated with any banking authority?

Mr. GREENE. No, sir.

Mr. ROSENTHAL. There must be some question I am missing, but you are not going to tell us, are you?

Mr. GREENE. No; there isn't. I have been representing national banks for approximately 11 years, and we represent three. In that period of time, I have learned a little about how things are done and what you have to do. Maybe I am sort of a quasi-expert by now, and maybe not.

Mr. ROSENTHAL. I do want to say for the record that you are associated with a very distinguished New York law firm, and one for whom I have great respect.

Mr. GREENE. Thank you, sir.

Mr. ROSENTHAL. Mr. Donner, do you want to say anything? I don't want to get into the litigation.

Mr. DONNER. I want to say something here that really gets down, I think, to the heart of this.

Mr. ROSENTHAL. We are only interested in the Comptroller.

Mr. DONNER. That is what I want to get to, Mr. Chairman.

This stricture regarding loans in excess of limits and the responsibility of directors is not that maybe someday we will get the money back. It is not "We can charge it off."

I state that it imposes a legal obligation on directors who act in such a manner knowledgeably.

It is not a punishment. It is the idea that these men are entrusted to the responsibility. If they exceed the statutory limit, they incur a personal liability for the loan.

It is not just some sort of a semantic game. It isn't even dependent upon recovery for the debtors. It isn't an answer to say, "We will get the money back from the guy that owes it." The liability is there for the director.

Therefore, when the Comptroller of the Currency requests it—and I do not know what is in his mind, but I am assuming from the plain intent of the language—it is that they are concerned that the bank will incur a liability which, if incurred by the bank, should be apportioned to the directors who share the responsibility for making the loan in excess of the statutory limits.

It is not just a rule game or a word game with the Comptroller of the Currency and how you will answer their letter. It is a legal fact. It is a violation of the United States Code.

I will agree that there may be questions of whether people are in violation of United States Code. That is why lawyers like Mr. Greene and myself pursue each other around. But the law is there. The interpretation of the law might be a game for lawyers. But as far as the requirement of the intent of that letter, it was "We want the directors liable; we want them to agree to be liable." And that was the intent of it.

At a meeting in 1975, and I cannot remember the exact language, the question was still being raised about the Comptroller's Office.

And whatever the charge-off factor, it doesn't recover the loan. It is just a bookkeeping transaction. So let's get back to basics. A loan was made in excess of limits and which was in default. A charge off does not recover the money; it is a bookkeeping adjustment. It shows on a financial statement, but it does not get the money back to the bank.

Mr. ROSENTHAL. And your point is vis-a-vis the Comptroller?

Mr. DONNER. Vis-a-vis the instructions of the Comptroller. I assume it is based upon the violation of a statutory stricture. And that is the plain question involved. And that was the question presented, I think, by the Comptroller's letter. And I said that the board declined—or whatever the word was, I do not remember the exact words—to comply with that.

Mr. ROSENTHAL. Thank you both very much. I wish you both well in your lawsuit.

Without objection, the letter dated June 1, 1972, will be read into the record.

[The letter referred to follows:]

THE REGIONAL ADMINISTRATOR OF NATIONAL BANKS,  
SECOND NATIONAL BANK REGION,  
New York, N.Y., June 1, 1972.

BOARD OF DIRECTORS,  
*First National Bank of East Islip,*  
East Islip, N.Y.

GENTLEMEN: Attached is the report of examination of the bank, made on April 24, 1972, by National Bank Examiner Royal B. Dunham, Jr.

A review of the report discloses that total criticized loans represent 113% of gross capital funds; past due obligations are heavy at 8.6%; 13% of total loans lack adequate credit data; the bank has not established limits or proper con-

trols on its indirect lines of credit, some of which have reached unwarranted levels; three loans in excess of the bank's legal lending limit are presently outstanding, including the Crest Affiliates Line in which there appears to be substantial losses; and the bank's capital is considered inadequate in relation to the risks taken and the volume of business transacted.

Confirming our discussions at the Board meeting held on May 9, 1972, attended by National Bank Examiner Royal B. Dunham, Jr., Regional Counsel Wallace S. Nathan, Bank's Counsel Walter F. Lang, Jr., all Board members, and the undersigned, it was understood that:

Prompt corrective attention would be given to each of the loans criticized in the report of examination;

Current and satisfactory credit information would be maintained on all loans;

Controls would be established over all indirect paper and such paper would receive closer supervision by the Board;

Prompt attention would be given to rectifying each of the loans in excess of the limits prescribed by 12 U.S.C. 84;

A program for the raising of at least \$1.3 million in capital funds would be formulated on or before July 9, 1972 and efforts would be made to have these funds in the bank on or before September 9, 1972.

The Directors will either remove that portion of the Crest Affiliates Line presently considered loss (\$464,776) on or before June 9, 1972, or furnish this Office with a written guarantee of this portion signed jointly and severally by the entire Board with the understanding that the loss portion will be removed within six months;

Consideration would be given to improving the supervision of the loan account through the expansion of the senior lending staff of the bank;

The bank will be kept on our list for more frequent examinations and periodic visitations until the adverse trend in the affairs of the bank is reversed.

Very truly yours,

GERALD H. LIPKIN,

*Deputy Regional Administrator of National Banks.*

Mr. ROSENTHAL. Mr. Metz and Mr. Hoppler, will you come back, please. Mr. Ruempler has some questions regarding your report. We will proceed with that.

Mr. RUEMPLER. When Arthur Roth testified before the committee in February, he was asked a question by Mr. Brown about the legal authority of the Comptroller to require the bank to take certain actions. And Mr. Roth testified in effect that their legal authority was a little fuzzy.

And yet you have indicated that the OCC failed to exercise all of their supervisory options and you have detailed some of those items.

Is there some difference of opinion here between you and Mr. Roth as to what could have been done with respect to specific items?

Mr. HOPPLER. We were speaking within the context of the options that Mr. Bloom had spelled out before this subcommittee. We did not consider what legal actions may have been available strictly considering the law. Mr. Bloom provided the frame of reference within which we were speaking.

Mr. RUEMPLER. Let me pose the question a little more specifically. On page 7 of your testimony, under "Other Enforcement Options," you state: "We found no evidence that the OCC threatened to initiate cease and desist \* \* \* sought to remove an officer \* \* \* or attempted to make a criminal referral \* \* \*" Did you find indications that there were grounds for doing those things?

Mr. HOPPLER. No; we did not. After we had identified options, we felt that we should make the statement that we found no evidence that they had been used. We were not attempting to make any kind of judgmental statement.

Mr. RUEMPLER. Could you discuss further the significance of the fact that the examiner did not cite the bank problems on page 2 of the examination report?

Isn't the information elsewhere in the report? Is there some special significance to having it on page 2?

Mr. HOPPLER. According to the procedures that the Office of the Comptroller of the Currency has established for conducting an examination of a bank, page 2 is considered to be one of the most important pages because it is supposed to summarize the matters which the examiner feels warrant attention. In fact, the examiner's handbook emphasizes that this is one of the most important pages. It is supposed to be prepared for both the Comptroller and the bank's board of directors as an action document. Therefore, one would assume, by following that logic, that the matters which they felt warranted attention should have been pulled forward onto that page.

Mr. METZ. I would also like to add that much of the information that was critical of the bank or the management is shown in the confidential portion of the report which the bank's officers and boards of directors are not privy to.

Mr. RUEMPLER. Are you aware of any changes in the Comptroller's procedures on this item?

Mr. METZ. Yes, sir. We reviewed the Haskins and Sells May 1975 report and, although I would not say we are thoroughly familiar with the report, we do understand that there are new procedures whereby much of the information in the confidential part of the report would be moved up into an open section of the report and it will be made available to the banks and their boards of directors.

Mr. RUEMPLER. You have suggested that the opportunity to deal with branch approvals, which is presented to the Comptroller on those occasions, is a good way to discipline a problem bank. I think we have had testimony on other occasions which would agree with that.

But are you leaving the impression that the rejection of these applications is always the wisest course? Do you have any figures to indicate whether the branches which were approved provided the bank with deposits in excess of loans which might have helped to ease its liquidity problems?

Mr. METZ. No, sir; we do not.

Mr. RUEMPLER. I have nothing further.

Mr. ROSENTHAL. I have no further questions.

Again, I want to thank you and compliment you both on a very productive and exhaustive study.

The subcommittee stands adjourned.

[Whereupon, at 11:50 a.m., the subcommittee adjourned, to reconvene subject to the call of the Chair.]



**OVERSIGHT HEARINGS INTO THE EFFECTIVENESS OF  
FEDERAL BANK REGULATION  
(Franklin National Bank Failure)**

WEDNESDAY, MAY 26, 1976

HOUSE OF REPRESENTATIVES,  
COMMERCE, CONSUMER,  
AND MONETARY AFFAIRS SUBCOMMITTEE  
OF THE COMMITTEE ON GOVERNMENT OPERATIONS,  
*Washington, D.C.*

The subcommittee met, pursuant to notice, at 10:05 a.m., in room 2247, Rayburn House Office Building, Hon. Benjamin S. Rosenthal (chairman of the subcommittee) presiding.

Present: Representatives Benjamin S. Rosenthal, Robert F. Drinan, David W. Evans, Anthony Moffett, Andrew Maguire, Edward Mezvinsky, and Willis D. Gradison, Jr.

Also present: Peter S. Barash, staff director; Robert H. Dugger, economist; Ronald Klempner, counsel; Eleanor M. Vanyo, assistant clerk; and Henry C. Ruempler, minority professional staff, Committee on Government Operations.

MR. ROSENTHAL. The subcommittee will be in order. We will continue this morning the examination of the affairs of the Comptroller of the Currency's regulation and activities with regard to the Franklin National Bank and matters associated thereto.

Our first witness this morning will be Mr. Dennis Weatherstone, senior vice president, Morgan Guaranty Trust Co.

At some point thereafter, we will take the testimony of other witnesses and proceed accordingly.

Mr. Weatherstone, we are very pleased that you could join us this morning. I have a number of questions in which your experience and expertise can be very useful to this subcommittee and to the record and to the decisionmaking process of this subcommittee. These questions are within your experience and knowledge, and I will ask them, hopefully, in an orderly fashion.

What are the mechanics and risks involved in spot and forward foreign exchange transactions?

**STATEMENT OF DENNIS WEATHERSTONE, SENIOR VICE PRESIDENT, MORGAN GUARANTY TRUST CO.; ACCOMPANIED BY FRANK MOSELET OF DAVIS, POLK & WARDWELL**

MR. WEATHERSTONE. There are two distinct risks on a spot contract and on a forward contract. On a forward contract, one risk is at maturity of the contract. These maturities are generally 30, 60, 90,

and 180 days ahead. At the maturity date, for some reason, the counter party may be unable to fulfill the contract. If that is so, the other party then will have to find a separate party to replace the original party. The exchange rate, meantime, may have moved and cause a loss.

We, in our bank, for administrative purposes, assess such fluctuation risks as 10 percent of the amount of the contract.

In the case of a spot contract or a maturing forward contract, there is a settlement risk. That means that when the currency is paid over in one center against receipt in the other center, one of the parties may have made his payment, but meanwhile during the day, the other party may have a problem and be unable to make his side of the payment. Therefore, one side of the contract is paid out and the other side is not received and one is exposed to loss. This would be a 100-percent risk exposure as opposed to the other 10-percent type.

Mr. ROSENTHAL. Was Franklin National Bank, to your knowledge, a major participant in spot and forward foreign exchange markets?

Mr. WEATHERSTONE. Are we talking about the years 1973 and 1974?

Mr. ROSENTHAL. 1972, 1973, 1974, 1975—particularly 1974.

Mr. WEATHERSTONE. They progressively became a bigger participant. In 1972, from our observation and our business with them, we had a bigger volume than in 1971. In 1973, it was more than in 1972. And of course, in 1974, we ceased doing business with them halfway through the year.

Mr. ROSENTHAL. Did Morgan Guaranty ever become reluctant to engage in foreign exchange transactions with Franklin National Bank?

Mr. WEATHERSTONE. We have a distinction there between spot exchange and forward exchange. We did become somewhat reluctant to do forward exchange with them during 1973, but we did continue to do spot exchange right up until May of 1974.

Mr. ROSENTHAL. Can you tell us why the reluctance in one area and not the other, and the risks inherent thereto?

Mr. WEATHERSTONE. In doing spot exchange, if a problem should arise, we could stop instantly and decide not to enter into any more contracts.

In the case of forward exchange contracts, if we saw problems arising, we would have contracts on our books until the maturity date. We thought that by stopping the forwards, if problems should develop later, we would need to do nothing about it. In the case of spot business, if a problem developed, we could promptly stop business.

Mr. ROSENTHAL. When did this reluctance first begin to show itself and when did you notify them, if you did?

Mr. WEATHERSTONE. The reluctance began in the spring of 1973 when we observed that they were rather more active in the market than they had previously been. We began to lessen our activities with them in the forward exchange market. In about May, I believe, it so happens that we did our last forward exchange contract. That was May of 1973. But we continued to do spot exchange.

Mr. ROSENTHAL. How much money was involved in these transactions? Can you in any way describe the extent?

Mr. WEATHERSTONE. During 1973, the total volume was several billions of dollars.

Mr. ROSENTHAL. Several billions of dollars at any one time?

Mr. WEATHERSTONE. No; that was the total volume during the whole of the year.

Mr. ROSENTHAL. We are going to break off your testimony for just a few moments for some administrative matters.

Mr. Clesner wants to release the testimony of a closed hearing which we had on November 4, 1975. It was in connection with the testimony of Richard E. Jaffe, special agent, IRS, Miami, Fla.; and another special agent who was identified in that hearing as TW-24.

The reason we held a closed hearing at that time was at the request of the attorneys for the parties. The Justice Department had requested that it be held in closed session because there was a grand jury proceeding pending.

Those matters have concluded and there are no further objections by any of the parties thereto to the release of this testimony.

I would ask that, without objection, this testimony might be released at this time.

The other matter, and one for which we need a quorum to act, is that we have two witnesses this morning who were former high-level officers of the Franklin National Bank. They were intimately involved in the efforts to save the Franklin National Bank through a merger with another bank in the early part of May of 1974.

Both men are currently associated with New York financial firms and are in constant contact with banks and other members of the financial community. There is a good deal of interest within the financial community regarding current lawsuits involving the events which they will testify about today.

Both of these prospective witnesses have given their full cooperation to this subcommittee. And we are sensitive to the potentially prejudicial impact their testimony might have on other parties to a number of these pending lawsuits involving significant sums of money. We are equally sensitive to the effects that public testimony would have both on their current positions and on their current relationships with others within the banking community.

Both of these witnesses have requested that we receive their testimony in executive session so that the testimony will not be inhibited in any way. We are interested in accommodating them. If the testimony is received in executive session, they will have the opportunity to present it fully and fairly, without any inhibitions and without fear that it will in any way affect either their personal careers or the lawsuits that are presently pending.

Therefore, I would at this moment entertain a motion that we could at the appropriate time this morning go into executive session to hear the testimony of Mr. Luftig and Mr. Heinemann.

Mr. DRINAN. Mr. Chairman, I so move.

Mr. GRADISON. Mr. Chairman.

Mr. ROSENTHAL. Mr. Gradison.

Mr. GRADISON. I am going to vote "no" on this motion. It seems to me that the most appropriate step would be to skip this testimony entirely. My reading of the staff documents suggests that we already have the benefit of a very thorough series of conversations with the witnesses, which should give us an adequate basis for questioning

future witnesses, including Mr. Smith, on matters of great importance to us.

I am at a loss to understand how the taking of additional testimony in executive session can add in any substantial way to what we already have. It would seem to me that obtaining information in that way might in subtle, and not so subtle ways, inhibit our use of the information in the questioning of future witnesses that we might have on these points.

I do not want to belabor the matter, but I did want to explain, because I felt this was the appropriate time, why I intend to vote "no" on the motion.

Mr. ROSENTHAL. The clerk will call the roll.

The CLERK. Mr. Rosenthal.

Mr. ROSENTHAL. Aye.

The CLERK. Mrs. Collins.

Mrs. COLLINS. [No response.]

The CLERK. Mr. Drinan.

Mr. DRINAN. Aye.

The CLERK. Mr. Levitas.

Mr. ROSENTHAL. Aye, by proxy.

The CLERK. Mr. Evans.

Mr. EVANS. Aye.

The CLERK. Mr. Moffett.

Mr. MOFFETT. Aye.

The CLERK. Mr. Maguire.

Mr. MAGUIRE. Aye.

The CLERK. Mr. Mezvinsky.

Mr. MEZVINSKY. Aye.

The CLERK. Mr. Brown.

Mr. BROWN. [No response.]

The CLERK. Mr. Gradison.

Mr. GRADISON. No.

The CLERK. Mr. Erlenborn.

Mr. ERLENBORN. [No response.]

The CLERK. The vote is seven "ayes" and one "no."

Mr. ROSENTHAL. The "ayes" have it with a vote of seven "ayes" and one "no". The motion is carried.

I apologize for this interruption, Mr. Weatherstone, but we do have some administrative problems. We will now resume your testimony.

At any point, if you can recall, what was the extent of the financial relationship, in amounts of dollars, between Morgan Guaranty and Franklin National?

Mr. WEATHERSTONE. It is a little difficult to answer when you say "the extent of the relationship." The size of any foreign exchange deal would be, say, \$3 million to \$5 million. One would not expect to do a lot of those in a day.

We were also, of course, engaged in other business with the Franklin National Bank besides foreign exchange business and Euro business. We did Fed funds business with them as well. Those would be amounts per day, I would imagine, of \$5 million or \$10 million.

And of course the number of forward contracts would tend to accumulate. I would not have thought that they got beyond, say, a maximum of \$50 million.

Mr. ROSENTHAL. I assume this was profitable business to Morgan Guaranty?

Mr. WEATHERSTONE. As a part of our foreign exchange and money market business, we would hope it would be.

Mr. ROSENTHAL. What is the Euro-dollar market?

Mr. WEATHERSTONE. Could I just get back to the other question for a moment?

Mr. ROSENTHAL. Surely.

Mr. WEATHERSTONE. I think we were occupied more on the when than on the why, which we did not quite finish. I should mention why we became reluctant. It was partly because of what appeared to be excessive trading on the part of a bank who had not been a major trader previously.

Mr. ROSENTHAL. Do you mean Franklin?

Mr. WEATHERSTONE. Yes; Franklin. Also, from what we could see in the market, it did seem that some of the positions which they appeared to be taking were not profitable ones. It is very difficult to know for sure whether transactions are profitable or not because one only sees a small segment of the market, but the segment that we saw did not look very profitable. That was part of our concern.

Mr. ROSENTHAL. What is the Euro-dollar market?

Mr. WEATHERSTONE. Let me first define a Euro-dollar. A Euro-dollar, I do not believe, has any precise legal definition, but the generally accepted definition is that it is a U.S. dollar placed on deposit with a foreign bank or a branch of a U.S. bank located outside the United States.

The Euro-dollar market is the system whereby those deposits are exchanged between banks.

Mr. ROSENTHAL. In general, what is the relationship between a foreign bank's willingness to engage in spot and forward foreign exchange transactions with another bank and the foreign bank's willingness to deposit Euro-dollars with that other bank?

Mr. WEATHERSTONE. Both types of transactions should be based, and I believe they are, on the credit standing of the other bank. One would examine the bank's balance sheet, the management, and general market abilities in making some kind of credit assessment. Then one would determine how much spot exchange, how much forward exchange, and how much Euro-dollar business one wanted to do with them.

Mr. ROSENTHAL. To your knowledge, was Franklin National a heavy user of Euro-dollar funds during 1973 or 1974?

Mr. WEATHERSTONE. I think that is a published number. It was a fairly substantial number.

Mr. ROSENTHAL. In addition to your bank's feelings about Franklin, did you become aware that other foreign and domestic banks were becoming reluctant to deal with Franklin during late 1973 or early 1974?

Mr. WEATHERSTONE. Yes; we did.

Mr. ROSENTHAL. How did you become aware of that?

Mr. WEATHERSTONE. This would be in conversations with other participants in the international money markets. During the day, we talk with banks all over the world about market conditions and try to get a feel of what is happening. And during the course of those conversations and from conversations with brokers, we were aware that Franklin had problems.

Mr. ROSENTHAL. How did you assess the seriousness and the nature of concern of these banks who were becoming reluctant to deal with Franklin had?

Mr. WEATHERSTONE. That is very difficult. There were so many facts that we did not know. We were concerned over a bank who had previously not been that active in the international money markets and was without what we would call natural commercial business in that area. We were curious and concerned as to exactly what they were doing.

With those uncertainties, we were somewhat worried. And with the numbers involved, we would imagine that other banks had questions in their minds.

Mr. ROSENTHAL. Did there come a time when you or other officers of your bank met with any of the Federal bank regulators about the matters you have just testified to?

Mr. WEATHERSTONE. Yes. We met with the Federal Reserve Bank of New York in November of 1973.

Mr. ROSENTHAL. With whom did you meet?

Mr. WEATHERSTONE. Mr. Hayes, Mr. Coombs, Mr. Bodner, and Mr. Tinman.

Mr. ROSENTHAL. Was that in their offices?

Mr. WEATHERSTONE. That was in their offices.

Mr. ROSENTHAL. Can you be more precise about the time of that meeting?

Mr. WEATHERSTONE. I think it was November 28, 1973.

Mr. ROSENTHAL. What was the purpose of the meeting? Did you ask for the meeting?

Mr. WEATHERSTONE. We asked for the meeting. We wanted to tell the Federal Reserve of our concern at the training activities of the Franklin Bank.

Also, at that time there were other problems in the market. It was not long after the U.S. National Bank difficulties, which were in October of 1973.

We were concerned about the Franklin Bank if there should be problems and if they had difficulties, and we had difficulty in putting our finger on exactly what they were doing, we were concerned about whether this would affect the banking system generally.

Mr. ROSENTHAL. Is it common practice within the banking community for one bank to have a meeting with the Federal regulators to discuss the conduct and activities and condition of another bank?

Mr. WEATHERSTONE. In my experience it is not common practice.

Mr. ROSENTHAL. Had you ever heard of it before?

Mr. WEATHERSTONE. Personally, no. But you must bear in mind that I have only been here 5 years. Others may have done it.

Mr. ROSENTHAL. In the meeting, what took place? Tell us about the discussions and what happened.

Mr. WEATHERSTONE. We told the Federal Reserve of our concern with the trading activities; that we had had some direct discussions with the Franklin Bank to try and get explanations from them of what they were doing; that we were not completely happy with the explanations; that we had no way of checking them; that the atmosphere in the international money markets was becoming rather tense; and that

we were really considering stopping doing spot exchange with the Franklin Bank.

To stop doing spot exchange would be quite a serious step. It would have to be notified to all of the foreign exchange brokers in New York and, by that means, all of the banks in New York. We would be telling the New York banking community, in effect, that we did not want to do business with this bank. That is a fairly serious step to take.

Mr. ROSENTHAL. Did you or your colleagues or associates tell the Federal Reserve Bank people that the situation was potentially explosive?

Mr. WEATHERSTONE. I do not remember whether those particular words were used, but I think our concern was such that if on examination there was a dangerous situation, it could easily spread throughout the system. But I cannot remember the exact words we used at the meeting.

Mr. ROSENTHAL. At any rate, you were serious in your approach?

Mr. WEATHERSTONE. We were very serious about the problems that might arise.

Mr. ROSENTHAL. Did you or your associates suggest that another bank take over Franklin's forward foreign exchange book?

Mr. WEATHERSTONE. We suggested that if the Franklin problems were purely matching up dates on their forward book, and we really did not know if that were the only problems they had, that it could be helpful in those circumstances if another bank were to save their going into the market with the embarrassment of having their name turned down or having to constantly roll over on a short-date basis their forward foreign exchange position.

Mr. ROSENTHAL. How did the people at the Federal Reserve Board react to these things? What do you recall was their response?

Mr. WEATHERSTONE. I think they listened most of the time to our remarks; they obviously said that they would look into what could be done. I do not recollect any specific suggestions which came from them.

Mr. ROSENTHAL. Did you or your bank receive any evidence in either late 1973 or early 1974 that the Federal Reserve Bank of New York or the Comptroller of the Currency was taking actions that were having the effect of improving the financial market's confidence in Franklin National Bank?

Mr. WEATHERSTONE. Nothing that we could directly associate with that. We did understand that the chairman of the Franklin National Bank had gone to see the Comptroller of the Currency to explain his problems to him. But I do not recollect any particular actions that we could relate to anything they had done publicly that would change the situation.

Mr. ROSENTHAL. And that continued for a period of months after the November 28 meeting.

Mr. WEATHERSTONE. There was another particular concern after November. In January 1974, there was a report in the newspapers that the Franklin had had some problems in Paris with a French franc contract where they had been unable to deliver the francs. And at another point earlier in November 1973, there had been a market rumor, which was confirmed to us by the Franklin, that their major German bank correspondent had requested them to close their account. This, again, was a rather serious step.

Mr. ROSENTHAL. Did your bank continue to deal with Franklin?

Mr. WEATHERSTONE. We continued to deal with Franklin on a spot

basis, but with no forwards and no Euro business, and with a very limited Fed funds business. This was done with a very close monitoring of their day-by-day outstandings.

Mr. ROSENTHAL. And there was never any further discussion about either your bank's or any other bank's taking over part of this business?

Mr. WEATHERSTONE. The forward book?

Mr. ROSENTHAL. Yes.

Mr. WEATHERSTONE. I did not have any particular discussions, but there may have been one more conversation that took place in which we were asked if we had given any further thought to taking over the book. We were not prepared to take over the book unless we had some kind of better assurances as to what was happening at the Franklin bank.

Mr. ROSENTHAL. Mr. Ruempler.

Mr. RUEMPLER. I have just a couple of questions. Is it accurate to say that your information about Franklin was derived from your role as a participant in the foreign exchange market?

Mr. WEATHERSTONE. That is correct.

Mr. RUEMPLER. Would it be possible for a nonparticipant to have the same information?

Mr. WEATHERSTONE. It would be very difficult.

Mr. RUEMPLER. At the time a bank is being examined by the regulator, certainly the regulator could acquire information of this nature. But between examinations, would there be some way that the Comptroller of the Currency could get information on the status of, for example, Franklin's position in this market?

Mr. WEATHERSTONE. If you had gone back historically, I would have said it was rather difficult. Today, it would not be so difficult because I think the Federal Reserve has a number of meetings on a fairly regular basis with market participants to chat about the state of the market. This may be on about a monthly basis. I would think that would give opportunities to them to get a quicker insight.

Mr. RUEMPLER. And that would be a good idea?

Mr. WEATHERSTONE. That is a good idea; yes.

Mr. RUEMPLER. That is all I have, Mr. Chairman.

Mr. ROSENTHAL. Thank you very, very much for a significant and important contribution. We appreciate particularly the effort you made in coming down here from New York. We thank you both very, very much.

Mr. WEATHERSTONE. Thank you.

Mr. ROSENTHAL. The subcommittee will now go into executive session.

[Whereupon, at 10:30 a.m., the subcommittee went into executive session.]

#### EXECUTIVE SESSION

[SUBCOMMITTEE NOTE.—The Commerce, Consumer, and Monetary Affairs Subcommittee met on Tuesday, July 20, 1976, at 10 a.m., in room 2203, RHOB, pursuant to notice from Chairman Benjamin S. Rosenthal.

[Those present were Representatives Benjamin S. Rosenthal (chairman of the subcommittee) presiding, Robert F. Drinan, Elliott H. Levitas, Andrew Maguire, Garry Brown, and Willis D. Gradison, Jr. Subcommittee staff present were Ronald A. Klempner, counsel;

Eleanor M. Vanyo, assistant clerk; and Henry C. Ruempler, minority professional staff, Committee on Government Operations.

[The purpose of the meeting was to authorize the release and printing of testimony taken in executive session on May 26, 1976, regarding the Franklin National Bank failure. The witnesses were Paul Luftig and H. Erich Heinemann who had requested that their testimony be received in executive session and now no longer objected to its release.

[Chairman Rosenthal moved that, without objection, the subcommittee authorize the release and printing of the testimony and, there being no objection, the motion was carried and the meeting was adjourned.]

Mr. ROSENTHAL. We will call Mr. Luftig and Mr. Heinemann up to the witness table, if we might. Others who are not members of the subcommittee staff will, regrettably, have to leave us.

My reputation for open hearings has taken a beating this morning pursuant to the request of you two fellows. I had to make what is known as a pragmatic decision.

Do either of you object to being sworn and having your testimony given under oath?

Mr. LUFTIG. No.

Mr. ROSENTHAL. Mr. Heinemann, do you object?

**STATEMENT OF H. ERICH HEINEMANN, FORMER VICE PRESIDENT,  
FRANKLIN NATIONAL BANK**

Mr. HEINEMANN. It was indicated to me that my testimony would not be sworn. On that basis, I chose not to be accompanied by counsel. I will obviously testify to the best of my recollection, but I had a representation explicitly on this issue from Mr. Klempner that the testimony would not be sworn. I chose to try to avoid the considerable personal expense of having counsel accompany me.

Mr. ROSENTHAL. We will forgo it. But it is your intention to be fully forthcoming in all of your answers, isn't it?

Mr. HEINEMANN. Absolutely.

Mr. ROSENTHAL. I am sure of that.

Will you identify yourself for the record?

Mr. PIERCE. My name is Samuel R. Pierce, Jr., a partner in the law firm of Battle, Fowler, Lidstone, Jaffin, Pierce, & Kheel. That is at 280 Park Avenue, New York, N.Y.

Mr. ROSENTHAL. We are honored to have you this morning.

We will begin with your testimony, Mr. Heinemann.

Mr. Heinemann, would you give your name and address?

Mr. HEINEMANN. My name is H. Erich Heinemann. My address is 7 Woodland Place, Great Neck, N.Y., 11021.

Mr. ROSENTHAL. At any time were you in any way associated as an officer or director of the Franklin National Bank?

Mr. HEINEMANN. From the first of August of 1973 through the 12th of May of 1974, I was a vice president of the bank. I had no other titled function there.

Mr. ROSENTHAL. Prior to that, what had been your professional experience?

Mr. HEINEMANN. From 1965 through 1973, I was an assistant to the financial editor of the New York Times. Prior to that, I was an associate economist with Morgan Guaranty Trust Co.; and, prior to that, I was an assistant finance editor of Business Week magazine.

Mr. ROSENTHAL. Generally, could you ascribe to yourself a particular expertise in the banking arena?

Mr. HEINEMANN. I have been a financial journalist and an analyst of banking affairs for nearly 20 years.

Mr. ROSENTHAL. Can you tell us something about your experience with Franklin? Tell us in narrative form what you did and what happened.

Mr. HEINEMANN. My role at Franklin was that I was hired by Mr. Luftig, who was president of the bank, with the responsibility for long-range corporate planning. In practice my function involved analyses of the bank's current operations and reporting on those analyses to Mr. Luftig personally.

Mr. ROSENTHAL. Tell us about some of the specific activities you pursued.

Mr. HEINEMANN. They ranged over virtually all of the bank's domestic operations, involving data processing, analysis of the earning characteristics of the bank, personnel problems, strategy questions, questions dealing with current administrative procedures, the collection of information about the bank's operations in the money market, and suggestions as to ways those operations might be improved.

Mr. ROSENTHAL. In the summer of 1973, did the Federal Reserve take any action regarding commercial banks to hold the prime interest rate from rising from above the 6-percent level?

Mr. HEINEMANN. The actions to which you refer actually occurred somewhat prior to that and were not taken by the Federal Reserve per se, but rather by the Committee on Interest and Dividends, which was an agency created under the price control program that President Nixon announced on August 15, 1971. Arthur Burns, who is Chairman of the Federal Reserve Board, was Chairman of the Committee on Interest and Dividends.

I have collected from my news files from my years at the New York Times a number of the press releases that were issued by the Committee on Interest and Dividends during that period. The first relevant document which came to my attention was about the 26th of January of 1973. It was in that period that the Committee on Interest and Dividends, under Dr. Burns' leadership, exerted very considerable pressure on banks to prevent the prime rate from rising, including, specifically, Franklin National Bank.

I was deeply involved as a reporter for the New York Times in reporting those stories on a daily basis. This was through the winter and early spring of 1973.

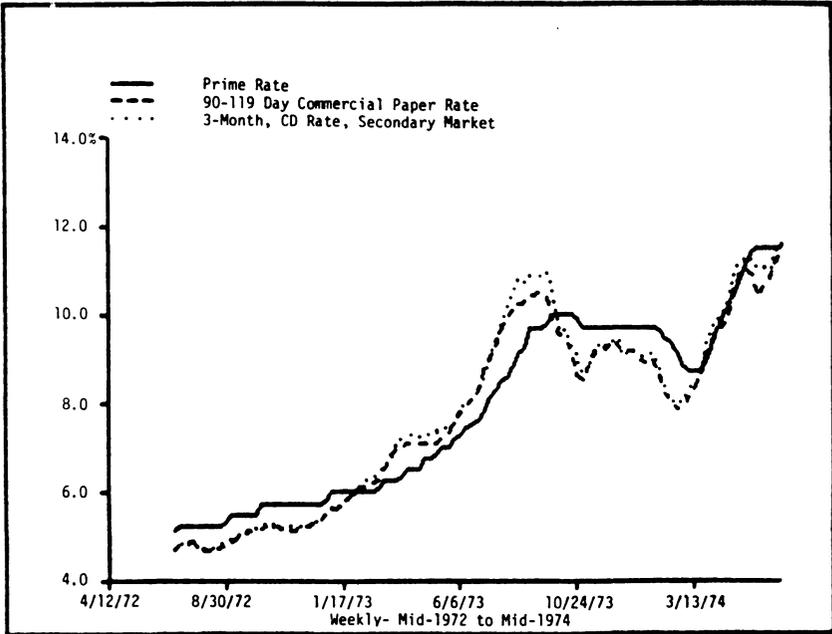
Mr. ROSENTHAL. During the summer of 1973, did the rate for Federal funds and short-term certificates of deposit (CD's) in fact rise above 6 percent?

Mr. HEINEMANN. Very substantially. It may be useful to the committee that I, in preparation for this hearing, have assembled some charts which show a number of money market interest rates and show how they related one to the other.

Mr. ROSENTHAL. Without objection, that shall be included in the record.

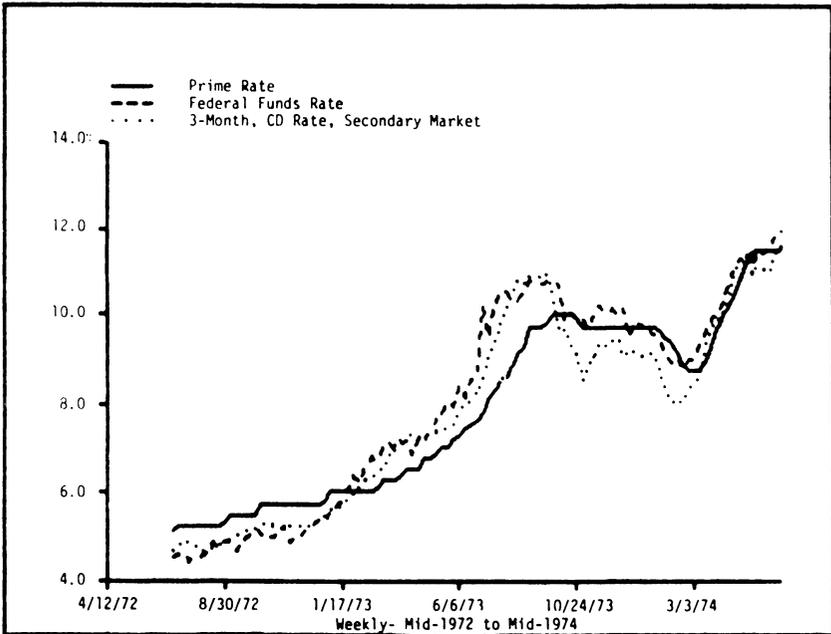
[The material referred to follows:]

CHART 1



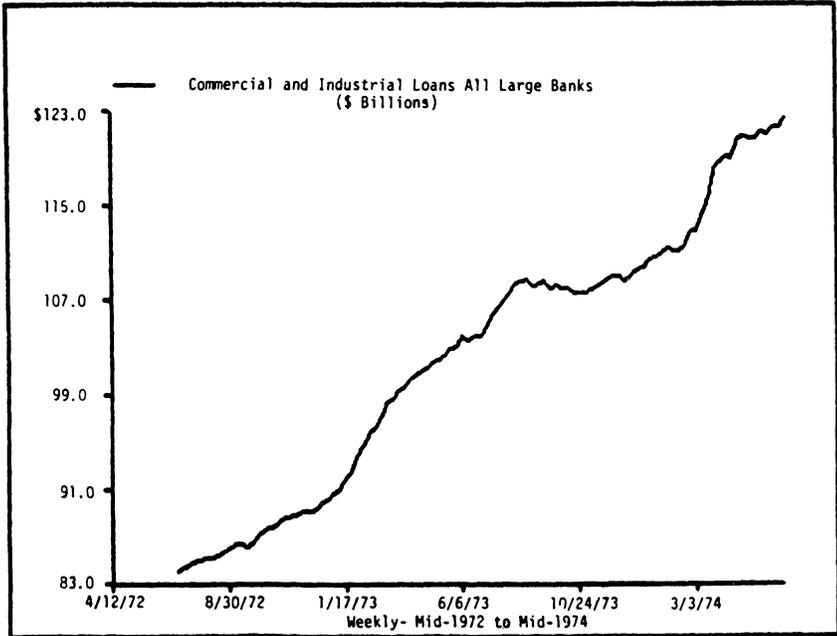
Source: Federal Reserve Board

CHART 2



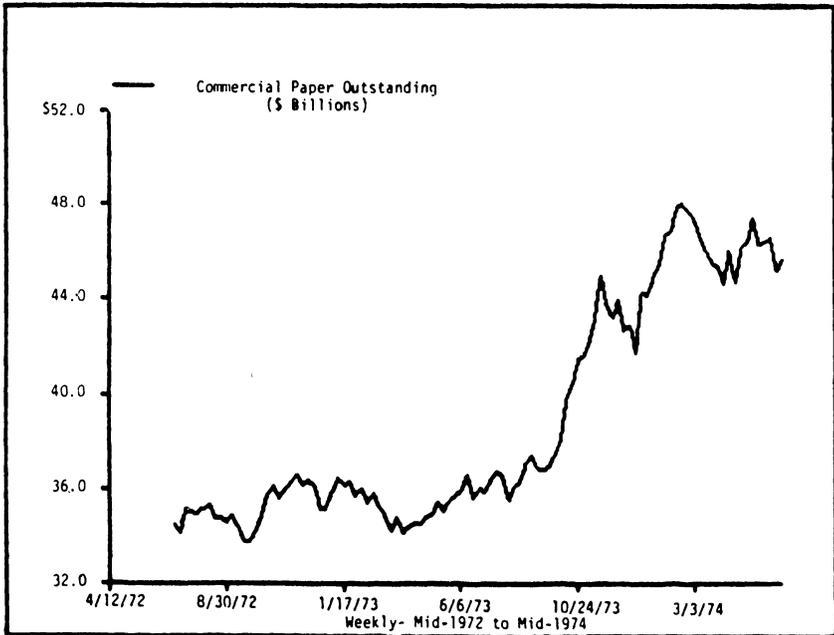
Source: Federal Reserve Board

CHART 3



Source: Federal Reserve Board

CHART 4



Source: Federal Reserve Board

Mr. ROSENTHAL. Was Franklin National Bank at some time during this period required to purchase a considerable amount of Federal funds and CD's to meet the demands on its unfunded lines of credit during the summer of 1973?

Mr. HEINEMANN. Yes; it was. It was prior to my association with the bank. My impression would be, from the few documents that I have available to me, that the bank's CD's in January of 1973 averaged \$350.1 million a day. In August of 1973 when I joined the bank, they averaged \$598.2 million. Gross Federal funds purchased averaged \$425.1 million a day in January of 1973, and \$797.8 million a day in August of 1973. The net Federal funds position, less Fed funds sold, was \$235.9 in January—that is hundreds of millions of dollars, obviously—and \$530.2 in August of 1973.

Mr. ROSENTHAL. During the summer of 1973, was Franklin thinly capitalized? In other words, did Franklin have an inordinately large amount of liabilities, especially interest sensitive liabilities, in relation to its capital?

Mr. HEINEMANN. That would be my opinion as a bank analyst, and certainly that would be so in comparison to other banks of similar size at that time.

Mr. Luftig, I think, would perhaps be a better one to whom to address that question. He had a much broader involvement in the banking affairs at that time than did I. I had just joined the bank as a brand new officer of the bank at that time.

Mr. ROSENTHAL. Of what consequence was it to Franklin and its CD position that the interest rates rose?

Mr. HEINEMANN. The general characteristic of Franklin's money market liabilities was that they were extremely responsive to changes in short-term interest rates in the open market. When interest rates in the open market rose, Franklin felt the impact of those cost increases almost at once.

Mr. ROSENTHAL. During the fall of 1973, or at any time, as a matter of fact, had you received any indication that other banks were not willing to sell Federal funds to Franklin or to purchase Franklin's CD's?

Mr. HEINEMANN. I can recall a specific instance in which Mr. Howard Crosse, who was a vice chairman of Franklin, indicated in a management meeting that 70 out of 100 of the largest commercial banks in the country were not willing to sell Federal funds to Franklin. As a matter of general recollection, I would put the date of that statement as sometime during October or November of 1973.

Mr. ROSENTHAL. Were you the person who was responsible for setting up a computer-based model of Franklin's operation? Was that your baby?

Mr. HEINEMANN. Yes. I worked on that very extensively.

Mr. ROSENTHAL. Why did you set up such a model? What was it intended to do?

Mr. HEINEMANN. The purpose of that effort was to provide and create a management tool which would allow us to see the consequences in terms of earnings of a variety of different managerial strategies.

As the model was finally completed, we were able to look at a combination of three different liability strategies and three different asset

strategies which gave us a matrix of nine different results relative to two different interest-rate forecasts. So we could put a set of assumptions into the computer and almost literally press a button and get 18 different earnings forecasts of the results of a variety of different management courses of action which would then perhaps be useful to management in making decisions about actual operations.

Mr. ROSENTHAL. When did you first make use of this computer operation?

Mr. HEINEMANN. The work was essentially complete in late February or early March of 1974. There were some minor refinements and additions that were made to the system subsequent to that, but the thing was basically in usable form by that time.

Mr. ROSENTHAL. What were the results of the first use of it?

Mr. HEINEMANN. Initially, it was simply used to speculate, assuming the market behaved in a certain way, as to what the results would be. These were "what if" calculations—calculations which were intended to be suggestive.

Mr. ROSENTHAL. Was that the entire purpose of this computer operation?

Mr. HEINEMANN. That was the purpose for which it was designed. Subsequently, and I think this may be the point at which you are driving, we did enter into the system specific indications or specific data regarding the actual operations of Franklin and run the system on the assumption that actual money market conditions at a particular point in time were to continue.

In other words, we used it to forecast earnings in a specific way. That was not the purpose for which it was designed; it was designed to be a management tool and as an analytical tool. But it was, in fact, at various points in time used to actually predict earnings.

Mr. ROSENTHAL. Did you actually do a computer run of Franklin in late 1974; and, what were the conditions upon which you based that computer run?

Mr. HEINEMANN. In the latter part of April, we did do such a computer run. The results of that was a forecast on our part that the bank was likely to show an operating loss, exclusive of any losses in the foreign exchange area about which we were not then informed, of between \$5 million and \$7 million during the second quarter—the April, May, and June period of 1974.

Mr. ROSENTHAL. Why were you not informed of the foreign exchange situation?

Mr. HEINEMANN. I was personally not involved in the international department in any way at that particular point in time. It was simply not known within the bank's management that there were problems or losses. They had not been uncovered at the point when that particular forecast was made, to the best of my recollection.

Mr. ROSENTHAL. Did the conditions upon which you based that computer run actually exist in May of 1974?

Mr. HEINEMANN. Yes; that was the intention. Our assumption was: Let's assume that the Federal funds rate continues at 11 percent through the second quarter. What will be the results?

Eleven percent was the actual rate that Franklin was paying in the Federal funds market at that time. Actually, the 11 percent would have been slightly higher than the bank was paying at that time, but

those were essentially the conditions at that time. So assuming they continued for the next 2 months, this was to determine what would be the results for Franklin's earnings. And that forecast was that Franklin would lose, solely from operations, between \$5 million and \$7 million.

Mr. ROSENTHAL. And did you conclude from that that the bank could not survive then?

Mr. HEINEMANN. My personal conclusion was that it was unlikely that if an operating loss of that magnitude were reported publicly that the market would be willing to continue to sell Federal funds or Eurodollars to Franklin so that it could continue to roll over, to renew its maturing short-term obligations.

Mr. ROSENTHAL. What would the effect of that be?

Mr. HEINEMANN. The bank would have been out of business.

Mr. ROSENTHAL. Did you convey this information or your opinion to anybody else? Did other people have the same opinion?

Mr. HEINEMANN. I think this was a point of view which a number of us who were in touch with the situation held. In the narrative that Mr. Klempner prepared, there was a reference to a consultant to the bank who was working for us at that time and the letter that he conveyed——

Mr. ROSENTHAL. Who was that?

Mr. HEINEMANN. Mr. Klempner had indicated that we could not identify him. I have subsequently gotten permission from him to give you a copy of that particular letter. It was a Mr. Gordon J. Crook of Lesta Research, Inc. I have a copy of his letter.

[The letter referred to follows:]

# Lesta Research, Inc.

MANAGEMENT CONSULTANT

111 JOHN STREET • NEW YORK, N. Y. 10038

May 1, 1974

Mr. Paul Luftig, President  
Franklin National Bank  
450 Park Avenue  
New York, New York 10022

Dear Paul,

The purpose of this memorandum is to summarize our conclusions stemming from work carried out by Lesta Research, Inc. for the bank since October 1973, and to indicate our recommendations for the future.

We wish to acknowledge the fact that our work has been carried out with the full participation and cooperation of yourself, Erich Heinemann and other Bank staff.

## Conclusions

As a result of our analyses, and in light of the present actions being taken by Bank management, we must advise you that we believe that the Bank is in immediate danger of becoming insolvent.

Although this danger appears to be partially recognized by senior management, we believe that the seriousness of the situation is not fully appreciated. We also believe that the necessary corrective action is not being taken at all in certain instances, and in others the action taken is doomed to failure as a result of lack of communication and coordination between members of senior management. In many instances, the information needed to make rational decisions is either not collected, or, if collected, is withheld from management.

We therefore urge that immediate action as indicated below be taken by the Board of Directors and the Executive Committee to avoid a financial collapse of the Bank.

A more detailed review of the basis of these conclusions and recommendations will be contained in a separate memorandum.

## Financial and Operating Characteristics of Franklin National Bank

Our reasons for the above conclusions are a result of our analyses of the financial and operating characteristics of the Bank as follows:

Mr. Paul Luftig  
May 1, 1974

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1. Net Money Margin - Domestic

The present structure for pricing loans is in and of itself guaranteed to lead to bankruptcy in the long run. The recognition of this fact by the money markets will probably lead to insolvency in the short run.

The average spread over prime, on prime related loans, appears to be some 90 basis points for domestic loans. This spread is quite insufficient to cover loan losses, money costs, and operating costs. The paucity of the spread has been apparent to management for some time, yet at this date work has barely begun to rectify the situation.

It is essential that the domestic spread over prime be increased to between 150 and 200 basis points within the next 30 days in order to avoid a repetition of the first quarter's disastrous earnings. It is our opinion that the action currently being taken is insufficient to accomplish any measurable change in the spread over prime within the next six months.

2. Net Money Margin - International

The historical behavior of the money spread for the international operation is so erratic as to be incomprehensible. Since there is no reason why the international spread should behave this way, we can only conclude that a totally ineffective management team has been at work without any rational set of policies or management tools. In view of the massive size of the London activity, we feel it is imperative that the management situation there be brought under control at once.

In order to accomplish this, we urge the Bank to dispatch a team led by Peter Shaddick together with someone of Erich Heinemann's calibre, and a programmer who is competent enough to put up a rudimentary asset and liability management system on time-sharing within a fortnight.

In order to minimize the exposure to money market fluctuations in London, the maturity and pricing characteristics of the assets must be made to closely match those of the liabilities. Otherwise, the potential short term losses that might be incurred could easily amount to \$10 to \$100 million.

Mr. Paul Luftig  
May 1, 1974

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Finally, London must be required to coordinate with New York daily their asset and liability position in order to minimize total Bank liability costs and to ensure that a money squeeze in London does not force the Bank under.

3. Bank Leverage

Franklin is one of the most, perhaps the most, leveraged banks in the country in terms of its recent reliance on rolling over almost \$1 billion of Fed Funds each day. We believe that the enormous risk inherent in this leverage is totally unjustified in that the interest earned on the money acquired from Fed Funds barely covers the borrowing costs at Fed Funds rates, particularly at the present level of interest rates.

It is our opinion that all that this leverage accomplishes is to leave the Bank highly vulnerable to the classic squeeze of borrowing short and lending long.

4. International Currency Trading

Although past activities of the Bank in the International Currency Market have been relatively profitable, again, the risk inherent in the tremendous leverage that is used in such dealings is grossly excessive considering the overall financial conditions of the Bank.

We strongly recommend that this activity be terminated forthwith.

5. Board of Directors

It is not apparent whether the Board of Directors has been kept fully and currently informed of the Bank's financial difficulties. We urge that the Board be immediately informed and be kept informed on a day to day basis until the situation is rectified.

6. Senior Management Coordination

It is transparently apparent that the various members of senior management of the Bank have acted in a unilateral and uncoordinated fashion in taking executive actions

Mr. Paul Luftig  
May 1, 1974

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that should have been totally coordinated with other members of senior management. Typical of this is the current withholding of relevant financial information from members of the staff reporting directly to senior management.

This lack of coordination and withholding of information should cease forthwith because, if it does not, it is inevitable that management will be acting at cross purposes which, in light of the current precarious position, will lead to immediate disaster.

7. Money Market Trading

It is apparent that the chain of command from senior management to the trading area at Hanover Square has impeded the timely flow of information to senior management regarding the attitude of the money markets towards providing the Bank with adequate funds. We again recommend that direct communication be established between senior management and the traders on an hourly basis.



Gordon J. Crook, President  
LESTA RESEARCH, INC.

Mr. ROSENTHAL. Briefly and generally, what were his conclusions?

Mr. HEINEMANN. His conclusion, bluntly put, in a letter dated May 1, 1974, was that the bank was in immediate danger of becoming insolvent.

Mr. ROSENTHAL. Did all of the officers and directors have this general information which you have described?

Mr. HEINEMANN. I think very few of them did.

Mr. ROSENTHAL. Why is that?

Mr. HEINEMANN. Perhaps because they were not involved in the kinds of analytical work in which I and others were; perhaps because they simply could not believe that an organization the size of Franklin was not in fact viable.

Mr. ROSENTHAL. Did any of them have the benefit of Gordon J. Crook's report?

Mr. HEINEMANN. Mr. Crook's report was addressed in a letter to Mr. Luftig. Mr. Luftig certainly had the benefit of it.

Mr. ROSENTHAL. Do you, yourself, know whether or not Mr. Luftig circulated it among the others?

Mr. HEINEMANN. No; I do not. Mr. Luftig would have to answer that.

Mr. ROSENTHAL. At any point in May, did Franklin's executive committee meet to discuss the possibility of seeking a merger with anybody else?

Mr. HEINEMANN. I was not a member of the executive committee, obviously, and had no direct knowledge of what it did or did not do. My understanding is that it did meet on the afternoon of Monday, May 6, 1974, to discuss this possibility. But I cannot speak to that of my own knowledge. Mr. Luftig was, of course, a member of the executive committee.

Mr. ROSENTHAL. When you joined Franklin in August 1973, were you told that you should not become involved in the international department?

Mr. HEINEMANN. I was told this was not necessary; yes.

Mr. ROSENTHAL. Did you draw any specific conclusions about that? Did that seem strange to you or anything like that?

Mr. HEINEMANN. I had more work than I could handle. I was glad that that was one area I did not have to work in. I was working alone and had virtually no assistance. I had more than my hands full in trying to understand the bank's domestic operation.

Mr. ROSENTHAL. Essentially you have told us about the factors that caused you to come to the conclusion that the bank was in serious trouble. Do you think this information was generally known within the financial community?

Mr. HEINEMANN. My impression is that in the investment community, certainly, there were widespread fears about Franklin's ability to survive. There were certainly very widespread rumors circulating at that time that the bank was in trouble. There was a constant drumfire of inquiry from my former colleagues in the press who were seeking information from me about the condition of the bank.

Mr. ROSENTHAL. Were you present at any meetings that either Mr. Luftig or Mr. Gleason or anybody had with Federal or State banking agencies during May 1974?

Mr. HEINEMANN. Only once. This was a meeting on May 8, when Mr. Luftig and I went down to the Federal Reserve to arrange some of the mechanical details which might possibly be involved in a large Franklin borrowing from the Federal Reserve System.

Mr. ROSENTHAL. Who was there and what took place at that meeting?

Mr. HEINEMANN. Mr. H. David Willey and Mr. Henry S. Fujarski, Jr., were there.

Mr. ROSENTHAL. Do you know whether Mr. Willey is related to Frank Wille?

Mr. HEINEMANN. No; he is not. He spells his name in a different way and, to the best of my knowledge, he is not related.

Mr. ROSENTHAL. What took place at that meeting?

Mr. HEINEMANN. As I recall, it involved a setting forth of a series of requirements that would have to be met in terms of the transfer of collateral from Franklin to the Federal Reserve Bank of New York in order for extensive borrowings to be undertaken by Franklin, under the authority that the Fed has under section (10) (b) of the Federal Reserve Act which allows borrowings which are other than normal discount window borrowings.

Mr. ROSENTHAL. Do you have anything to do with the marshaling of assets for the Federal Reserve?

Mr. HEINEMANN. This is the process about which I was speaking. The arrangements were to physically transfer the loan documents from Franklin to the Federal Reserve Bank of New York so they could be held as collateral or to physically segregate them under Federal Reserve control on Franklin's premises.

I worked on this mechanical problem of physically transferring pieces of paper from the Franklin to the Fed.

Mr. ROSENTHAL. How much money was involved?

Mr. HEINEMANN. We did not know how much was going to be involved. We were making arrangements essentially to transfer virtually the entire loan portfolio of \$2.5 billion over to the Fed. We did not know how much was going to be needed. Basically, we were going around trying to scare up every available piece of paper that had any value as collateral.

I worked on this from Wednesday, May 8, through Sunday, May 12. I was fired on the 13th, so I do not know what happened after that.

Mr. ROSENTHAL. Were you involved in any merger discussions with anybody?

Mr. HEINEMANN. I was physically present on Saturday, May 11, 1974, when a large contingent of senior officers from the Manufacturers Hanover Trust Co. came to Franklin to discuss the bank's problems and to see whether or not it would be possible to arrange some kind of a business combination.

I was a relatively junior officer of the bank, and at no time did I have the authority nor was I ever involved in any actual merger negotiations. I had no authority to do that and did not do that. But I was physically present when discussions of this nature were taking place.

Mr. ROSENTHAL. Do you have an opinion as to what the attitudes of the other bank people were toward a merger—the people of Manufacturers Hanover?

Mr. HEINEMANN. The fact is that virtually the entire senior management of the Manufacturers Hanover came in to work on Saturday morning, May 11, 1974, to the offices of Manufacturers Hanover at 350 Park Avenue in New York City, and walked up Park Avenue to Franklin's offices at 450 Park Avenue. I am told, although I do not know this to be a fact, that they came in small groups to avoid attracting attention.

I would assume that they would not have come to Franklin under those circumstances if they had not been serious about it. But I cannot go into their minds; I do not know what their attitudes actually were.

Mr. ROSENTHAL. They were serious?

Mr. HEINEMANN. That would be my impression based on their actual behavior.

Mr. ROSENTHAL. Can you briefly tell us the nature and the extent of the discussions of that Saturday meeting?

Mr. HEINEMANN. As I recall it, the Manufacturers team, which was headed by Mr. John McGillicuddy, president of Manufacturers Hanover, arrived and then split up with each person of Manufacturers Hanover pairing up with his counterpart at Franklin.

I was physically present in Mr. Luftig's office while Mr. McGillicuddy was there. I was not physically present in any of the other meetings. I do not know what was going on in the other meetings.

The discussion in Mr. Luftig's office involved general descriptions of the characteristics of Franklin and some very general comments by Mr. McGillicuddy about his concern about not becoming too deeply involved in Franklin's problems.

Mr. ROSENTHAL. Did Mr. McGillicuddy at any point say why he was there?

Mr. HEINEMANN. They very clearly, in my opinion, were there because they wanted to explore the possibility of an acquisition. After all, Manufacturers Hanover Trust Co., the principal operating subsidiary of Manufacturers Hanover Corp., had just made a \$30 million loan just a few weeks before to Franklin New York Corp. And I think the Manufacturers Hanover people were concerned about the possibility of protecting the funds they had just disbursed.

But, again, I cannot speak for them. I do not know what their intentions were. That would be my presumption.

Mr. ROSENTHAL. Was Mr. Gleason present that day?

Mr. HEINEMANN. I am sure he was present at one time or another. Whether he was physically present though during those discussions, I do not know. I cannot recall that.

Mr. ROSENTHAL. Did you see him there that day?

Mr. HEINEMANN. I saw him at least once or twice in the morning. Whether he was physically present when the Manufacturers Hanover people were there or not, I cannot recall.

Mr. ROSENTHAL. Did you see him leave the office?

Mr. HEINEMANN. No. There were a great many people milling around on several floors of the bank. I cannot recall either having seen him arrive or depart.

Mr. ROSENTHAL. After that Saturday meeting, were there any further meetings in which you were involved or know about with Manufacturers Hanover?

Mr. HEINEMANN. Certainly there were none that I was involved in; and, to the best of my recollection, there were none that I know about.

Mr. ROSENTHAL. Could you in any way characterize the progress made at the meeting toward a merger or in any other way?

Mr. HEINEMANN. I believe that I would not be competent to make such a characterization. I believe Mr. Luftig can.

Mr. ROSENTHAL. Do you have any opinion as to whether it would have been necessary, if Franklin and Manufacturers were to engage in a merger, to have the support and assistance and cooperation of both the Federal Reserve and the Comptroller of the Currency?

Mr. HEINEMANN. Yes; I believe that would have been the case. Our discussions were predicated on the assumption that such assistance would be forthcoming not only from the Fed and the Comptroller's office, but also from the Federal Deposit Insurance Corporation.

Based on the precedent of assistance that the Federal Deposit Insurance Corporation and, I might add, the Federal Savings and Loan Insurance Corporation has extended to companies which had acquired troubled institutions prior to that, we felt there was ample precedent on the record for FDIC to provide some assistance to the Manufacturers Hanover in order to make this transaction possible.

Mr. ROSENTHAL. Were you present at any meetings with any Federal regulators from either FDIC, the Federal Home Loan Bank Board, the Federal Reserve Board, or the Comptroller pursuing the kind of discussions you have just responded to?

Mr. HEINEMANN. No; none.

Mr. ROSENTHAL. Do you know the approximate amount of Federal funds and CD's that came due on Monday, May 13, 1974?

Mr. HEINEMANN. This has to be a guess. On May 9, 1974, Franklin had \$81.7 million in CD's coming due within 1 week after that date. On May 9, Franklin had a total of \$561.1 million in Federal funds purchases outstanding; of which, all but about \$42 million came due the next day.

There were—and this is a recollection based on informal reports within the bank because I never saw any document or piece of paper that would have confirmed it—approximately \$60 million or \$70 million of overnight Euro-dollars coming due on a routine basis and being renewed on a routine basis.

So by adding those up in round numbers, that would be about \$670 million of overnight obligations or CD's coming due at approximately that point in time.

Mr. ROSENTHAL. How did they handle that? What happened?

Mr. HEINEMANN. Our opinion that weekend was that absent a firm, definitive merger agreement, the market would not be willing to renew those obligations and that the bank, while possibly solvent in an accounting sense in that it had a positive net worth, would be incapable of meeting its obligations as they became due and, thus, would be unable to open its doors absent the Federal Reserve support.

Mr. ROSENTHAL. What happened?

Mr. HEINEMANN. I was fired on Monday morning, May 13. I do not know what happened.

Mr. ROSENTHAL. Who fired you?

Mr. HEINEMANN. I guess Mr. Gleason did. I do not know. I never got official notice as to who was responsible for my firing.

Mr. ROSENTHAL. Do you have any thoughts as to why you were fired?

Mr. HEINEMANN. I never received a formal communication from the bank setting forth the reasons for my dismissal. A public relations spokesman for the bank asserted in a press conference that I was fired for failing to perform my assigned responsibilities. That is the only formal statement that was ever made.

Mr. ROSENTHAL. Why did you fail to perform your assigned responsibilities?

Mr. HEINEMANN. I believe that that was a totally unjustified allegation regarding me. I tried for a long time to get a formal retraction from the bank. I was unable to do so prior to the bank's failure on October 8 and I eventually decided to drop the matter.

Mr. Luftig was my de factor superior and supervisor; I think he can perhaps testify as to whether or not I was performing my responsibilities.

Mr. ROSENTHAL. My question as of three questions ago was: Do you have any opinion as to why you were fired?

Mr. HEINEMANN. I think, as the committee knows, Mr. Luftig also left Franklin on that same day. As a practical matter since I was working for him and was closely identified with him, I think that if for no other than political reasons, I would have left very quickly after his departure.

My departure was probably hastened because on Sunday evening, May 12, I made a statement to a reporter for the Wall Street Journal that certain items in a press release, issued under Mr. Gleason's name, were in fact inaccurate. Those specific items related to whether or not the foreign exchange loss was attributable just to the second quarter or whether it in fact also applied in part to the first quarter and whether or not the foreign exchange loss was going to be covered by insurance.

I felt that Mr. Gleason's statements in his press release were inaccurate. Subsequently, in civil litigation filed by the Securities and Exchange Commission, one of the allegations regarding Mr. Gleason was that he had issued an inaccurate statement on May 12, and essentially on those points.

Mr. ROSENTHAL. When did Sindona come into the bank?

Mr. HEINEMANN. Mr. Sindona's acquisition of 1 million shares of Franklin New York Corporation's stock at \$40 a share was announced on July 12, 1972, I believe. I wrote the story for the New York Times.

Mr. ROSENTHAL. You had obviously heard of Sindona before this hadn't you?

Mr. HEINEMANN. Only in very vague terms. I had to go to the Times morgue to really find out who he was. I really did not know anything about him.

Mr. ROSENTHAL. Have you learned more about him since that time?

Mr. HEINEMANN. By hearsay; yes.

Mr. ROSENTHAL. Had you ever heard of an enterprise in which Mr. Sindona had been involved with David Kennedy from Chicago?

Mr. HEINEMANN. I am aware that Mr. Kennedy, the former Secretary of the Treasury and former chairman of the Continental Bank in Chicago, was, to the best of my knowledge, on Mr. Sindona's payroll. He was an officer of Mr. Sindona's holding company, to the best of my

knowledge. So I would assume there was a common interest of some kind.

Mr. ROSENTHAL. Do you have the newspaper clippings that indicate what you have just told us?

Mr. HEINEMANN. No; I do not. I did not maintain a clip file of my own work at the Times. It is actually much too voluminous to be worth keeping.

Mr. ROSENTHAL. In your opinion, would a merger between Franklin and Manufacturers in May of 1974 have been less destructive to the financial community than permitting Franklin to continue as it did in May of 1974?

Mr. HEINEMANN. Yes. I feel that very strongly. I feel very strongly that in a technical sense the subsequent acquisition by the Chemical Bank of the Security National Bank under remarkably similar circumstances indicated that the merger that Mr. Luftig and others were trying to arrange in that fateful May weekend was in fact technically feasible.

Mr. ROSENTHAL. Why did it not take place?

Mr. HEINEMANN. I do not know.

Mr. ROSENTHAL. Do you have an opinion?

Mr. HEINEMANN. Apparently the regulatory authorities did not share the opinion that we had of the gravity of the situation. They believed, apparently, that it would be possible, if Mr. Sindona made an additional \$50 million investment in Franklin, for the bank to continue as an independent enterprise.

Mr. ROSENTHAL. Did Mr. Sindona make that additional \$50 million investment?

Mr. HEINEMANN. No; he simply offered to do so.

Mr. ROSENTHAL. Would the \$50 million have been adequate to save Franklin?

Mr. HEINEMANN. No—not in my opinion.

Mr. ROSENTHAL. Why?

Mr. HEINEMANN. I think, to use a metaphor, that Humpty Dumpty had fallen off the wall. The egg was broken and there was no way to put it back together again.

The deposit base had started to fall apart.

Mr. ROSENTHAL. Why do you think the regulators took that position?

Mr. HEINEMANN. I do not know why they took it. I am at a loss to understand why this occurred.

Mr. ROSENTHAL. When you say the “regulators,” whom do you mean?

Mr. HEINEMANN. In this case, I think that we are really talking about all three regulatory agencies—the Federal Reserve, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

Mr. ROSENTHAL. Do you have any hypothesis on which you could base a judgment as to why they did that? Do you have any conjecture as to why they did that?

Mr. HEINEMANN. No; not really. I have nothing which is based on any knowledge of any kind.

Mr. ROSENTHAL. How about an opinion based on surmise or suspicion?

Mr. HEINEMANN. As a matter of pure speculation, the regulators apparently felt that the so-called Sindona plan, which was announced in Mr. Gleason's press release of May 12, would be adequate.

I felt that position was an incorrect one and that it would not be adequate. I do not know how they came to that conclusion. I do not know what political influences may or may not have been brought to bear on the regulators to make the decision that they made.

Mr. ROSENTHAL. What kind of political influences are you talking about?

Mr. HEINEMANN. As I have said, I don't know whether there were any. There were many connections though. Mr. Sindona's counsel was Mudge, Rose, which was Mr. Nixon's law firm. I do not know what happened.

Mr. ROSENTHAL. Did Mr. Gleason leave the office of the bank that day to go down to Mudge, Rose during these negotiations?

Mr. HEINEMANN. You are referring now to Sunday, May 12, Mother's Day?

Mr. ROSENTHAL. Saturday.

Mr. HEINEMANN. I do not know whether he did or not.

Mr. ROSENTHAL. Did you ever see David Kennedy in the bank?

Mr. HEINEMANN. Frequently. We knew each other from my days as a reporter and on half a dozen occasions, there was a cordial hello-how-are-you kind of thing.

Mr. ROSENTHAL. Would a merger between Franklin and Manufacturers Hanover in May of 1974 have been less disruptive to Franklin's customers and the economy of the Long Island market than permitting Franklin to operate as it did after May 1974 and eventually having its assets and operations managed by both FDIC and, thereafter, European-American?

Mr. HEINEMANN. I think that is probable. I think that Manufacturers Hanover, from my point of view, since it is a large, very well-established, very well-run New York City and New York region institution, understands the market well. I think that if a merger of that sort had been consummated, there would have been no significant or discernible impact on the Long Island business community of any kind.

My personal opinion is that Franklin, despite its deep trouble and deep distress, as of that weekend in May 1974, represented substantial potential value to Manufacturers Hanover Trust Co.

Mr. ROSENTHAL. On the other side of the question, were there any economic or financial factors which would have dictated against a merger between Franklin and Manufacturers?

Mr. HEINEMANN. Franklin, as we all know, was a deeply troubled organization. It would have been very difficult and very complex and it would have been a risky transaction. There were lots of things that could have gone wrong. There could have been problems that we did not know about.

There were leases on branches which were uneconomic which would have been very hard to break. It would have been a tough job to do.

My personal opinion is that there were no obstacles of a sufficient order of magnitude to prevent a transaction of that sort from going through.

Mr. ROSENTHAL. And on balance, it would have been better to do it that way than the way it happened?

Mr. HEINEMANN. That is my personal belief. It was my personal belief very strongly at that point in time.

Mr. ROSENTHAL. Do you know of your own knowledge or have you heard of any particular special relationship between David Kennedy and any of the Federal regulators?

Mr. HEINEMANN. Since he was a former Secretary of the Treasury, I would assume that he had close relationships with essentially all of them. And since he was a former chairman of one of the largest banks in the country, I would assume that he knows them all very well.

But I have no direct knowledge. The present Comptroller of the Currency became a Treasury official during the period when Mr. Kennedy was Secretary of the Treasury. He became the Comptroller of the Currency, however, after Mr. Kennedy had left Government service, to the best of my knowledge.

Mr. ROSENTHAL. Was that on Kennedy's recommendation, do you know?

Mr. HEINEMANN. I do not know.

Mr. ROSENTHAL. Where is Kennedy now?

Mr. HEINEMANN. I assume he is retired; but, I have no knowledge.

Mr. ROSENTHAL. Thank you very much. Don't go away.

Mr. HEINEMANN. May I make just one comment?

Mr. ROSENTHAL. You did very well without a lawyer.

Mr. HEINEMANN. I am not in any way involved in any of the litigation involving Franklin National Bank. I think the record should be clear on that. As a factual matter, I am not named in any of the litigation and I have no role in any part of it.

Mr. ROSENTHAL. Did you escape with your scalp generally unscathed?

Mr. HEINEMANN. I hope so.

Mr. ROSENTHAL. Mr. Luftig, we are deeply grateful that you could be with us today. I am sure you can shed considerable light on the matter we are interested in.

I should say for the record that you are represented by a very distinguished and eminent counsel for whom I have a great personal respect.

Mr. PIERCE. Thank you very much.

Mr. ROSENTHAL. Would you give us your name and address, Mr. Luftig, and your present employment? And if you have an opening statement, you may then tell us about it.

**STATEMENT OF PAUL LUFTIG, FORMER PRESIDENT, FRANKLIN NATIONAL BANK; ACCOMPANIED BY SAMUEL R. PIERCE, JR., COUNSEL**

Mr. LUFTIG. My name is Paul Luftig. My home address is 83 Willow Avenue, Larchmont, N. Y. 10538.

I am presently executive vice president of Commercial Funding, Inc., New York City, N. Y.

I would like to read my statement.

Mr. ROSENTHAL. You may proceed.

Mr. LUFTIG. You have asked me before this committee to discuss events preceding and during the weekend of May 13, 1974. As you are aware, I was president of Franklin National Bank from June

1972 until May 13, 1974, on which date I was dismissed by its board of directors. I was also president of Franklin New York Corp., the parent bank holding company, during the same period of time. Prior to joining Franklin I was employed by the Bankers Trust Co. in New York for 21 years and my title when I left was senior vice president.

I think it is important that you understand that the financial condition of Franklin in May 1974 was brought about by certain management decisions dating back a decade or more. Given those decisions coupled with the unprecedented high level of interest rates, the bank was a troubled institution by May, 1974.

The decisions to which I refer are :

1. In the years prior to 1972, the bank had decided to expand its facilities into New York City from Long Island where it had its origins. The expansion came about through merger, new branch openings, and through a new business effort geared at the national name accounts in New York City. The branch openings particularly hurt the bank since they led to an inordinately high level of fixed costs for rent in prime locations. The bank's new main office in New York City, at 450 Park Avenue, increased these fixed costs tremendously.

2. The bank bought hundreds of millions of dollars of tax-free, long maturity securities. At the time that it was earning money, these securities provided it with a sound earnings position; but, by the latter part of the sixties, the bank had experienced high loan losses and consequently a lower tax rate. The tax-free securities were therefore a drain on earnings since their pretax yield was so low.

3. The bank, in its zeal to enter the New York and national markets, had attracted a lot of marginal business that caused high loan losses. It also gave very advantageous terms to national accounts and other banks in order to have "quality business" on its books. As a result, its ratio of deposits to loans was very low and it had to purchase funds in the form of certificates of deposits and Federal funds to support its loans. Of course, other banks were doing the same thing, but Franklin's percentages were far in excess of the competition. A drive to improve the loan-to-deposit ratio and loan rates was conducted during 1973 and 1974, but results in this area are long range.

4. The bank was making fixed-rate loans at what were then high interest rates. As interest rates increased and the bank's cost of acquiring time deposits and Federal funds went up, the yield on these loans was less than the cost of acquiring liabilities to cover them. In effect, it was borrowing short at variable rates, and lending long at fixed rates. When in late 1973 and 1974 rates began their rapid acceleration, the precarious earnings position of the bank began to turn perilous. Since costs of operations were so high, the already thin margins of profit evaporated in the second quarter of 1974.

5. The bank's financial reporting system was of such poor quality that much of what I am reporting to you today was virtually unknown to its management until it was too late. There was no adequate measure of fixed and variable rate liabilities and assets and their relationship until a few months prior to my dismissal. Efforts to improve this system by hiring of a top-quality financial officer were frustrated time and time again. As a result, I was working in the dark in trying to solve the bank's problems since, not only was its then present condition

a matter of guesswork, but the effect of actions to be taken could not be measured.

6. The bank's management was not of a quality to cope with these situations. There were cliques and intrigues prevalent that made it almost impossible to get things done. Simple plans did not take effect; face-saving and image were more important than results. With the bank's change in minority ownership in 1972, these intrigues deepened almost to the point where there were pro-ownership and anti-ownership groups fighting each other. The selection of very senior officers of the bank without my knowledge, even though I was nominally chief administrative officer, did not help the situation.

As rates increased in the 6 months prior to May 1974, it became harder and harder for the bank to go about its daily business. We were terribly dependent upon Federal funds to keep us going; and as rumors about the bank's financial problem increased, it became a daily chore to convince other banks to lend us Federal funds. There were also rumors about overextension in foreign operations, and Mr. Sindona's presence did not help us to assuage our lenders.

The management of the bank assumed a character of crisis. We were dealing with potentially damaging rumors one moment and the inability to fund our assets the next. As rates continued to escalate during early May 1974, a few of us became aware that it was in the best interest of a majority of our shareholders and all of our depositors to try to merge the bank. This action was formally approved at an executive committee meeting on May 6, 1974, prior to the knowledge that there were foreign exchange losses in the bank. It is important to remember that it was after merger talks were started that we learned of the extent of those foreign exchange losses. This action to merge was formally approved in an executive committee meeting on May 6.

During the week of May 6, we informed the Federal Reserve Bank of the possible foreign exchange losses and of our inability to meet our dividend payment. We also told the Fed of our efforts to attempt a merger with the Manufacturers Hanover Trust Co. I am sure that you are aware of the events of the weekend of May 10 when merger talks intensified. At that point I realized I was attempting the merger against the wishes of Mr. Sindona who informed me that if I proceeded, I would "be in trouble." I proceeded. I was in trouble and was fired by the Sindona-dominated board on Monday, May 13, 1974.

During the weekend, various things happened that trouble me to this day. The most troubling is of course the change in the attitude and the lack of support I received from the regulatory agencies. They must have known of the bank's condition through examinations they had conducted. I had discussed these problems with the resident examiner of the Comptroller of the Currency who concurred that my efforts at merger were directed properly. And yet sometime during that weekend, regulatory support for the merger dissolved and support for Mr. Sindona's solution grew—culminating with my dismissal on Monday, May 13.

The merger which I had suggested involved FDIC and Comptroller's assurances. This had been done in the past and of course was successful several times since the Franklin collapse, particularly in the Security National acquisition by Chemical Bank. But the regulatory agencies

chose the much more hazardous route of lending huge sums of money to a bank that could not exist, supported by the word of a minority, but controlling shareholder.

It will, of course, take years to see how much of this money is returned to the Government and at what expense to the taxpayer. I hope it takes less time to determine how the bank regulatory authorities came to the positions they took during that weekend.

I am a professional banker and I know that merger, with some moderate Government help at that time, was in the best interests of depositors, shareholders, and the Government itself. I hope you gentlemen can determine what caused the regulatory authorities to think otherwise.

Mr. ROSENTHAL. I was just going to ask you that question. Why do you think they changed?

Mr. LUFTIG. I do not know.

Mr. ROSENTHAL. Are you reluctant to speculate?

Mr. LUFTIG. I think a committee such as this should really be the one that investigates it. I just do not know.

Mr. ROSENTHAL. Tell us more about the change. Was it an abrupt thing? When did you have the first meeting with any regulator concerning a merger?

Mr. LUFTIG. I believe it was the afternoon of May 6, 1974, but it could have been either May 6 or May 7. I am not sure. It was early in the week.

Mr. ROSENTHAL. Who was it with and where was it?

Mr. LUFTIG. It was in the Federal Reserve Bank in New York. The early meetings, I believe, were with Mr. Hayes, Mr. Debbs, Mr. Willey, and a number of others.

Mr. ROSENTHAL. Are these all second- or third-level types?

Mr. LUFTIG. No, no; Mr. Hayes was president of the Federal Reserve Bank of New York.

Mr. ROSENTHAL. That is first-level. Did you have a conversation with him?

Mr. LUFTIG. Yes. We had gone down to the Federal Reserve several times during that week. I do not recall exactly on which dates that occurred.

Mr. ROSENTHAL. I am interested in finding out Mr. Hayes' attitude and the only way I can find that out is to ask you what you said and what he said. But I am more interested in what he said.

Mr. LUFTIG. I was down there to try to impress upon the Fed the condition that the bank was in. I think he understood it in that we were directed to marshal the assets of the bank in the event of a possible loan of the Fed to the bank. And we worked on that during that week.

Mr. ROSENTHAL. I am interested in what Hayes said. I should like to know what his response was and, if you would like to tell us, your perception of Hayes' remarks.

Mr. LUFTIG. I think that instead of getting to the earlier meetings which were concerned with the condition of the bank, we announced to the Fed on Friday, May 10, that we had talked to the Manufacturers and that they were willing to discuss a merger with us.

The Manufacturers, in discussing it with me, had imposed some conditions upon which they would continue merger talks. One of the

conditions was that the Fed would help in marshaling Justice Department support for such a merger.

Mr. ROSENTHAL. Do you mean to eliminate the antitrust problem?

Mr. LUFTIG. To eliminate the antitrust problems; yes. And this was communicated to the Federal Reserve Bank through Mr. Hayes, I believe, on May 10. I was led to assume that the Fed had such discussions with the Justice Department or other people in Washington. I know there had been talk of that sort.

In any case, I was also led to believe all through this period, up until Sunday, May 12, that the Fed was very much in favor of trying to merge the banks and had gone so far as to call other banks and ask them about a merger just in case the merger with Manufacturers did fall through.

Mr. ROSENTHAL. Was Manufacturers Hanover serious?

Mr. LUFTIG. I certainly believed so. We had a meeting on Friday night, May 10, in the Manufacturers, with our attorneys, the attorneys from Manufacturers, the chairman of the board of Manufacturers, the president of Manufacturers, and a number of their senior officers.

We went through the condition of the bank, telling them exactly what it was like. During the discussions of Friday night, May 10, with Manufacturers, I received a call from the foreign department of the bank in which we were first told of the magnitude of the foreign exchange losses. And during that meeting, I told the Manufacturers people what these numbers appeared to be. I asked if they were going to call off discussions, and they said, "No; it is just a question of price. Let's continue to talk."

Mr. ROSENTHAL. When you say "price," do you mean price to the stockholders?

Mr. LUFTIG. Yes; the price of the purchase of the bank.

Mr. ROSENTHAL. What price are we talking about?

Mr. LUFTIG. We had never discussed the price.

Mr. ROSENTHAL. That would have been a very important thing for Sindona and his group, because they were significant stockholders. Isn't that correct?

Mr. LUFTIG. I assume so.

Mr. ROSENTHAL. At some point you did discuss a price, though, didn't you?

Mr. LUFTIG. No.

Mr. ROSENTHAL. Never?

Mr. LUFTIG. No. We decided that before a price could be arrived at, we would have to have a very intense investigation of the bank—which led to the Saturday meeting of all senior officers of Manufacturers and all senior officers of Franklin.

Mr. ROSENTHAL. After all of the events that have taken place, what is the net effect on the stockholders? Are there significant losses?

Mr. LUFTIG. As of today?

Mr. ROSENTHAL. As of today.

Mr. LUFTIG. I assume so.

Mr. ROSENTHAL. From the point of view of the stockholders and the point of view of the Long Island community, would things have been better or worse had the merger with Manufacturers gone through rather than the takeover by European-American?

Mr. LUFTIG. In my opinion, obviously, a merger with Manufacturers would have been certainly far superior to the route that was finally taken. Of course.

Mr. ROSENTHAL. Was there any discussion about the taking over of officers and personnel of Franklin by Manufacturers? In other words, would your personal future have been better off had there been a merger? Did they offer any jobs or any security?

Mr. LUFTIG. No. One of the conditions of the proposed merger that Manufacturers insisted on was that there were to be no commitments to any senior officer or to any member of the board of Franklin.

Mr. ROSENTHAL. Tell us about the Saturday meeting and about Gleason and about Sindona and anything else about which you want to tell us.

Mr. LUFTIG. I did not see Sindona during that whole weekend. Mr. Gleason was in and out of the bank that Saturday.

Mr. ROSENTHAL. You told McGillicuddy about the extent of the foreign exchange losses and he said that that did not slow down the negotiations.

Mr. LUFTIG. No.

Mr. ROSENTHAL. As the chief operating officer, why did you not know about these foreign exchange losses?

Mr. LUFTIG. We were told at the same executive committee meeting on May 6 when the merger was discussed that there were some foreign exchange losses. No dollar amount was ever mentioned and we did not know the full extent of them until later on in the week.

However, I think the point you are getting at is that in May of 1974, the foreign department of the bank did not report to me. Further, as I understand it, although most of these things came out after I left, there was falsification of the books. So I certainly would not have known of that while I was there.

Mr. ROSENTHAL. In your original presentation, you talked about a press release that Gleason issued which was erroneous. After learning of the press release, did you meet with Ed Lake and others? If so, what was the discussion about the solvency of Franklin?

Mr. LUFTIG. I do not think I alluded to the press release in my statement, but I will answer the question.

I don't believe I met with Ed Lake after the press release. I think that was prior to the press release. At one point, either on Friday or Saturday or Sunday—I think it was Sunday—Ed Lake, who was the resident representative of the Comptroller of the Currency, did meet with me in my office.

I don't remember the exact words, but in effect, I asked him if the bank were a viable institution. He said: "No; it was not."

I told him of my efforts which were directed solely toward merger and he thought that was a correct solution. He said that it was.

Mr. ROSENTHAL. While you were in an operating position at Franklin, did you meet with Mr. Van Horn on any occasion?

Mr. LUFTIG. Oh, yes; many times.

Mr. ROSENTHAL. Did you discuss the examination findings with him?

Mr. LUFTIG. The examination findings were discussed with the entire board.

Mr. ROSENTHAL. Do you mean the board of directors of Franklin?

Mr. LUFTIG. The board of directors discussed it with Mr. Van Horn.

Mr. ROSENTHAL. Mr. Van Horn met with the board?

Mr. LUFTIG. Yes.

Mr. ROSENTHAL. During what period of time was this?

Mr. LUFTIG. I do not recall the dates.

Mr. ROSENTHAL. Was it 1972, 1973, 1974?

Mr. LUFTIG. It was 1973 or 1974, but it might have been both.

Mr. ROSENTHAL. Generally, what did Van Horn say? Do you recall anything at all at any time?

Mr. LUFTIG. Generally, he said that the bank should be reduced in size to reduce the reliance on borrowed funds and that he was concerned about the reliance on borrowed funds of the bank. Everything really came down to that.

Mr. ROSENTHAL. Were the corrective actions the reports called for responded to generally? Were they met?

Mr. LUFTIG. We tried to do what they had asked us to do. I do not think there was enough time. With the rates going up, we ran into the earnings problem that really became paramount before we had a chance to correct the things that were called for.

Mr. ROSENTHAL. Were Van Horn and his associates forceful and persistent in trying to get you to make the corrections that were shown on page 2 of the reports?

Mr. LUFTIG. I believe so.

Mr. ROSENTHAL. I am interested in getting down to the nitty-gritty of the operation, the final hours of the last weekend. At what point did you get the feeling that the regulators had changed gears and that they were not supportive of a merger with Manufacturers?

Mr. LUFTIG. We had been working Friday night, all day Saturday and Saturday night—

Mr. ROSENTHAL. What were those dates?

Mr. LUFTIG. That was Friday night, May 10; all day Saturday, May 11; and Saturday night, May 11, toward the merger. We had met most of the day with the Manufacturers Hanover Trust Co. and later in the day with the Bank of New York also to talk about a merger which they felt right on the spot that they could not handle.

On Saturday night, May 11, I had suggested to somebody from the Fed, although I do not recall to whom, that there would have to be some type of Government assurances of loans, similar to the way other mergers had taken place, to support this. I also told this to Mr. McGillicuddy.

We left late Saturday night, May 11. On Sunday morning, I came into the bank wanting to pursue the merger further. It was my belief that the bank just could not open its doors if not with a merger which I knew could not take place over the weekend. But certainly an announcement of intent to merge would have helped tremendously.

On Sunday morning when I arrived in the bank, Mr. Gleason came into my office and said, "You might as well go home."

I found this an incredulous statement, but I got the idea that something was out of my hands. I did not go home; I stayed there most of the day. I knew there were meetings going on outside—down at the Fed and I don't know where else—but I was no longer a part of them

from Sunday morning, May 12, on, I knew something was happening.

Mr. ROSENTHAL. Was Gleason chairman of the board?

Mr. LUFTIG. Yes; and chief executive officer.

Mr. ROSENTHAL. And he represented a majority of the voting stockholders or a majority of the board?

Mr. LUFTIG. I don't know what you mean by represented.

Mr. ROSENTHAL. Did he have within his confluence of interests the majority of the board?

Mr. LUFTIG. I found out the next day that he did.

Mr. ROSENTHAL. Did you ever meet with the Comptroller of the Currency?

Mr. LUFTIG. No.

Mr. ROSENTHAL. At any time?

Mr. LUFTIG. At any time.

Mr. ROSENTHAL. To this day?

Mr. LUFTIG. To this day.

Mr. ROSENTHAL. And all of your dealings that weekend were with officials of the Federal Reserve Board in New York?

Mr. LUFTIG. Yes. There were representatives of the Comptroller at the meetings with the Fed and while we were discussing it with the Fed. Mr. Van Horn was present at at least one and probably several of the meetings.

Mr. ROSENTHAL. I asked you earlier, but we got sidetracked. When did you get the notion that the Federal regulators were cooling off on a merger—if they had ever been warm at all?

Mr. LUFTIG. That Sunday morning when I came in and I was told to go home. I was told that there would be no merger.

Mr. ROSENTHAL. Gleason told you?

Mr. LUFTIG. Yes.

Mr. ROSENTHAL. But he did not say to you that the Feds had called off the merger and that they would not support a merger?

Mr. LUFTIG. I was not told any reasons for the thing. I was just told there was nothing to be done.

Mr. ROSENTHAL. Why did you assume the Federal regulators had cooled off on the merger? In other words, maybe Gleason just did not like you from before. Why did you say that the regulators had cooled off?

Mr. LUFTIG. The regulators up until this point were working with us toward the merger. When I was told that there would be no merger, obviously since the regulators knew the condition of the bank because we had told them and they certainly had access to their own examinations and were as aware as I was of the conditions of the bank, everything lead toward the merger in my own logic. When I was told there would be none, I assumed it was done with the full concurrence of the regulators. That was an assumption on my part.

Mr. ROSENTHAL. That is what I am trying to find out. Did Gleason say anything to you to indicate that the Feds had withdrawn their support or that he capriciously did not want a merger?

Mr. LUFTIG. I do not think that he made either of those two statements.

Mr. ROSENTHAL. Did you have any conversation with anybody after that event which you would want to tell us about and which is pertinent to this point?

Mr. LUFTIG. Do you mean the regulators?

Mr. ROSENTHAL. Yes—about the support of the regulators.

Mr. LUFTIG. I am not sure, but I do not believe I spoke to the regulators that Sunday.

Mr. ROSENTHAL. Did you at any time thereafter?

Mr. LUFTIG. No. From that point on, I was no longer with the bank and never met with them again. I did speak to Mr. McGillicuddy from Manufacturers that Sunday at his home. I don't remember the exact words, but I told him that something had gone wrong and it was out of my hands and I did not know what was happening.

Mr. ROSENTHAL. What did he say?

Mr. LUFTIG. He said, "It sounds like you are right"—or words to that effect. And that was the last time I spoke to Mr. McGillicuddy in that capacity.

Mr. ROSENTHAL. But did the regulators withdraw their support or didn't they? Presumably, you do not know the answer to that.

Mr. LUFTIG. Obviously they supported another position, which was the Sindona suggestion to put more capital in the bank as against a merger; yes. I think that is logical to assume.

Mr. ROSENTHAL. Did Sindona ever in fact put the capital in?

Mr. LUFTIG. No; he did not.

Mr. ROSENTHAL. So that was just a holding action.

Mr. LUFTIG. That is what it turned out to be.

Mr. ROSENTHAL. Did you ever compose a letter to the Federal Reserve Board which you never had a chance to send as to the conditions of the bank?

Mr. LUFTIG. Yes. Mr. Heinemann and I did compose such a letter which we did not have a chance to send.

Mr. ROSENTHAL. When was that?

Mr. LUFTIG. Some time after May 9, I believe. It was May 9, 10, or 11. I do not recall the exact date.

Mr. ROSENTHAL. Was your intent to alert them to the seriousness of the condition of the bank?

Mr. LUFTIG. No, no, no. The Fed, in effect, was asking us how, if they loaned us large amounts of money, we would repay it. We told them there was no way to repay it except through merger.

They said, "Give us your ideas anyway on how you would pay us back." They insisted on such a letter.

Mr. HEINEMANN and I sat down and wrote such a letter.

Mr. ROSENTHAL. But you had difficulty composing it.

Mr. LUFTIG. It was impossible to compose. It really turned out to be more of a comic letter than an actual letter.

Mr. ROSENTHAL. In the totality, how much money did the Federal Government put into Franklin—either before or after the takeover by European-American?

Mr. LUFTIG. I do not know. Of course, I have no access to that.

Mr. ROSENTHAL. Do you know, Mr. Heinemann?

Mr. HEINEMANN. Yes. The public record would indicate that the aggregate Fed lending to Franklin was about \$1.7 billion—slightly in excess of that.

Mr. ROSENTHAL. Do you know, from the public record, whether that has been repaid at all?

Mr. HEINEMANN. The entire amount has been assumed as an obligation of the Federal Deposit Insurance Corporation. The FDIC publishes reports on its receivership of Franklin on a quarterly basis. I believe they have repaid about \$700 million of the \$1.7 billion. And they are in the process of liquidating the remaining Franklin portfolio and will pay it off as time goes on.

I think as of the last public statement, there was something like \$164 million in accrued interest which was owed the Fed which had not been paid by FDIC. This is working out over time and the FDIC has stated publicly that it will take a period of, I believe, from 9 to 14 years.

Mr. ROSENTHAL. Who loses by these events? What elements of the public have lost anything by these events? And presumably FDIC will eventually be totally paid back.

Mr. HEINEMANN. The FDIC has stated that it believes that it will recover its advance. But of course there is great uncertainty about that statement.

There are creditors of the Franklin New York Corporation, including the Manufacturers Hanover Trust Company, stockholders in the Franklin New York Corporation, creditors of the Franklin National Bank, and preferred stockholders of the Franklin National Bank, all of whom have lost substantial amounts of money.

Many people believe that since the holders of these obligations include many large investing institutions that these possible losses have helped to raise the cost of capital to other banks simply by, shall we say, souring the investment atmosphere.

There are many large institutions that will not today consider the purchase of debentures or notes of a bank holding company no matter what the company is. They have a flat rule of "We don't want bank obligations."

Mr. ROSENTHAL. Should the general public be at all concerned by what happened?

Mr. LUFTIG. Yes; the general public should be concerned.

Mr. ROSENTHAL. Why?

Mr. LUFTIG. The Government has stepped in and loaned \$1.7 billion in a situation where I do not think it was needed, and with some doubt as to whether they are going to get it back.

Mr. ROSENTHAL. Do either of you have any information or knowledge as to whether David Kennedy had anything to do with European-American?

Mr. LUFTIG. I have no knowledge.

Mr. HEINEMANN. Nor do I.

Mr. ROSENTHAL. Or of any of the banks overseas that formed the European-American consortium?

Mr. LUFTIG. I have no knowledge.

Mr. HEINEMANN. I have no knowledge.

Mr. ROSENTHAL. Are there any other questions by the staff?

Mr. RUEMLER. You have made several references to a possible merger with Manufacturers Hanover. Was that contemplated as a statutory merger under New York State law, or was that contemplated to be a financially assisted transaction?

Mr. LUFTIG. A financially assisted transaction.

Mr. RUEMLER. That is all I have.

Mr. ROSENTHAL. Thank you very much. You have been very helpful. We shall continue to pursue this investigation with vigor.

Mr. HEINEMANN. May I add one thing?

Mr. ROSENTHAL. Yes, Mr. Heinemann.

Mr. HEINEMANN. There is one cautionary comment I should have made initially, but did not. My comments here today were purely personal and were in no way a reflection of viewpoints that might or might not be held by my employer.

Mr. ROSENTHAL. With that understanding, the committee stands adjourned.

[Whereupon, at 11:50 a.m., the subcommittee adjourned, to reconvene subject to the call of the Chair.]



**OVERSIGHT HEARINGS INTO THE EFFECTIVENESS OF  
FEDERAL BANK REGULATION  
(Franklin National Bank Failure)**

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**TUESDAY, JUNE 1, 1976**

**HOUSE OF REPRESENTATIVES,  
COMMERCE, CONSUMER,  
AND MONETARY AFFAIRS SUBCOMMITTEE  
OF THE COMMITTEE ON GOVERNMENT OPERATIONS,  
*Washington, D.C.***

The subcommittee met, pursuant to notice, at 10:10 a.m., in room 2247, Rayburn House Office Building, Hon. Benjamin S. Rosenthal (chairman of the subcommittee) presiding.

Present: Representatives Benjamin S. Rosenthal, Cardiss Collins, Robert F. Drinan, and Garry Brown.

Also present: Peter S. Barash, staff director; Robert H. Dugger, staff economist; Ronald A. Klempner, counsel; Doris Faye Taylor, clerk; and Henry Ruempler, minority professional staff, Committee on Government Operations.

Mr. ROSENTHAL. The subcommittee will be in order.

Today, the Commerce, Consumer, and Monetary Affairs Subcommittee continues its oversight review of the effectiveness of Federal regulation of commercial banks.

The subcommittee is studying the findings and implications of a 3-month investigation of the Comptroller of the Currency's examination and supervision, and its processes, involving the Franklin National Bank.

While other interested congressional committees have inquired into the circumstances surrounding the Federal Reserve's loan of \$1.7 billion to Franklin after May 1974 and the declaration of its insolvency in October of 1974, this subcommittee has been examining crucial regulatory actions from 1969 until May 1974—actions which failed to halt Franklin's slide into insolvency.

Last week the subcommittee heard testimony from two subcommittee investigators. They advised the following: That the Office of the Comptroller of the Currency's enforcement and compliance documents do not clearly establish the division of responsibility and authority among examiners, regional administrators, and Washington officials to require a bank to take corrective actions on problems identified during examinations. As a consequence, there exists among OCC staff a difference of opinion as to who has the responsibility and authority to require such corrective action.

It was revealed that the management portfolio problems that plagued Franklin since the late 1960's and led to its eventual failure in 1974 were amply documented by national bank examiners over a 5-year period.

However, it was not until February 1974—only 3 months before the beginning of massive Federal Reserve support—that OCC took aggressive supervisory action to force Franklin to correct problems.

The committee examiners found that OCC failed to utilize fully its supervisory options to correct the problems identified by the national bank examiners. Though the examiners generally identified Franklin's problems, there were two notable exceptions. First, in February 1973, OCC examiners failed to include in their report a \$50 million instance of balance-sheet window dressing which resulted in an overstatement of the bank's resources. Second, in June 1973, in a 1-day check of the bank's foreign exchange profit and loss statement, the OCC examiner apparently did not verify the foreign exchange rates used in preparing these schedules.

The subcommittee investigators believe that had these rates been verified, the OCC would have become aware in June 1973 of Franklin's misrepresentations of foreign exchange profits, rather than almost a year later in May 1974.

Though examiners generally identified Franklin's problems, the critical comments found scattered throughout the examination report frequently did not get recorded on page 2 of the report, which is titled "Comments on Matters Requiring Attention."

Page 2 is important because it is on that page that examiners are supposed to itemize areas of concern. Noninclusion could suggest to bank officers and directors that a problem is not of great importance. For example, though examiners regarded Franklin's liquidity as very low or marginal from 1969 through 1972, and even hazardous in 1973, liquidity was cited on page 2 only in 1 year, 1969.

Today's witnesses are Mr. James E. Smith, Comptroller of the Currency; Mr. Charles Van Horn, Regional Administrator of National Banks, Second National Bank Region; and Mr. John Fleming, National Bank Examiner.

Mr. Smith, we are very pleased that you could be with us this morning. We know that you have a prepared statement. Feel free to read all of it or as much as you would like.

**STATEMENT OF JAMES E. SMITH, COMPTROLLER OF THE CURRENCY; ACCOMPANIED BY CHARLES VAN HORN, REGIONAL ADMINISTRATOR OF NATIONAL BANKS, SECOND NATIONAL BANK REGION; AND JOHN FLEMING, NATIONAL BANK EXAMINER**

Mr. SMITH. Thank you, Mr. Chairman. I appreciate this opportunity to appear before the committee in connection with its inquiry into the Comptroller's regulatory processes. In this hearing the committee is attempting to evaluate those processes through a study of the Franklin National Bank, which was placed in receivership on October 8, 1974.

I believe that we can learn from our past experiences, both good and bad. Thus, as the committee staff testified last week, I initiated even before the failure of the Franklin National Bank a special study of the events leading to the bank's difficulties.

This committee's record on Franklin National Bank would be incomplete, however, without including information on the behavior of the financial marketplace during the critical years of 1970-74. Also, I think the committee should take note of changes that have occurred in the Comptroller's Office since that period of time.

I will endeavor to be as brief as I can, Mr. Chairman, and to summarize the statement as I move through it.

Mr. ROSENTHAL. Without objection, the entire statement will be included in the record.

Mr. SMITH. National banks are privately owned corporations. The most important decisions made in each bank are those of the bank's own board of directors and management, responding to competitive pressures and opportunities. Thus no inquiry into the failure of Franklin National Bank can be complete without an examination of the decisions made by the Franklin management in the context of the then existing marketplace environment.

Inflation during the 1970-74 period was rampant. Because of the effects of the Vietnam war, an expansionary monetary policy and other such factors, consumer prices increased by 31.9 percent from 1970 to 1974. At the same time, the steepest recession since the Great Depression of the 1930's had begun to set in.

From the banker's point of view, the greatest problem was the enormous increase in interest rates. The Federal funds rates during the summer of 1974 rose to an unprecedented 12.9 percent and the prime rate was at a staggering 12.1 percent. The basic cost of money to banks aggressively using liability management during the 1970-74 period had increased an incredible 105.3 percent during this time. Franklin was particularly ill-suited to survive these economic pressures.

Franklin was a marginal operation throughout the 1960's, yet the bank managed to operate and grow to a \$3 billion institution by the end of 1969 without arousing any significant concerns by this office or the financial industry. Despite its apparent progress, however—particularly in the 1968 and 1969—the bank had neither the management depth and acumen nor the operational systems and controls to cope with its ambitious expansion program and the financial perils of the 1970's. Had the bank curtailed its activities after 1969 and solidified its position in the marketplace, the results may have been different.

By December 31, 1973, Franklin's resources exceeded \$5 billion. The bank's management proved incapable of developing and handling the sophisticated asset and liability management techniques necessary for a bank of this size.

During the 1960's and early 1970's, the money market banks, faced with declining rates of growth in deposits, sought new ways to meet the heavy credit demands of their customers. In consequence, Franklin and other banks placed less and less reliance on the generation of liquidity through asset composition and cash flow. Instead, increasing emphasis was given to acquisition of deposits and the purchase of a

wide array of borrowed money, including Federal funds, Eurodollars, negotiable CD's and long-term debt.

Franklin thus was able to buy its liquidity in the marketplace to support its rapid asset growth. In retrospect, Franklin's liability structure and asset structure made the bank exceptionally vulnerable to the confidence of the money markets.

Confidence in financial institutions declined significantly in 1973 and 1974 as a result of bank failures, both here and abroad, significant foreign exchange losses in several major banks, and evidence of deterioration in bank loans to struggling real estate firms, airlines, public utilities, and the like. This decline in confidence, coupled with steadily rising interest rates, tight money conditions, high inflation, and the beginnings of a recession led to a rush to safe havens for funds.

The very largest banks with unquestioned national and international reputations were the direct beneficiaries since the money market participants seemed to be making the judgment that biggest also meant safest. Marginally operated and smaller money center banks like Franklin were often denied funds altogether or were forced to pay high premiums for a limited amount of funds.

The tiered markets which developed forced many banks to scramble to avoid negative margins and to assure liquidity adequate to meet the claims against them. Franklin had long-term, low-yielding assets in both its loan and its investment portfolios, and thus was locked into a negative margin between the cost of the funds it borrowed and the uses it made of those funds.

Under these turbulent market conditions, Franklin struggled. The money market's continuing concern about Franklin was greatly aggravated in the spring of 1974 when significant problems were disclosed and market rumors about substantial losses became generally known. A loss of confidence occurred and a massive outflow of funds resulted, from which Franklin never recovered. The specific actions taken by the Comptroller's office during the November 1973 through October 8, 1974, period are detailed in appendix II.

The lesson that all banks could not always be assured of equal access to the money markets was a rude awakening for many banks practicing liability management, and an important lesson for us in the bank supervisory field.

We believe we now have the sophisticated analytical techniques and a far better understanding of money market banks to taken remedial action early and effectively. However, because our powers—by design—fall far short of actually running a bank, there will always be a limit on our capacity to insure a fail-safe national banking system.

Mr. Chairman, if I may, I would like to briefly detail the remainder of my presentation since I have your assurance that this will appear in the record.

Changes have occurred in the Comptroller's office since the Franklin experience. These changes are due in part to a study which was set in motion in early 1974 by an outside consulting group, as well as by reasons of some decisions that we made internally in terms of improving our performance.

In terms of dealing with banks which we believe have performed significantly below the norm, we first initiated, in 1974, what became known as the victor program. It is now known as our special situations

program. This was primarily an in-house technique for us to better assess problems and banks needing very close supervisory attention from the office. Second, it was designed to create a more coordinated system for the performance of the office with respect to those banks.

Under this program, Washington becomes more deeply involved in the supervision of difficult problem situations. Washington does not take the lead at the bank level; that responsibility continues at the regional administrator level, but with considerably more backup from Washington. This would even include Washington's presence, where it is deemed necessary, at board meetings.

Out of the consultant's study of the office, we are now implementing an entirely new format of examination procedures. Our examination handbook has been entirely rewritten, covering 42 or 43 separate examination functions and giving more attention than we have ever given heretofore to the banks' policies. It begins right at the top with what management perceives its credit and investment policies to be; what the board perceives them to be; how they have spelled out those policies in terms of written documents; how they communicate that policy down the line in the bank to the various lending and investment departments; and what kinds of controls and other operating systems they have within the bank to assure that policies that have been determined and enunciated are in fact being implemented and affected by the operating units of the bank.

We believe that with this examination procedure that our examiner in the field and his supervisory personnel will have a far better understanding of their roles and of what is expected of them. We believe that, through these procedures, we will make more effective use of our human resources by having a better road map as to how we are going to examine banks. And as I have said, we are giving more attention today to procedures and to internal controls and operating systems so that we can begin to detect weakness and deterioration before it evidences itself in a sufficient and severe degree in the loan portfolio.

In the past, the principal focus of the bank examination was on the quality of the loan pouch. And we are going to continue to give a considerable degree of attention to that. But the problem is that that is a lagging indicator. By the time you have significant problems in the loan portfolio, it is often difficult to treat with and to remedy them. We think the problems in the loan pouch generally reflect a breakdown in systems and in management policymaking well before the problem loans appear in any great number.

We are augmenting our onsite examinations by a new effort at early warning. This is called the National Bank Surveillance System. It is a computer based data and ratio analysis system not unlike the systems employed by financial analysts. It is a system designed to permit us to keep better track of the condition of a bank during the period when we are outside the bank, during the intervals between onsite examination, and to make better and more effective use of the reporting formats, which we have on a quarterly basis. It would permit us, when going onsite to an examination, to plan more effectively and more efficiently for that examination through indication of deterioration in the bank's condition. This would allow us to focus our onsite examination resources at those indicated problems.

In terms of the examination itself, we are also making considerable modifications in the report of examination. Mr. Chairman, you referred to matters discussed or not discussed on page 2—the so-called lead page of the open section of the report. Under the new format of examination, we are now going to make certain that every major criticism that we have of a bank which can be documented will appear in the open section of the report in narrative form that can be understood by operating bankers as well as by directors of banks who are not necessarily well-schooled in all of the custom and practice and terminology of banking. There can be no question by management and the directorate of the bank as to what we regard a bank's current problems and deficiencies to be.

We will continue in the new report of examination to have what is known as a confidential section. That was the section, unfortunately, in the past which tended to contain the most detailed description of the examiner-in-charge's judgment of a bank's condition. We will continue a confidential section. It will, however, be for three principal reasons.

First, where we have suspected violations of law which the examiner does not feel competent to resolve himself, those suspected violations will be moved up in the system for analysis by the chief counsel's office and others. And, of course, if they are determined to be violations, they will then be communicated to the bank.

Second, we will use the confidential section for critical comments about management in those cases where the office may desire to take formal enforcement action. We obviously would not want to tip our hand on that until we had made that decision.

Last, the confidential section of the examination, which goes only to us and not to the bank, will be utilized to permit a seasoned examiner to make those sorts of instinctive judgments that a good professional can make where documentation is not possible. Where he or she feels something in the pit of his stomach that he thinks is not right, it is important that that be communicated up the line as well.

If I may refer back to our National Bank Surveillance System, that, as I have said, is our principal means of keeping in touch with the bank while we are out of the bank. We will be using the financial analysts' techniques and grouping banks in peer groups as to size, similar markets, and similar structure. And by going into extensive ratio analysis, we think we can begin to detect problems early on through a bank's performance being out of line with what is demonstrated by other peer group institutions.

Using the computer, those kinds of anomalies can be identified and brought to our attention. The human analyst then applies his or her skills to those indicated problems. If necessary, we go to the region or into the bank itself to get clarification for this anomalous performance on the part of this bank. And all of that activity and all of those inquiries are going to become part of a recorded, computerized action control system. So we will always know when a query has been made by a bank. And if there is no timely response from the region or from the field with respect to this inquiry, that lack of response or inadequacy of response will be a recorded matter and will constantly be brought to our attention in Washington through a, I guess you could

call it, computerized tickler system that will be keeping us regularly in touch with how we are performing our job.

Furthermore, we have created for the first time in the office, a performance audit unit, known as an operations review group. It is headed by a very seasoned Deputy Comptroller who has over 25 years of experience. Through regularized sampling of our examinations, we are going to begin to make judgments ourselves as to how we are performing.

For the moment, we have that unit reporting directly to me. But I have recommended to the Treasury Department that I think it, as any internal auditing unit, would have a far higher degree of credibility if we could have created within the Treasury Department a senior review group that did not involve the Comptroller at all. It would be like a board of directors and would perhaps include a couple of senior career people from the Treasury Department—the Deputy General Counsel or individuals of that type—to whom this operations review group might periodically report on its judgments as to the performance of the office.

In an area critical to the final days of the Franklin, our examination of foreign exchange operations, we have made numerous and important changes. You referred, Mr. Chairman, to our failure on one occasion to reach back and to test the valuations being used in the reconciliation of the Franklin's foreign exchange position. It is true that under previous procedures, examinations were always conducted on an "as of" basis and an "as of" date. And we rarely went back to that date to see what had been occurring prior to our entry into the bank.

Under new procedures, we will be sample testing the valuations used in reconciling foreign exchange positions. We are also recommending to banks various types of internal and dual control systems. I must say that the banking system itself has given this matter a high degree of attention since the Franklin, the Herrstadt and other major foreign exchange problems.

But I am satisfied that our procedures today would clearly pick up the kind of behavior that was occurring in the Franklin in early 1974.

We think, Mr. Chairman, that we have procedures and systems which are far improved over those which were in place in early 1973 and 1974. We believe that we, along with the banking industry, have learned some important lessons. I do not think that any of us had the real sensitivity to the explosive problem that could be provided by a combination of a high utilization or a liberal utilization of liability management in terms of funding assets largely with short-term interest rate sensitive funds coupled with a declining and deteriorating earnings performance.

I think we are far more sensitive to that today and I think the banking system itself is. I have pointed out to banking groups in the past that what occurred at the Franklin in that critical period of late 1972 to late 1973, when the bank's assets grew nearly one-third, was that its conventional deposits in fact declined. It funded that entire growth out of highly volatile short-term funds. I think that could not happen today because the market is so sensitive to those kinds of events that it would simply not be possible for a bank wishing to follow such a strategy to acquire the funds. And that was certainly

an important aspect of Franklin's development during that period of time.

We think too, that we perhaps need some additional enforcement and supervisory tools. We have recommended to the Congress that we be given certain money-damage remedies for banks which fail to comply with certain key provisions of law and certainly for banks which fail to comply with cease-and-desist orders.

We also think that the present law with respect to officer and director removal, especially as it relates to officers and directors of national banks, is needlessly cumbersome. We have recommended, along with the Federal Reserve, that there be some streamlining of its procedural operation. Also, we have recommended that we be relieved of the onerous standard in proceeding for an officer or director removal for demonstrating elements of personal dishonesty. We think that it is equally possible through gross negligence, gross mismanagement, or outright stupidity for management to seriously affect the future of a bank.

I think that personal dishonesty is certainly not the solely important factor that need be considered in such cases. And I am pleased to say that your standing Committee on Banking in the House of Representatives and the standing Committee on Banking in the Senate are moving forward on those recommendations for additional enforcement powers. And I would fully expect that we will have that additional authority before this Congress is adjourned.

Mr. Chairman, I would conclude by merely making this closing observation. I think there were a whole host of factors that went into the final demise of the Franklin. The conventional wisdom, in looking back, has been, "If that marvelous bank on Long Island had never gone to the big city, everything would have been lovely."

And I think that Franklin's entry into the Manhattan market was a factor. But, clearly, if any bank supervisory agency had told this bank in the early sixties that it could not come into Manhattan, that agency, I think, would have properly been charged with conducting some sort of anticompetitive policy.

Franklin's management during that period, I think, contributed. And its lack of management obviously contributed at the end.

But Mr. Roth, who deserves a great deal of credit for having taken this bank on Long Island and having built it into a very significant institution, was also a unique manager in that he was a kind of one-man show. And little was done to develop the necessary management succession during those periods of the sixties.

And as a consequence, when Mr. Roth left the bank, it simply was not equipped with skillful personnel to manage an institution of that size.

Our customs and practices of that time, which were no different than the customs and practices of other bank regulatory and bank supervisory agencies, were probably also a factor which cannot be ignored. We typically did not give the detailed and objective attention to management qualifications that we are doing today. We, as I have said, addressed most of our attention to the loan portfolios of banks and reported on the condition of that loan portfolio to the directorate and management of banks, and urged them to take remedial and correc-

tive steps depending upon the situation. That was done with this bank after every examination.

In the mid-sixties, we gained some new enforcement tools in terms of cease-and-desist powers. But to be perfectly honest, these were not actively employed by this agency or any other banking agency until the early 1970's. And even now we are still learning the utilization of those enforcement powers. Even today, we are still on a learning curve.

We then take the bank's assumed judgment. In 1973 the bank, seemingly unable to deal with its increasing problems of overhead and expense and apparently not wanting to undertake an austerity program or feeling that that was not the quickest route to solution, decided to grow and to try and overwhelm its expense problems through a growth in assets. And in that 10-month period between our last two full-scale examinations, the bank grew nearly one-third. All of that growth was funded by highly volatile, short-term liabilities, Fed funds, Euro-dollar placements and the like.

Mr. ROSENTHAL. Mr. Smith, I want to get a couple of things into the record and then begin questions.

Without objection, we shall include into the record the material that has been furnished to the subcommittee staff investigators which was backup material for some or all portions of their examination.

These include: (1) an affidavit by James E. Smith in the matter of liquidation of the Franklin National Bank; (2) a letter to Mr. Charles Van Horn, dated February 22, 1974, from James E. Smith, the Comptroller of the Currency; (3) a memorandum to Deputy Comptroller John Gwin, dated February 1, 1973; (4) a letter to Mr. Charles Van Horn, dated June 18, 1973; (5) a memorandum to Mr. Charles Van Horn, dated February 1, 1974; (6) office procedure for rating national banks; (7) a memorandum from Mr. John Gwin, dated March 19, 1971; (8) statement of Robert Bloom before the Subcommittee on Commerce, Consumer and Monetary Affairs, dated January 20, 1976; (9) a memorandum for the files, dated March 28, 1974; (10) a memorandum for the files, dated June 15, 1972; (11) an agenda for a meeting, dated September 6, 1971; (12) a memorandum for the files, dated January 21, 1971; (13) a letter to Mr. Charles Van Horn, dated January 16, 1970; (14) a Haskins and Sells draft report, dated October 4, 1974; (15) an interoffice letter, dated October 2, 1969; (16) a memorandum to Mr. William B. Camp, dated March 5, 1970; (17) a memorandum for the files, dated January 24, 1974; (18) a memorandum for the files, dated January 29, 1974; (19) a letter to Mr. Robert Mullin, dated May 15, 1972; (20) an interoffice letter, dated April 24, 1972; (21) an interoffice letter, dated May 3, 1972; (22) a letter to Mr. Robert Mullin, dated June 9, 1972; (23) a letter from Mr. Robert Mullin, dated June 14, 1972; and (24) a memorandum to James E. Smith, dated May 31, 1974.

[The material referred to may be found in the appendix.]

Mr. ROSENTHAL. Would you identify your colleagues?

Mr. SMITH. On my right is Mr. Charles Van Horn, regional administrator for region 2, which includes New York, New Jersey, Puerto Rico, and the Virgin Islands.

To my left is Mr. John Fleming, a national bank examiner in region 2.

Mr. ROSENTHAL. When were you sworn in as Comptroller of the Currency?

Mr. SMITH. July 5, 1973.

Mr. ROSENTHAL. When did you assume your duties?

Mr. SMITH. July 5, 1973.

Mr. ROSENTHAL. So in normal parlance, in terms of assessing responsibility, you were prepared to accept responsibility for everything that was or was not done from that date on?

Mr. SMITH. That is when I began my watch; yes, sir.

Mr. ROSENTHAL. And in the sense of equity and fairness, we recognize that you were in no way responsible for what took place prior to that date.

What amount of Federal Reserve funds, or any other Federal regulatory or insurance agency funds, has gone into the Franklin operation?

Mr. SMITH. At one point, the Federal Reserve note was in the order of \$1.7 billion. I guess that is where it was on the day we announced the receivership. That obligation was assumed by the Federal Deposit Insurance Corporation in connection with the purchase and assumption transaction in which the FDIC took somewhat over \$2 billion of Franklin assets to be liquidated.

Mr. ROSENTHAL. Has some of that money been repaid?

Mr. SMITH. Yes, sir.

Mr. ROSENTHAL. How much has been repaid?

Mr. SMITH. The FDIC is the better source on this; but, it is something over \$700 million. I think the Federal Reserve obligation is now beneath \$1 billion. It is earning interest at about 7.5 percent, which is, I assume, a little above the normal portfolio yield at the Fed.

And the provision is, as I recall it in the purchase and assumption agreement and in the arrangement between the FDIC and the Fed, that if at the end of 3 years from the date of the receivership the FDIC has not liquidated sufficient of the Franklin's asset portfolio to pay off the note, it will pay it off in one lump sum and then it will continue with the process of liquidation.

Mr. ROSENTHAL. Hopefully, the Federal Reserve will be repaid the entire \$1.7 billion plus the interest.

Mr. SMITH. Yes; plus the interest yielding at 7.5 percent, which was deemed a fair return by the Board of Governors.

Mr. ROSENTHAL. Is it your testimony that the Office of the Comptroller of the Currency did not have timely warning of Franklin's weaknesses?

Mr. SMITH. Mr. Chairman, I think that throughout the period of the sixties and into the period of the seventies, there were obvious, indicated weaknesses in this institution. And those weaknesses, by and large, were criticized. Mr. Van Horn and a series of examiners met regularly after each examination with the bank management and directorate.

Our criticisms tended to dwell upon the quality of the bank's loan portfolio because, frankly, that is the way bank examinations were directed in that period.

Those were certainly factors in the final collapse. But the real factor in the collapse was this bank's declining earnings performance and

its total incapability to do an effective job of liability-asset management.

Mr. ROSENTHAL. In other words, OCC had some warnings, but they were not anything that got anybody overheated?

Mr. SMITH. I think that that is true. They were not the kinds of indicated problems that would cause you to believe that this bank was going to the wall. And the fact is that during the latter period of the sixties—and I am certain in part because of criticism by this office of the bank's loan portfolio—there were improvements in the quality of that loan portfolio.

But then beginning in 1969, the subpar quality reappeared and it never improved until the closing of the bank.

Mr. ROSENTHAL. For the record, I want to read to you from comments made in the examination reports in the areas of liquidity.

On September 29, 1969, the examiner said: "Very low liquidity. This is the main area of concern at this examination."

On August 31, 1970, he said: "Marginal due to the heavy volume of problem loans."

On May 17, 1971: "Marginal due to the heavy volume of problem loans currently reflected."

On March 6, 1972: "Marginal due to heavy volume of problem loans currently reflected."

On December 11, 1972: "Marginal due to the heavily loaned position, volume of problem credits, unused commitments and the need for consistent large borrowings."

Now, all of those comments were made before you became Comptroller of the Currency. And as I said earlier, we do not hold you accountable for them. But during that same period of time, did the examiners ever waive an examination of Franklin? In other words, the law requires either one or two examinations each year. Is that correct?

Mr. SMITH. The law requires two each year, and permits the waiving of one examination in any 2-year period.

Mr. ROSENTHAL. At any time during this period, to your knowledge or to Mr. VAN HORN's, did the Comptroller ever waive an examination of Franklin?

Mr. SMITH. As a general rule, Mr. Chairman, we waive that one examination in the 2-year period so that we, in effect, conduct three examinations in a 2-year period.

Mr. ROSENTHAL. Did the Office of the Comptroller of the Currency at any time prior to your assuming this office waive the required statutory examinations? Can anybody answer that question "yes" or "no"?

Mr. VAN HORN. No, sir; to my knowledge, nobody specifically waived an examination of the Franklin National Bank.

Mr. ROSENTHAL. Did your office conduct the two examinations as required by law every year—say from 1969 until 1972?

Mr. VAN HORN. The law permits the waiving of one examination within each 2-year period, as I understand. Now you are asking if there were two each year. The answer is "no." They did not conduct two examinations during each year of that period.

Mr. ROSENTHAL. Mr. Smith, you came aboard on July 5, 1973. This is what the examiner said on November 14, 1973—after you were here. "Bank's liquidity position is considered hazardous by the examiner."

When did you first have notice of that kind of comment? That is obviously a serious comment.

Mr. SMITH. You are right.

Mr. ROSENTHAL. And I would add, it is one warranting remedial action.

Mr. SMITH. In February 1974, as Examiner Lake was completing that examination which he had started on November 14, 1973, I met in Washington with Regional Administrator Van Horn and Examiner Lake and a number of my senior associates in Washington. Examiner Lake gave us the rundown on the examination. His conclusion was perfectly accurate.

The bank, by that time, had a liability structure, close to 50 percent of which was comprised of liabilities such as Eurodollar placements through its London branch, Federal funds purchases in the order, as I recall, of \$700 million or \$800 million—all funds which are exceedingly lacking in any loyalty to a particular institution. It was a very sensitive liquidity situation.

Mr. ROSENTHAL. The situation was lousy.

Mr. SMITH. It was a very sensitive liquidity situation.

Mr. ROSENTHAL. A very sensitive liquidity situation which the people in Wall Street could describe as lousy. What did you do about it?

Mr. SMITH. We instructed Mr. Van Horn and Mr. Lake to meet with the bank's management and then with its directorate, and to give to them a specific series of requests for actions to be taken to reduce the liability on this short-term and highly volatile funding.

Mr. Van Horn returned to New York and met with the bank's management the following week. Thereafter, Mr. Gleason, the chief executive officer of the bank and Mr. Norman Schreiber came to Washington to meet with me.

Norman Schreiber had just joined the bank, having recently retired as the chief executive officer of Walter Heller. He was an exceedingly competent financial manager. He was in the process of a very indepth analysis of the bank at that point.

We all agreed as to what had to be done—that the bank had to be shrunk, if you will. And that is a process which cannot, unfortunately, be achieved overnight.

Mr. ROSENTHAL. In that same November 1973 report, the examiner described the management as "poor." Could poor management have done the job which you mandated?

Mr. SMITH. I felt, based on my meetings with Mr. Schreiber and what he told me of some other people who had come into the bank, that they probably had the horses at that point to do the job.

I think it is very difficult in the aftermath to judge if that were entirely true. Obviously we learned some things later on about the foreign exchange operations of that bank which would raise questions about the competency and maybe the ethics of those who were overseeing the international operation. But the task Mr. Schreiber and his associates had before them at that point in time was an exceedingly tough one.

Mr. ROSENTHAL. At that time, was Mr. Luftig still president?

Mr. SMITH. Mr. Luftig was still in the bank. Mr. Ray Anderson, who had come over with Mr. Luftig from Bankers Trust, was also there.

Mr. ROSENTHAL. With the cooperation of my colleagues, I am going to proceed for 5 more minutes and then recognize others.

When did Sindona purchase a major share in this bank?

Mr. SMITH. My recollection is that that occurred sometime in the middle of 1972.

Mr. ROSENTHAL. Did you at any time meet with Mr. Sindona?

Mr. SMITH. I met with Mr. Sindona late in 1973. He came to Washington with Mr. Gleason. It was what I guess you could call a courtesy call.

He made it clear to me that he knew little about American bank regulatory practices and that if I found deficiencies in the bank, he wanted to be advised of them.

He also took that occasion to talk with me about a proposed acquisition that was in the mill at the Fed—the acquisition by the Franklin National Corp. of the Talcott Corp., another corporation in which Mr. Sindona had a substantial ownership interest.

Mr. ROSENTHAL. During this period of time when Frankin was described to have problems of low liquidity, Franklin acquired 17 banks. There were 17 acquisitions by Franklin during that 5-year period.

Mr. SMITH. No—I think you are referring to branch office approvals during the early 1970's. Those were de novo branches; they were branches organized by the Franklin.

Mr. ROSENTHAL. Did each of those branch acquisitions require Comptroller approval?

Mr. SMITH. Yes, sir.

Mr. ROSENTHAL. The Comptroller, had they wanted to exercise some restraint or some slowing down of this phenomenon, could have rejected the approval of all or any 1 of those 17, couldn't they?

Mr. SMITH. We think, Mr. Chairman, that we have the authority to, in effect, use a branch approval or disapproval as a supervisory lever, if you will, on a bank that is recalcitrant.

I have not looked at these particular branch applications in depth, but after superficially looking at them, 12 of them, as I recall, are situated in what was the home country of the Franklin—Suffolk and Nassau Counties. They were applications which indicated on a pro forma basis that they were going to generate a good degree more in the way of deposits than they would of loans. And that is exactly the type of branch the Franklin needed.

In other words, they needed a branch that would generate more deposits than loans.

Mr. ROSENTHAL. But it had the exact opposite effect. The expansion was deleterious to the bank's interests.

Mr. SMITH. I do not think that you can necessarily say that these acquisitions or expansions were deleterious. You would have to examine each one of them. There may have been a couple that were. The Park Avenue one is in there, and that was certainly a high-cost operation and didn't help them at all.

Mr. ROSENTHAL. By unanimous consent, we will each take 10 minutes and then come around again.

Mr. VAN HORN. Mr. Chairman, may I have one moment, please?

Mr. ROSENTHAL. Certainly.

Mr. VAN HORN. I would like to get back to your question about the statutory examinations. That statute, as you may know, is imprecise. It does not say there shall be a written report made. It does not say, for example, that an examiner shall visit the bank. There is just no prescription for an examination under that statute, as I understand it.

Conceivably, a board meeting could be considered an examination. Conceivably, or at least it seems to me, a report from the bank could be considered an examination.

Mr. ROSENTHAL. Mr. Van Horn, do you consider a board meeting or a report from the bank, in common terminology, as an examination?

Mr. VAN HORN. Not in the traditional sense; no. I am merely saying that the statute in that respect is imprecise.

And I also want to assure this committee that during that period of 1968 to 1974, that bank was under very close surveillance by the Office of the Comptroller of the Currency.

Mr. DRINAN. Will the chairman yield?

Mr. ROSENTHAL. I will be happy to.

Mr. DRINAN. On December 11, 1972, the bank was examined. Almost an entire year, until November 14, 1973, went by before another examination took place. And the prior year, the same thing had occurred. Almost a whole year went by between examinations.

I think the statute is quite precise; examinations are required twice every calendar year. An exam may be waived once in every 2 calendar years. So I think the key question is: Were these examinations waived when people knew that the bank was marginal or in a perilous condition?

Mr. SMITH. Mr. Drinan, let me say that you referred to an examination in December of 1972. That, again, is the "as of" date. That is when the examination was begun.

Mr. DRINAN. And lasted for 3 months; yes, I know.

Mr. SMITH. Yes. And then we went back into the bank in November of 1973. So there was perhaps a 7- or 8-month interval between those two examinations.

Mr. DRINAN. But, Mr. Smith, the statute says that you are supposed to do that every 6 months.

Mr. SMITH. If we want to take this to the absurd, let's assume that we had an examination that was so difficult that we went into the bank in January and did not come out of it until December. We have had some examinations that have taken 7 and 8 months. Are we then going to say that we are in noncompliance with the statute because we did not stop somewhere and start up again?

Mr. DRINAN. Yes, sir.

Mr. SMITH. You are a lawyer; I am a lawyer. We are each open to learn.

Mr. DRINAN. The statute means something, sir. Were there any formal waivers of this examination?

When the Congress puts through a statute, we have the right to say that when you waive something, you waive it. And you can't say, "We were in there all of the time and the other examination is still going."

It seems to me that you should ask for the repeal of the statute if you are going to defy it.

Mr. SMITH. I do not regard it as defying the statute. I may well recommend to Congress some improvements in that statute to permit us to do what I think would be a more effective job of examining. I think it places a time burden on the office which often cannot be justified in terms of the conditions of many banks.

Mr. ROSENTHAL. Mr. Brown.

Mr. BROWN. Thank you, Mr. Chairman.

May I first go back to a technical matter. There were certain things which you asked to be included in the record without objection. But I do not think you ever put the question as such.

I want to reserve the right to object only until I make inquiry of Mr. Smith.

I think you understand, Mr. Smith, what he asked to be put in the record; do you not?

Mr. SMITH. Yes.

Mr. BROWN. And I presume that these documents have been supplied to the committee?

Mr. SMITH. Yes.

Mr. BROWN. And that any information which should remain confidential has been deleted. Is that right?

Mr. SMITH. That is my understanding; yes.

Mr. BROWN. Thank you. I have no objection, Mr. Chairman.

We kick around the term "liquidity" all of the time, Mr. Smith. And I think there are many who look upon the term "liquidity" as meaning solvency. You may have a liquidity problem and not have a solvency problem. Isn't that correct?

Mr. SMITH. You may have a liquidity problem and also have a solvency problem.

Mr. BROWN. But one may occur without the other?

Mr. SMITH. Yes. You can be in a position of determined low liquidity, when looking at your asset structure, and still not have an insolvency problem simply because you do not have the claims that require the liquidation of assets.

Mr. BROWN. You as Comptroller have no authority to intervene in a bank's operation because of a liquidity problem as you do if the bank has a solvency problem, have you?

Mr. SMITH. When we have deemed a bank insolvent, we have an obligation to declare it so and to seek the appointment of a receiver. When we find a bank whose liquidity is lower than we think it appropriately should be for its type of operation, our remedy is to bring that matter to the attention of the directorate and of the management.

And as I have said, on the learning curve that we are on today, it might be that, if we deemed the problem serious enough and were receiving so little cooperation, we might find it an unsafe and unsound banking practice and formally enter a cease and desist order against the management of the bank.

Mr. BROWN. The chairman discussed with you these branches that were approved during a time when the examination reported serious liquidity problems.

Isn't it true that an argument could have been made by management that by the addition of these branches they would be able to improve their liquidity situation somewhat since they would probably

be able to develop funds at a lower cost than if they had to go into the market for funds?

Mr. SMITH. I think you could make that argument. As I have said, my review has been pretty superficial. But a lot of those branches were situated in the heart of Franklin's retail banking market. And the objective of the branch was to generate more deposits which had some loyalty to the bank. And in doing so, yes; you would improve their overall liquidity position.

Mr. BROWN. Since there is no way in which we can determine why some of the things occurred or did not occur prior to your regime, and under the regime of the late Mr. Camp, let us look at the period while you have been Comptroller. You came in in July. As of some 7 or 8 months later, you had then had your meeting with Mr. Van Horn, with Mr. Lake, and with others. And you did put forth in letter form some rather stringent requirements concerning the bank. Is that correct?

Mr. SMITH. Yes, sir.

Mr. BROWN. Is there anything to indicate why all of the bad information that had been developed by examination reports in the past had not resulted in a comparable action during Mr. Camp's regime?

Mr. SMITH. I think the problems indicated in Mr. Lake's 1973-74 report were of a higher degree of severity, if you will, than anything that had been indicated heretofore.

I have referred to the learning curve, Mr. Brown. We were in a period in which larger banks were making increasing use of the so-called technique of liability management. Both the industry and we, ourselves, were not as sensitive, I think, as we should have been to the dangers inherent in a liberal utilization of that technique coupled with a declining earnings position in which the market ultimately loses confidence in the purchaser of the funds.

So I find it a little difficult to look back and say, "Gee, look how smart I was." I have been through some damn tough problems in the banking system and I am smarter for them. When you look at 1968, 1969, 1970, and 1971, you are talking about a period representing some 35 to nearly 40 years of relative tranquility in the American banking system. That was the period since the big collapse of the thirties.

And I think the conventional wisdom of that time was that banks of this size may have problems, but they just do not get to be the kinds of problems that would take them to an insolvent status.

We now know that that is not the case. We learned it first in U.S. National in October of 1973. And we learned it again in October of 1974 with the Franklin.

Mr. BROWN. We know that the real crux of your ability is when the insolvency issue is raised or exists.

Isn't it true that the FDIC, in connection with its handling of Franklin, either is bringing or has brought or contemplates bringing an action against the directors for not complying with certain of the OCC directives and requests that were made of them?

Mr. SMITH. I do not know what their specific plans are; but, that is a fairly customary occurrence in FDIC receivership.

Mr. BROWN. If the FDIC does bring such an action and if it is successful, then directors that fail to conform to the things that you

require do possibly place themselves in jeopardy of some action. Is that not correct?

Mr. SMITH. Yes, sir.

Mr. BROWN. So that is an authority that you possess?

Mr. SMITH. Yes. We do have the authority today and have had since 1966. We are using it with increasing frequency. It is the power to either bring through voluntary entry or through formal entry a formal cease and desist agreement or a formal memorandum of understanding between us and the management and directorate of a bank as to what we deem to be unsafe and unsound practices in that bank, and practices which need to be corrected.

Now in the case of the Franklin, we did not have a cease and desist order. But we had a formal request made to them in February 1974. That agreement was fully accepted by the management of that bank. They said, "Yes; you are right. We must do these things."

And Mr. Schreiber, who had taken the bull by the horns up there, was developing such a program. It included, for example, the liquidation of the bank's trading account and the insistence that borrowers of the bank comply with contractual requirements for compensating balances or get their loans out of the bank. And he concluded that out of these actions alone they might be able to reduce their requirements for these short-term funds by as much as \$500 million.

We figured the bank had to be shrunk about \$1 billion to \$1.5 billion to turn it into a safe institution. And as he was beginning that program in March and April, he just found himself putting out one fire after another. At first it was this bank calling to shut off its Fed funds sales and then another bank. And then the whole thing just unraveled in early May.

Mr. BROWN. With that chronology, it is difficult—having known Joe Barr—to see that as of September 16, 1974, in a letter to Bloom, he said, "This bank is solvent."

Mr. SMITH. It was solvent, Mr. Brown. It was solvent so long as the Federal Reserve Bank of New York was willing to support its needs for liquidity.

Mr. BROWN. In that letter he also pointed out the things that were being done which he thought would phase the Fed out of the picture.

Mr. SMITH. He was convinced that some things could be done with the assistance which the FDIC can provide under section 13(c) of the Federal Deposit Insurance Act to permit the Franklin to continue on an independent basis.

Now from the standpoint of the corporation, if one has to make a finding that that institution is providing in the market an essential banking service, I think that would have been a fairly tough showing to make in the New York market. And second, there had to be some real, reasonable prospect that certain types of assistance by the FDIC would, over time, return this bank to a viable position.

In an effort of good faith with the corporation and with Mr. Barr, I employed the investment banking firm of Blythe, Eastman, Dillon to review the so-called Barr proposal. And they concluded that there were a variety of assumptions in there concerning interest rates and so forth, any one of which, if it did not hit right on the target, could throw the whole proposal in the ashcan. And it was their reasoned judgment that the proposal did not have a great deal of merit.

But Mr. Barr is to be commended for having tried.

Mr. BROWN. My time is just about up, but let me ask one further question. What is there about your new procedures and operations, had they been applicable to Franklin National Bank, that would have prevented a Franklin National?

Mr. SMITH. I have referred to the National Bank Surveillance System.

Mr. BROWN. Could you be a little more specific as to which things you would have picked up.

Before you proceed, I presume that you are going to come to the conclusion that with the new system of regulations and the new auditing methods, there will not be another Franklin National—at least under the conditions under which Franklin National occurred.

Mr. SMITH. I cannot make an absolute flat assurance of that. It would depend too on economic and financial market conditions.

But, for example, with an efficiently functioning National Bank Surveillance System, I think we would have tracked the growth of the Franklin in that critical 10-month period much more closely and much more intensively than in fact was the case.

I think that, coupled with our new emphasis in examination on starting at the top of a bank to ascertain what that bank perceives its lending and investment policies to be and then moving down through the bank to chart how that has been communicated and how, in fact, it is being effected in the bank, would have indicated to us in a much more specific way the lack of management systems in this bank fairly early on.

Now our examiners were satisfied that this bank was not well managed. But our process of examination did not give them the kinds of detailed evidence to say to a bank's directorate, "We think it is badly managed for these reasons: (a), (b), (c), (d), (e), (f), and (g)."

And in today's world, I think that, with that kind of documentation and that kind of declaration, you will have management replaced.

We simply, I think, had not given the examiner enough tools to do that kind of job. Also, I think that we, along with our sister agencies, have in the last 3 years been making increasing use of the formal agreement. And it is altogether possible that in the case of the Franklin that we might have done that at an earlier stage—based on what we know today, not what we knew then.

I think all of those actions combined might have saved the day.

Mr. ROSENTHAL. Mrs. Collins.

Mrs. COLLINS. Mr. Smith, what is your policy in regard to the bank's relationships with, and disclosure of information to, shareholders and the investing public? Have you adopted regulations along the lines of the Securities and Exchange Commission in connection with your regulation of national banks?

Mr. SMITH. Yes. Our sole legal authority there, Mrs. Collins, is under the 1934 Securities Exchange Act with regard to so-called covered banks. These are banks having 500 or more shareholders and \$1 million or more assets.

Frankly, in the case of the Franklin, they were not a covered bank because their shareholder was the Franklin National Corp.—the holding company. And disclosure for the Franklin National Corp., of

which the bank was its principal subsidiary, would have been subject to the oversight of the Securities and Exchange Commission.

But we do have regulations for banks which are subject to our securities oversight which are nearly identical to the regulations of the Securities and Exchange Commission.

Mrs. COLLINS. To what extent do you actively oversee and enforce these regulations?

Mr. SMITH. I would say that we are very active in that field through reviewing proxy materials, through reviewing offering circulars for new debt and debenture issues.

Mrs. COLLINS. Is that a separate department?

Mr. SMITH. It is a division of our law department.

Mrs. COLLINS. Who is in charge of that?

Mr. SMITH. Mr. David Jacobsohn is in charge of that division today.

Mrs. COLLINS. How much personnel do you have in that division?

Mr. SMITH. I think we have approximately six or seven attorneys working in that area. I can get you the exact number.

[The information referred to follows:]

The Securities Disclosure Division of the Law Department of the Comptroller of the Currency had, as of June 1, 1976, six attorneys and two senior accountants.

Mrs. COLLINS. What is your policy for handling complaints by shareholders or directors of a bank that the bank is making misleading statements in its proxy materials, annual reports or other public disclosures?

Mr. SMITH. I think if we were to receive such a complaint, we would review it on the basis of what we know about the bank. We would certainly make recommendations to the bank based on that judgment. It may finally turn on shareholders bringing suit and those involved having liability.

You could conceivably have a situation which involved a so-called 10(B) (5) violation, which is a fraud violation, in which the matter would be in the hands of the SEC.

Mrs. COLLINS. Mr. Roth was here and testified in February of this year and spoke about a meeting that you attended. With reference to your policy in handling complaints by shareholders of a bank that the bank was being poorly managed, Mr. Roth has told us that you had little to say at a meeting which you attended. Could you possibly tell us about that?

Mr. SMITH. Yes; I did have little to say. If you have ever had a meeting with Mr. Roth, it is, to begin with, not easy to have very much to say.

But, second, we were right in the midst of dealing with the problem. I knew that there was a lot of unrest within the directorate of that bank. Some of it, in part, I think was encouraged by Mr. Roth.

There was nothing Mr. Roth, frankly, could tell me about the current status of that bank that I did not know in spades. So I thought my role was to sit courteously and listen to Mr. Roth and let him go about his business. And that is what I did.

Mrs. COLLINS. Can you tell me what steps you took on the questionable practices of the Franklin National Bank in the foreign exchange market? Was there any coordination with the Federal Reserve in this matter?

Mr. SMITH. The practices that have been most prominently discussed, Mrs. Collins, we did not discover until the spring of 1974. By that time the fat, so to speak, was in the fire. We worked with everybody to see what we could do to make the best of a bad situation. This included our taking the rather unusual role of going out and recruiting for the bank a highly skilled foreign exchange trader by the name of Edwin Reicher, who had formerly been the chief of foreign exchange trading at the First National City Bank. That followed a spirited discussion between Mr. Sindona and myself one day.

Mrs. COLLINS. I have one final question. I am wondering about the critical problem of undercapitalization. That is a problem that seemed to have been known to examiners from 1970 until 1974. Do you know why that was not included in examination reports in such a way that the bank should have known that this was a matter requiring special attention?

Mr. SMITH. I would doubt that there was ever any question in the minds of the management or the directorate as to how we felt about the capital of the bank. Indeed, as I look back over the record, on one occasion during the acquisition proceeding, the bank did agree, once the acquisition was completed, to increase its capital. And it did, although it was not quite to the level that it had promised.

When you are talking about very big banks with very big numbers, it is one thing to criticize; but, it is another thing for the bank to go out and acquire capital. And we do not have the power to mandate them, if you will, into the market to acquire the capital.

Mrs. COLLINS. Thank you, Mr. Chairman.

Mr. ROSENTHAL. Congressman Drinan.

Mr. DRINAN. Thank you, Mr. Chairman.

I suppose, Mr. Smith, that we cannot establish the ultimate culpability for what transpired at Franklin. But I suppose that is our task to some extent. The loss is obviously very substantial. Can you give us a ball park figure of what it is going to cost the FDIC to monitor this bank over 9 or 13 years and try to restore it?

Mr. SMITH. The FDIC, of course, Congressman Drinan, would give the best evidence there. I have recently read a press release from the corporation in which they anticipate, at this point, that through their liquidation of the assets of the Franklin, which they acquired in the process of the purchase and assumption transaction, they are going to be able to fully liquidate the obligation to the Federal Reserve with the accruing interest; that they will be able to fully cover—

Mr. DRINAN. That is not my question. How many dollars will the taxpayer pay because of the failure of the bank? Millions of dollars are going to the supervisory personnel over an extended period of time.

Mr. SMITH. No. The supervisory agencies that look after banks are funded entirely by assessments of banks. In the case of the FDIC, that is from the assessment for insurance purposes and the investment of those assessments.

What I was about to say was that it was the conclusion of the FDIC at this point that the liquidation of that loan portfolio which they now have will also cover the corporation's costs and conceivably—conceivably, but not certainly—may even include at the end a sufficient surplus to take care of some of the other creditors of the bank. These would primarily be debenture holders.

Mr. DRINAN. I have tried to follow this closely with the subcommittee staff's report and all. But I come to the inevitable conclusion that there is a division of authority and a confusion as to where the lines run, and that nobody really has any unquestioned authority.

For example, Franklin's foreign exchange transactions volume grew from \$19 million in May 1971 to \$3.7 billion in November 1973. And the OCC, in the report of the examination that began on March 6, 1972, found that the foreign division operations were in chaos and internal controls are virtually nonexistent.

This is March 6, 1972. And I see that nothing was done.

Mr. SMITH. That is not correct.

Mr. DRINAN. Obviously, it was not corrected.

Mr. SMITH. It was corrected.

Mr. DRINAN. Are you telling me that all of this did not contribute to Franklin's eventual bankruptcy?

Mr. SMITH. I would say that the announced losses in its foreign exchange operation in the spring of 1974 was a further straw in terms of the loss of market confidence in that bank. But that process was well underway before that announcement was made. What I am saying is that during the time that we severely criticized the bank for a lack of adequate procedure in its foreign exchange operation, recommended procedures were put in place. Then apparently sometime in 1973 or early 1974, they were neglected in one important term: that is that the auditor of that operation became a working part of the trading operation, entirely contrary to any acceptable practice. So the system, while ostensibly in place, broke down.

But they had taken very considerable steps after our criticisms. Mr. Fleming could probably go into that in much more detail.

Mr. DRINAN. Mr. Smith, the record seems to contradict you. I have here the very detailed report of two subcommittee staff investigators, on loan from the GAO, who spent 4 months on that. And in 1969, 1970, 1971, and 1972, all of the examinations reported about Franklin's need to develop a system which would provide adequate controls over this foreign operation.

You say that it did not contribute, but nothing seemed to happen. There must be a division of authority where either the Comptroller or the Federal Reserve or other officials are not given clear statutory or regulatory power because no one really exercised the full power to move in on Franklin, starting in 1969, and correct this situation. Do you think that there was a division of authority?

Mr. SMITH. No; not with respect to the supervision of that bank. I think that was clearly the responsibility of this office. It was the principal subsidiary of a registered bank holding company and, therefore, would get some secondary oversight from the Federal Reserve; but, the responsibility, such as the law imposes, was clearly the responsibility of this office.

Mr. DRINAN. Of the 17 branches that were organized, you say that your review has been superficial. Has anybody in your office done an indepth review? Do we have any hard knowledge as to whether or not these did or did not contribute?

It was said that the Park Avenue branch did not help. But someone here at the panel denied that these acquisitions were deleterious. And frankly, we have no hard information.

Mr. SMITH. Father, I think I can say that it is inconceivable to me that a bank of \$5 billion in total resources with over 100 branches could have had as a pivotal factor in its demise the approval of a relative handful of branches—most of them small retail branches in Long Island.

I say that if there were any shortcomings on our part in the approval of those branches, that it was in not using them for whatever value they might have had as a lever to obtain better compliance with our directives to the bank.

Mr. DRINAN. I think, Mr. Smith, that that may or may not be so. But we have to respond to the public on whether or not the Comptroller's Office utilized the applications as a device to discipline the bank, and on the fact that someone rubber-stamped these branches when your predecessors or you knew that this bank was not shaping up.

Mr. SMITH. As I have said, I think the failure to use them as a lever to obtain from them improved performance may have been a shortcoming on our part. But I do not think that the creation of the branches was in any sense pivotal in the final analysis.

Mr. DRINAN. Someone admitted that the Park Avenue branch did not help.

Mr. SMITH. It did not help. It was a very high-cost operation.

Mr. DRINAN. That means it was a disaster.

Mr. SMITH. It was a very high-cost operation.

Mr. DRINAN. On the famous weekend in New York and Washington when a merger was attempted—you know all of the facts far better than I—was there anything that you would have done differently if you had had all of the foresight then that you have hindsight now?

Mr. SMITH. No. We concluded, obviously, that the likely candidate for the merger was Manufacturers Hanover.

Mr. DRINAN. Who is we?

Mr. SMITH. There were interagency discussions going on. I was talking with the Fed, with the FDIC, and within Treasury with some very knowledgeable people about that market—including the now Secretary, who was then the Deputy Secretary.

And Manufacturers Hanover in fact, had had some of its key credit people and auditors in the Franklin. I talked on at least three occasions with Gabriel Hauge, whom I have known well for many years. And I went so far, Congressman Drinan, as to say this. I said, "Before you make a decision in this matter, I ask that you please have your counsel review the Wellsville case."

Now that is a case involving a small bank in Pennsylvania, in which the Comptroller exercised his powers of conservatorship to complete a sales transaction. Another one had been informally agreed to and it was felt unlikely that they could get timely approval of it by the shareholders.

The Comptroller moved in and took control of the bank under his powers of conservatorship and consummated the sale. That sale was latter challenged by the shareholders, but the Comptroller's action was upheld in the United States Court of Appeals.

There was no mystery in Mr. Hauge's mind as to what I had in mind when I suggested that that be reviewed. When he came back to me on Monday, I expressly asked him if he had considered a Wellsville approach in his decision not to merge.

He said, "We have. And it would not be an important consideration in that decision."

Mr. DRINAN. Do you think your office and the other regulatory agencies exercised all of the options they could have during the fatal week that began on May 6, 1974?

Mr. SMITH. Congressman Drinan, I will always ask myself that. I am afraid that the smell of death somehow got out into the marketplace. And when that happens, banks decide that if they want to swoop in on the situation, they will swoop in on it via an FDIC receivership.

Throughout the month of May and into early June, I endeavored, utilizing the good offices of former Secretary Kennedy, to have contact made with London banks to see whether they were interested in coming in either as sort of a partner, acquiring a piece of the Franklin Corp., or to come in, in effect, as sole owners.

As I have said, I think the rumors were running sufficiently at that time that to complete a commercial transaction then was impossible. And something that I did not know at that time was that the London clearing banks had their hands full with lots of fringe bank problems in London and were probably not looking for any more problem situations.

Mr. DRINAN. Could you state a simple reason why you apparently changed your mind about the possibility of a merger after your meeting with Gleason and Sindona?

Mr. SMITH. I never changed my mind.

Mr. DRINAN. But you lost enthusiasm?

Mr. SMITH. I never lost enthusiasm. If there had been a merger partner, that bank would have been merged. I would have been out of my mind not to have done that. The fact is that there was no merger partner.

And even after we decided to go the route of an FDIC transaction, we had to include in the prospective merger bidders, London banks. We endeavored to interest Canadian banks because it would have been a very unique opportunity for Canadian banks to have entered the New York market. And even with the significant assistance offered by the FDIC in that transaction, we were not bowled over by participants.

Mr. DRINAN. I have one last question. Do you have any thoughts as to whether Mr. Gleason was justified in firing Mr. Luftig and Mr. Heinemann for their allegedly unauthorized efforts to seek a merger?

Mr. SMITH. I do not know the details of that situation well enough to comment on your specific question. I think Mr. Luftig has been unfairly dealt with, perhaps, in terms of his role in the bank. I think he arrived at a point when it was probably too late to achieve any great improvements there. From all I know, he is a very competent bank officer.

Mr. DRINAN. My time has expired. Thank you very much.

Mr. ROSENTHAL. We will attempt to come around again if we can.

I want to pursue the merger phenomena, Mr. Smith. Obviously, I gather from your testimony and from the testimony of others, merger would have been a far more acceptable route than what in fact took place.

Mr. SMITH. Yes. There would have been the hope that we could have done something very quickly. As you know, we had been through the San Diego case.

Mr. ROSENTHAL. Then the answer is that a merger would have been far more acceptable?

Mr. SMITH. Yes, sir.

Mr. ROSENTHAL. And for a whole host of reasons financial, psychological, community-oriented, Long Island-oriented—it would have been better. And in answer to Mr. Drinan's question, you said that you were a supporter of a merger if there were a willing partner available.

Mr. SMITH. There is no question about it.

Mr. ROSENTHAL. On Saturday, May 12, McGillicuddy and his Manufacturers Hanover group met with their counterparts at Franklin and apparently spent a great deal of time reviewing the facts and figures and so forth.

Mr. SMITH. Yes, sir.

Mr. ROSENTHAL. Mr. Luftig testified here that he understood you were an active merger supporter and that, obviously, the cooperation of both the Comptroller and the FDIC was necessary. And Mr. Luftig testified also, I think, that he was stunned when Gleason told him that you had turned off your support for the merger. That, presumably, is incorrect.

Mr. SMITH. I would much prefer that Mr. Luftig get it from me rather than through Mr. Gleason. There was no question that I was fully in support of a merger if we could find one.

Mr. ROSENTHAL. I want to be perfectly candid with you. Mr. Roth also testified. I have every confidence that your staff brought to you Luftig's testimony, Heinemann's testimony, and Roth's testimony.

Mr. SMITH. Yes, sir.

Mr. ROSENTHAL. And there has been smoke raised that because of the intercession of David Kennedy and his 12-year partnership with Sindona in Europe that that was a factor in your cooling off as to the merger prospect—that Sindona was not in favor of merger and had hoped to turn the situation around.

Mr. SMITH. Let me, if I may, deal with that episode. There was no intercession by David Kennedy. Indeed, the contact with David Kennedy was made by me to him, rather than by him to me.

Mr. ROSENTHAL. You called David Kennedy?

Mr. SMITH. I called David Kennedy.

Mr. ROSENTHAL. On what day?

Mr. SMITH. On Sunday morning.

Mr. ROSENTHAL. I want to have the record absolutely clear. Was David Kennedy instrumental in your appointment as Comptroller?

Mr. SMITH. No, sir, he was not.

Mr. ROSENTHAL. Did he recommend you to Secretary Schultz?

Mr. SMITH. Not that I am aware of, no, sir.

Mr. ROSENTHAL. You surely would have been aware of it if he had?

Mr. SMITH. I would think that I would have been. But I have no knowledge that he was involved in that decision at all.

Mr. ROSENTHAL. What had been your prior association with Mr. Kennedy, and for how long had it existed?

Mr. SMITH. I had known him since the mid-sixties, when I was a legislative counsel with the American Bankers Association. I was deeply involved in a controversial piece of legislation now known as the Bank Merger Act.

David Kennedy was then the chief executive officer of the Continental Illinois Bank, a bank which had a very considerable interest in that legislation because, but for it, the bank would have had to unwind a merger that had already been consummated.

So I knew him for 5 years before he became the Secretary of the Treasury. When he was about to become the Secretary, I decided that I was ready to move back into the public sector and asked if he would be interested in having me come into the Department as the congressional representative for the Department. He so appointed me. I served under him for 2 years in that capacity.

That really is the extent of it.

Now if I could tell you about what happened on Sunday morning, I would like to do so.

Mr. ROSENTHAL. First, let me ask this. We have been told that Kennedy has been a partner of Sindona for many years in European transactions.

Mr. SMITH. I think the Continental Illinois Bank had had a common ownership of a small bank in Italy with the Sindona interests. It was not a controlling interest, but an equity position in a bank that Sindona was apparently a controlling factor in.

Mr. ROSENTHAL. Did Kennedy have any official interest in Franklin National?

Mr. SMITH. No. He was a director of the Sindona personal holding company, which was the entity which held the Franklin National Corporation's stocks—some 21 to 22 percent.

And as the story will unwind, I will tell you that I found out, in the course of my Sunday morning discussions—first, with Mr. Sindona and later with David Kennedy, that he had—

Mr. ROSENTHAL. I am sorry to interrupt you, but is it common practice for a Comptroller of the Currency to talk to a stockholder—even one of Sindona's size in Franklin?

Mr. SMITH. No; it is probably not common practice. In this particular case, Mr. Sindona was proposing to do something which seemed at the time to be useful. He was proposing to guarantee a \$50 million rights offering if the directorate of the Franklin National Corporation decided to offer \$50 million in stock to the other shareholders. He said he was willing to inject an additional \$50 million.

Mr. ROSENTHAL. Would that have had any effect on this situation?

Mr. SMITH. Nobody can say for sure. We thought at the time, since we knew that at sometime during that day the corporation was going to be reporting foreign exchange losses which might exceed \$40 million, that the infusion of new capital slightly in excess of that amount might—and I underline "might"—stabilize the market situation.

Mr. ROSENTHAL. The merger operation never went through. Did he ever put up the \$50 million?

Mr. SMITH. No; he never put up the \$50 million because we never got to that point. By the time it would have gone through the course of shareholder approval, the inevitable was so obvious that it was not done.

Mr. ROSENTHAL. You could have avoided a shareholder approval, pursuant to the Wellsville case.

Mr. SMITH. No. I could only have done that, Mr. Chairman, in the case of a purchase and assumption transaction.

Mr. ROSENTHAL. With Manufacturers Hanover?

Mr. SMITH. I could have. It would have been a very, very unusual undertaking, but I was prepared to engage in that sort of unusual undertaking.

Mr. ROSENTHAL. In hindsight, the stockholders might have been happier under those circumstances than they are today.

Mr. SMITH. This is in effect what we hinted that we would do in the Security takeover by Chemical. And the fact is that those shareholders have got some \$30 million or \$35 million to look forward to in that case—versus zip.

Mr. ROSENTHAL. Was Sindona opposed to the merger?

Mr. SMITH. I never discussed it specifically with him; but, my guess is that he probably would have been; yes. Obviously, any commercial merger would have occurred at a per-share value far below what he had paid to come into the bank. I can't explain it, but I had the feeling that this guy somehow thought this was going to get turned around.

Mr. ROSENTHAL. Did David Kennedy at any time convey to you Sindona's opposition to the merger?

Mr. SMITH. He indicated to me, at one time when he agreed to go to London in pursuit of interests, that Sindona would be more interested in a London bank's coming in as a coowner of the Franklin Corporation, rather than in selling all of his stock. But he told me that Sindona had agreed that if that were the only way to go, he would be willing to sell his stock. It was a kind of a borderline position, as I understood it.

Mr. ROSENTHAL. How many conversations did you have with David Kennedy about the Franklin situation?

Mr. SMITH. The first occurred, as I have said, on Sunday morning. Let me describe the background of that.

We were preparing to meet at the Federal Reserve to discuss whether or not the New York Federal Reserve Bank should be prepared to extend liquidity support to the Franklin Bank. As I recall it, we had received a call from Mr. Gleason, and later from Mr. Sindona, indicating that if the Franklin National Corporation's directorate would recommend, and if its shareholders would approve, the issuance of an additional \$50 million in capital stock to be offered on a preemptive rights basis, that Mr. Sindona would be willing to guarantee that rights offering and pick up any stock not purchased by other shareholders.

I conveyed that proposition to those Governors who were present at the Fed. George Mitchell, the Vice Chairman, was presiding. We were really in an informal session at that point.

And all of us were not particularly pleased with enlarging Mr. Sindona's ownership interests because he was obviously a negative factor in the market's reaction to this institution. There were a lot of stories about him. I did not know whether they were true or false; but I did know that he was not helping the market's appraisal of this institution.

After we had chatted about it for awhile, they said, "It is really the only game in town at this particular point. Why don't you talk to Sindona and see whether he would be willing to set up any sort of voting trust for both the stock he holds today and the additional

stock that he would acquire for some stated period—a year or 2—and appoint a trustee acceptable to us as well as to him.”

I got Mr. Sindona on the phone; I made the proposition to him. I told him why we felt that was necessary. And I suggested to him that a likely trustee of the stock would be Norman Schreiber.

Something had happened between Schreiber and Sindona. They were having personality difficulties at that point. And Sindona said “No; I will not accept Schreiber. But I will accept David Kennedy, who happens today to already have the coequal authority to vote this stock.”

Mr. ROSENTHAL. I hate to interrupt you, but this is what was happening on Sunday. I would like to turn back to Saturday.

On Saturday, McGillicuddy and his team and their lawyers met with the Franklin team and their lawyers.

Mr. SMITH. Right. We are moving on two tracks at the same time, Mr. Chairman.

Mr. ROSENTHAL. As of Saturday, Mr. Luftig testified that Mr. McGillicuddy was very keenly interested in a merger if everything could fit into place.

Mr. SMITH. That was my impression, too.

Mr. ROSENTHAL. At some point Gleason left the meeting and went down to the office of Mudge, Rose. That is the firm that John Mitchell was a partner in.

Mr. SMITH. Yes, sir.

Mr. ROSENTHAL. They are also Sindona's lawyers.

Mr. SMITH. I think Mr. Guthrie of that firm is Sindona's lawyer; yes.

Mr. ROSENTHAL. Were either you or Mr. Van Horn down in that office on that Saturday?

Mr. VAN HORN. I was not.

Mr. SMITH. I know I wasn't because I was in the Treasury Department in Washington.

Mr. Chairman, I can understand the question that you are having because we were, at that point, moving on two alternative courses. A final decision had not yet been forthcoming from the Manufacturers Hanover as to whether or not they were interested in a merger. And we were exploring any and every other possibility.

Mr. ROSENTHAL. Did Manufacturers Hanover at any time say that they had turned around and were definitely not interested in a merger?

Mr. SMITH. Yes. That is what Gabriel Hauge said to me at, I think, noon on Monday—whatever that date was.

Mr. ROSENTHAL. Did he tell you when they reached that decision?

Mr. SMITH. No, sir; he did not.

Mr. ROSENTHAL. Was Hauge the chairman of the board of Manufacturers?

Mr. SMITH. He was the chief executive officer; yes, sir.

Mr. ROSENTHAL. What was McGillicuddy?

Mr. SMITH. President and chief operating officer. I think that is still the designation.

Mr. ROSENTHAL. And it is clearly your position that Kennedy's relationship with Sindona had nothing to do with the breaking off of the merger possibilities?

Mr. SMITH. I am certain that it did not because Kennedy did not even know what was happening over that weekend until I called him on Sunday morning. I do not know what time that was out in Seoul, Korea. I insisted on calling him because if Sindona said, "I am willing to surrender my voting position to David Kennedy," I obviously was not going to accept that unless I had David Kennedy's concurrence to perform in that role.

And I said, "It is probably going to become a publicized fact. Does that trouble you?"

And he said, "No, I will accept that responsibility."

Mr. ROSENTHAL. Is Kennedy still a partner of Sindona?

Mr. SMITH. I don't have any idea of what their relationship is, Mr. Chairman.

Mr. ROSENTHAL. Sindona has been indicted or wanted for extradition, hasn't he?

Mr. SMITH. I think he has. I do not know what the circumstances are in Italy. He has not been indicted here.

Everything that I know is hearsay. And to be perfectly honest, that is about all I knew in May of 1974, too.

Mr. ROSENTHAL. There is something that still troubles me. On Saturday afternoon, Manufacturers Hanover was keen about the merger. But apparently something happened between Saturday and Sunday.

Mr. SMITH. My guess of what happened was that it was on Sunday that the full extent of that unauthorized foreign exchange trading came to light, with the magnitude of that possible loss in excess of \$40 million. My guess is that that was enough to cut off a budding marriage.

Mr. ROSENTHAL. As I recall, Luftig testified that that information was available and that he, Luftig, said to McGillicuddy, "You now have all of the information about the foreign exchange loss. Are you still interested?"

And McGillicuddy said, "yes."

Mr. SMITH. It may have been known, but, according to my recollection—and I will check with Bob Mullin—that number was going up almost by the hour on late Saturday and early Sunday. When we first heard about it, they were talking about, as I recall, something on the order of \$25 million. And by Sunday evening, they were up over \$40 million.

I might say that if I had been on the other side of the transaction, I would have been a little uneasy too as to how much I actually knew. It is a very tough call, Mr. Chairman, to come into a \$5 billion institution over the weekend and decide whether you are going to commit yourself.

Mr. ROSENTHAL. It may be my inexperience, but in a \$5 billion institution, does the difference between \$25 million and \$40 million make much difference?

Mr. SMITH. It did with the capital position of this bank. There is no possibility, if you had to put \$30 million or \$40 million or \$50 million or \$60 million into that bank with its locked-in portfolio, that you would earn anything on that money for quite a period of time.

Mr. ROSENTHAL. Let me ask one last question and then I want to get to my colleagues. Manufacturers was particularly interested in this bank because it gave them an outlet into the Long Island market.

Mr. SMITH. They seemed the absolute natural. And the fact also that they had just, a matter of 30 or 60 days before, advanced the holding company a \$30-million loan made them a likely candidate to protect what they already had invested.

Mr. ROSENTHAL. Was David Kennedy in any way associated with the European-American group that finally came in?

Mr. SMITH. No; I am certain that he is not. That is a consortium of about six major European banks.

Mr. ROSENTHAL. And to the best of your knowledge, he has no association either with that consortium or with any of the six banks.

Mr. SMITH. Yes, sir.

Mr. ROSENTHAL. Mr. BROWN.

Mr. BROWN. Mr. Smith, we have talked about the Saturday and Sunday. And you have said that there were two parallel transactions going on. Did you at any time on Saturday participate or have any input into the discussions which Manufacturers Hanover was having with Franklin?

Mr. SMITH. Only to the extent that I have talked with Gabriel Hauge and indicated through the reference to the Wellsville case my willingness, if it became necessary, to undertake that very unusual position of perhaps standing in for the bank's owners in order to consummate a sale.

Mr. BROWN. And to the extent that you participated, limited though it was, your participation was consistent with and encouraged a merger.

Mr. SMITH. Yes, sir. As I have said, I would have been a damned fool not to have supported the merger. I am a lot of things, but I do not think that I am a damn fool.

Mr. BROWN. And what you were doing when you were contacting Sindona and Kennedy was to see what could happen in that option in the event the merger discussions did not prove satisfactory?

Mr. SMITH. Yes, sir. This was constantly a balancing of alternatives as we proceeded after that time to seek out merger partners abroad. When Manufacturers Hanover said, "No," we were all satisfied that no other New York bank was going to step up in a normal commercial transaction. So from that date and beyond, we were still proceeding to seek out a possible commercial transaction abroad. But at the same time, we brought about the unusual undertaking of asking the New York Clearing House to go in and give us its management judgments as a group about the bank.

Now that was bona fide in the sense that we did indeed welcome their considerable expertise. But it was also to serve a secondary purpose of beginning to acquaint every member of that clearing house with the Franklin in the likelihood that we had to move to an FDIC assisted transaction. We at least had that step up on the learning curve already accomplished.

Mr. BROWN. I gather, from what has been a rather interrupted discussion of the Sunday telephone calls, that David Kennedy agreed to act as the voting trustee.

Mr. SMITH. Yes, sir; he did.

Mr. BROWN. But you never went through with that transaction.

Mr. SMITH. It went to the point that the proposal was presented to the Franklin board during the following week. We asked Mr. Sindona

to tender his proposal to the board in writing—which he did. So to that extent, it proceeded ahead. But it was then going to have to be approved by a shareholders' meeting which never in fact occurred. And by the time we got to that point, it was apparently going the FDIC route anyway. So we just did not continue to pursue it.

Mr. BROWN. But you did attempt to pursue the Sindona infusion of capital proposal until after you had heard on that Monday that the merger discussions had broken up?

Mr. SMITH. Yes, sir.

Mr. BROWN. It bothers me that we have name dropping and that we have in this committee tried to indicate that there is some hanky-panky going on or something. It seems to me that it should be fairly easy and simple to get Manufacturers Hanover to come in and say whether or not, as you say, you were supporting the merger or if you were telling them something different. I happen to prefer to believe you and I think that we should not just leave this up in the air. I think we ought to bring in somebody from Manufacturers.

Mr. SMITH. Clearly, the best evidence is Mr. Hauge.

Mr. BROWN. I have no further questions.

Mr. ROSENTHAL. Congressman Drinan.

Mr. DRINAN. Thank you, Mr. Chairman.

On that weekend, Mr. Smith, did you feel that you had adequate information about the status of Franklin to come to some conclusion as to which option you should recommend?

Mr. SMITH. Clearly, the merger option was the preferable one. We knew that we were in extremis; we knew that this bank was exceedingly vulnerable to a liquidity hit once the bank opened on Monday. And, of course, that in fact happened. In 10 days, nearly \$1 billion rolled out of there. So we were fully aware of that likelihood.

Mr. DRINAN. Was there any way by which Mr. Hauge's offer to take over the Long Island branches could have been accepted?

Mr. SMITH. No. I do not think that we would have seriously entertained that even on Sunday. That becomes an exceedingly difficult operation. Later on, well down the road, when the FDIC was in the picture, we considered a proposal at one point from First National City that they would come in and be the original acquirer and then disseminate branches to various banks in New York.

It was their idea. But once they got into the details of it, they finally came back about 2 weeks later and threw their hands up in the air and said, "Forget it; it just cannot be done."

The difficulty is trying to balance assets and liabilities—loans with deposits. And it is just an enormously complex undertaking.

Mr. DRINAN. Coming back to the relationship between David Kennedy and Mr. Sindona, my understanding from what we have heard before is that Mr. David Kennedy phoned you in January of 1974 and set up a meeting between you and Mr. Sindona and Mr. Kennedy—or at least between you and Mr. Sindona. Is that an accurate statement?

Mr. SMITH. I think that Secretary Kennedy did call me. I am not certain whether it is with respect to that meeting or whether it was the meeting in late 1973. I will have to go back and check my own records. They may be one and the same meeting.

But the purpose was for Sindona to make a courtesy call and to talk to me about the proposed Talcott transaction which never came off.

[The information referred to follows:]

Mr. Kennedy called Mr. Smith on January 17, 1974, and requested an appointment for Mr. Sindona. The meeting with Mr. Sindona was held on January 23, 1974.

Mr. DRINAN. Did you make any memos for the file about your meeting with a shareholder of a bank?

Mr. SMITH. No, sir, I did not. I am not in the habit of writing a lot of memos for the file. Maybe I am at fault in that.

Mr. DRINAN. Do you think there should be regulations about a thing like that?

Mr. SMITH. This was not a shareholder of a bank as such; it was a shareholder of the holding company that owned the bank. He was talking to me about a proposed acquisition of the holding company, and one which he deemed was going to strengthen the whole organization.

The Federal Reserve, which was charged with making the decision in that matter, reached a contrary decision. And I would be hard put to say that it was a wrong decision.

Mr. DRINAN. Have the regulations which you have been telling us about brought about a situation where a case like the Franklin could never happen again?

Mr. SMITH. I am not talking about regulations, in large part; I am talking about procedures. And I think that, barring extreme circumstances in the financial market, we feel that we have the tools today to never let a situation in a major money market bank develop to the point that it would be threatened with insolvency.

I am not going to make the same guarantee for very small banks because it does not take a very sizeable event to threaten one of those with insolvency.

Mr. DRINAN. Do you think that the procedures that you developed will correct the situation that we have discovered in the First National Bank of East Islip?

We had Mr. Aaron Donner testify that he was assured regularly that the provision of law which makes acquiescing directors personally liable for losses on loans in excess of legal lending limits was not enforced by the Comptroller. He learned that from all types of important sources.

One, is that assertion true; and two, has there been any correction?

Mr. SMITH. It is not a clear-cut legal judgment, to begin with, Congressman. Where we find a loan made in excess of the bank's legal lending limits approved by the directorate and where loss accrues on that loan, we regularly endeavor to persuade the directors to hold harmless, in effect, the bank—to either take the loan out or to guarantee the margin of loss.

Sometimes we are successful in those persuasive undertakings; sometimes we are not. I think there is open question as to whether we have further authority. There is the possibility that we could undertake initiatives to cause the bank itself to sue the directorate. But we do not have any independent authority to do that. That is something

which I think is worthy of consideration—whether or not the supervisory agency should have the authority to sue in behalf of the bank.

Mr. DRINAN. So Mr. Donner's contentions are correct. And when he talked to Mr. Jacobsohn of the legal department of the Comptroller's Office, he discovered that Mr. Jacobsohn, said that theoretically the Comptroller should respond to loans in excess of the statutory limit by holding the directors individually liable, but that they do not do it. Do you want statutory power to do that; or do you need such statutory power?

Mr. SMITH. We clearly do not have the statutory power today to bring suit ourselves.

Mr. DRINAN. But that is not in the recommendations that you made to us this morning?

Mr. SMITH. No, sir.

Mr. DRINAN. So, therefore, you have not corrected this situation in East Islip.

Mr. SMITH. But what did happen in that case was that we did, through our securities unit, cause disclosure to occur, which caused the minority shareholders to bring suit, which suit is still ensuing. And that is the best of all courses of action. There you have litigation between the real parties.

But failing that, I think it is worth considering whether or not the banking supervisory agencies should have the authority to bring suits themselves.

Mr. BROWN. Would the gentleman yield?

Mr. DRINAN. Yes.

Mr. BROWN. What would the suit seek?

Mr. SMITH. The suit would seek restitution in behalf of the bank, and, thus, the bank's shareholders. In other words, this is a loan which has been approved in violation of the law by the directorate of the bank. It has resulted in a loss to the bank, and, thus, to the bank's shareholders.

Mr. BROWN. But would you have to wait until there has been a loss? Otherwise, what is the damage?

Mr. SMITH. It is a question of time. We always seek to have the overline corrected—usually through a sale of all or a part of the loan to another lender.

Mr. DRINAN. I have one last question, Mr. Smith. Your Deputy Comptroller, Mr. Bloom, testified in the recent past here that the policy is not to disclose any of these bank examination reports. He said that this would jeopardize the relationship.

You said something here about disclosure. But is it still the policy of your Office not to disclose under any circumstances the adverse reports that your examiners might make about a particular bank?

Mr. SMITH. Yes. I do not think that we, Congressman Drinan, ought to be disclosing our judgment.

Mr. DRINAN. Then there is no way by which the depositors or consumers can be warned. This is important. Mr. Bloom insisted upon that. And I think that is a wrong policy and that the depositors of the Franklin should have gotten some warning. And I think that you have the duty of going to them. If you do not have sufficient statutory power to do that, I think that we ought to give it to you.

Who is going to warn the depositors?

Mr. SMITH. We have all kinds of public disclosure about banks. Banks and bank holding companies are subject to the disclosure requirements of the Federal Securities law. And that is the way the disclosure should occur.

Banks are privately owned corporations which have to compete in the capital market, Congressman Drinan, for their capital, along with all other business corporations. Now there is no Federal agency which discloses to the public its subjective judgments about General Motors or A.T. & T. I say cause banks and bank holding companies to disclose four-square with other sellers of public securities, but do not impose more disclosure.

Mr. DRINAN. General Motors is not a regulated industry. That analogy is absurd.

Mr. SMITH. I do not think it is absurd at all. In other words, if you wish to have a special market that funds only regulated industries and figure out how you are going to dragoon people into participating in that market, then maybe your point of view will be sustained.

Mr. DRINAN. A simple warning to Franklin, saying, "We are going to disclose these objective facts, not subjective conclusions, a week from Monday." would have caused Franklin to shape up. Thank you very much.

Mr. ROSENTHAL. Has the Victor group listing replaced what we had read about at one time as the "Problem Bank" list?

Mr. SMITH. Yes, sir.

Mr. ROSENTHAL. How many banks are in this Victor group?

Mr. SMITH. At the last report that I made—and I think it is still current—we have some 27 banks under intensive surveillance by the special situations group; and another 50 to 60 banks which we have doing more than normal reporting, but which we do not regard as problem banks.

Mr. ROSENTHAL. Of the 27, are any of them of the size of Franklin or are they major money market banks?

Mr. SMITH. We have a couple of banks in the \$1 billion plus class. But I would not categorize them with Franklin. Their liquidity situation is nothing like Franklin's either.

Mr. ROSENTHAL. Thank you very much, Mr. Smith, for appearing today.

The subcommittee stands adjourned.

[Mr. Smith's prepared statement follows:]

PREPARED STATEMENT OF JAMES E. SMITH,  
COMPTROLLER OF THE CURRENCY

I appreciate this opportunity to appear before the Committee in connection with its inquiry into the Comptroller's regulatory processes. In this hearing the Committee is attempting to evaluate those processes through a study of the Franklin National Bank, which was placed in receivership on October 8, 1974.

I believe that we can learn from our past experiences, both good and bad. Thus, as the Committee staff testified last week, I initiated even before the failure of Franklin National Bank a special study of the events leading to the bank's difficulties.

This Committee's record on Franklin National Bank would be incomplete, however, without including information on (a) the behavior of the financial market place during the critical years 1970-1974 and (b) the changes that have occurred in the Comptroller's Office.

I. The Financial Market Place and Its Effect on Franklin

National banks are privately owned corporations. The most important decisions made in each bank are those of the bank's own board of directors and management, responding to competitive pressures and opportunities. Thus no inquiry into the failure of Franklin National Bank can be complete without an examination of the decisions made by the Franklin management in the context of the then existing market place environment.

Inflation during the 1970-1974 period was rampant: because of the effects of the Vietnam war, an expansionary monetary policy and other such factors, consumer prices increased by 31.9% from 1970 to 1974. At the same time, the steepest recession since the Great Depression of the 1930's had set in.

From the banker's point of view, the greatest problem was the enormous increase in interest rates: the Federal funds rates during the summer of 1974 rose to an unprecedented 12.9% and the prime rate

was at a staggering 12.1%. The basic cost of money to banks aggressively using liability management during the 1970-1974 period had increased an incredible 105.3% during this time. Franklin was particularly ill-suited to survive these economic pressures.

Franklin was a marginal operation throughout the 1960's, yet the bank managed to operate and grow to a \$3 billion institution by the end of 1969 without arousing any significant concerns by this Office or the financial industry. Despite its apparent progress, however-particularly in 1968 and 1969-the bank had neither the management depth and acumen nor the operational systems and controls to cope with its ambitious expansion program and the financial perils of the 1970's. Had the bank curtailed its activities after 1969 and solidified its position in the marketplace, the results may have been different.

By December 31, 1973, Franklin's resources exceeded \$5 billion. The bank's management proved incapable of developing and handling the sophisticated asset and liability management techniques necessary for a bank this size.

During the 1960's and early 1970's, the money market banks, faced with declining rates of growth in deposits, sought new ways to meet the heavy credit demands of their customers. In consequence, Franklin and other banks placed less and less reliance on the generation of liquidity through asset composition and cash flow. Instead, increasing emphasis was given to acquisition of deposits and the purchase of a wide array of borrowed money, including Federal funds, Eurodollars, negotiable CD's and long-term debt.

Franklin thus was able to buy its liquidity in the marketplace to support its rapid asset growth. In retrospect, Franklin's liability structure and asset structure made the bank exceptionally vulnerable to the confidence of the money markets.

Confidence in financial institutions declined significantly in 1973 and 74 as a result of bank failures, both here and abroad, significant foreign exchange losses in several major banks and evidence of deterioration in bank loans to struggling real estate firms, airlines, public utilities and the like. This decline in confidence, coupled with steadily rising interest rates, tight money conditions, high inflation and the beginnings of a recession led to a rush to safe havens for funds. The very largest banks with unquestioned national and international reputations were the direct beneficiaries, since the money market participants seemed to be making the judgment that biggest also meant safest. Marginally operated and smaller money center banks like Franklin were often denied funds altogether or were forced to pay high premiums for a limited amount of funds. The tiered markets which developed forced many banks to scramble to avoid negative margins and to assure liquidity adequate to meet the claims against them. Franklin had long term, low yielding assets in both its loan and its investment portfolios, and thus was locked into a negative margin between the cost of the funds it borrowed and the uses it made of those funds.

Under these turbulent market conditions, Franklin struggled. The money market's continuing concern about Franklin was greatly aggravated in the spring of 1974 when significant problems were disclosed and market rumors about substantial losses became generally known. A loss of confidence occurred and a massive outflow of funds resulted, from which Franklin never recovered. The specific actions taken by the Comptroller's Office during the November 1973 through

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October 8, 1974 Franklin difficulties are detailed in the Appendix to my statement.

The lesson that all banks could not always be assured of equal access to the money markets was a rude awakening for many banks practicing liability management, and an important lesson for us. We believe we now have the sophisticated analytical techniques and a far better understanding of money market banks to take remedial action early and effectively.

However, because our powers -- by design -- fall far short of actually running a bank, there will always be a limit on our capacity to insure a fail-safe national banking system.

#### II. Changes in the Comptroller's Office

The Committee staff's testimony last week mentioned several times the year-long study and report on the Comptroller's Office by the nationally known management consulting firm of Haskins & Sells. There was apparently no direction to the Committee staff, however, to evaluate the many changes which have resulted from implementation of the recommendations in that report.

As the Committee knows, the General Accounting Office is now undertaking a full scale review of the operations of the Comptroller's Office. GAO's report is expected to deal with these changes in our regulatory and supervisory procedures.

Meanwhile, however, I should review for the Committee some of these changes in order to dispel the erroneous impression that might be left in the record from the limited scope of the testimony already presented to this Committee.

#### Domestic Examination Procedures

Substantial improvements in national bank examination procedures now are being adopted.

The new procedures will gear examination efforts more precisely to the needs of the Comptroller's Office and the particular bank being examined and will stress review of bank internal controls, such as credit and investment rules, and internal audit procedures. Examiners will devote more time to the review and evaluation of the bank's own policies and procedures, its decision-making process, and its management information system. Had these new examination procedures and processes been in place earlier, they may have enabled the examiners of the Franklin National Bank to perceive much earlier the inherent weaknesses in the bank's philosophy, policies, and procedures which eventually created the problems leading to its demise.

In addition to these new examination processes, major revisions are being made in the examination report itself. The primary purpose of the revised report of examination is to communicate meaningful information effectively to both the Office of the Comptroller of the Currency and to bank directors and management. The report must clearly identify the problems of special concern to the examiner, the factors that have caused the problems, and the remedial action that is suggested.

To promote effective communication of these matters to the intended recipients, the new report of examination is divided into three sections designed to explain the relative importance of the examiner's findings of problems and causes and to indicate recommended corrective action to the applicable recipient.

The first section of the report is designed specifically for the immediate benefit of the Board of Directors and its Examining Committee, as well as senior management. It is to be in letter form and will set forth the scope of the examination plus a summary of all critical comments, in narrative form, backed by appendices and schedules that will support the conclusions in sufficient detail to enable the Board,

or its representatives, to take specific corrective action. The examiner's comments are to include probable problem causes and recommended actions to assist the Directorate with this aspect of remedial responsibility.

The second section of the report consists of various schedules, technical irregularities and deficiencies, and comments by the examiner relative to the conclusions and evaluation of specific areas. This section will be a checklist against which a bank's auditor, cashier, or other designated officer can effect correction and against which the bank's Board of Directors and/or senior management can measure the progress of the corrective action.

The third section of the report is designed specifically for the Comptroller's Office, although we will receive copies of all three report sections. The third section will include confidential information and a certain amount of additional informative data necessary to the operation of our Office. The confidential section will set forth matters requiring the prompt attention of our senior staff, such as:

- Suspected violations of law uncovered during the course of the examination reported, or to be reported, to the appropriate Comptroller officials or other regulatory enforcement agencies.
- Critical comments relating to senior bank officers which may require official remedial action by the Comptroller's Office such as the threat of cease and desist orders or officer removal.
- Subjective comments regarding management or other matters which have not been factually proven by the examiner but which, nevertheless, constitute areas of concern.

As is evident, the report of examination and related procedures have undergone substantial change. Perhaps the most important change is that most of the information previously "hidden" in the confidential section of the report of examination is now presented in the open section. Directors and management of the bank will have no excuse for

doubt concerning our Office's evaluation of the condition of the bank.

National Bank Surveillance System

We are also implementing a bank evaluation and monitoring system called the National Bank Surveillance System (NBSS). Had this system been in operation at the time when Franklin's earnings problems were developing, the system - in coordination with the new examination procedures - would have assisted in detecting the detailed causes of those problems and, more importantly, it could have helped management to correct those problems in a timely manner.

The NBSS consists of four elements: a data collection system; a computerized analysis system which detects unusual or changing conditions in any national bank; an analysis of those changes by trained NBSS specialists; and, of primary importance, an Action Control System.

Rapidly processed reports of condition and income from each national bank are entered into the system at quarterly intervals. The computer calculates fifteen pages of meaningful ratios and percentages for each bank. A second computer program summarizes these performance reports and ranks each bank in an "Anomaly Severity Ranking Report." This report simply designates those banks in the national banking system which deserve a priority review. At that point the human element re-enters the process. The trained NBSS specialists review each of the fifteen page reports and all other relevant data on each bank which the Anomaly Severity Ranking Report has designated for priority review.

The Anomaly Severity Ranking System covers three basic aspects of a bank's condition in relation to that of other banks in its peer group. It considers the bank's current position in each ratio, its short term trend in the most recent quarter and its long term trend over the past five years. Had the NBSS been in use earlier, it would have designated Franklin for priority review. The NBSS specialists would have noted a number of conditions in the Franklin report,

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including its low and declining earnings; its sources of those earnings; its inadequate provisions for its reserve for possible loan losses; and its inability to utilize fully its municipal tax exempt income. In view of all of those factors, the hazards involved in its large, volatile liabilities would have been flagged.

With the Anomaly Severity System having designated Franklin for priority review, the NBSS specialist would have reviewed the performance report, noted conditions of concern, and then turned to the Action Control System.

All banks designated for priority review are placed in the Action Control System quarterly. The bank cannot be removed from the Action Control System until the conditions of concern have been corrected. While the bank remains in the Action Control System, reports will be made every two weeks showing the progress or the lack of progress in correcting conditions of concern.

The conditions of concern must be acknowledged by the Regional Administrator, who has the responsibility for the initiation of corrective action. He must respond to the conditions cited in the Action Control System. He can achieve correction at his discretion, but correction and/or his response must be made within 30 days.

The Action Control Reports will also be utilized by various functional units of the Washington office. If those reports show a bank or a region as delinquent or unsuccessful in its corrective efforts, they can be assisted by other appropriate units such as our Special Projects staff or the staff of our Enforcement and Compliance Division.

The NBSS does exist now to this extent. Fast and accurate data is flowing into the system. The fifteen page performance reports are being produced and they are being utilized in most of our geographic

regions. Seven trained NBSS specialists are now in regional offices and all fourteen regional offices will have trained specialists before the end of June, 1976. The Anomaly Severity Ranking Reports have been utilized repeatedly and they have proven reliable. We have used in the banks the results of the reports and the specialists to cause the correction of serious problems which would otherwise not have been detected at an early date.

The Action Control Program is a crucial part of the system. Its programming is nearly complete; its action, condition and response codes have been tested and, with the input of the next quarter's data, the Action Control System is to be implemented.

We will then be using a new system of bank supervision. We know that system must remain flexible to cope with the rapid changes in the banking system. It must also maintain the proper balance between its machine-operated segments and those involving good human judgment.

Foreign Exchange Procedures

We are in the process of finalizing a new examination procedures manual which covers every aspect of foreign exchange trading and requires written policy goals and guidelines, segregation of specific duties by trading and bookkeeping personnel, specific confirmation requirements, internal controls and audit programs.

Recognizing that with relatively minor changes in our old techniques we might well have found reason to suspect some less than prudent action on the part of Franklin's personnel, we now require that the examiner review, not just the most recent, but all monthly revaluation worksheets since the last examination to insure that proper market rates were in fact used. The new procedures, under appropriate circumstances, require the examiner to intercept all mail

to insure that all incoming confirmations can be identified with contracts on the bank's books. These new examination procedures are the most comprehensive guidelines written to date.

We have made other modifications in personnel, training, and examining procedures and policies. These are designed to help prevent the occurrence of similar situations in other banks.

We insist that the Board, through senior management, set up strict segregation of duties and responsibilities for every function of this and every other area. Traders should trade and nothing else. Accounting personnel should be responsible for all accounting, confirmation, revaluation, and other recordkeeping functions, completely independent of all trading functions. This would include sending and receiving trade confirmations and checking discrepancies directly with the counterparties and reporting these activities to the audit department, obtaining forward rates for revaluations independently and performing these revaluations without interference from the traders. Auditors must be truly independent from influence by senior management or by the personnel they are auditing. They must feel free to report their findings to proper Board-level committees. The Position Clerk should only keep records for the trader and not prepare reports for management. This should be a function of the accounting department.

Examiners are evaluating the organization and effectiveness of this separation of duties and commenting upon deficiencies or overlapping of responsibilities. Critical comments are made directly to senior management and the Board. Examiners include in their examination procedures an inspection of internal bank reports from periods between examinations to insure their accuracy and the correctness of their content.

In addition, as part of the "ongoing examination" concept, while examiners are in the bank they review reports, daily activities, and similar matters, at least on a test basis, to ascertain if required procedures are followed as a regular practice and also to determine any major changes in positions and policies.

The International Banking Group continues its efforts at upgrading the quality, knowledge, and experience of personnel engaged in examining international activities. Examiners-in-Charge of international divisions are now recommended by the Regional Administrators and final selections are made by the International Banking Group, based on experience, ability, and availability. Additional personnel are participating in quarterly training sessions on international banking. This training, both in general international banking and in foreign exchange, is conducted by Washington staff personnel, as well as by other authorities from government agencies such as the Ex-Im Bank and the Federal Reserve, and by experienced bankers. An advanced seminar on foreign exchange trading is also given at least twice annually to help disseminate knowledge of this subject to as many of our examiners as possible. In addition, international examiners travel to other areas of the country in order to help where experienced support personnel are needed, and gain experience from this increased exposure.

#### Branch and Other Approvals

Procedures for actions on corporate activities, such as new branches, mergers and other applications in the corporate area, are being developed to examine more closely the expansion policies of a national bank in light of its historical and current condition.

The Comptroller's Office will soon announce policy statements which will be published for comment by the public prior to their adoption. These policies will set forth guidelines under which the

Comptroller's Office will either grant or deny branches, mergers and other applications of a corporate nature. These guidelines will specify that, if a Regional Administrator wants to approve a branch or merger which falls outside the guidelines, the application will get close scrutiny in Washington. If a particular bank is subject to special surveillance, its application will undergo special analysis by the Bank Organization and Structure Division in consultation with the special surveillance units in Washington.

In short, our new policies in regard to corporate expansion will permit closer monitoring, in conjunction with our new examination and analysis techniques, both at the regional and Washington levels.

#### Operations Review

Prior to 1976 the Comptroller's Office had no formal process for reviewing in a systematic way the manner in which national bank examiners perform their examinations to assure that they are performed consistently in accordance with established instructions and procedures. Such a formal operations review process is now in place. It is headed by a Deputy Comptroller with 27 years examining experience who reports directly to me. He is our own internal inspector general.

Under his supervision, examiners in each of our 14 regions have been specially trained to review the procedures by which banks in other regions are examined and supervised. Any exceptions from established procedures and instructions are noted and reported to the Washington Office.

Additionally, our Deputy Comptroller for Operations Review is the person to whom a banker who is fundamentally aggrieved by any of our regulatory activities can bring his complaint.

These operations review procedures should lessen the possibility of examinations being conducted improperly or not in accordance with

the new procedures which are being established by our Office.

Recommended Enforcement Legislation

Although these changes should make our Office more effective, there are still more tools we need that only the Congress can provide. The Congress is currently considering enforcement legislation recommended jointly by the Comptroller, the Federal Reserve Board, and the FDIC to enable us better to deal with problem banks. I urge prompt consideration and passage of this legislation.

The legislation has several provisions. The first empowers the banking agencies to assess civil penalties for violations of various banking statutes and cease and desist orders. I endorse the idea of giving the agencies this authority.

Another provision of the bill which I heartily support would give the banking agencies power to remove an officer, director, or other person participating in the affairs of the bank from his position upon being able to show gross negligence in the operation or management of the bank, or a willful disregard for the bank's safety and soundness. Under the present statute, bank officials can be removed only if the agency can establish "personal dishonesty." The judicial review provisions already contained in the statutes are ample to protect against arbitrary or capricious use of this power.

The procedures by which an officer or a director of a national bank can be removed also need amendment. Under existing law, the Comptroller lacks power to remove a bank official unless that official has been indicted. If he has not been indicted, the Comptroller can do no more than certify facts to the Federal Reserve Board. The Federal Reserve is given the responsibility for issuing a notice of proposed removal, prosecuting the case, hearing the evidence

and making the final decision. The Comptroller cannot even institute the proceeding.

This procedure is so cumbersome to use that neither the Federal Reserve Board nor my Office believes that it has been very effective. We thus have recommended a provision which would empower the Comptroller to institute and prosecute proceedings. The Comptroller also would have the power to suspend a bank official pending completion of the proceedings. The Federal Reserve Board, however, would retain its authority to hear the case and make final decisions. I am in complete agreement with this recommendation.

In addition to this general statement on Franklin and the operations of our Office, responses to specific questions in your letter of invitation of May 4, 1976 are addressed in the Appendix<sup>1/</sup> to the statement.

<sup>1/</sup> Appendix is in the subcommittee's files.

[Whereupon, at 12:15 p.m., the subcommittee adjourned, to reconvene subject to the the call of the Chair.]



# A P P E N D I X

## ADDITIONAL MATERIAL AND CORRESPONDENCE SUBMITTED FOR THE RECORD

U.S. District Court, Eastern District of New York

Civ. No. —

AFFIDAVIT

In the matter of the liquidation of

FRANKLIN NATIONAL BANK, A NATIONAL BANKING ASSOCIATION

STATE OF NEW YORK,  
*County of New York, ss:*

JAMES E. SMITH, being duly sworn, deposes and says:

1. I am the Comptroller of the Currency of the United States. I have held that position since July 5, 1973. I submit this affidavit in support of the petition of the Federal Deposit Insurance Corporation ("FDIC") as receiver for court approval pursuant to 12 U.S.C. § 192 of a proposed sale of assets and transfer of liabilities of Franklin National Bank.

2. I make this affidavit upon the basis of personal knowledge and the official records of the Office of the Comptroller of the Currency.

3. The Office of the Comptroller of the Currency was established in 1863 and is a bureau of the United States Department of the Treasury. The Comptroller supervises the national banking system and is charged with the responsibility for executing laws relating to the national banking system (12 U.S.C. §§ 1 and 2). There are more than 4,600 national banks located throughout the United States. The Comptroller's Office is required to examine each of these banks three times in every two years (12 U.S.C. § 481). To perform this task, the Comptroller's Office employs 1,952 persons as national bank examiners or assistant national bank examiners. The Comptroller also approves or disapproves the chartering of new national banks (12 U.S.C. § 27), applications by existing national banks to establish branches or to relocate banking offices (12 U.S.C. §§ 30 and 36), applications to merge or consolidate banks when the surviving bank is a national bank (12 U.S.C. §§ 214, 214a, and 1826(c)), and changes in the capital structure of a national bank (12 U.S.C. §§ 57 and 58; 12 C.F.R. Part 14). The Comptroller also determines when a receiver should be appointed to close up a national bank because the Comptroller has become satisfied of the bank's insolvency (12 U.S.C. § 191).

4. One of the national banks supervised by the Comptroller of the Currency is Franklin National Bank, Brooklyn, New York. Franklin National Bank was chartered by the Comptroller's Office in 1926. In 1969 the Comptroller approved the corporate reorganization under which all outstanding shares of Franklin National Bank, except for directors' qualifying shares, were acquired by Franklin New York Corporation. Franklin New York Corporation is a publicly owned company whose securities are registered with the Securities Exchange Commission ("SEC") and whose only substantial asset is shares of Franklin National Bank. As of December 31, 1973, Franklin National Bank was the twentieth largest bank in the United States with total resources of \$5 billion, total deposits of \$3.7 billion, and total loans of \$2.4 billion. It has a main office and 103 branches, most of which are located in Long Island, New York.

5. A regular examination of Franklin National Bank by the Office of the Comptroller of the Currency pursuant to 12 U.S.C. § 481 began on November 14, 1973, and concluded on March 8, 1974. This examination disclosed that Franklin had serious financial problems. As of November 14, 1973, total resource had grown to

\$4.9 billion, or 29 percent greater than shown by the prior examination of the bank on December 8, 1972. In the same period, however, the capital of the bank had increased less than one-half of one percent, and demand and savings deposits had declined by 5.5 percent. The bank's growth had been financed almost entirely by the use of short-term borrowed funds, including so-called money-market certificates of deposit, and time deposits of other banks. These borrowings were as follows:

Type of borrowing	Nov. 14, 1973 (millions)	Dec. 8, 1972 (millions)	Difference (millions)	Percentage increase
Net Federal funds purchased <sup>1</sup> .....	\$570	\$221	\$349	158
Bonds sold under agreements to repurchase .....	124	16	108	675
All certificates of deposit .....	<sup>2</sup> 626	475	151	32
Time deposits of other banks .....	956	535	421	79
Borrowed securities .....	3	48	-45	-94
Total .....	2,279	1,295	984	76

<sup>1</sup> Computed for each date by subtracting Federal funds sold by Franklin to other banks from Federal funds purchased by Franklin from other banks.

<sup>2</sup> Includes \$445,000,000 of so-called money market certificates of deposit, which are (a) in amounts greater than \$100,000; (b) unregulated as to interest rate; and (c) of short-term maturity, usually less than 1 yr.

These funds totaling \$2.3 billion, or 50 percent of the bank's liabilities, were of a highly volatile nature and were likely to be withdrawn from the bank rapidly in the event that there was any reason to question the soundness or stability of Franklin National Bank. For example, as to Federal funds, which are excess reserves of one bank loaned (or "sold") to another bank, usually on an unsecured overnight basis, there is no assurance that the funds may be borrowed (or "purchased") again the next day.

In addition, the November 14, 1973 examination showed uncollectible loans totaling \$10 million, and loans whose credit quality was criticized, although the loans were not necessarily deemed uncollectible, of \$275 million. The amount of the criticized loans equaled 162 percent of the bank's equity capital of \$170 million. The bank also had outstanding \$3.8 billion in contracts to buy or sell foreign currency at a future date, a volume which far exceeded the bank's normal needs and showed heavy speculation in foreign currency. Additionally, the bank's operating income was poor. It was apparent that the bank's poor earnings, potential loans losses, or extended foreign exchange position might easily cause a loss of confidence in the bank, which in turn would result in a serious and overwhelming liquidity crisis. Representatives of the Comptroller's Office met with the bank's board of directors to advise them of my concern about the bank's condition and to seek corrective action.

6. On April 18, 1974, Franklin New York Corporation announced net operating income, after securities transactions and preferred dividends, for the first quarter of 1974 of \$79,000, or two cents per share. The comparable earnings figure for the first quarter of 1973 was \$3,123,000, or sixty-eight cents per share. The announcement stated in part that income was "... adversely affected by the sharp rise in the cost of short-term borrowings needed to carry assets during the 1974 quarter."

7. During the week of May 6, 1974, the Comptroller's Office and the Federal Reserve System learned from Franklin National Bank that severe losses, whose exact amount had not yet been determined had occurred in Franklin's foreign exchange department. The management of Franklin New York Corporation decided to announce these losses, and it was apparent that such an announcement would dry up the bank's sources of borrowed funds, thus resulting in a severe liquidity crisis. In anticipation of this liquidity crisis Franklin sought approval for an immediate and massive loan from the Federal Reserve Bank of New York should it become necessary.

8. On Friday, May 10, 1974, Franklin New York Corporation announced that its management would recommend to its board of directors at the board's next scheduled meeting on Thursday, May 16, that the board not declare the regular dividends on the company's common stock and convertible preferred stock. The announcement attributed this recommendation to the small profit for the first quarter of 1974 and to management's preliminary estimate of operating results for the second quarter. On Sunday, May 12, 1974, Franklin New York Corporation

announced that the foreign exchange department of the bank had discovered that, because of a trader in that department operating beyond his authority and without the bank's knowledge, the bank had sustained losses of \$12 million, and additional losses might be as high as \$25 million. In addition, the Corporation requested the SEC to suspend trading in the company's securities. The SEC did so suspend trading, and that suspension is still in effect. The SEC has since been conducting a private investigation into the accuracy of Franklin New York Corporation's financial statements.

9. These announcements caused a dramatic decline in the ability of Franklin National Bank to borrow funds from the sources listed in Paragraph 5 of this Affidavit, as follows:

Type of borrowing	May 10, 1974 (millions)	June 28, 1974 (millions)	Difference (millions)	Percentage decrease
Net unsecured Federal funds purchased.....	\$330	—\$11	\$341	103
Bonds sold under repurchase agreement.....	341	186	155	45
Money market certificates of deposit.....	468	151	317	68
Other certificates of deposit.....	242	116	126	52
Time deposits of other banks.....	689	399	290	42
Borrowed securities.....	16	8	8	50
Total.....	2,086	849	1,237	59

This large run-off of borrowings and money-market instruments created a severe cash drain which the bank could meet only by massive borrowings from the Federal Reserve Bank of New York. In its press release of May 12, 1974, Franklin had announced that the Federal Reserve System was prepared to advance funds to Franklin as needed, within the limits of acceptable collateral—an arrangement which prevented Franklin's immediate collapse. By May 22, 1974—just ten days after the Franklin announcement—the Federal Reserve Bank loan had reached \$1.125 billion. Franklin National Bank was unable to meet its need for cash by selling the bank's portfolio of securities because the market value of its portfolio had declined due to a general rise in interest rates and because many of the bank's securities were pledged to secure public deposits or trust department obligations. As of June 28, 1974, depreciation in the bank's securities portfolio was \$129 million. Thus, any sale would have required Franklin National Bank to realize the enormous loss between the cost of these securities and the market value at which they could be sold.

10. On June 20, 1974, Franklin New York Corporation announced the bank's foreign exchange and other losses, the Corporation's restated earnings for the first quarter of 1974 and the Corporation's projected earnings for the first half of 1974. Aggregate foreign exchange losses were \$45.8 million. Realized losses in the bond trading account of \$5.6 million were announced. Additionally, the Corporation stated that deferred taxes which had been carried on the books of the bank as an asset of \$7.9 million were being written off on recommendation of the bank's accountants and under generally accepted accounting principles. Restated earnings for the first quarter of 1974 showed a net loss, after preferred dividends and securities transactions, of \$40.4 million, or a loss of \$8.75 per share, compared to the net income of \$79,000 or \$0.02 per share originally reported on April 18, 1974 for that period. Franklin New York Corporation estimated that it would incur a substantial loss for the second quarter of 1974 and for the year 1974 as a whole.

The announcement also stated that average net domestic deposits of the bank had declined from \$2,078 million for the week ended May 8, 1974, to \$1,570 million for the week ended June 12, 1974. Average net foreign branch deposits for the same period declined from \$916 million to \$613 million. Franklin New York Corporation announced that it was unlikely that payments upon the company's common or preferred stock would be resumed in the near future, and that dividends would be suspended for an undetermined period on the bank's common stock held by Franklin New York Corporation and on the bank's publicly held cumulative preferred stock. Operation of the sinking fund for the preferred stock also was suspended. The announcement also pointed out that, because of the bank's inability to pay dividends to Franklin New York Corporation, the Corporation would not be able to meet its existing debt obligations without using the proceeds of a proposed \$50 million new stock offering, the first portion of which was to be completed by early 1975.

11. From the middle of May until the end of September, I pursued various possible long-term solutions to the problems of Franklin National Bank. I assisted the bank in obtaining a new chief executive officer and a new foreign exchange officer. On May 13, 1974, I requested the member banks of the New York Clearing House Association to review the problems of Franklin National Bank. The purpose of this review was threefold: (A) to advise me and my staff of the views of other bankers on the condition of Franklin National Bank; (B) to establish a basis of information upon which the clearinghouse association members might act to help with Franklin's liquidity problems; and (C) to provide information to members of the clearing house who might be interested in acquiring Franklin National Bank. In this regard it was agreed that any information received through this process by members of the clearing house also would be made available to any non-clearing house member interested in acquiring Franklin National Bank.

12. On June 11, 1974, with the encouragement of the Federal Reserve System, an arrangement was reached whereby members of the clearing house individually would lend federal funds to Franklin in an amount which aggregated \$225 million. A security agreement was signed among Franklin, the Federal Reserve Bank of New York, and the participating clearing house banks under which the clearing house banks, in the event of non-repayment of these federal funds by Franklin National Bank could look to the assets already held by the Federal Reserve Bank of New York as security for its loan to Franklin. Under this agreement, the participating clearing house banks had a security interest in those assets prior to the interest of the Federal Reserve Bank of New York. The insistence of the clearing house banks on obtaining such a security agreement was in itself an indication to me of the difficulties faced by Franklin, because such federal funds transactions normally are done without any security and, indeed, with no more formality than a telephone call and a wire transfer.

13. On July 22, 1974, a representative of my staff convened a meeting of representatives of more than two dozen of the largest banks in the United States, commencing what proved to be an unsuccessful effort to sell to them a \$350 million portion of Franklin National Bank's considerable portfolio of Euro currency loans. If a sale could have been effected it would have infused a large amount of cash into Franklin National Bank and reduced reliance on the Federal Reserve Bank loan. Franklin was reluctant to consummate the sale, however, because the market value of the loans was below their book value, and the sale would have required Franklin to realize an immediate capital loss. In addition, many of the potential buyers were reluctant to deal with Franklin National Bank without a guarantee against losses in these loans. For these reasons, the proposed sale of Euro currency loans never took place.

14. While I was attempting to restore confidence in Franklin National Bank and to stabilize its situation, I also believed that a prudent discharge of my statutory responsibilities required the development of a plan to protect the bank's uninsured depositors and other general creditors and to minimize the impact on the country's and the world's banking systems if I should become satisfied that the bank was insolvent. In May and June 1974, I made inquiries of other banks which might be large enough and have enough management resources to take over Franklin National Bank. None of these banks were interested in taking over Franklin without protection from undisclosed liabilities and without other financial assistance from the FDIC.

15. On July 2, 1974, I wrote the FDIC requesting it to contact other banking organizations which were potential purchasers of some or all of the business and assets of Franklin National Bank. The FDIC developed a plan to assist a bank to assume liabilities and purchase assets of Franklin, and began negotiations with interested banks to draft a set of acquisition papers upon which banks could bid competitively. As set forth in the petition, paragraphs 8-10 and Exhibits A through C, it was proposed that the FDIC, as receiver of Franklin National Bank, would transfer all of Franklin's deposits and certain other liabilities to an assuming bank, which would select assets of Franklin in an amount equal to the liabilities assumed, less the purchase price bid. The assuming bank would be required to keep most of Franklin's banking offices open for 30 days, and would have the right to select any of these offices permanently. In its corporate capacity the FDIC (1) would indemnify the assuming bank against losses from unassumed liabilities, (2) would purchase the remaining assets of Franklin, and (3) would assume Franklin's obligation to the Federal Reserve Bank of New York, which would be repaid to the extent possible out

of the assets purchased by the FDIC, but would be fully repaid in any event at the end of three years whether or not sufficient collections had been made by that time.

16. On August 23, 1974, Franklin's new Chairman and Chief Executive Officer presented to the Comptroller's Office and the other federal regulatory agencies a plan by which, with substantial assistance from the FDIC and the prolongation for three years of Franklin's indebtedness to the Federal Reserve Bank of New York, Franklin National Bank might give up most of its national and international business and become an approximately \$2 billion bank with its business oriented almost exclusively toward Long Island. Franklin's plan was formally submitted to the FDIC by letter on September 16, 1974. A true copy is annexed hereto as Exhibit 1. On September 4, 1974, I requested the investment firm of Blyth Eastman Dillon & Co. to advise me concerning Franklin National Bank's proposal. On October 3, 1974, the firm advised me that, in its opinion, the prospects of Franklin achieving both financial viability and viability as an independent banking institution were unlikely. This conclusion was based upon the weakness of the plan's underlying assumptions. For example, the success of the plan was dependent upon an assumed deposit growth from September 13, 1974, of 26 percent by June 30, 1975 and 45 percent by June 30, 1977. This assumption was considered unrealistic in light of: (a) the competitive nature of the banking market faced by Franklin; (b) the lack of public confidence in Franklin which has precipitated a severe deposit run-off over the last six months; (c) the proposed reduction of the bank's loan portfolio which would probably result in a decrease in Franklin deposits by corporations who also are borrowers from Franklin; and (d) a growth rate in deposits for all members of the Long Island Bankers Association over the last year of approximately 3.4 percent. Additionally, this plan contained no provision for dividend payments by the bank to Franklin New York Corporation to service the Corporation's debt. The Corporation's outstanding debt of \$65 million includes \$35 million of notes held by members of the public. Unless the Corporation arranges a moratorium on interest payments on its publicly held debt, or unless it raises funds through a new stock issue—both of which are unlikely—the Corporation, as foreseen in its press release of June 20, 1974, soon will not be able to meet its existing debt obligations. In the experience of this office, a national bank cannot be a viable institution when wholly owned by a holding company in financial difficulty.

17. On August 14, 1974, at my direction, a special examination of Franklin National Bank was begun. That examination showed book equity capital on August 14 of \$175 million. The examiner found loan and other losses of \$3 million. He also found \$53 million in loans of doubtful collectibility. The Comptroller's experience has been that 50 percent of loans so classified—or, in this instance, \$26 million—become losses. Thus, Franklin National Bank had equity capital, after adjusting for estimated losses, of \$146 million. Additionally, depreciation in the securities account of Franklin National Bank was \$127 million. Banks ordinarily hold securities in their investment portfolios until maturity, never realizing before maturity any market gain or loss. Such securities thus are usually carried on the bank's books at cost, without giving effect to either appreciation or depreciation as compared to the current market. When, however, a bank is in a severe liquidity crisis, the market value of the securities must be considered because these assets may have to be sold to meet demands for cash. Franklin's own proposal, described in Paragraph 16 of this affidavit; involved selling these securities to the FDIC at a price set higher than their market value. With Franklin's dire need for cash, depreciation in the value of its securities portfolio (amounting to 87% of book equity capital) must be taken into account in any determination of whether the bank could continue to meet the demands of its depositors and other creditors. Giving effect to the securities depreciation, the net equity capital of Franklin National Bank as of August 14, 1974, was \$19 million.

For purposes of liquidation, Franklin's loan portfolio must be depreciated in a manner similar to that of the bank's securities portfolio. The amount of this depreciation is difficult to estimate because, unlike securities, there is no regularly established market with quoted prices for loans. In the absence of a quoted market price, the estimation of the true value of loans is complex because the credit risk on each individual loan must be considered in addition to any difference in yield caused by a change in interest rates since the loan was made. The attempt described in Paragraph 13 of this affidavit to sell Franklin's portfolio of Euro currency loans would have resulted in a multi-million dollar loss to

Franklin because the market value of these loans was less than their face amount on the Franklin books. The examiner who supervised the August 14, 1974, examination thus has advised me that the discount factor involved in the sale of sufficient loans to pay off Franklin's obligation to the New York Federal Reserve Bank undoubtedly would eliminate Franklin's book equity capital. In evaluating Franklin's condition, and considering the bank's need for liquid funds, I therefore have concluded that Franklin has no real equity capital.

18. Based on all the facts available to me, including Franklin National Bank's own proposal, which virtually conceded that the bank could not survive without substantial government assistance, and the Blyth Eastman Dillion & Co. report, I concluded that Franklin National Bank did not appear to be a viable institution. On October 4, 1974, I wrote to the Federal Reserve Bank, which was Franklin's major creditor, with a loan which, on October 2, 1974, amounted to approximately \$1.768 billion. I briefly reviewed the situation, and asked for the Federal Reserve Bank's views with respect to its outstanding extension of credit to Franklin. A true copy of my letter is attached hereto as Exhibit 2. On October 7, 1974, the Federal Reserve Bank replied, stating that its emergency credit assistance to Franklin was based on public policy considerations arising from the responsibility of the Federal Reserve System as a lender of last resort and was designed to give Franklin and the Federal banking regulatory agencies concerned a sufficient period to work out a permanent solution to the bank's difficulties. The Federal Reserve Bank also had concluded that the Franklin proposal of September 16, 1974, to the FDIC did not offer a feasible means of achieving the continuation of Franklin as an independent bank. The Federal Reserve Bank believed that the plan developed by the FDIC, as described in Paragraph 15 of this affidavit, offered a viable long term solution to the problems of Franklin. In these circumstances the Federal Reserve Bank advised me that it would not be in the public interest for that bank to continue its program of credit assistance to Franklin. A true copy of the Federal Reserve Bank's letter is attached hereto as Exhibit 3.

19. Based upon my examination of the bank's affairs, including the facts recited in this Affidavit, I became satisfied of the insolvency of Franklin National Bank, Brooklyn, New York. The Comptroller, as the official charged with the responsibility of determining insolvency and protecting a bank's depositors, is not required to wait until the losses he finds in the bank's assets are actually charged against the bank's book equity capital. A computer could perform that function. The Comptroller's duty is to determine when a bank has reached the point that it will not be able to meet obligations to its depositors in the near future. There can be no doubt that, without the aid of the Federal Reserve Bank of New York, Franklin would have reached that point many months ago. The Federal Reserve Bank has indicated that, in all of the circumstances, and with the FDIC plan available, it would not be in the public interest for the Federal Reserve Bank to continue its program of credit assistance to Franklin. It is impossible for Franklin National Bank to survive without such credit assistance. It is not in the best interests either of Franklin's depositors or other creditors or of its shareholders to wait for further deterioration in the bank's condition, particularly when the alternative of an FDIC-assisted purchase of the bank, at a price including a substantial premium for going concern value, is available.

20. On October 8, 1974, at 3 p.m., having become satisfied that Franklin National Bank, Brooklyn, New York, was insolvent, and acting pursuant to 12 U.S.C. §§ 191 and 1821 (c), I appointed the FDIC as receiver of Franklin National Bank. A true copy of this appointment is attached to the petition as Exhibit F.

21. As of August 30, 1974, Franklin National Bank had approximately \$1515 million in deposits belonging to 631,163 depositors. If the agreements proposed by the FDIC to effectuate the purchase and assumption transaction are not approved by the Court, the impact on all of these depositors will be substantial. The approximately 625,000 depositors who are insured would be paid by the FDIC, but even these depositors would have their funds tied up for weeks while the FDIC makes the necessary arrangements. The 5,941 uninsured depositors, whose deposits amount to more than half of Franklin's total deposits (approximately \$771 million, some 307 million of which are interbank transactions at Franklin's London branch), would share ratably with the other general creditors of Franklin, and would have to await liquidating dividends for the repayment of their deposits. There is a strong possibility that such creditors would never be paid completely, and that Franklin's subordinated noteholders and shareholders would

receive nothing if a payout became necessary. Thus, a liquidation and payout by the FDIC, which would result if the proposed purchase and assumption agreement were not approved, would cause considerable disruption to the banking public in New York and to the international monetary markets. The effect of such a liquidation and payout would also, in my opinion, severely damage the public confidence which is necessary to the operation of the banking system of the United States. Approval of the purchase and assumption transaction, on the other hand, will avoid any disruption in service for the depositors of the bank, will increase the chances of creditors for full repayment of their claims will preserve for the subordinated noteholders and shareholders the going concern value of Franklin National Bank to be realized through the payment of a premium by the assuming bank, and will help to retain confidence in the banking system. Thus, it is in the interest of creditors and the public for the purchase and assumption agreement to be approved as rapidly as possible so that all banking offices of Franklin can open as offices of the assuming bank on the next business day.

JAMES E. SMITH,  
*Comptroller of the Currency.*

Sworn to before me this 8th day of October, 1974.

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Notary Public

FEBRUARY 22, 1974.

Re Franklin National Bank, Brooklyn, New York.

Mr. CHARLES M. VAN HORN,  
*Regional Administrator of National Banks,  
New York, N.Y.*

DEAR MR. VAN HORN: You and I recently have discussed in some detail the situation revealed by National Bank Examiner Edward Lake's current examination of Franklin National Bank. This letter confirms those discussions.

The bank has grown too fast in the last year, basing its growth on the use of high cost borrowed money. The bank's capital accounts have not kept pace with the volume of business handled. This rapid growth also seems related to a number of loans and other investments with an undue degree of risk. Additionally, the responsibilities of and line of authority among the senior officers of the bank are unclear. The bank needs for a period of time to de-emphasize growth, to reduce greatly all forms of borrowings, to strengthen its management and capital, and to exercise greater control and discretion in the making of new loans and the supervising of existing loans.

Please meet as soon as possible with the senior management of the bank and express to them our views about the bank. Additionally, you are to request and receive from the bank a written program, satisfactory to the Comptroller's Office, by which the bank proposes to deal with these problems. This program shall include:

1. A list by name of the senior officers of the bank, together with a description of the responsibilities of each and who reports to whom. I also wish to know the bank's plans for recruiting a new controller and a new head of the national division, or for otherwise assigning the responsibilities formerly associated with those positions.

2. A definite plan with stated goals for reducing all forms of borrowings, including (but not limited to): certificates of deposit, time deposits of other banks, federal funds purchased, and securities sold subject to repurchase.

3. The means and standards by which the granting of new loans and the servicing of existing loans will be policed by senior management, with a view toward upgrading the quality of the loan portfolio. A method should be established by which written loan policies of the bank will be adhered to strictly.

4. A definite program for adjusting the imbalance between the bank's capital and the size of its operations.

5. A description of the bank's plans in the international field, including its foreign currency operations.

6. Whatever other matters you and Examiner Lake believe should be dealt with. I further request you to meet with the bank's board of directors to discuss these problems at the board's next regularly scheduled meeting, which I understand will be on March 28, 1974. At that meeting the board should approve the written program outlined above.

Very truly yours,

JAMES E. SMITH,  
*Comptroller of the Currency.*

FEBRUARY 1, 1973.

## Re Current Examination Franklin National Bank.

JOHN GWIN,  
*Deputy Comptroller of the Currency.*  
 ROBERT A. MULLIN,  
*Director, International Division.*

Examiner El-Dada was contacted today by telephone. He had reviewed all of Franklin's foreign bank accounts and found no evidence of window-dressing except for \$50 million due to and from Banco de Roma, all in U.S. dollars, and all with the same maturity dates and rates of interest.

The head of the bank's international department told him that this was not window-dressing and that the Banco de Roma had initiated the transaction by placing the \$50 million with them. I told him that banks do not accept deposits unless they want them, and that only Franklin National Bank could have placed the deposits with Banco de Roma. I asked him if he still consider the result of the transaction as window-dressing and he said he believed that it was. I asked if his belief or his opinion in the matter was stated in his report, and he said that it was not.

I told him quite frankly that when an examiner finds a problem in a bank, his comments on that problem should appear in the report and this is especially true if the problem is not resolved during the examination and if the examiner expects the Comptroller's Office to take action.

I told him additionally that there was no need for him to repeatedly call me for assistance on bank problems if he was not willing to record those problems in his report of examination. He said that while he had completed the international portion of the examination yesterday, he would now state his views on this window-dressing transaction on Page 2 of the report. I told him I would fully support his criticisms.

THE REGIONAL ADMINISTRATOR OF NATIONAL BANKS,  
 SECOND NATIONAL BANK REGION,  
 New York, N.Y., June 18, 1973.

## Re Frankling National Bank Foreign Exchange Position.

Mr. C. M. VAN HORN,  
*Regional Administrator of National Banks,*  
 New York, N.Y.

DEAR MR. VAN HORN: In accordance with your telephone instructions, I have examined the foreign exchange position of the above captioned bank and conducted such tests deemed necessary to check its accuracy. In addition, I have checked the monthly profit and loss schedules for the first five months of 1973. My findings and conclusion are heretofore:

*Size of Positions.*—Total spot and future contracts purchased and sold as of June 8, 1973 amounted to U.S. dollar equivalent \$814,213M and \$798,107M respectively, compared to \$683,638M and \$691,537M as of last examination December 11, 1972. The increases are large, however, the risk the bank has taken is not affected materially since the net positions in the different currencies are not out of the ordinary, for a bank of this size. No speculative activities were discerned.

*Customer Liabilities.*—I have reviewed the customer liability ledger as to the amount outstanding and name. All but a few of the customers are well known banks and/or corporations.

*Limits.*—All position limits were cancelled on February 15, 1973 as per a memorandum dated same date and signed by Mr. Peter Shaddick, Senior Executive Vice President. Instead of established limits all approvals for overnight positions will be given by either one of the three top officers in the International Division. Mr. Shaddick is keeping a very close supervision over the activities of the department, through his frequent daily visits to the trading room.

*Profit and Loss.*—The monthly profit and loss registered since the beginning of 1973 reveal the following:

January, \$9,444; February, \$72,310; March, (\$58,941); April, \$42,239; May, \$43,414.

*Conclusion.*—Even though the volume of the foreign exchange transactions and positions have increased, the bank has not taken any undue risk in its foreign exchange trading. Trading is still largely with well known international and domestic banks where the risk is minimal.

All internal control procedures seem to be well observed and the undersigned examiner was introduced to a new internal resident auditor whose sole job will be to keep a constant eye on the workings of the foreign exchange department.

Respectfully,

HUSSEIN B. EL-DADA,  
National Bank Examiner.

THE REGIONAL ADMINISTRATOR OF NATIONAL BANKS,  
SECOND NATIONAL BANK REGION,  
New York, N.Y., February 1, 1974.

To : Mr. C. M. Van Horn, Regional Administrator.  
From : John A. Fleming III, National Bank Examiner.  
Subject : Franklin National Bank, Foreign Exchange Department.

Today I met with Messrs. A. Garafolo, vice president and head trader, George Hermann, senior vice president, and H. Barrand, executive vice president of Franklin National Bank at 1 World Trade Center. The topic of discussion was about ". . . due to a bookkeeping error, it (Franklin National Bank) underestimated its requirements for French franc balances . . .", New York Times, February 1, 1974.

Every week, a daily cash flow sheet is prepared by currency, showing each day's net overbought or oversold position (same as a daily gap report—not to be confused with the net overall currency position) to allow the trader to cover shortages or sell overages.

Apparently, the trader mistakenly believed he had covered the Jan-31-74 F/F shortage of 200MM (approximately \$40MM). When this was discovered it was too late to obtain the needed francs because French banks are forbidden to lend F/F to non-residents. Therefore several matured F/F contracts went unpaid for one day. Today those contracts were paid, including any loan and/or overdraft charges (this extra cost should not exceed \$11M).

A simple parallel is an individual made a mistake in his checkbook, and a check bounces. The bank calls for immediate cover. Other than an outright cash deposit no settlement would clear in time. The bank, unable by law to grant a one-day loan must bounce the check. These errors do happen occasionally to most banks. That an occurrence of this insignificance was publicised is unfortunate. Apparently the Paris correspondent of the New York Times got wind of the error and cabled New York that Franklin was not meeting its obligations abroad. When confronted with this story, Franklin officials clarified the issue and stated their case.

#### OFFICE PROCEDURE—RATINGS OF BANKS

##### 1-A-S

##### 1

#### Capital Position—Quality of Assets—Management Composite or Group Rating

It is desired that the following instructions pertaining to the composite or group rating of banks and the ratings accorded Capital, Quality of Assets and Management be considered carefully and placed in use at once.

Group Ratings: Range from 1-4.

No. 1. Sound institutions in every respect.

No. 2. Those institutions with :

A. Asset weaknesses ranging from relatively moderate to moderately severe; or

B. Negligible asset problems but definitely undercapitalized; or

C. Unsatisfactory management; or

D. A modified combination of these and other weaknesses.

No. 3. Those institutions, which have, in relation to capital protection, an immoderate volume of asset weaknesses which, in view of the (A) character of the asset problems, or (B) management deficiencies, or (C) economic conditions, or a combination of those and other points, could reasonably develop into a situation urgently requiring aid from the shareholders or otherwise. Banks in this category require special attention.

No. 4. Banks rated No. 4 are those confronted with asset weaknesses of a character and volume, in relation to capital protection and quality of manage-

ment urgently requiring aid from the shareholders or otherwise and whose failure, if such aid is not forthcoming would appear to be probable. These are the serious or hazardous cases requiring constant supervisory attention.

**Capital Position : Range 1-4.**

The following factors will be considered by the Comptroller in assessing the adequacy of capital :

**No. 1. Capitalization adequate in relation to factors :**

- A. The quality of management.
- B. The liquidity of assets.
- C. The history of earnings and of the retention thereof.
- D. The quality and character of ownership.
- E. The burden of meeting occupancy expenses.
- F. The potential volatility of deposit structure.
- G. The quality of operating procedures ; and
- H. The bank's capacity to meet present and future financial needs of its trade area, considering the competition it faces.

**No. 2. Capitalization inadequate in relation to factors A through H, above.**

**No. 3. Deterioration of bank's condition to a point where it is considered hazardous. This normally will include all banks whose aggregate of classified assets is sufficient to impair the capital account.**

**No. 4. Capital impaired by losses.**

**QUALITY OF ASSETS**

**Quality of Assets : Range from A-D.**

**Rating A :**

*Good.* Ordinarily banks so classified will not have an aggregate total of (1) classified assets, plus (2) unclassified speculative bonds, stocks, and O.R.E., that is in excess of 20 percent of the gross capital structure and the character of the problems in such assets is not severe in the judgment of the Regional Administrator. An aggregate total somewhat in excess of 20 percent of the gross capital structure will not preclude an A rating, provided the actual or potential seriousness of the problems in the assets concerned is regarded as relatively moderate. However, if the primary asset problems are regarded as severe, or if additional problems exist in large lines, bond concentrations, or a heavy investment in fixed assets, a less favorable rating should be used even though the aggregate total of primary asset problems is less than 20 percent of the gross capital structure.

*Fair.* Instructions, and elasticity to exercise judgment through use of a more favorable or less favorable rating, are the same as noted under rating A, except banks so classified ordinarily will *not* have an aggregate total of :

- (1) classified assets, plus
- (2) unclassified speculative bonds, stocks and O.R.E. that is *in excess of 40 percent* of the gross capital structure.

**Rating C :**

*Poor.* Instructions, and elasticity to exercise judgment through use of a more favorable or less favorable rating, are the same as noted under Rating A, except banks so classified will *not* have an aggregate total of :

- (1) classified assets, plus
- (2) unclassified speculative bonds, stocks and O.R.E. that is *in excess of 80 percent* of the gross capital structure.

**Rating D :**

*Hazardous.* Any bank will be so classified when the total of :

- (1) classified assets, plus
- (2) unclassified speculative bonds, stocks and O.R.E. is *in excess of 80 percent* of the gross capital structure.

**Management Rating : Range : S F P**

**S** Strong or Competent.

**F** Fair.

**P** Poor, Incompetent, Integrity Questioned.

It is desired that the Capital, Asset, and Management ratings be entered at the bottom of page 3 by Regional Administrators (initial opposite rating) as follows :

2-C-F (initials)

Assistant Chief Examiners will, in addition, show the Capital, Asset and Management ratings and group rating on page 1 as follows:

2-C-P

3

All reports other than 1-A-S or 1-A-F are to be sent to respective Deputy Comptroller.

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MARCH 19, 1971.

Memorandum to Mr. Camp:

Based on the recent report of examination, the following bank is in need of close supervision by the Regional Administrator of National Banks: Franklin National Bank, Mineola, New York.

JOHN D. GWIN,  
*Deputy Comptroller of the Currency.*

Statement of  
Robert Bloom  
First Deputy Comptroller of the Currency for Policy  
before the  
Subcommittee on Commerce,  
Consumer and Monetary Affairs  
of the  
House Government Operations Committee  
January 20, 1976

I have been asked by the Subcommittee to discuss the examination practices and procedures of the Office of the Comptroller of the Currency. In view of recent newspaper articles on the subject of so-called "problem banks," it is important to shed light on this topic as the publicity has tended to confuse rather than enlighten the public.

The term "problem bank" is a vague term which has become banking agency jargon without precise definition. If what is meant is a bank, the liquidity and solvency of which is in serious question, let me hasten to assure you that very few national banks, and none of the money center national banks, are considered by our Office to be "problem banks."

On the other hand, many national banks receive extra analysis and attention for a variety of reasons. The degree of supervision is determined through objective and subjective judgments made by field examiners, Regional Administrators and Washington staff. The Comptroller's Office maintains no list of such banks that could be characterized as a "problem bank list." Each bank is handled on a case-by-case basis.

There is no magic formula or ratio which is capable of identifying banks for special supervision with any degree of accuracy. As a practical matter, however, we have used in the past a quantitative formula based on examination report data which identify those banks to be given further analysis at all staff levels. All banks with criticized assets (100% of substandard, 50% of Other Loans Especially Mentioned, 50% of doubtful) aggregating 65% or more of adjusted capital funds (Equity accounts,

reserves for loan losses and capital notes less losses and 50% of doubtful) are given special analysis and attention by this Office.

It is apparently a list of banks with classified assets over 65% of capital which was referred to in the "Washington Post" story as the Comptroller's "problem bank" list. As the Comptroller stated in his press release following the "Post" story, the labeling of every bank with a ratio of criticized assets to capital of 65% or more as a "problem bank" is a misstatement and over-simplification. The volume of criticized loans in a particular bank, taken alone without further information as to the strength of management, earnings, liquidity, ability to raise additional capital, access to the money markets and other factors, is not significant. In addition, a great deal depends on the state of the economy during the period in question. The significance of classified asset ratios as a supervisory tool is greater during prosperous times than it is during periods of recession such as 1974 and 1975. A ratio of 65% or more of classified assets in a prosperous economy could be reflective of poor management. A ratio of 65% or more during 1975 and at present does not necessarily reflect adversely on management. It is common knowledge in financial circles that many banks, both large and small, well managed and poorly managed, today have ratios in excess of 65% to capital. Indeed, any bank whose volume of criticized loans did not increase during 1975 probably had not been performing the normal risk-taking functions through which a commercial bank serves its community.

There are two principal aspects in singling out banks for special supervisory attention. First, there are the procedures and criteria to be used in identifying such banks, and second, there are the procedures and methods for correcting whatever deficiencies exist in such banks. This Office is now engaged in a major revision and improvement of its operations in both of these areas, based largely on the recommendations of Haskins and Sells, an outside consulting firm retained by the Office in May, 1974. The Haskins and Sells recommendations have been made public and copies of the report have been sent to each member of Congress.

#### Existing Grading Systems

Under the traditional system for pinpointing banks for special attention, a great deal of emphasis was placed on the ratio of classified assets to gross capital. Classified assets are those assets which are singled out by the examiner as having credit weakness of varying degrees of intensity. The classifications in ascending order of severity are Other Loans Especially Mentioned (OLEM), Substandard, Doubtful and Loss. Banks are graded in four groupings according to the ratio of assets classified as loss, doubtful or substandard to gross capital funds. The four groupings are:

Group A - zero to 20%

Group B - 20% to 40%

Group C - 40% to 80%

Group D - 80% or more

In addition to the above classified asset categories, the examiners rate capital adequacy on a one through four scale taking

into account the quality of management, the liquidity of assets, the history of earnings, the quality and character of ownership, the burden of meeting occupancy expenses, the potential volatility of the deposit structure, the efficiency of operations, and certain competitive factors. Bank Management is rated as well in three categories, Strong, Fair or Poor. After the Capital Position, the Quality of Assets and Management are scored, the examiners assign a Composite or Group rating to the bank. Group 1 banks are those considered to have good capital, competent management, good operations, good liquidity and less than 20% of classified assets to gross capital. On the other end of the spectrum, Group 4 banks include those which could be approaching insolvency, thus requiring immediate injection of capital, new management or both.

In the past, this Office has maintained lists of banks falling within Groups 3 & 4 as described above. For your information, a schedule is attached to this statement which reflects the number of banks on these lists from July 5, 1972 to July 1, 1974. Such lists, because of the primary emphasis placed on the volume of classified loans, are not considered under present economic conditions as particularly meaningful. This Office still reviews each examination report on a case-by-case basis and, after discussions with our Regional Administrators and the national bank examiners, determines whether or not additional supervision is necessary. In those cases where it is decided that such supervision is required, personnel from Washington work closely, in some cases on a daily basis, with personnel in the region and with personnel from the bank.

The New System

As I have noted, our Office is presently actively engaged in modernizing its system for identifying and dealing with banks requiring special attention. A computerized "early warning system" called the National Bank Surveillance System (NBSS) will consist of four basic elements:

- (1) A data-collection system.
- (2) A computer-based monitoring system that would detect unusual or significantly changed circumstances within a bank and within the national banking system.
- (3) An evaluation by experienced personnel of the impact of such changes on bank soundness.
- (4) A review procedure that would provide administrative controls over all proposed Office of the Comptroller of the Currency remedial actions, including those of Washington personnel.

A Deputy Comptroller of the Currency and a project manager from Haskins and Sells initiated the NBSS in September, 1975. Their efforts have been directed toward steps 1 and 2, a data-collection system and a computer-based monitoring system. They also have begun work on step 3 by selecting experienced examiners who will analyze the importance of the computerized data.

The data which have been reported to the three Federal regulatory agencies by their respective banks have traditionally been utilized for historical statistical purposes. Major portions of this data have, by joint agreement of the three agencies, been stored in the FDIC's computer. Since this Office decided to use that data for supervisory purposes, one of the first steps in creating the NBSS required the transfer of portions of the

data in the FDIC's computer to a data base in a separate computer which could be used by our Office for supervisory purposes. The data base has been transferred and it essentially covers the condition and income reports of national banks during the past five years.

Three additional steps are being taken to improve and expand the data base. First, we are conducting frequent, almost daily, discussions with representatives of the Federal Reserve and the FDIC to amend the banks' condition and income reports so that the facts in these reports will be more meaningful for supervisory purposes. When information desired by this Office is not deemed necessary by the other two regulators, we will acquire that data through special reports submitted by the bank separately from the customary call and earning reports. Second, certain portions of the non-public reports of examination will be included in our data base. Third, if all of this data is to be analyzed on a timely basis, it must be processed rapidly. To accomplish this objective, the Management Services Division of the Comptroller's Office has made two trial runs on the direct processing of NBSS data from reports of condition and has concluded that this data can be processed within 45 days of the date of the call in lieu of the five-months period normally required for the combined production by the three Federal bank regulators.

The NBSS will work with banks that are segregated into peer groups in our data base. The statistical trends of each peer group and of each bank within the peer group will alert this Office to exceptional banks or groups of banks on no less than a quarterly basis. In view of today's rapidly changing economy, this system will be more timely than the traditional

system of supervision through the receipt of reports of examination which are required only three times in each two-year cycle.

The fourth element of the system involves an administrative review procedure or monitoring system which would stem from the quarterly analysis of data. The review and monitoring system will enable a staff of experienced examiners to make recommendations on a bank-by-bank basis to each of fourteen Regional Administrators as to the type and scope of examination which may be required promptly for individual banks. The monitoring system will also be computer assisted to the extent that the recommendations and the reactions, both positive and negative, by both examiners and bankers will prompt successive steps of recommended corrective action as needed.

What we are developing is an NBSS which will serve the regulator and the banker in maintaining a sound financial system to serve the public needs. The NBSS will help in the detection and the correction of impending problems before they become serious cases. This system will neither eliminate the human element from bank regulation nor will it eliminate the human element from the management of individual banks. It should, however, substantially aid in the prevention of future bank failures.

#### Enforcement Follow-up

Once significant problems of a national bank have been identified through the examination process, the examiner commences the supervisory action process by commenting in the report of

examination on important matters requiring attention of the Comptroller, the Board of Directors and the active executive management. The examiner's comments are supplemented by a letter from the Regional Administrator which highlights the bank's problems and requests the Board of Directors and executive management to institute appropriate corrective measures. Depending on the circumstances and severity of problems, the bank's executive management may be requested to submit monthly reports regarding progress it has made toward improving unsatisfactory areas of the bank. In addition, frequent visitations and examinations may be conducted.

When an examination or special visitation of a national bank discloses a condition so unsatisfactory as to warrant that the Board of Directors should be promptly and personally informed, a special meeting with the Board is called by the examiner or his Regional Administrator. Special representatives of the Comptroller's Office may attend the meeting depending on the circumstances and severity of the problem. The objectives of meeting with a Board of Directors are to discuss the conditions and affairs of the bank that were observed during the most recent examination, to reach an agreement on any significant problems in the bank, to obtain a definitive commitment from the Board, to institute the proper corrective actions, and to obtain information concerning future plans and proposed changes in bank policy that may have a significant impact on the future condition of the bank.

Bank supervision provided at the regional level is coordinated with the Washington staff which provides additional legal

assistance, coordination with other regulatory agencies, attendance at Board meetings, analytical support, and follow-up review. Where the facts indicate a serious problem, a possible violation of law, or unsafe and unsound practices, we may call upon the Enforcement and Compliance Division of our Law Department. This assistance may consist of the attendance of an attorney from the Enforcement Division at a Board of Directors meeting to discuss with the bank the problems and the suggested corrective action. In other cases it may require the investigation by the Enforcement Division to determine whether sufficient facts justify the commencement of a cease and desist proceeding or the certification to the Federal Reserve Board for removal of an official or the making of a criminal referral to the Department of Justice. In the latter two situations, the investigation must disclose that the particular activities of an individual constitute evidence of personal dishonesty.

In addition the bank must come to the Comptroller for approvals of various corporate changes, such as the opening of a new branch, dividend restrictions, investments in premises and other approvals. The Comptroller may withhold his approval on such applications until he is satisfied concerning the responsiveness of a bank to his recommendations.

In determining the appropriate remedy for a particular bank, the Comptroller, together with the Deputy Comptrollers, Regional Administrators, examiners and the Legal Division, must determine which type of action will be the best rehabilitative type of

remedy to assist the bank. Where the facts indicate that there are serious problems or that there are repeated violations of law or unsafe and unsound practices, this Office has a wide range of administrative remedies to deal with the situation. These remedies, however, are not punitive but are of a rehabilitative nature. One of the principal remedies available to the Comptroller is the power given under the Financial Institutions Supervisory Act of 1966 to commence cease and desist proceedings. Cease and desist proceedings are rehabilitative, intermediate tools which allow the Comptroller to force a bank to work out its problems without resorting to the more drastic measures of receivership, conservatorship, termination of insurance, forfeiture of charter, or forced merger. Our experience has indicated that the threat of a cease and desist proceeding enables this Office to handle the majority of bank problems through the less formal techniques of persuasion, frequent examinations and meetings with directors.

Of course, the success of all these efforts will depend on the quality of information we receive. While our examiners independently search for information in examining banks, much information is derived from a candid exchange of views with bank directors and officers and other members of the public conducted on a strictly confidential basis. If the rules are changed to require public disclosure of what is in the examination report, there is no doubt that we will be hampered considerably in obtaining a complete picture of national banks. Likewise, the disclosure of which banks are subject to

special supervision will make correction of problems incomparably more difficult, if not impossible, in some cases.

The confidentiality of government examinations, however, does not impair the public's right to obtain necessary financial information about banks. Banks are subject to the disclosure provisions of the Securities Exchange Act of 1934 to the same extent as are other publicly held companies. In addition to what non-bank corporations must disclose, banks must publish quarterly a report of condition, which includes both balance sheet and income and expense information. The three federal banking agencies have recently increased substantially these disclosure requirements. Beginning with the March 31, 1976 report of condition, banks will be disclosing publicly more financial information than any other major category of publicly-owned companies.

We thus respectfully must decline to comment specifically on the affairs of any particular bank, including Chase Manhattan Bank and First National City Bank. To violate confidences which we have elicited in order to investigate more thoroughly these and other banks would run counter to the venerable Congressional policy of protecting the confidentiality of bank records and examination reports. (See 5 USC 552(b)(8), 12 USC 1817(a)(2), 12 USC 1442, 12 USC 481, 12 USC 484, 18 USC 1905, 18 USC 1906).

Thank you for this opportunity to discuss the examination and supervisory activities of the Comptroller's Office.

Attachment

<u>Date of List</u>	<u>Total Number of National Banks</u>	<u>Number of Banks on List</u>	<u>Banks Listed as % of Total Banks</u>	<u>Date of Call Reports</u>	<u>Total Assets ( in millions)</u>	<u>Total Deposits ( in millions)</u>	<u>Total Assets of Bank on List as % of Total Assets of Nat'l Banks</u>	<u>Total Deposits on Bank List as % of Total Deposits of All National Banks</u>
July 5, 72	4607	122	2.6%	Jun. 30, 72	18,661	15,222	4.8%	4.7%
Jan. 10, 73	4614	110	2.4%	Dec. 31, 72	21,796	18,282	5.0%	5.1%
July 3, 73	4629	94	2.0%	June 30, 73	21,095	16,723	4.7%	4.6%
Jan. 11, 74	4661	109	2.3%	Dec. 31, 73	22,924	18,146	4.7%	4.6%
July 1, 74	4695	133	2.8%	June 30, 74	42,086	31,282	8.1%	7.7%

MARCH 28, 1974.

Re Franklin National Bank, Brooklyn, New York.  
Memorandum for the files:

National Bank Examiner Edward B. Lake and I met with the Board of Directors of the captioned bank today to discuss the conditions of the bank as revealed by the report of examination made on November 13, 1973. All directors were in attendance. Secretary to the Board of Directors George E. Becht; Senior Executive Vice President Peter R. Shaddick and Executive Vice President John Sadlik were also present.

Loans classified Substandard, Doubtful and Loss aggregate \$141 million versus \$109 million at the previous examination made on December 12, 1972. Other Loans Especially Mentioned aggregate \$149 million at this examination versus \$84 million at the previous examination. Examiner Lake reviewed, in detail, some of the larger loans which are criticized for the first time at this examination. He pointed out that further deterioration of the loan portfolio can be attributed to the fact that established lending policies had not been adhered to. He emphasized the need for strengthening the bank's liberal lending policies and for improved loan administration.

Mr. Lake pointed out that borrowings during the year 1973 ranged from a low point of \$450 million in January to a high point of \$1.1 billion in December. He emphasized that immediate consideration be given to reduction of all forms of borrowings to a more prudent level. He pointed out that capital protection is inadequate and that consideration should be given to the injection of additional capital funds to bring the level of capital protection within a more acceptable range.

The directors were informed that during the course of the examination, it was noted that foreign exchange position was extremely heavy and that consideration should be given to establishing guidelines for keeping the foreign exchange position within more reasonable bounds.

I told the Board of Directors that Examiner Lake and I had discussed the affairs of the bank with the Comptroller of the Currency James E. Smith and his staff and that Mr. Smith had requested that Mr. Lake and I meet with senior officers of the bank to ascertain the nature of the problems involved and the steps taken or contemplated to alleviate the problems. On February 28, 1974, Examiner Lake and I met with Chairman of the Board and Chief Executive Officer Harold V. Gleason; Senior Executive Vice President Peter R. Shaddick; President Paul Luftig; Senior Vice President Raymond Andersen and Chairman of the Executive Committee Norman Schreiber to outline the concerns of the Comptroller. It was requested that we be furnished with a written program, satisfactory to the Comptroller of the Currency, by which the bank proposes to deal with the problems. To avert the possibility of a misunderstanding on the part of the bank's officers, I presented Mr. Schreiber with an outline of the areas of concern. A copy of the outline is attached. Management gave assurance that they would prepare a comprehensive written report on their plans to deal with the problems; that they would present it to the Board of Directors for affirmation and forward it to us over the signature of each member of the Executive Committee.

When Examiner Lake and I entered the Board meeting today at 11:00 A.M., Chairman of the Board Harold Gleason reported that he had read verbatim to the directors, page 2 and continuation of the current report of examination. Mr. Gleason reported, and Mr. Schreiber affirmed, that they had discussed with the directors each of the items listed on the outline which I had left with Mr. Schreiber.

Chairman of the Board Gleason gave assurance that we would receive the written program within one week. I told the directors that if there is any significant change in basic policies set forth in the written program, we wish to be informed promptly. Also I requested that we be furnished with written monthly reports of progress in eliminating or strengthening the weaknesses associated with the criticized loans. I expressed the hope that future reports would show better progress in eliminating criticized loans than such reports received during 1973.

C. M. VAN HORN,  
*Regional Administrator of National Banks,  
Second National Bank Region.*

## AGENDA

## I. Management:

- (a) Name of each of the senior officers, Department by Department, of the bank:
1. description of responsibilities of each;
  2. to whom each reports;
  3. management contracts; and
  4. extent of influence of Mr. Sindona.
- (b) Plans for recruiting a new financial officer.
- (c) New director of National Division or otherwise reassign responsibilities formerly associated with these positions.

## II. Borrowings: (a) Stated goals for reducing all forms of borrowings:

1. Eurodollars;
2. Certificates of Deposit;
3. Time deposits of other banks;
4. Federal funds purchased; and
5. Securities sold subject to repurchase.

## III. Lending Policy:

- (a) Methods and standards for granting new loans;
- (b) Methods and standards for administration of existing loans;
- (c) Correcting or eliminating weaknesses associated with criticized loans;
- (d) Up-grading for quality and liquidity of the loan portfolio;
- (e) Formation and/or enforcement of a written lending policy.

## IV. Capital Adequacy: (a) A definite program for adjusting the imbalance between the bank's capital and the volume of its operations.

## V. International Operations: (a) A description of the bank's plans for further expansion in the International field, including foreign currency operations.

1. London Branch—clean letters of credit not recorded: (a) Plans for expanding International staff.
2. Details of a loan commitment to construct a steel plant in Spain.

Request a written program, satisfactory to the Comptroller of the Currency, by which the bank proposes to deal with the above problems.

Meet with Board, discuss problems, and obtain approval by Board of written program outlined above.

JUNE 15, 1972.

## MEMORANDUM FOR THE FILES:

Re Franklin National Bank, Brooklyn, N.Y.

National Bank Examiner Walter R. Schlicht and I met today with the Board of Directors to discuss the affairs of the bank as revealed by the report of examination made by Examiner Schlicht on March 3, 1972. All directors except Vice Chairman Howard Crosse were in attendance. In addition, Executive Vice President—International Banking Group Harry Barrand and Executive Vice Presidents Jerome Twomey and John Sadlik were in attendance.

Loans classified Substandard, Doubtful and Loss aggregated 46 percent of Gross Capital Funds versus 51 percent at the 1971 examination. Other Loans Especially Mentioned aggregated 36 percent of Gross Capital Funds versus 42 percent at the previous examination. Examiner Schlicht pointed out, however, that the improvement is attributed primarily to a \$30 million increase in capital. Also, he pointed out that \$24 million or 25 percent of the loans classified Substandard are concentrated in three loans (i.e. \$6.3 million; \$5 million and \$12.8 million). Of the \$217 million Classified or Especially Mentioned at the previous examination, aggressive collection efforts reduced this amount by \$53 million paid; an additional \$24 million have been improved to the extent that they are no longer subject to criticism. However, of the \$216 million reflected in the current report, \$76 million appear for the first time which would indicate weaknesses in supervision and follow-up after the loan is booked.

The directors were also informed of the serious operating and internal control deficiencies brought to light in the Foreign Exchange Department of the bank. The need for a top-level operations officer was stressed.

Departmental problems were reviewed briefly with emphasis placed on the much-improved real estate equities and instalment loan areas. Comparison of the

investment portfolio was discussed on 50 percent write off of the bank's \$1 million investment. The unsound practice of appropriating securities held as loan collateral and utilizing these to secure Federal Funds transactions was discussed in detail. Assurances were given that such practices will not reoccur.

It was stated by Mr. Gleason that an intermediate and long-range capital needs program was in process of formulation.

The trend in the affairs of the bank is favorable. The matter of greatest concern is the relatively heavy volume of loans, classified doubtful.

C. M. VAN HORN,  
*Regional Administrator of National Banks,  
Second National Bank Region.*

FRANKLIN NATIONAL BANK, SEPTEMBER 6, 1971

Opening remarks—Mr. Van Horn.

Loan Review:

Comparison of criticized assets with last examination.

Substantial increase in Doubtful and Loss aggregate.—relation to bad debt reserve loss history since 1966—

Review some of larger credits—causes of problems: Overexpansion; mismanagement; sale of equity or refunding could not be accomplished.

Past due—5.9 percent versus 4.8 percent L/X Mortgage Dept. 11 percent excessive (includes construction loans).

Departmental problems:

Mortgage Dept. & R/E Equities—memos; documentation—mostly old workout situations. Large new—Southgate State Bank—\$3MM.

Installment Loans—Inaccurate reports from Eastern States Bancard Assoc. Both reported insufficient number of personnel in Collection Dept. rectified.

Special Loans—Residue of high risk credits from branches—workouts.

Sheffield Watch \$1MM loss—transferred to depart. during exam.

Operating results for 1970 and (6) months earnings 1971— . Heavy interest costs on time deposits and borrowed money. Retained earnings suffering from heavy loan losses.

Investment Portfolio—maturities materially shortened (see memo)—liquidity conscious (21.3 percent). Depreciation in relation to capital 31 percent—considered disproportional in view of unsettled market. Virtually all transactions through Trading Account.

Capital—prospects for raising.

Management Realignment—comments.

Cooperation excellent—Solid senior management team.

Closing Remarks—Mr. Van Horn.

FRANKLIN NATIONAL BANK—COMPARISON OF CRITICIZED ASSETS

[In millions of dollars]

	Examination date						
	January 1966	October 1966	September 1967	September 1968	September 1969	August 1970	May 1971
Substandard.....	32.7	48.5	36.7	30.6	29.4	98.3	80.5
Doubtful.....	10.2	0	0	1.7	3.9	10.3	21.7
Loss.....	5.8	7.8	5.9	4.8	1.6	6.8	14.0
Subtotal.....	48.7	56.3	42.6	37.1	34.9	115.4	116.2
OLEM.....	42.2	75.3	61.0	56.9	57.7	126.6	100.4
Total.....	90.9	131.6	103.6	94.0	92.6	242.0	216.6
Capital.....						220.6	230.2
Deposits.....						2,241.3	2,406.2
Reserve for loan losses.....						31.1	30.3

Note: Corrective action program commenced in early 1967.

[In thousands of dollars]

	This examination				Last examination			
	OLEM	Sub-standard	Doubtful	Loss	OLEM	Sub-standard	Doubtful	Loss
Metropolitan division.....	26,253	14,061	9,022	2,950	27,158	23,099	5,228	0
National division.....	16,357	31,882	7,110	4,600	38,743	36,739	2,590	0
International department.....	14,581	11,230	130	0	7,247	16,473	186	413
Real estate equities.....	12,882	1,822	0	27	13,470	2,965	0	103
Special loan department.....	0	10,652	2,947	2,409	0	8,016	984	2,135
Property acquired for lease.....	0	0	0	0	547	0	0	0
International department.....	703	2,237	1,187	125	14,837	1,029	0	0
Installment loan department.....	0	0	0	2,109	0	0	0	1,854
Accounts receivable department.....	1,106	381	797	12	0	0	0	0
Branches.....	28,554	6,229	0	100	24,567	8,521	1,269	1,496
Industrial credit department.....	0	0	0	89	0	0	0	0
O. R. E.....	0	1,996	0	331	0	724	0	549
Unpaid accrued interest.....	0	46	0	554	0	696	0	273
Miscellaneous.....	0	0	500	701	0	0	0	8
Totals.....	100,436	80,536	21,693	14,007	126,569	98,262	10,257	6,831

Note: See table below:

	This examination	Last examination
Substandard.....	80,536	98,262
Doubtful.....	21,693	10,257
Loss.....	14,007	6,831
Total classified.....	115,236	115,350
OLEM.....	100,436	126,570
Total criticized.....	216,672	241,920

## FRANKLIN NATIONAL BANK—RECAP OF CONTINGENT LIABILITIES INCLUDED IN CRITICIZED LOANS

	Classified loans	OLEM	Total
Letters of credit:			
Metropolitan division.....	\$227,400		\$227,400
National division.....	4,410,000	\$4,868,475	9,278,475
International department.....	591,195		591,195
Special loan department.....	533,000		533,000
New York City branches.....		3,722,060	3,722,000
Subtotal.....	5,761,595	8,590,475	14,352,070
Loan commitments:			
Metropolitan division.....	478,800		478,800
Real estate department.....	139,154		139,154
Special loan department.....	117,375		117,375
Subtotal.....	735,329		735,329
Disputed return item: Hanover Square Branch.....	500,000		500,000
Grand total.....	6,996,924	8,590,475	15,587,399

## FRANKLIN NATIONAL BANK—LETTERS OF CREDIT INCLUDED IN CRITICIZED LOANS

Division	OLEM	Substandard	Doubtful	Loss
Metro.....		\$227,400		
National.....		4,410,000		
International.....		520,000		
Do.....		71,195		
Special loans.....			\$533,000	
National.....	\$4,545,562			
	240,000			
	82,913			
New York City branches.....	2,700,000			
Colliseum, 90 Park Ave.....	1,022,000			
Total.....	8,590,475	5,228,595	533,000	0

## LOAN COMMITMENTS INCLUDED IN CRITICIZED LOANS

Metro.....		\$478,800		
Real estate.....		139,154		
Special loans.....		117,375		
	0	735,329	0	0

Note: Disputed item included in criticized items p. 4, Delafield Capital (Hanover Square Branch)—\$500,000.

FRANKLIN NATIONAL BANK  
[Amount in thousands of dollars]

	Last examination	This examination
Other real estate.....	1,272.0	2,534.0
Installment loans—delinquencies.....	11.4	13.1
Loss:		
Installment loans.....	258.0	525.0
Master charge.....	1,334.0	1,400.0
Military purchase.....	60.0	67.0
Steady credit.....	4.0	7.0
Food purchase plan.....	0	12.0
Bond account:		
Book value all bonds.....	561,502.0	746,406.0
Maturities:		
Up to 1 yr.....	.7	29.3
1 to 5.....	26.8	14.5
5 to 10.....	7.4	6.2
10 to 20.....	24.1	21.3
20 and over.....	41.0	28.7
Secured liabilities.....	631,345.0	475,873.0
	1969	1970
Earnings:		
Total operating income.....	173,123	191,129
Total operating expenses.....	145,521	164,636
Income before taxes and securities.....	27,602	26,493
Net income.....	27,102	23,816
Add:		
Provision for loan losses.....	285	3,067
Recoveries.....	2,138	1,674
Less losses charged to reserves.....	2,423	7,523
Adjusted net income.....	27,102	21,034
Total dividends.....	9,946	10,508
Profits retained.....	17,156	10,526
Capital funds—end of year.....	207,952	218,477
	Last examination	This examination
Loans (in millions of dollars):		
Real estate mortgages.....		217
Installment loans.....		207
Commercial loans.....		1,115
Special and accounts receivable.....		51
Past due.....		36
	1,657	1,626

<sup>1</sup> Percent.

Newly criticized loans on since last examination :	
Special mention (9)-----	8,382
Substandard (16)-----	5,945
Doubtful (2)-----	1,622
Total -----	15,949

JANUARY 21, 1971.

MEMORANDUM FOR THE FILES :

Re Franklin National Bank  
Mineola, N.Y.

National Bank Examiner Edward B. Lake and I attended the regular meeting of the captioned bank today to discuss the adverse trend in the affairs of the bank as revealed in the report of examination made on August 28, 1970 by Examiner Lake. All Directors except Director Prosswimmer were present. Also in attendance were Executive Vice President and Cashier Becht, Executive Vice President Sadlik and Toomey.

The report reveals aggregate classified assets equal to 52% of Gross Capital Funds; Substandard represents \$98 million, Doubtful \$10.3 million and Loss \$6.8 million. In addition, loans aggregating \$126.6 million are Especially Mentioned. Combined criticized loans represent approximately 110 percent of Gross Capital Funds.

Examiner Lake reviewed the trend of criticized loans over the last five-year period. He discussed briefly each of the larger loans summarizing the causes of the lending weaknesses. He observed that between examinations, the bank has made substantially larger loans than heretofore, i.e. \$5—\$10 million vs. \$2—\$3 million loans previously. Chairman Gleason replied that they had inaugurated a "house rule" which would limit the size of any single line of credit.

It was pointed out to the Directors that vigorous management effort is needed to rectify the heavy and increasing volume of criticized loans. Management presented the December 31, 1970 Corrective Action Program Report. (See attached copy). According to this report, criticized loans have been reduced in the aggregate of \$9 million as of that date. After the meeting, Senior Executive Vice President Lewis informed Examiner Lake he anticipates a further reduction of \$25 million in criticized loans in the next 3-4 months.

The Investment Account was reviewed and it was pointed out that over 65 percent of the Investment Account is centered in securities with maturities in excess of ten years. Also it was noted that on examination date, August 31, 1970, depreciation was \$109 million. However, management reported that by yearend the depreciation had shrunk to \$57 million due to improvements in the long-term bond market.

The Directors were informed that in light of the potential loan losses centered in the loan portfolio and the volume of business handled, capital protection is considered somewhat marginal. It was suggested that consideration be given, in due course, to an appropriate increase of the capital funds. Liquidity at 21.9 percent is within an acceptable range.

The Directors were informed that the unsatisfactory condition of the bank may cause a problem in connection with domestic branch expansion. Mr. Gleason stated that they had already decided that further branch expansion will be on a highly selective basis.

Pursuant to the suggestion of Deputy Comptroller of the Currency John D. Gwin, the Directors were informed that the condition of the bank may cause a problem with the bank's London Branch application. After the meeting, Chairman Gleason expressed concern that an adverse ruling on the London Branch might focus unfavorable publicity on the bank.

Management was requested to keep us currently informed with respect to alleviating the criticisms. They gave assurance that they will furnish this Office with Corrective Action Program Reports monthly.

C. M. VAN HORN,  
Regional Administrator of National Banks,  
Second National Bank Region.

COMPTROLLER OF THE CURRENCY,  
Washington, D.C., January 16, 1970.

Re Franklin National Bank.  
Mineola, New York.

Mr. C. M. VAN HORN,  
Regional Administrator of National Banks,  
New York, N.Y.

DEAR MR. VAN HORN: The following is a resume of the Board Meeting attended by yourself and the undersigned on January 15, 1970. All directors with the exception of Messrs. Gibson, Kittay and Prosswimmer were present.

The first matter of discussion was the bank's liquidity, which on examination date was 2.3 percent according to our liquidity formula on an adjusted basis (giving credit for Farmers Home Loan Notes and Municipal Notes). By the end of the examination, this had improved to 12.9 percent. President Gleason advised the liquidity has improved further, and that commercial loans are back at their March, 1969 level.

The second matter of discussion was the amount of assets subject to criticism, comparing this examination to last examination:

[In thousands of dollars]

	Last examina- tion	This examina- tion
Special mention.....	56, 863	57, 685
Substandard.....	31, 678	29, 383
Doubtful.....	1, 702	3, 919
Loss.....	5, 259	1, 737

President Gleason advised that after the very heavy charge offs from 1964 through 1968 (Losses were \$39,261M before recoveries of \$5,473M), the net loss for 1969 was about \$300M.

The ratio of Loans to Capital Funds was discussed; on examination date it was rather high at 1 to 7.6. The Bond depreciation of 52 percent of adjusted capital funds was also mentioned.

The Board was advised that the progress made in correcting the bank's condition was considered very good.

Very truly yours,

EDWIN K. LANGDON, JR.,  
Senior National Bank Examiner.

COMPTROLLER OF THE CURRENCY

Preliminary Draft by Haskins and Sells (Draft of October 4, 1974)

OBSERVATIONS AND COMMENTS CONCERNING SPECIAL REVIEW OF FRANKLIN  
NATIONAL BANK

HON. JAMES E. SMITH,  
Comptroller of the Currency, the Administrator of National Banks,  
Washington, D.C.

Scope

DEAR MR. SMITH: In accordance with your request, we have read the files relating to Franklin New York Corporation ("Franklin") and Franklin National Bank (the "Bank") maintained in the Office of the Comptroller of the Currency (the "Comptroller") in Washington and in the Regional Office in New York that were provided to us (including examination reports prepared by your examiners as of various dates between June 15, 1964 and May 14, 1974). The information obtained from these files has been supplemented by data obtained from (1) the annual reports to stockholders of Franklin or the Bank for the years 1964 through 1973, (2) a Registration Statement prepared in connection with a proposed merger with Talcott National Corporation dated March 29, 1974, (3) an Offering Statement relating to the sale of \$35 million of 7.30% notes dated November 16, 1971, and (4) readings of the minutes of the Boards of Directors of Franklin and the Bank from 1968 to July 11, 1974, copies of which were made available to us.

For reference purposes, we have included herein a consolidated statement of condition of Franklin (or the Bank) as of December 31 for the ten years from 1964 to 1973 (Exhibits A and B), a consolidated statement of earnings for the ten years ended December 31, 1973 (Exhibits C and D), and a summary of changes in capital funds for the same period (Exhibit E). In certain instances, reclassifications of amounts were made in the interest of presenting the information for all years on a comparable basis.

We did not examine the accounting records of Franklin or of the Bank and are therefore unable to express any opinion with respect to the accuracy of the financial data included in this report.

Our comments on the following pages are intended to inform you of the facts which were known (or which should have been known) to the members of the staff of the Comptroller and their reactions to the conditions revealed in those facts. We have, in preparing these comments, relied almost entirely on the documentary evidence made available to us and have had only limited discussions with certain of those persons in the Comptroller's Office who were involved directly or indirectly in the examination of the Bank or the discussions with the officers of the Bank or Franklin.

### *Conclusions*

The information which came to our attention during the course of our work has led us to the following conclusions:

1. The National Bank Examiners (the "Examiners"), during their examinations, developed significant information which indicated the condition of the Bank was at best only fair. The quality of the loan portfolio and the status of the investment portfolio were commented upon critically in virtually every examination report we read.

2. The critical comments of the Examiners were given to the Regional Administrator in New York and to the Deputy Comptrollers in Washington. There is evidence that the situation at the Bank was called to the specific attention of the Comptroller by the Regional Administrator as early as 1964.

3. Representatives of the Comptroller's Office (the "Comptroller's Office") frequently discussed the condition of the Bank with the directors and with the senior officers of the Bank. While the senior officers of the Bank apparently promised to take corrective actions, the actions appear to have been only minimal and temporary, and over the years there was no substantive improvement in the situation discovered by the Examiners.

4. In retrospect it appears that the Comptroller's Office did not aggressively attempt to force the Bank to adopt more drastic measures to correct the situations criticized by the Examiners. Inasmuch as the statutory rights of the Comptroller in this area are limited, the steps that might have been taken would necessarily be informal. For example, there is no provision in any of the statutes which permits the Comptroller to exercise supervision over the day-by-day lending policies of a bank, nor does the Comptroller's Office have the right to approve new loans. Nevertheless, had the Comptroller's Office successfully attempted to exercise suasion, it is possible that many of the classified and criticized loans would not have been made.

5. Despite the constant criticism to which the Bank was subjected, the Comptroller's office, beginning in 1964, approved the expansion of the Bank into the highly competitive New York City market, which expansion was accelerated through the merger with Federation Bank & Trust Company in 1967 and the opening of 21 new branches since 1969. The Comptroller's Office also approved the expansion of the Bank into the international field with the opening of the London office in 1972.

6. There were several areas in which neither the Examiners, the Regional Administrator, nor the Deputy Comptrollers appear to have expressed concern, but which were, in retrospect, potentially troublesome. The significant depreciation in the investment portfolio was noted by the Examiners, but apparently was not considered as an element to be used in measuring capital adequacy. The significant rise in the cost of borrowed funds and the diminishing spread between the cost of such funds and the interest on earning assets does not appear to have been critically reviewed by the Comptroller's Office in evaluating the Bank's earnings record. The substantial rise in foreign deposits (which by the end of 1973 represented 30 per-

cent of total deposits) does not appear to have prompted any special investigation as to the nature of the deposits.

The situation at Franklin illustrates the need for the Comptroller's Office to establish uniform procedures for handling problem bank situations (short of the legal remedies of officer removal, "cease and desist" orders, and bank closing). It also demonstrates the need to establish objective criteria for approving bank expansion plans (whether by merger or new branches) and having them understood by all persons charged with the responsibility for making recommendations to the Comptroller. Furthermore, the Franklin situation serves to illustrate the need for a greater critical analysis of the financial statements of a bank, including financial ratios, trends, and comparisons with other banks, in order that potential problems can be discovered before they occur.

In subsequent sections of this report, as shown in the accompanying index, we are commenting on these matters in greater detail.

Yours truly,

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### HISTORY AND BUSINESS OF THE BANK AND FRANKLIN

The Bank was incorporated in 1926 and until 1964 had offices only in Nassau and Suffolk Counties on Long Island. Franklin was organized by the Bank in 1965 and remained inactive until 1969 when it acquired all the voting capital stock of the Bank, which has been its only subsidiary.

The Bank opened its first New York City offices in May 1964. At December 31, 1966 the Bank had total resources of \$1,966 million and 68 banking offices. In

1967 the Bank acquired, by merger, Federation Bank & Trust Company, which company had total resources of \$291 million and 13 banking offices in New York City. Before its expansion into New York City, substantially all of the Bank's deposits were derived from Long Island sources, but in recent years a majority of its deposits have been derived from New York City and national and international sources.

As of December 31, 1973 the Bank was ranked twentieth in the United States and ninth in the State of New York in order of deposits. Since then, as a consequence of withdrawals, it has dropped in rank. The Bank is a member of the New York Clearing House Association and the Long Island Bankers Association, Inc.

The Bank conducts a general commercial banking business through its offices in the Greater New York City area. At December 31, 1973 there were 31 offices in New York City, 49 in Nassau County, and 24 in Suffolk County. The Bank conducts an international banking business through its International Banking Division with headquarters in the World Trade Center in New York City, foreign branch offices in London (opened in 1972) and Nassau, Bahamas (opened in 1969), and representative offices in Singapore and Mexico City.

At December 31, 1973, the Bank had correspondent relations with over 400 banks in other parts of the United States and also maintained correspondent relations with over 300 banking institutions in over 70 foreign countries.

The Bank provides investment and administrative services to individuals and estates, acts as trustee for personal, pension, and profit sharing trusts, and provides investment management services to individual investors, corporations, partnerships, and non-profit organizations. The Bank offers stock transfer, stock registration, trustee, and paying agency services to corporations and municipalities.

Pursuant to an agreement with Bradford Computer & Systems, Inc. the Bank, in effect sold in January 1973 its stock transfer, registrar, and other corporate agency activities to the Bradford Group for a purchase price equal to 125 percent of the average annual revenues, as defined, to be derived from such corporate agency business over a three-year period.

The financial difficulties of Franklin became publicly known in May 1974 as a result of announcements relating to the passing of the dividend payment and to the existence of foreign exchange losses.

#### GENERAL OVERVIEW OF THE NATIONAL BANK EXAMINERS' RATINGS

During the past ten years the National Bank Examiners (the "Examiners") have examined the Bank thirteen times, or on the average of once every ten months. The Examiners' comments relating to the specific problems noted with respect to the Bank and the actions of the Comptroller's Office in New York and Washington are discussed separately in the sections of the report that follow. At the conclusion of each examination the Examiners rated the Bank in various categories. A summary of the rating is as follows:

Examination date	Condition of bank	Management	Earnings	Capital	Internal controls	Future prospects	Overall rating <sup>1</sup>
June 15, 1964	Fair	Good	Excellent	Adequate	(?)	(?)	1-B-S
Apr. 26, 1965	Fair	Good	Good	Good	(?)	Good	1-C-F
Jan. 10, 1966	Fair	Good	Fair	Inadequate	(?)	Good	(?)
Oct. 3, 1966	Fair	Good	Fair	Inadequate	(?)	Good	2-C-F/3
Sept. 25, 1967	Fair	Good	Fair	Inadequate	(?)	Good	2-B-F
Sept. 30, 1968	Fair	Good	Fair	Strengthened	(?)	Good	1-B-F/2
Sept. 29, 1969	Fair	Good	Good	Borderline	Adequate	Good	2-B-F/2
Aug. 31, 1970	Poor	Fair	Fair	Inadequate	Adequate	Good	2-C-F/3
May 17, 1971	Fair	Fair	Fair	Inadequate	Adequate	Good	2-C-F/3
Mar. 6, 1972	Fair	Fair	Marginal	Inadequate	Weak	Fair	2-C-F/2
Dec. 11, 1972	Unsatisfactory	Fair	Poor	Inadequate	Generally adequate	Good	2-C-F/2
Nov. 14, 1973	Extremely poor	Poor	Poor	Inadequate	Adequate	Fair	2-D-P/3
May 14, 1974	(?)	(?)	(?)	(?)	(?)	(?)	(?)

<sup>1</sup> The overall rating of the bank by the examiners is based upon the following formula: Capital position minus quality of assets minus management divided by composite or group rating. Capital position is rated from 1 to 4 (1 being adequate based upon the examiners' considering such factors as management, liquidity, earnings, etc. Quality of assets is rated from A to D (A being good) based upon the ratio of classified and speculative assets to gross capital. Management is rated as S (strong or competent), F (fair), or P (poor, incompetent, or integrity questioned). The composite or group rating is from 1 to 4 (1 being a sound institution) based upon consideration of all ratings.

<sup>2</sup> Ratings were not shown in the examination report. In the case of the May 14, 1974 examination, the ratings were not prepared due to the limited nature of the examination.

## BRANCH EXPANSION

*Merger with Federation Bank & Trust Company*

In 1967 the Bank merged with Federation Bank & Trust Company ("Federation") and, as a result, acquired thirteen additional branches, all located within New York City.

The first indication in the files reviewed by us of the pending merger is a November 10, 1966 memorandum by Mr. C. F. West, Deputy Regional Administrator of National Banks, relating to a meeting with Mr. A. T. Roth, Chairman of the Board of the Bank. The purpose of the meeting was to inform the Comptroller's Office of the proposed merger and to discuss the procedures to be followed by the Examiners in classifying loans in connection with their then current examination.

At this meeting Mr. Roth stated that he had discussed with Examiner Langdon the minimum use of the "doubtful" classification of loans because of the merger negotiations then being held with the directors of Federation. Mr. Roth stated that he would rather have all possible losses charged off immediately and the balance of loans considered subject to classification shown as "substandard".

In order to put this meeting in proper perspective, it should be noted that at the conclusion of the prior examination as of January 10, 1966, the Examiners had classified the condition of the Bank and its earnings as "fair" and its capital as "inadequate". As discussed in greater detail under the heading "Condition of Bank-Loans", the lending policies of the Bank had been subject to criticism for several years. In the judgment of the Examiners, the quality of the Bank's loans had declined as shown by the following classifications:

[In millions of dollars]

Examination date	Loss	Doubtful	Substandard	Total classified	Special mention
June 15, 1964.....	\$3.1	\$14.9	\$25.1	\$43.1	\$16.6
Apr. 25, 1965.....	7.6	13.2	35.3	56.1	21.2
Jan. 10, 1966.....	5.7	9.5	32.7	47.9	42.2

As a result the bank was required to report, commencing in May 1966, to the regional administrator as to the status of loans classified in the previous examination.

At the conclusion of the October 1966 examination it appears that the Examiners complied with Mr. Roth's request since there were no loans classified as "doubtful".

On January 20, 1967 Peat, Marwick, Mitchell & Company rendered a letter report on their review of the Examiners' report on the Bank as of October 3, 1966 to Mr. J. P. DeSantis, President of Federation. The following is a summary of such report:

(1) Based on their limited review of classified loans it appeared to them that the reserve for loan losses was adequate.

(2) Based on their brief review of the Bank's loan policies and manual entitled "Commercial Loan Policies" issued in January 1966, they were of the view that the Bank had taken definitive steps to improve the quality of its loan portfolio and eliminate prior practices that may have been responsible for the high level of classified loans.

(3) They noted that the Bank had entered into a sale and leaseback arrangement with an affiliate and recognized a gain of \$10.4 million on such arrangement which was added to undivided profits by the Bank and was being amortized by the affiliate as part of the total purchase price over the lives of the leases. At September 30, 1966 the unamortized portion of the gain included in capital funds amounted to approximately \$9.5 million. They stated that although the transaction was not uncommon in banking and was undertaken with the approval of supervisory authorities, the transaction was not recorded in accordance with generally accepted accounting principles in that no gain or loss should be recognized on transactions entered into with affiliates for financing purposes.

In 1967, the 1966 financial statements were restated for the above transaction and the following appeared in the notes to the financial statements:

"The financial statements include the accounts and operations of the Bank combined with those of Franklin Buildings, Inc. (lessor of certain premises occupied by the Bank) whose outstanding capital stock is under option to the Bank at a nominal amount. The combination has been made on the basis of regulations issued by the Comptroller of the Currency during 1967. Accordingly, in the accompanying financial statements the balance in Capital Accounts at January 1, 1966 has been reduced by \$9,850,000 as a result of eliminating from undivided profits the remainder of amounts credited thereto in 1962 and 1963 on recording a gain on the sale of certain properties to Franklin Buildings, Inc."

On March 1, 1967 Mr. J. L. Donovan, Assistant Chief National Bank Examiner, sent a memorandum to Mr. F. H. Ellis, Chief National Bank Examiner, stating that he was not in favor of the proposed merger. In the memorandum Mr. Donovan, among other things, listed the following points:

- (1) Condition of the merged banks would only be fair.
- (2) Management would be aggressive and would have a liberal lending policy.
- (3) Earnings of the merged bank would only be fair as the earnings of neither bank were good at that time.
- (4) Capital protection would be strained but within desired proportions at that time.
- (5) Future prospects would be reasonably good.
- (6) Various banking factors were not favorable.
- (7) The asset condition of the two banks would at best be fair and would not improve greatly until there was a change in the business climate, especially the real estate sector, and the money markets.

On March 27, 1967 Mr. F. H. Ellis and Mr. W. B. Camp, Comptroller of the Currency met with Mr. A. T. Roth and Mr. H. D. Crosse, Vice Chairman of the Board of the Bank, to discuss the proposed merger. Mr. Camp specifically pointed out the following unfavorable factors relating to the Bank:

- (1) Imprudent banking practices that were common knowledge to the public as well as to the banking industry.
- (2) Transactions with "unsavory individuals" and "hoodlums".
- (3) Acceptance of weak loans which had been ferretted out of other national banks.
- (4) The existence of an inordinate volume of classified assets and loans subject to criticism representing in the aggregate some \$124 million, or more than 80 percent of gross capital structure of \$150 million.
- (5) Exorbitant loan losses amounting to \$31.6 million during the prior four years with recoveries of only \$2.9 million during the same period.
- (6) Unsatisfactory composition of loans with principal criticism directed toward inordinate volume of real estate equity loans.
- (7) Unsatisfactory composition of deposits, with savings bonds and certificates of deposit aggregating 44 percent of the total.
- (8) Inadequate capital structure which included an undesirable level of senior securities. It appeared obvious to him that an additional \$25 million in common equity funds were needed.

The memorandum stated that although Messrs. Roth and Crosse concurred with Mr. Camp's position on the unsatisfactory condition of the Bank and offered no defense as to the unfavorable banking conditions, Mr. Roth stated that more prudent banking policies had been adopted and the bank was on an improving trend. The memorandum indicated that Mr. Camp stated he was not as optimistic as management about moving the Bank to a fully acceptable condition at an early date.

As a result of the meeting Mr. Roth provided Mr. Camp, on April 12, 1967, with the following:

- (1) An analysis of substandard loans as of April 5, 1967 showing a 27 percent reduction since the October 3, 1966 examination.
- (2) An analysis of "less desirable special mention loans" as of April 5, 1967 showing a reduction of 15 percent since the October 3, 1966 examination.
- (3) An analysis of "desirable accounts with good prospects" but listed as special mention loans as of April 5, 1967 showing a reduction of 44 percent since the October 3, 1966 examination.
- (4) An analysis of deposits and loans as of December 1966 and March 1967 and estimated December 1967.

(5) An analysis of market values of government and agency obligations as of March 31, 1967.

(6) An analysis of the municipal bond evaluations as of March 31, 1967.

(7) An analysis of the Bank's liquidity.

(8) The Bank's statement of condition as of March 31, 1967.

In an April 17, 1967 letter Mr. Roth asked Mr. Camp to arrange to have the loans which were classified as "substandard" and "special mention" in the October 3, 1966 examination report re-examined to determine their present status. The Examiners were asked to review all such loans and all new loans of \$500,000 and over made at the Franklin Square and Madison Avenue offices since that date.

On May 9, 1967 Messrs. Watson and Gwin, Deputy Comptrollers, met with Messrs. Roth, Crosse, and DeSantis to discuss the results of the Examiners' special review of classified loans. The Examiners reported that there had been a substantial improvement in the loans classified at the previous examination and the great majority of the new loans reviewed were of better quality than the Bank's previous loans. At the prior examination in October 1966 classified assets plus 50 percent of loans classified "special mention" represented 62 percent of capital funds. Based on the figures prepared by the Examiners the amount had been reduced to 42 percent by April 1967.

As a result of the improvement in the loan portfolio and on the condition that a commitment be received from the Board of Directors of the merged bank to undertake a capital revision program in the fall of 1967 to produce at least \$20 million new capital in the form of common stock, Messrs. Watson and Gwin said that they would recommend approval of the merger by the Comptroller.

On May 22, 1967 the Directors sent a letter of their intentions to increase capital funds by \$20 million through the sale of additional common stock and on May 26, 1967 Mr. Watson informed Mr. Roth that the Comptroller had approved the merger.

Management of the Bank, despite its earlier commitment to raise capital funds through the sale of common stock, proposed in August 1967 to issue \$30 million convertible debentures. In September 1967 Mr. M. Goodman, Chief of the Capital Increase Section, recommended that the proposal by the Bank be rejected, but Mr. T. M. Brezinski, Director of the Bank Organization Division recommended approval. In October 1967 Mr. Gwin recommended approval "provided that the examination in process shows satisfactory progress in improving asset condition." The Examiners' report on the September 25, 1967 examination rated the condition of the Bank as "fair" and its capital as "inadequate," which ratings were unchanged from the previous examination on October 3, 1966. The amount of loans classified and criticized as of September 25, 1967 had, however, declined to \$104.6 million from \$129.9 million at the prior examination.

In 1968 the Bank raised \$15 million dollars in new capital through the sale of common stock. This increase in equity funds was \$10 million less than the amount Mr. Camp indicated as being needed by the Bank in March 1967. Further, such increase was \$5 million less than the above-mentioned commitment of the Board of Directors upon which approval of the merger by the Comptroller was granted in May 1967.

#### *New branches*

A national bank may not open a branch office without the approval of the Comptroller. In the discharge of this responsibility the Comptroller is given wide discretion. In practice, when an application is received, it is circulated to the following persons for recommendations and comments:

Examiners in the Region,  
Regional Administrator,  
Director of the Bank Organization Division, and  
Deputy Comptroller.

In addition, comments are requested from the State Banking Department.

The reports of the aforementioned parties are reviewed and provide the basis for the final decision by the Comptroller.

At December 31, 1969 the Bank had 86 domestic branches. From such date through December 31, 1973, information provided to us indicates that 21 domestic branches were opened and 3 were closed. Thus, as previously indicated in "History and Business of the Bank and Franklin" there were 104 domestic branches at December 31, 1973.

A listing of the branches opened during the four years ended December 31, 1973, together with a summary of the recommendations of the aforementioned parties, is shown in the accompanying Exhibit F. In connection with an application for a new branch an Examiner is assigned to review the application. Various Examiners were so assigned to the applications shown in Exhibit F. Except for the application relating to the Lake Success Quadrangle branch, for which Mr. A. E. Wilkens, Jr., Deputy Regional Administrator, reviewed the application with an unfavorable recommendation, all recommendations from the Regional Administrator were favorable and were made by Mr. C. M. Van Horn. Except for the application relating to the 475 Park Ave. So. branch, for which Mr. B. G. Glisson made the review, all recommendations from the Director of the Bank Organization Division were made by Mr. T. M. Brezinski. The recommendations from the Deputy Comptroller, with respect to all of the listed applications, were made by Mr. R. J. Blanchard.

The information provided to us with respect to such branch approvals indicates that either a letter was received from the New York State Banking Department without comment or no letter was received.

Comments from the "Senior Economist" were received with respect to several of the applications. For example, Mr. E. W. Hanczaryk recommended approval of the application relating to the 535 7th Avenue branch, and Mr. S. I. Greenbaum, while stating that approval of the application for the Lake Success Quadrangle branch appeared to be warranted, commented as to a possible negative effect on competition.

Except for the Southampton branch, all of the applications shown in Exhibit F were primary (original) applications. The primary application for the Southampton branch was filed on August 6, 1968 and disapproved on February 28, 1969 and a new application was filed on December 23, 1969.

Final approval for each of the branches was granted by Mr. W. B. Camp as Comptroller or by Mr. J. T. Watson or Mr. T. DeShazo, as Acting Comptroller.

A listing of the branches disapproved during the four years ended December 31, 1973, together with a summary of recommendations of the above-mentioned parties, is shown in the accompanying Exhibit F. All recommendations from the Regional Administrator, Director of Bank Organization Division, and Deputy Comptroller were made by Mr. Van Horn, Mr. Brezinski, and Mr. Blanchard, respectively. A letter was received from the New York State Banking Department without comment as to each application disapproved. There were no comments from the "Senior Economist" as to the disapproved applications. The final disapproval was made by Mr. Camp, as Comptroller or Mr. Watson, as Acting Comptroller.

#### *London branch*

According to the information provided to us, the Bank made formal application on November 4, 1970 to the Board of Governors of the Federal Reserve System for permission to open a London branch. A copy of this application, accompanied by a notice of intent to establish such a branch, was sent to the Comptroller's Office. The procedures followed by the Comptroller's Office under such circumstances provide for a member of the International Division to review the files on the applicant, to discuss the application with the appropriate Assistant Chief National Bank Examiner, and to review the latter's examination report summary file. Because the Bank was classified as a "problem" bank, the International Division also was required to discuss the application with the appropriate Regional Administrator, the Deputy Comptroller for the region, and the First Deputy Comptroller.

The files include numerous letters and memoranda indicating that the over-all problems of both the Bank and Franklin, as well as the prospects for the London branch, were discussed at the various levels mentioned in the preceding paragraph. There is evidence in the letters and memoranda that the application was also discussed frequently with various officers of the Bank.

In a memorandum dated January 13, 1971, Mr. R. A. Mullin, Director, International Division stated that the Bank's international capabilities appeared to be of a higher quality than those of most other banks and it was regretful that they were tied to a poorly managed problem "parent". He stated further that he was delaying a final conclusion until the Examiners' report for the August 31, 1970 examination was completed and reviewed with the Bank's Board of Directors. This memorandum was initiated by Mr. J. D. Gwin, Deputy Comptroller.

The August 31, 1970 examination report was reviewed by Mr. Van Horn and Examiner Lake with the Board of Directors on January 21, 1971. At this meeting the continuing problems with loans, liquidity, and capital adequacy were discussed. The directors were advised that capital protection was considered marginal and that consideration should be given to an appropriate increase in capital funds. A memorandum prepared with respect to the meeting states that, at Mr. Gwin's suggestion, the directors were informed that the condition of the Bank might cause a problem with the pending London branch application. After the meeting, Mr. H. V. Gleason, Chairman of the Board, expressed concern that a delay of approval of the London branch might focus unfavorable publicity on the bank.

Mr. Mullin in a memorandum dated February 12, 1971 reiterated the problems noted in the August 31, 1970 examination report. He concluded by stating he could not recommend approval of the London branch application on a basis of potential growth when so many adverse factors were involved. He further stated that he believed that the Bank should withdraw its application or the Board of Governors of the Federal Reserve System should deny approval of the application.

In a March 1, 1971 letter to the Board of Governors of the Federal Reserve System, Mr. Mullin stated that the basic domestic problems of the Bank had been reviewed with the Bank's Board of Directors and that corrective measures, which were considered satisfactory, had been initiated by the Bank's management. He concluded by stating that, with full consideration granted to all of the present and future aspects of the proposal, "we have concluded that we do not object to your approval of the application to open the London branch." The letter was initiated by Mr. Gwin.

Mr. Gleason, on December 2, 1971, wrote to Mr. A. F. Burns, Chairman of the Board of Governors of the Federal Reserve System, with reference to the delay in approving the establishment of a London branch. In his letter Mr. Gleason pointed out that a successful capital offering of \$35 million had been completed by Franklin, of which \$30 million had been added to the Bank's capital funds.

On December 31, 1971, Mr. T. Smith, Secretary of the Board of Governors of the Federal Reserve System, wrote to the Comptroller, enclosing a letter from the Board granting permission for the Bank to establish a branch in London, on the condition that it be established and open for business prior to January 1, 1973.

The foregoing is a chronological summary of the events leading to United States regulatory authority approval of the Bank's London branch. In addition, however, permission for the branch to deal in the London interbank market required the approval of the Bank of England.

During 1972 various letters were exchanged between Mr. Mullin and Mr. P. J. Keogh, Principal, Discount Office, Bank of England. Various aspects of the Bank's London branch, including meetings by Mr. Keogh in London with various officers of the Bank (Messrs. Gleason, Crosse and H. P. Barrand, Executive Vice President), were discussed in the letters. Throughout the correspondence, Mr. Keogh repeatedly stated that his sole interest was in being assured that Franklin was in good standing with the regulatory authorities in its own country.

During the period in 1972 that Messrs. Mullin and Keogh were exchanging letters, an examination was made of the Bank. This examination, as of March 6, 1972, disclosed significant problems in the Bank's New York International Department. The specific problems are set forth in greater detail under "International Division". In an April 12, 1972 memorandum to Mr. Gwin, Mr. Mullin referred to a meeting he had had with various officers of the Bank at which the problems disclosed in the March 6, 1972 examination were discussed. The memorandum includes a comment that Examiner Schlicht emphasized that the London branch should not be opened until the International Department in New York was operating properly. In a June 14, 1972 letter to Mr. G. G. Herrmann, Senior Vice President of Franklin, Mr. Mullin acknowledged the former's letter of June 9, 1972 with which he had enclosed a progress report on the Bank's international operations in New York. In his letter Mr. Mullin indicated that he was satisfied with the Bank's foreign operations as reported and that since all segments of the operations appeared to be operating efficiently, no further progress reports would be required.

In an August 10, 1972 letter to Mr. Mullin, Mr. Keogh inquired, "Am I right in assuming that you are reconciled to the situation in Franklin and that no further action is likely to arise? The matter is of some importance to me because we are currently delaying Franklin's authorization under the Exchange Control Act. You will appreciate that I would not like to recommend a name to our own

Treasury if there was any possibility that some action might follow in your country which caused doubts on the status of that name."

Further, in a letter of August 18, 1972, Mr. Keogh informed Mr. Mullin, "I am telling Franklin today that they must apply again for authorization and in not less than three months time." Finally, in a letter dated October 26, 1972 Mr. Keogh asked Mr. Mullin, "Can you tell me you have no problems with Franklin which would lead us to postpone recognition for a further period?"

During this period Mr. Mullin had been responding in general terms, suggesting that Mr. Keogh make his decision without concern about embarrassing the Comptroller's Office or Franklin. In response to Mr. Keogh's letter of October 26, 1972, Mr. Mullin stated, in a letter dated October 31, 1972, that Franklin's problems had not only been apparent to the public but also, in detail, to the Examiners. He further stated that senior management was required to file monthly progress reports. He discussed other matters including the possible effect Mr. M. Sindona, a director and major stockholder of Franklin, might have on senior management and concluded by stating, "In view of all of these factors, we believe Franklin should be recognized in London."

Thus, during a period of approximately two years the Comptroller's Office changed from a position favoring disapproval of the application for the London branch to one recommending to the authorities in London that the branch be recognized and be permitted to commence operations. Since the principal reasons for initially opposing approval were the numerous adverse factors present within the New York operations of the Bank, it is difficult to understand the change in position in the absence of any significant improvement in the Bank's operations. Although management had indicated that action was taken to correct the weaknesses in the International Department disclosed in the March 6, 1972 report, there is no evidence, in the material provided to us, that any significant tests were made by the Comptroller's Office to ascertain that improvement had in fact been made.

#### INTERNATIONAL DIVISION

As mentioned under "History and Business of the Bank and Franklin" the Bank conducts an international banking business. In addition to services provided through its International Division located in New York City, significant international activities are conducted through branches in London and Nassau and services are provided through representative offices in Singapore and Mexico City.

Prior to 1969 the international banking business was solely conducted through the International Division in New York City, and did not represent a significant part of the total operations of the Bank. Based on the information provided to us, the growth in international banking commenced in 1969 with the opening of the Nassau branch and accelerated in 1972 when permission was granted for the London branch to commence operations.

The following table presents information, in millions of dollars, obtained from published information as of December 31 for the years shown :

Year	Deposits in foreign branches	Percent of total deposits	Foreign branch loans	Percent of total loans
1969.....	\$159.7	7.7	\$30.0	2.0
1970.....	209.6	8.2	108.9	6.8
1971.....	256.1	9.0	192.6	11.2
1972.....	771.6	22.3	243.8	11.7
1973.....	1,136.0	30.5	549.3	19.8

A principal activity of the New York International Division was foreign exchange trading on both spot and future bases. A summary of foreign exchange positions as of the various dates of examinations made by the Examiners from August 31, 1970 to May 14, 1974 is shown in the accompanying Exhibit G. The growth in the magnitude of such positions, other than positions in U.S. dollars, is evident from the following summary (in thousands of dollars) :

	Long positions	Short positions	Net long (short) positions
Aug. 31, 1970.....	\$9,368	\$6,817	\$2,551
May 17, 1971.....	18,448	17,880	568
Mar. 6, 1972.....	211,249	210,251	998
Dec. 11, 1972.....	678,439	683,644	(5,205)
Nov. 14, 1973.....	1,037,741	1,100,356	(62,615)
May 14, 1974.....	53,562	286,146	(232,584)

Data shown above as of May 14, 1974 are after the revaluation of foreign exchange positions made as of May 10, 1974, which resulted in the disclosure of previously unrecognized foreign exchange losses aggregating approximately \$43 million.

The operations and procedures of the International Division were comprehended in the regular examinations of the Bank made by the Examiners. In addition, the material provided to us indicated that the independent accountants for the Bank had rendered a report, addressed to Mr. H. P. Barrand, Executive Vice President in charge of international operations, which included recommendations for improvements in internal control, developed as a result of a surprise examination of the International Division as of October 1, 1971.

The Examiners' report on examinations made as of September 29, 1969, August 31, 1970, and March 6, 1972 include comments regarding the International Division. The growth pattern was noted, as well as the need to develop a system which would provide for adequate controls and reliability of management information to meet the anticipated requirements resulting from continued growth.

The report rendered by the Bank's independent accountants as a result of their examination of the International Division as of October 1, 1971 pointed out several significant weaknesses and included recommendations for improvements in internal control. Significant items pointed out in their report included:

1. Subsidiary records for open foreign exchange future contracts did not agree with the general ledger control.
2. The foreign currency account included amounts for transactions already sold, but for which payment had not been received.
3. The foreign exchange section appeared to be experiencing difficulty in handling the expanding volume of activity.

In view of the above, recommendations were made to establish formalized procedures, preferably through a "procedures manual", with the inclusion of the reconciliation of subsidiary accounts to general ledger controls as a basic procedure and the utilization of bookkeeping control over foreign currency transactions by means of an account receivable procedure for protection in situations where cash receipts were delayed. Further, there was concurrence with management as to the need for an overall systems review in light of expanding activity and a suggestion for independent audit or verification of basic transactions.

In the March 6, 1972 examination report the Examiner assigned to the International Division stated that he had been unable to balance the foreign exchange contracts, that entries in the accounts contained many errors, and that his general reaction was that the Division was in a state of "chaos".

Specific comments included in the report were:

1. Internal controls were virtually non-existent.
2. Too many specific functions were being handled by the trader.
3. Nostro accounts, maintained in Westbury, Long Island, were not being reconciled. Open items were present dating back to 1970.
4. Minimum accounting procedures and formalized records were lacking.
5. There was an absence of subsidiary foreign currency ledgers for forward contracts purchased or sold.
6. Review of data available revealed unrecorded contracts, mispostings, and other errors which obviated the value of position records.
7. Forward contract forms were neither prenumbered nor controlled, making it possible for such contracts to remain unrecorded until liquidation.
8. Official gap reports were lacking.
9. Aggregate limits, necessary for management to control growth rates within limits deemed reasonable, were lacking.

When senior management was made aware of the above-mentioned deficiencies, trading in foreign exchange was sharply curtailed and a crash program was instituted by the Bank to ameliorate the disorganized condition of the foreign exchange department. The program was four-pronged:

1. The responsibility of the foreign trader would be limited solely to foreign exchange trading. He would have nothing to do with the preparation of the paper work, the accounting, and the follow-up.

2. Permanent operational procedures for a more orderly flow of transactions would be finalized by the Systems & Standards Department. An interim system coupled with temporary forms would be installed, which, it was expected, would improve the efficiency of the operations of the department.

3. The Nostro (due from) accounts would be moved to the International Division at Hanover Square. The majority of the accounts were properly reconciled and in most cases all open items were cleared. Write-offs in this area were expected to be nominal.

4. New experienced personnel would be employed to insure the proper implementation of the procedures and systems that were being formulated.

The Examiner concluded that prompt and proper corrective action had been taken by the Bank; however, he stated that the efficacy of the measures taken could only be judged when the volume of activity in the foreign exchange department returned to preexamination levels.

The December 11, 1972 report indicated that growth in foreign exchange transactions was substantial. The Examiner stated that the department had made substantial improvements in its accounting procedures since the prior examination, but still had internal control deficiencies. He specifically recommended that the internal audit department assist in the development of required internal controls. The Examiner was also critical of the problems of "limits", specifically, net position limits, trading limits, customer limits, and future contract net position limits. He stated that even where limits had been established, the examination disclosed instances where they had been exceeded.

The Examiner, in the November 14, 1973 examination report, did not mention any significant problems in the foreign exchange operating areas. His comments indicated that the accounting system then employed was adequate for the existing daily volume.

The May 14, 1974 examination was a limited examination specifically directed to known problem areas. Because of the public announcement regarding losses in the foreign exchange department, this became an area for special attention. The Examiner stated that the foreign exchange exposure was substantial. The following is a quote from the report:

The bank is faced with the critical situation of determining the exact positions, arriving at the proper loss calculation, and the inability to obtain forward cover. Senior management was unaware of the magnitude of the Sterling, Swiss Franc, Deutsche Mark, French Franc, Dutch Guilder, and Lire positions and the loss contained therein. Actually, the last revaluation (April 26, 1974) indicated nominal net positions and substantial profits in the forward contracts. Based on an appraisal of the positions as of May 10, 1974, as adjusted, the actual unrealized loss exceeds \$43 million. The fault for these losses lies with senior management. Their failure to supervise the activities of the foreign exchange traders, their failure to review profit and loss calculations, and their failure to enforce a system of proper safeguards are responsible for the bank's predicament.

The investigations into the activities of personnel of the department disclosed unbooked future contracts, as well as speculation on the forward movement of rates. The submission of the adjusted position information to management in May 1974 was followed by a series of resignations from senior officers down to the head exchange trader.

The foregoing sets forth the information obtained from the examination reports. Subsequent to the March 6, 1972 examination Mr. R. A. Mullin requested and received progress reports from Mr. G. G. Herrmann, Senior Vice President of the Bank, as to the specific procedures being implemented by the Bank to correct the weaknesses noted by the Examiner. In addition, Mr. C. M. Van Horn, Regional Administrator, requested his Examiner, H. B. El-Dada, to make a special examination of the foreign exchange operations in mid-1973. In a letter to Mr. Van Horn dated June 18, 1973 Mr. El-Dada stated that he had made the requested examination and commented on the continued growth in transactions. He stated, however, that he did not believe the net positions to be unusual. He stated that no speculative activities were discerned. His conclusions, as stated in his letter, follow:

Even though the volume of the foreign exchange transactions and positions have increased, the Bank has not taken any undue risk in its foreign exchange trading. Trading is still largely with well known international and domestic banks where the risk is minimal.

All internal control procedures seem to be well observed and the undersigned examiner was introduced to a new internal resident auditor whose sole job will be to keep a constant eye on the workings of the foreign exchange department.

From the foregoing it is apparent that the existence of problems in the Bank's International Division were known to the Comptroller's Office and senior management of the Bank.

The files indicate that management of the Bank appeared to have been taking corrective action when the Examiners brought weaknesses to its attention but the corrective action taken does not appear to have been effective. Included in such actions was the institution of procedures designed to keep management currently informed as to the operations of the International Division, particularly those relating to foreign exchange trading. Despite these actions and the recognition by management of the existence of problems, the internal controls were circumvented as disclosed in the May 1974 examination report.

Based on the information provided to us it does not appear that any attempt was made to determine the extent to which unrecorded foreign exchange losses existed at the date of the November 1973 examination or the extent to which erroneous foreign exchange rates were used in valuing open foreign exchange positions.

#### CONDITION OF BANK

##### General

The ratings of the Examiners as to the condition of the Bank have been set forth previously under "General Overview of the National Bank Examiners' Ratings". The various reports indicate that the principal items considered in determining the ratings were the amount of "classified assets" and the relation of such assets to total capital and, in an overriding sense, the potential effect on liquidity. In their comments, the Examiners appear to have concentrated primarily on the overall problems relating to loans, with more generalized comments as to the investment portfolio. In certain examinations some attention was directed to other assets, such as the future tax benefit of operating loss carry-forwards. The following sections summarize problems noted with regard to loans, investments, and liquidity.

##### Loans

The Examiners, as evidenced by the comments included in their reports, have been acutely aware of the unsatisfactory condition of the loan portfolio and the sizeable amount of loan losses. At each examination they classified and criticized substantial amounts of the loan portfolio. As early as the June 15, 1964 examination, the Examiners commented that classified and criticized loans were very high in relation to total loans and to the Bank's total capital. The substance of this comment has appeared in every examination report issued between June 15, 1964 and November 14, 1973.

The following is a summary (in millions of dollars) of loans classified and criticized by the Examiners:

Examination date	Loss	Doubtful	Sub-standard	Total loans classified	Special mention	Total loans classified and criticized	Percent of loans classified and criticized to—	
							Total loans	Total capital
June 15, 1964	\$3.1	\$14.9	\$25.1	\$43.1	\$16.6	\$59.7	8.1	48.4
Apr. 26, 1965	7.6	13.2	35.3	56.1	21.2	77.3	8.4	63.3
Jan. 10, 1966	5.7	9.5	32.7	47.9	42.2	90.1	8.6	72.4
Oct. 3, 1966	6.4	-----	48.5	54.9	75.0	129.9	10.9	100.8
Sept. 25, 1967	5.9	-----	36.7	42.6	62.0	104.6	7.9	66.8
Sept. 30, 1968	4.8	1.7	30.6	37.1	56.9	94.0	7.3	53.7
Sept. 29, 1969	1.4	3.7	24.6	29.7	57.0	86.7	5.4	47.5
Aug. 31, 1970	6.0	10.3	90.4	106.7	126.6	233.3	12.7	128.0
May 17, 1971	12.4	20.7	72.5	105.6	100.4	206.0	12.7	102.2
Mar. 6, 1972	9.3	15.4	92.3	117.0	94.1	211.1	11.6	91.2
Dec. 11, 1972	6.8	21.7	77.3	105.8	83.6	189.4	9.3	82.1
Nov. 14, 1973	10.4	39.5	90.1	140.0	148.6	288.6	11.2	126.3
May 14, 1974	13.4	36.6	97.2	147.2	155.7	302.9	11.6	120.7

In their reports, the Examiners have commented on :

1. The effect of the heavy volume of classified and criticized loans on the liquidity of the Bank.
2. The high ratio of classified and criticized loans to total capital funds.
3. The large number and amount of initially classified or criticized loans.
4. The apparent laxity and inadequacy of supervision and follow-up after loans are made.
5. The potential losses reflected by the substantial amount of loans classified as doubtful.
6. The small percentage of recoveries on loans charged off.

Through the years the Examiners have also commented that many of the loans were not supported by current or satisfactory credit information and that such information is essential for the proper supervision of the loan portfolio. The Examiners did not appear, however, to have stressed the need for immediate attention to this matter by management.

There are several references in the examination reports to the liberal lending policies of the Bank. For example, in the June 15, 1964 examination report the Examiners commented that, in the Bank's 1959 annual report to shareholders, Chairman Roth stated that a review of 500 of the Bank's loans by ten lending officers who had previously been with other New York City banks disclosed that 66.2% of the 500 loans reviewed would not have been granted by such officers in their capacities as lending officers with their former banks.

In several examination reports the Examiners stated that they were encouraged by the Bank's progress in eliminating loans classified or criticized in the prior examination. They also noted, however, that substantial amounts of loans were being initially classified or criticized. For example, the March 6, 1972 examination report stated that \$53 million in previously criticized loans had been collected since the last examination but that \$76 million of loans were being initially criticized.

At the conclusion of each examination, the examination report, except for the confidential to the Comptroller section, was reviewed with the Board of Directors of the Bank and a memorandum was prepared in the Regional Office describing the corrective action to be taken by the Bank. For example, in a January 5, 1967 memorandum, Mr. C. M. Van Horn, Regional Administrator, stated that the Bank had agreed to take the following corrective actions :

1. Continue vigorous efforts to strengthen or eliminate the weaknesses associated with each of the criticized loans.
2. Prepare and furnish to the Comptroller detailed monthly reports on progress in eliminating the criticized loans.
3. Consider employing additional competent lending officers.

In a follow-up to this memorandum, on January 6, 1967 Mr. H. D. Crosse, Vice Chairman of the Board, informed Mr. Van Horn that Mr. A. T. Roth, Chairman of the Board, would parcel out the classified loans to senior officers for appropriate attention.

The files contain a copy of a June 28, 1965 letter from Mr. W. B. Lewis, Jr., President of the Nassau Division of the Bank, to Mr. A. T. Roth, Chairman of the Board, concerning a re-evaluation of the Bank's lending policies. In the memorandum, Mr. Lewis stated that the examination report of April 26, 1965 clearly indicated that the Bank has suffered from the following unsatisfactory lending policies :

1. Inadequate and unreliable financial statements and supporting data.
2. Lending to people of questionable integrity.
3. Failure to control borrowers in their expansion programs.
4. Acceptance of representations of Certified Public Accountants and attorneys without verification.
5. Poor administration and follow-up of existing loans.
6. Inadequate credit files which, in many instances, made it difficult to evaluate credit extension.
7. Failure to establish and conform to standard loan policies.
8. Lack of a written statement of loan policies.

In summary, Mr. Lewis stated that the Examiners' report as of April 25, 1965 indicated that while there had been an improvement in the standards for making new loans a complete reappraisal of the Bank's lending policy should be made. He further stated that unless "drastic action" was taken future losses might continue to be excessive.

There is no indication in the files of the reason why the letter was received or of any meetings held to discuss the contents of the letter. The problems noted by Mr. Lewis for the most part appear to be the same problems commented upon by the Examiners in subsequent examinations.

As indicated above, the Washington Office was furnished with copies of the memoranda relating to the meetings held with the Board of Directors of the Bank. In addition, at the conclusion of the June 15, 1964 and April 26, 1965 examinations, the Regional Administrator sent letters directly to the Comptroller, in which he noted a heavy and increased volume of criticized loans, heavy loan losses, an extremely liberal lending policy, and a lack of adequate supervision of the loan portfolio. There is no indication that any such letters were sent subsequent to the April 26, 1965 examination. During the January 10, 1966 examination, however, Mr. J. T. Watson, First Deputy Comptroller, prepared a memorandum dated March 9, 1966 concerning a telephone conversation with Mr. Van Horn regarding the latter's preliminary review of the examination report which disclosed that the ratio of criticized assets to capital funds was 47% and that loan charge-offs would be in the neighborhood of \$11 million.

Commencing in May 1966 and almost continuously thereafter the Bank has been providing the Regional Administrator, at his request, with copies of the monthly status reports to the Board of Directors of loans classified at the prior examination. After being reviewed in the Region the reports were sent to Washington. Generally, they showed that the Bank was making progress in reducing loans previously classified. Some of these reports on file in Washington have been initiated by Messrs. J. D. Gwin, Deputy Comptroller, and L. T. Gerzema, Assistant Chief National Bank Examiner.

On occasion, the Regional Administrator wrote to the Bank complimenting it on the progress being made in reducing loans previously classified. The Regional Administrator appears, however, to have ignored the fact that at the same time the total loans classified or criticized were, in general, increasing both in amount and in relation to the total loan portfolio.

At the conclusion of each examination, the examination report was reviewed in Washington by the Assistant Chief National Bank Examiner who prepared a memorandum to the Comptroller or his Deputy on the review. The memoranda summarized the classified and criticized assets, the problems noted by the Examiners, and any corrective actions noted in the examination reports. The memoranda were apparently reviewed at a high level in the Office of the Comptroller, since several bear the initials of Messrs. W. B. Camp, J. T. Watson, or J. D. Gwin.

Further indication that the Bank's loan problems were known in Washington is a March 19, 1971 memorandum from Mr. L. T. Gerzema, Assistant Chief National Bank Examiner, to Mr. J. D. Gwin, Deputy Comptroller. Mr. Gerzema stated that the Bank was faced with some serious problems in its loan account and with the possibility of additional losses of substantial amounts in the future. In his opinion, management would not be able to turn the loan portfolio around in the near future.

In a letter dated February 22, 1974 to Mr. Van Horn, Mr. J. E. Smith, Comptroller, instructed Mr. Van Horn to meet with the Board of Directors to arrange to have the Bank prepare a written program for clearing its problems. One item that Mr. Smith wanted the Bank's program to include was, "The means and standards by which the granting of new loans and the servicing of existing loans will be policed by senior management, with a view toward upgrading the quality of the loan portfolio. A method should be established by which written loan policies of the Bank will be adhered to strictly." Mr. Van Horn and Examiner Lake met with key officers of the Bank on February 28, 1974 to discuss Mr. Smith's concerns. Mr. Van Horn gave Mr. N. Schreiber, Chairman of the Bank's Executive Committee, an outline of the areas of concern. The following are the items concerning loans which were requested in Mr. Van Horn's outline:

1. Methods and standards for granting new loans.
2. Methods and standards for administering existing loans.
3. Correcting or eliminating weaknesses associated with criticized loans.
4. Up-grading quality and liquidity of the loan portfolio.
5. Formation and/or enforcement of a written lending policy.

In a letter dated April 4, 1974, Mr. H. V. Gleason, Chairman of the Board, responded; a summary of the contemplated actions described in the section of the letter pertaining to loans is as follows:

1. The establishment of a formal loan amount authorization policy.

2. The establishment of a special task group of five experienced lending officers to effect a reduction in classified and criticized loans.

3. The review of the Lending Officer's Manual in order to improve the quality and liquidity of the loan portfolio.

In reviewing the files, it is clear that the unsatisfactory condition of the loan portfolio was known to the Examiners, the Regional Administrator, and the Washington office for at least the past ten years. It is also clear that the Comptroller's Office recommended that the Bank take appropriate action to strengthen its lending policies and improve both the quality and liquidity of its outstanding loans.

In retrospect, it appears that the corrective actions taken by the Bank were not effective and that the conditions found by the Examiners at each examination remained virtually unchanged. Even in retrospect it is difficult to assess additional steps that might have been taken by the Comptroller's Office, other than the statutory right of officer removal or the formal cease and desist procedures. One course of action (which does not appear to have been considered) would have been to assign an Examiner to the Bank to maintain active daily supervision over the loan portfolio when it became obvious that the corrective actions reported by the Bank were not effective.

#### *Reserve for loan losses*

In making their examinations the Examiners do not appear to consider the adequacy of the Reserve for Loan Losses. Rather, they include such reserve as part of total capital funds and they relate their appraisal of the condition of the bank to such total capital funds.

The amount of loans classified and criticized in examination reports and the percentage relationship of such amounts to total loans and total capital are shown in the accompanying Exhibit H. The loans classified and criticized and the balance in the Reserve for Loan Losses as shown by Examiners' reports is summarized as follows:

[Dollar amounts in millions]

	May 14, 1974	Nov. 14, 1973	Dec. 11, 1972	Mar. 6, 1972	May 17, 1971
Reserve for loan losses.....	\$28.7	\$31.4	\$28.6	\$31.1	\$30.3
Less loans classified as loss.....	13.4	10.4	6.8	9.3	12.4
Balance.....	15.3	21.0	21.8	21.8	17.9
Less 50 percent of loans classified as doubtful.....	18.3	19.8	10.8	7.7	10.3
Balance available for remaining loans.....	(3.0)	1.2	11.0	14.1	7.6
Remaining loans:					
Remaining 50 percent of doubtful...	18.3	19.8	10.8	7.7	10.3
Substandard.....	97.2	90.1	77.3	92.3	72.5
Special mention.....	155.7	148.6	83.6	94.1	100.4
Not classified or criticized.....	2,310.9	2,295.1	1,839.4	1,614.6	1,419.0
Total.....	2,582.1	2,553.6	2,011.1	1,808.7	1,602.2
Percentage relationship of reserve for loan losses, after assumed writeoff of loans classified as loss, to loans, after assumed writeoff of loans classified as loss:					
Classified.....	11.4	16.2	22.0	20.2	19.2
Classified and criticized.....	5.3	7.5	11.9	10.8	9.2
Total.....	.6	.8	1.1	1.2	1.1

An analysis of the activity in the Reserve for Loan Losses, obtained from published information, is presented in Exhibit I. The following is a summary of the transactions reported in the Reserve for Loan Losses for the five years ended December 31, 1973:

[In millions of dollars]

	1973	1972	1971	1970	1969
Portion of reserve provided by charges to income (described by bank as valuation portion).....	12.5	8.1	7.2	3.0	0.3
Less net loans charged off.....	(12.6)	(8.8)	(13.6)	(5.8)	(.3)
Net increase (decrease) in valuation portion.....	(.1)	(.7)	(6.4)	(2.8)	-----
Portion of reserve provided by charges to retained earnings (described by bank as contingency portion).....	-----	-----	3.0	1.5	5.3
Portion of reserve provided by deferred tax benefits.....	(3.0)	-----	3.4	1.3	5.9
Net change.....	(3.1)	(.7)	-----	-----	11.2
Balance at beginning of year.....	30.4	31.1	31.1	31.1	20.0
Balance at end of year.....	27.3	30.4	31.1	31.1	31.2

### Investments

A summary of the investment portfolio, as shown by Examiners' reports, is presented in the accompanying Exhibit J. This summary shows that the carrying value of the securities was substantially in excess of the related market value at the dates of the examinations, as follows:

Examination date	Depreciation (millions)	Depreciation as a percentage of—	
		Book value of investments	Total capital funds
Sept. 29, 1969.....	\$107.2	18.0	58.6
Aug. 31, 1970.....	109.0	19.4	59.8
May 17, 1971.....	62.8	8.4	31.2
Mar. 6, 1972.....	58.9	9.3	25.5
Dec. 11, 1972.....	55.3	11.2	24.0
Nov. 14, 1973.....	58.4	9.0	25.5
May 14, 1974.....	110.4	12.2	44.0

The Examiners were aware of the unrealized depreciation in relation to capital funds, but there is no evidence that such depreciation was considered in determining capital adequacy. Furthermore, there is no evidence in the files that this depreciation was discussed with the Bank as a matter of concern. The comments on the depreciation were included in the Confidential to the Comptroller section of the Examiners' reports, but there is no evidence that these comments received any special attention.

In connection with their examinations, the Examiners customarily analyzed the investment portfolio in terms of maturities. A summary of these maturities, as shown by examination reports, is presented in the accompanying Exhibits K and L in dollars and as a percent of total investments. These summaries show that there has been a considerable lengthening of the maturities, as follows:

[In percent]

Examination date	Maturities	
	Up to 5 yr	In excess of 5 yr
Sept. 29, 1969.....	31.60	68.40
Aug. 31, 1970.....	27.58	72.42
May 17, 1971.....	43.81	56.19
Mar. 6, 1972.....	42.06	57.94
Dec. 11, 1972.....	25.37	74.63
Nov. 14, 1973.....	22.56	77.44
May 14, 1974.....	18.48	81.52

A general criticism of the length of maturities is included in each report of examination. The Examiners did note improvement in connection with the May 17, 1971 and March 6, 1972 examinations but in subsequent reports observed

a reversal in the trend, with significant increases in long-term maturities. The comments are brief and only commencing with the report on the December 11, 1972 examination are there notations in the Examiners' reports indicating that the lengthening of maturities was due principally to the sale of short-term investments, rather than new purchases. The files we have seen do not indicate that the Examiner's criticisms of the maturities were ever communicated to the Bank nor that suggestions were made that the Bank take action to shorten maturities. While the comments were included in the Confidential to the Comptroller section of the Examiners' reports, there is no evidence that this matter became the subject of discussion between personnel in Washington and the Regional Administrator.

### *Liquidity*

The computation of the Bank's liquidity positions is shown in the accompanying Exhibit M. Following is a summary of these positions:

Examination date :	<i>Liquidity percentage</i>
September 29, 1969-----	23.7
August 31, 1970-----	20.6
May 17, 1971-----	21.3
March 6, 1972-----	20.7
December 11, 1972-----	28.8
November 14, 1973-----	11.2
May 14, 1974-----	14.1

The liquidity percentage referred to above is the percent of "Net Liquid Assets" to "Net Deposits and Unsubordinated Short-term Liabilities".

The first indication, in the files reviewed by us, of a potential liquidity problem was in the April 26, 1965 examination report, in which the Examiners stated that, as a result of the sizable amount of criticized paper and the high total of certificates of deposit, the Bank could have a serious liquidity problem. The Examiners commented upon the Bank's weak liquidity position, generally, in each subsequent examination report.

Mr. C. M. Van Horn, Regional Administrator, in a July 27, 1965 letter to Mr. J. J. Saxon, Comptroller, stated that the liquidity position of the Bank was unsatisfactory, being 12.8 percent at April 26, 1965 as compared to 31 percent at the date of the previous examination.

As a result of a meeting on March 29, 1966 between Mr. H. D. Crosse, Vice Chairman of the Board, and Mr. C. F. West, Deputy Regional Administrator, the Bank agreed to provide the Comptroller's Office with semi-monthly computations of the Bank's liquidity position. The Bank generally continued to send such computations until Mr. Van Horn informed Mr. Crosse on June 23, 1967 that the Bank would no longer be required to send periodic reports of liquidity position as long as such position remained at an acceptable level. The Bank's liquidity position during the first six months of 1967, based upon the information provided to us, appears to have ranged from 20 percent to 30 percent.

On April 4, 1969 Mr. Van Horn informed Mr. H. V. Gleason, President of the Bank, that, because the Bank's liquidity position of 18.6 percent was significantly below the acceptable level of 25 percent, the Bank would be required to provide periodic liquidity reports to the Comptroller's Office. Except for the liquidity reports furnished with "Call" reports, there is no indication in the files provided to us that the Bank complied with this requirement after April 15, 1969.

In a March 5, 1970 memorandum to Mr. W. B. Camp, prepared on the September 29, 1969 examination report, Mr. L. T. Gerzema, Assistant Chief National Bank Examiner, stated that the Bank's liquidity position should be followed very closely.

As indicated above, the Bank's liquidity position, except at the March 6, 1972 examination, was below the level described by Mr. Van Horn as acceptable. There is no indication that the liquidity reports in the files provided to us had been the subject of discussions between the Bank and the Comptroller's Office or within the Comptroller's Office, except as mentioned above.

### MANAGEMENT

As shown above in "General Overview of the National Bank Examiners' Ratings", management was rated as "good" until the August 31, 1970 examination when the rating was reduced to "fair". The rating was further reduced to "poor" in the November 14, 1973 examination.

Prior to the September 30, 1968 examination report, the Examiners commented upon the dominance over the Bank's affairs of Chairman of the Board, Mr. A. T. Roth. In the April 26, 1965 examination report the Examiners stated that such dominance was not considered detrimental.

In the September 30, 1968 examination report, the Examiners stated that the one-man reign of Chairman Roth was ended in that the duties of the Chairman of the Board had been reduced solely to presiding over Board meetings. The Examiners stated further that Mr. H. V. Gleason, President, who was basically a public relations man, had assumed the duties of Chief Executive Officer and was endeavoring to build a competent management team. This was the first reference in the files reviewed by us to any problems with the Bank's management team.

The comment concerning Mr. Gleason being public relations oriented and endeavoring to build a competent management team was repeated in the next five examination reports through December 11, 1972. Although the same comment was not made in the November 14, 1973 examination report, it was stated in such report that "the senior management situation has still not stabilized."

Commencing with the August 31, 1970 examination report, the Examiners commented upon the lack of depth in both senior and middle management and a lack of seasoned lending officers. In the November 14, 1973 examination report, the Examiner stated that it appeared that management was over-reacting to various problem areas and that the Bank was being run by crises. The Examiner concluded by stating that he had serious doubts that the Bank would ever be able to build a competent management team.

The ratings of management of the Bank were the subject of discussions between the Comptroller's Office and the Board of Governors of the Federal Reserve System in connection with the London branch opening and the proposed merger with Talcott National Corporation. The lack of seasoned lending officers was discussed on various occasions with the Bank's management whose response was always that attempts would be made to employ qualified lending officers. In addition, discussions were held with respect to obtaining a qualified operations officer to supervise the international operations, and the Bank, in 1972 responded by engaging Mr. P. R. Shaddick to assume general supervisory responsibility in this area.

#### EARNINGS

As shown in "General Overview of the National Bank Examiners' Ratings", the Examiners' ratings of earnings have declined from "excellent" in the June 15, 1964 examination report to "poor" in the November 14, 1973 examination report.

Commencing with the January 10, 1966 examination report, the Examiners commented, generally, that increases in operating income were being offset by increased interest expense. The accompanying Exhibits N and O summarize the return on earning assets and the related cost of funds, respectively, for the five years ended December 31, 1973. The following is a summary of the dollar and percentage spreads between the return on earning assets and the related cost of funds, as shown in those exhibits:

[Dollar amounts in millions]

	Return on earning assets	Cost of funds	Spread	Return on earning assets (percent)	Cost of funds (percent)	Spread (percent)
Year ended Dec. 31:						
1969.....	\$188.8	\$97.8	\$91.0	7.88	5.71	2.10
1970.....	229.6	121.1	108.5	9.09	6.51	2.57
1971.....	202.6	100.4	102.2	7.68	5.08	2.60
1972.....	198.6	100.3	98.3	4.85	4.85	1.68
1973.....	335.9	235.8	100.1	8.66	7.66	1.00

As shown above, the dollar spread between the return on earning assets and the related cost of funds has remained fairly constant. As shown in the accompanying Exhibit C, operating expenses, exclusive of interest expense, have increased from approximately \$56 million in 1969 to approximately \$95 million in 1973. Although such increase has been partially offset by increases in items of operating income other than return on earning assets, the failure by the Bank

to achieve an increase in the interest spread has been a significant factor in the decline in the Bank's earnings.

The Examiners also commented on the effect of the "heavy" loan losses on the Bank's earnings. Following is a comparison of provisions charged to income for possible loan losses and the net loan charge-offs (in thousands of dollars) during the five years ended December 31, 1973 :

	Provision charged to income	Net loan chargeoffs	Excess of net loans written off over provision charged to income
Year ended Dec. 31:			
1969.....	\$285	\$285	
1970.....	3,087	5,849	\$2,782
1971.....	7,200	13,624	6,424
1972.....	8,100	8,817	717
1973.....	12,488	12,565	77
Total.....	31,140	41,140	10,000

As shown above, the provisions charged to income were \$10 million less than the net loans charged off during the five years ended December 31, 1973. There is no indication in the files provided to us that this fact was considered by the Examiners in rating the Bank's earnings.

#### CAPITAL

A summary of the changes in capital funds during the ten years ended December 31, 1973 is set forth in the accompanying Exhibit E.

The composition of capital funds at December 31, 1973 was as follows :

#### The Bank :

Capital debentures (4.75 percent—1988)..... \$28,500,000

Preferred stock (\$4.60—\$100 Par)..... 18,879,000

#### Franklin :

Convertible preferred stock (\$2.45—\$25 par)..... 20,523,000

Common stock (\$5 par)..... 23,102,000

Capital surplus..... 66,953,000

Retained earnings..... 41,435,000

Total..... 199,392,000

The terms of the capital debentures of the Bank provide for redemption of \$1,500,000 principal amount during each of the years 1973 through 1987 and the balance in 1988. The preferred stock of the Bank became callable after October 15, 1972. The Bank is required annually to offer to purchase up to \$700,000 of such stock. In 1973, 11,214 shares of the preferred stock of the Bank were repurchased at a cost of approximately \$615,000.

The Examiners rated the capital of the Bank as "borderline" in the September 29, 1969 examination and as "inadequate" in subsequent examinations. The ratings were based primarily on the substantial amount of classified and criticized loans, significant loan losses, and general growth trend. There is no indication in the various reports that depreciation of the investment portfolio was considered in determining capital adequacy.

There are shown below the calculations of adjusted gross capital of the Bank as computed by the Examiners. There are also shown below certain further reductions in adjusted gross capital which were not made by the Examiners, but which relate to the underlying asset valuations.

[In millions of dollars]

	May 14, 1974	Nov. 14, 1973	Dec. 11, 1972	Mar. 6, 1972	May 17, 1971	Aug. 31, 1970	Sept. 23, 1969
<b>Capital funds:</b>							
Capital note.....	30.0	30.0	30.0	30.0	30.0	30.0	30.0
Capital debentures.....	28.5	28.5	30.0	30.0	30.0	30.0	30.0
<b>Equity capital:</b>							
Preferred stock.....	17.7	18.9	20.0	20.0	40.5	40.5	40.5
Commonstock.....	33.3	27.4	27.3	27.3	23.1	23.1	23.1
Surplus.....	106.2	81.7	81.3	81.3	65.1	65.2	65.1
Undivided profits.....	35.2	42.2	42.2	42.9	43.0	23.5	24.2
<b>Total capital funds.....</b>	<b>250.9</b>	<b>228.7</b>	<b>230.8</b>	<b>231.5</b>	<b>201.7</b>	<b>182.3</b>	<b>182.9</b>
Reserve for loan losses.....	28.7	31.4	28.6	31.1	30.3	31.1	27.2
<b>Total.....</b>	<b>279.6</b>	<b>260.1</b>	<b>295.4</b>	<b>262.6</b>	<b>232.0</b>	<b>213.4</b>	<b>210.1</b>
<b>Less adjustments made by examiners:</b>							
Loans classified as:							
Loss.....	13.3	10.4	6.8	9.3	12.4	6.0	1.4
(Doubtful (50 percent of total)).....	18.3	19.8	10.8	7.7	10.3	5.2	1.9
<b>Total.....</b>	<b>31.6</b>	<b>30.2</b>	<b>17.6</b>	<b>17.0</b>	<b>22.7</b>	<b>11.2</b>	<b>3.3</b>
<b>Adjusted gross capital as computed by examiners.....</b>	<b>248.0</b>	<b>229.9</b>	<b>241.8</b>	<b>245.6</b>	<b>209.3</b>	<b>202.2</b>	<b>206.8</b>
<b>Less adjustments not made by examiners but which relate to underlying asset valuations:</b>							
Depreciation in security portfolio <sup>1</sup> .....	110.4	58.4	55.3	58.9	62.8	109.0	107.2
Capitalization of operating loss carryforward <sup>2</sup> .....	* 15.2	23.0	19.2	15.7	-----	-----	-----
Minimum loss reserve (1 percent of total loan portfolio (excluding loans classified as "Loss") Loss amounts specifically provided for doubt-loans) <sup>4</sup> .....	7.7	5.9	9.4	10.5	5.8	13.1	14.0
<b>Total.....</b>	<b>133.3</b>	<b>87.3</b>	<b>83.9</b>	<b>85.1</b>	<b>68.6</b>	<b>122.1</b>	<b>121.2</b>
<b>Net capital funds as adjusted.....</b>	<b>114.7</b>	<b>142.6</b>	<b>157.9</b>	<b>160.5</b>	<b>140.7</b>	<b>80.1</b>	<b>85.6</b>

<sup>1</sup> The amount of depreciation in the carrying value of the security portfolio is shown in the accompanying exhibit J.

<sup>2</sup> This amount represents the potential tax benefit that could result from future utilization of the net operating loss carryforward for Federal income tax purposes. Since this amount can be used only to offset taxable income in future years its realization is, in the light of the present circumstances, doubtful. The examiners in the Mar. 6, 1972 examination report criticized the capitalization of this amount. In June 1974, Franklin announced that the amount previously capitalized had been written off.

<sup>3</sup> Actual amount not known in information provided to us; the amount shown is the amount as of Dec. 31, 1973 per Franklin's 1973 annual report.

<sup>4</sup> There is no generally accepted standard for the amount of valuation reserve required against loans, and the amount will vary by circumstances. Many accountants hold the view, however, that, as a minimum, the reserve should equal 1 percent of the total loan portfolio after all known losses have been charged off. For purposes of these calculations, the 1-percent guideline has been applied.

The determination of the adequacy of capital is made pursuant to the individual judgment of the Examiners and takes into consideration such factors as the quality and character of the risk assets, competency of management, and the relative stability of the local currency where balances are in currencies other than United States dollars. We have been informed by Mr. Van Horn that the calculation of adjusted gross capital is solely for the purpose of determining legal lending limits.

#### INTERNAL CONTROLS

As shown above in "General Overview of the National Bank Examiners' Ratings", the Examiners' initial rating of internal controls appeared in the September 29, 1969 examination report. Except for the March 6, 1972 examination, in-

ternal controls have been rated as "adequate". As a result of the serious internal control problems noted in the International Division in the March 6, 1972 examination (see "International Division" above), internal controls at that examination were rated "weak".

The March 6, 1972 examination report contained a comment that the Bank's Audit Department had experienced "growing pains" as a result of the transition from a manual to a fully automated operation and aggressive branch expansion.

Based upon the Examiners' comments, it appears that a primary factor in rating the internal controls of the Bank was the degree and nature of confirmation procedures employed by the internal and external auditors.

#### FUTURE PROSPECTS

As shown above in "General Overview of the National Bank Examiners' Ratings", the ratings of the Bank's future prospects have been "good" except for the June 15, 1964 examination when they were not rated and the March 6, 1972 and November 14, 1973 examinations when they were rated as "fair".

In their comments on the Bank's future prospects, the Examiners made reference in several examination reports to the asset problems of the Bank, primarily the amount of classified and criticized loans. The Examiners referred to the rapid expansion of the Bank, both in branches and in deposits, in all reports. In the January 10, 1966 examination report, the Examiner characterized the Bank as "one of the fastest growing banks in the nation over an extended period (of time)".

In rating the future prospects of the Bank the Examiners apparently failed to take into consideration that the increase in the Bank's total resources was due primarily to increased loans which were being financed mainly through costly time deposits and borrowings. The following is a summary of loans and time deposits and borrowings as of December 31 for the years 1964 to 1973:

[In millions of dollars]

	Loans	Time deposits and borrowings
Dec. 31:		
1964.....	765.1	853.5
1965.....	921.9	953.3
1966.....	1,079.3	1,148.6
1967.....	1,245.9	1,537.4
1968.....	1,348.4	1,583.8
1969.....	1,490.3	1,578.7
1970.....	1,596.9	1,937.0
1971.....	1,719.3	1,853.3
1972.....	2,078.5	2,446.5
1973.....	2,767.0	3,164.5

The above information was summarized from the consolidated statement of condition in the accompanying Exhibit A. Included in time deposits and borrowings above are time and savings deposits, foreign deposits (including demand deposits which we were unable to segregate based on the available information), Federal funds purchased and securities sold under agreement to repurchase, and other liabilities for borrowed money.

During the same period total resources increased from \$1,521 million to \$5,006 million, an increase of \$3,485 million. In addition to the \$2,002 million increase in loans shown above, cash and due from banks increased by \$1,041 million, which, in total, accounts for significant part of the aforementioned increase in total resources. The increase in cash and due from banks was offset by an increase in demand deposits amounting to \$916 million. (See "Earnings" for the effect of the above on the income of the Bank and Franklin.)

## OVERALL RATING

The overall ratings of the Bank are shown above in "General Overview of the National Bank Examiners' Ratings". The overall rating has declined from 1-B-S at the June 15, 1964 examination to 2-D-P/3 at the November 14, 1973 examination. For certain of the examinations the information provided to us did not disclose the Group or Composite Rating.

A review of the Examiners' ratings shown in "General Overview of the National Bank Examiners' Ratings" reveal several inconsistencies. At the conclusion of the October 3, 1966 examination the overall rating of the Bank was 2-C-F/3. However, at the conclusion of the September 30, 1968 examination the Examiners' ratings of Condition of Bank, Management, Earnings, and Future Prospects had not changed, but capital was rated "Strengthened" as compared to "Inadequate" and as a result the overall rating was improved to 1-B-F/2. A comparison of the ratings based upon the May 17, 1971 and March 6, 1972 examinations reveals that the ratings of Earnings went from "Fair" to "Marginal" and Internal Controls went from "Adequate" to "Weak" while the Group or Composite Rating improved from 3 to 2. A comparison of the ratings based upon the March 6, 1972 and December 11, 1972 examinations reveals that the ratings of Condition of the Bank went from "Fair" to "Unsatisfactory" and Earnings went from "Marginal" to "Poor" while Future Prospects improved from "Fair" to "Good" and the overall rating remained unchanged.

EXHIBIT A  
FRANKLIN NEW YORK CORP.

[In millions of dollars]

Consolidated Statement of Condition as of Dec. 31										
	1973	1972	1971	1970	1969	1968	1967	1966	1965	1964
<b>Resources:</b>										
Cash and due from banks (including interest bearing time deposits—1973, \$595,421; 1972, \$534,816; 1971, \$68,837).....	1,200.7	1,200.9	583.4	456.6	389.8	305.3	317.9	193.6	177.8	159.4
U.S. Treasury securities.....	95.2	7.4	108.3	158.0	211.6	388.2	361.7	164.5	182.3	212.5
Securities of other U.S. Government agencies and corporations.....	150.7	91.9	134.6	147.1	127.8	36.1	51.7	21.2	-----	-----
Obligations of States and political subdivisions.....	281.1	312.6	396.3	472.2	415.2	426.6	485.0	382.5	356.6	289.0
Other securities.....	107.0	83.3	175.3	59.1	57.5	16.0	20.2	9.1	4.6	4.5
Total investment securities.....	634.0	495.2	814.5	836.4	812.1	866.9	918.6	577.3	543.5	506.0
Trading account securities.....	103.2	159.1	51.0	103.9	70.3	101.7	-----	-----	-----	-----
Federal funds sold and securities purchased under agreement to resell.....	110.5	271.3	182.5	319.9	111.6	163.1	71.8	42.0	14.5	49.2
Loans.....	2,767.0	2,078.5	1,719.3	1,596.9	1,490.3	1,348.4	1,245.9	1,079.3	921.9	765.1
Bank premises and equipment.....	54.0	55.2	54.1	46.2	44.5	42.9	45.0	37.5	19.8	18.0
Customers' liability on acceptances outstanding.....	27.7	45.0	54.8	43.7	45.1	20.9	20.4	22.3	19.7	13.9
Accrued interest receivable.....	59.8	27.5	23.2	27.0	19.1	20.7	17.3	8.3	6.8	-----
Other resources.....	49.8	33.6	32.0	23.5	19.5	25.7	9.0	5.6	4.0	9.8
Bank premises and other resources.....	191.3	161.3	164.1	140.4	128.2	110.2	91.7	73.7	50.3	41.7
Total resources.....	5,006.7	4,366.3	3,514.8	3,454.1	3,002.3	2,895.6	2,645.9	1,965.9	1,708.0	1,521.4

<b>Liabilities:</b>										
<b>Deposits:</b>										
Demand .....	1,408.7	1,506.9	1,266.8	1,163.6	1,095.0	1,032.4	849.7	598.7	562.7	492.3
Time and savings .....	1,177.8	1,181.9	1,315.9	1,193.9	804.8	1,269.0	1,321.8	1,039.5	854.5	777.5
Foreign .....	1,136.0	771.6	256.3	209.6	159.7					
<b>Total deposits .....</b>	<b>3,722.5</b>	<b>3,460.4</b>	<b>2,839.0</b>	<b>2,567.1</b>	<b>2,060.3</b>	<b>2,301.4</b>	<b>2,171.5</b>	<b>1,638.2</b>	<b>1,417.2</b>	<b>1,269.8</b>
Federal funds purchased and securities sold under agreement to repurchase .....	795.4	472.7	277.6	466.2	496.8	314.8	215.6	109.1	98.8	76.0
Other liabilities for borrowed money .....	55.3	20.3	3.5	67.3	117.4					
Mortgage indebtedness .....	21.6	22.4	23.1	24.1	24.8	25.5	26.1	26.7		
7.30 percent notes percent—due 1979 .....	35.0	35.0	35.0							
Acceptances outstanding .....	28.5	45.4	56.3	47.0	45.7	21.5	20.8	23.6	19.9	14.0
Dividends payable .....	2.6	2.6	2.6	2.6	2.4	2.3				
Other liabilities .....	119.0	79.1	52.3	60.9	47.4	40.1	43.7	31.6	22.1	15.5
<b>Total liabilities .....</b>	<b>4,779.9</b>	<b>4,137.9</b>	<b>3,389.4</b>	<b>3,235.2</b>	<b>2,794.8</b>	<b>2,705.6</b>	<b>2,477.7</b>	<b>1,829.2</b>	<b>1,558.0</b>	<b>1,375.3</b>
Reserve for possible loan losses .....	27.4	30.4	31.1	31.1	31.1	20.0	20.0	16.0	25.3	23.0
<b>Capital funds:</b>										
Capital debentures of bank (4.75 percent—due (1988)) .....	28.5	30.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0
Preferred stock of bank (\$4.60—\$100 par) .....	18.9	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0
<b>Total .....</b>	<b>47.4</b>	<b>50.0</b>								
<b>Stockholders' equity:</b>										
Convertible preferred stock (\$2.45—\$25 par) .....	20.5	20.5	20.5	20.5	20.5	20.5	20.5			
Common stock (\$5 par) .....	23.1	23.1	23.1	22.9	22.9	22.8	19.9	19.4	18.9	18.5
Capital surplus .....	67.0	66.4	66.5	65.5	65.0	65.0	50.0	50.0	50.0	50.0
Retained earnings .....	41.4	38.0	34.2	28.9	18.0	11.7	7.8	1.3	5.8	4.6
<b>Total stockholders' equity .....</b>	<b>152.0</b>	<b>148.0</b>	<b>144.3</b>	<b>137.8</b>	<b>126.4</b>	<b>120.0</b>	<b>98.2</b>	<b>70.7</b>	<b>74.7</b>	<b>73.1</b>
<b>Total capital funds .....</b>	<b>199.4</b>	<b>198.0</b>	<b>194.3</b>	<b>187.8</b>	<b>176.4</b>	<b>170.0</b>	<b>148.2</b>	<b>120.7</b>	<b>124.7</b>	<b>123.1</b>
<b>Total liabilities, reserve for possible loan losses and capital funds .....</b>	<b>5,006.7</b>	<b>4,366.3</b>	<b>3,514.8</b>	<b>3,454.1</b>	<b>3,002.3</b>	<b>2,895.6</b>	<b>2,645.9</b>	<b>1,965.9</b>	<b>1,708.0</b>	<b>1,521.4</b>

Note: The above is based upon annual reports of Franklin New York Corp. for the years 1969 to 1973 and Franklin National Bank for years prior thereto and does not include certain other information such as that shown in notes to financial statements.

EXHIBIT B  
FRANKLIN NEW YORK CORP.  
[Percentage of total resources]

	Consolidated statement of condition as of Dec. 31—									
	1973	1972	1971	1970	1969	1968	1967	1966	1965	1964
<b>Resources:</b>										
Cash and due from banks .....	24.0	27.5	16.6	13.2	13.0	10.6	12.0	9.8	10.4	10.5
U.S. Treasury securities .....	1.9	.2	3.1	4.6	7.1	13.4	13.7	9.4	10.7	14.0
Securities of other U.S. Government agencies and corporation .....	3.0	2.1	3.8	4.2	4.3	1.2	2.0	1.1	-----	19.0
Obligations of states and political subdivisions .....	5.6	7.2	11.3	13.7	13.8	14.7	18.3	19.5	20.9	-----
Other securities .....	2.1	1.9	5.0	1.7	1.9	.6	.7	.5	.3	.3
<b>Total investment securities .....</b>	<b>12.6</b>	<b>11.4</b>	<b>23.2</b>	<b>24.2</b>	<b>27.1</b>	<b>29.9</b>	<b>34.7</b>	<b>29.5</b>	<b>31.9</b>	<b>33.3</b>
Trading account securities .....	2.1	3.6	1.5	3.0	2.3	3.5	-----	-----	-----	-----
Federal funds sold and securities purchased under agreement to resell .....	2.2	6.2	5.2	9.3	3.7	5.6	2.7	2.1	.8	3.2
Loans .....	55.3	47.6	48.9	46.2	49.6	46.6	47.1	54.9	53.9	50.3
Bank premises and equipment .....	1.0	1.3	1.5	1.3	1.5	1.5	1.7	1.9	1.2	1.2
Customers' liability on acceptances outstanding .....	.6	1.0	1.5	1.3	1.5	.7	.8	1.1	1.2	.9
Accrued interest receivable .....	1.2	.6	.7	.8	.6	.7	.7	.4	.4	-----
Other resources .....	1.0	.8	.9	.7	.7	.9	.3	.3	.2	.6
<b>Bank premises and other resources .....</b>	<b>3.8</b>	<b>3.7</b>	<b>4.6</b>	<b>4.1</b>	<b>4.3</b>	<b>3.3</b>	<b>3.5</b>	<b>3.7</b>	<b>3.0</b>	<b>2.7</b>
<b>Total resources .....</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

<b>Liabilities:</b>										
<b>Deposits:</b>										
Demand.....	28.1	34.5	36.0	33.7	36.5	35.7	32.1	30.5	32.9	32.4
Time and savings.....	23.5	27.1	37.4	34.6	26.8	43.8	50.0	52.9	50.0	51.1
Foreign.....	22.7	17.7	7.3	6.0	5.3					
<b>Total deposits.....</b>	<b>74.3</b>	<b>79.3</b>	<b>80.7</b>	<b>74.3</b>	<b>68.6</b>	<b>79.5</b>	<b>82.1</b>	<b>83.4</b>	<b>82.9</b>	<b>83.5</b>
Federal funds purchased and securities sold under agreement to repurchase.....	15.9	10.8	7.9	13.5	16.6	10.8	8.1	5.6	5.8	5.0
Other liabilities for borrowed money.....	1.1	.5	.1	1.9	3.9					
Mortgage indebtedness.....	.4	.5	.7	.7	.8	.9	.9	1.4		
7.30 percent notes—due 1979.....	.7	.8	1.0							
Acceptances outstanding.....	.6	1.0	1.6	1.4	1.5	.7	.8	1.2	1.2	.9
Dividends payable.....	.1	.1	.1	.1	.1	.1	.1			
Other liabilities.....	2.4	1.8	1.5	1.7	1.6	1.4	1.7	1.6	1.3	1.0
<b>Total liabilities.....</b>	<b>95.5</b>	<b>94.8</b>	<b>93.6</b>	<b>93.6</b>	<b>93.1</b>	<b>93.4</b>	<b>93.6</b>	<b>93.2</b>	<b>91.2</b>	<b>90.4</b>
Reserve for possible loan losses.....	.5	.7	.9	.9	1.0	.7	.8	.8	1.5	1.5
<b>Capital funds:</b>										
Capital debentures of bank (4.75 percent—due 1988).....	.6	.7	.8	.9	1.0	1.0	1.1	1.5	1.7	2.0
Preferred stock of bank (\$4.60-\$100 par).....	.4	.4	.5	.6	.7	.7	.7	1.0	1.2	1.3
<b>Total capital funds.....</b>	<b>1.0</b>	<b>1.1</b>	<b>1.3</b>	<b>1.5</b>	<b>1.7</b>	<b>1.7</b>	<b>1.8</b>	<b>2.5</b>	<b>2.9</b>	<b>3.3</b>
<b>Stockholders' equity:</b>										
Convertible preferred stock (\$2.45-\$25 par).....	.4	.5	.6	.6	.7	.7	.8			
Common stock (\$5 par).....	.5	.5	.7	.7	.7	.8	.8	.9	1.2	1.2
Capital surplus.....	1.3	1.5	1.9	1.9	2.2	2.3	1.9	2.5	2.9	3.3
Retained earnings.....	.8	.9	1.0	.8	.6	.4	.3	.1	.3	.3
<b>Total stockholders' equity.....</b>	<b>3.0</b>	<b>3.4</b>	<b>4.2</b>	<b>4.0</b>	<b>4.2</b>	<b>4.2</b>	<b>3.8</b>	<b>3.5</b>	<b>4.4</b>	<b>4.8</b>
<b>Total capital funds.....</b>	<b>4.0</b>	<b>4.5</b>	<b>5.5</b>	<b>5.5</b>	<b>5.9</b>	<b>5.9</b>	<b>5.6</b>	<b>6.0</b>	<b>7.3</b>	<b>8.1</b>
<b>Total liabilities, reserve for possible loan losses and capital funds.....</b>	<b>100.0</b>									

EXHIBIT C  
[In thousands of dollars]

Franklin New York Corporation Consolidated statement of earnings for the year ended Dec. 31—										
	1973	1972	1971	1970	1969	1968	1967	1966	1965	1964
<b>Operating income:</b>										
Interest and fees on loans:										
Commercial.....	188,659	96,373	94,510	107,770	95,176	67,015	51,984	49,289	36,000	27,636
Personal and installment.....	27,414	23,435	23,494	23,148	18,147	14,971	12,847	7,468	6,484	5,465
Mortgage.....	25,579	18,857	17,271	19,265	18,329	15,207	14,171	10,392	7,024	6,902
Total.....	241,652	138,665	135,275	150,183	131,662	97,193	79,002	67,149	50,108	40,003
Interest and dividends on investments:										
U.S. Treasury securities.....	1,689	1,870	4,989	10,768	13,506	18,928	14,009	5,856		
Securities of other U.S. Government agencies and corporations.....	8,331	7,350	6,142	4,376	1,678	2,459	2,222	1,291		
Obligations of states and political subdivisions.....	12,277	14,199	19,888	22,388	17,274	16,010	15,640	12,339		
Other securities.....	6,647	4,729	2,297	1,360	873	1,752	926	276		
Total.....	28,944	28,148	33,316	38,892	33,331	39,149	32,797	19,762	16,585	14,889
Other interest income.....	45,349	8,714	7,136	7,841	865					
Trading account income.....	8,875	10,446	8,806	8,420	3,910					
Service charges on deposit accounts.....	5,971	5,683	5,714	5,735	5,352	4,804	4,198	3,891	3,498	3,167
Foreign exchange trading income.....	7,754	384	442	243	244					
Other operating income.....	5,439	8,282	8,120	7,283	6,384	7,149	4,744	3,625	4,779	4,081
Total operating income.....	343,984	200,322	198,809	218,597	181,738	148,295	120,741	94,427	74,970	62,140
<b>Operating expense :</b>										
Staff expenses:										
Salaries.....	37,783	37,429	35,843	32,568	26,720	21,230	16,145	12,188	11,165	9,282
Profit sharing, pension and other benefits.....	6,224	5,541	5,292	5,062	4,175	3,404	2,574	1,760	1,460	1,258
Total.....	44,007	42,970	41,135	37,630	30,895	24,634	18,719	13,948	12,625	10,540

Interest expense:											
On deposits.....	156,085	71,259	79,165	69,194	55,151	61,914	58,059	45,693	32,939	25,856	
On Federal funds purchased and securities sold under agreement to repurchase.....	72,049	23,900	17,131	37,706	38,847	16,848			3,936	2,275	
On borrowed money.....	7,563	5,047	4,062	14,212	3,845	1,425	8,445	4,303			
Total.....	235,697	100,206	100,358	121,112	97,843	80,187	66,514	49,996	36,875	28,131	
Occupancy expense of bank premises (net of rental income).....	14,542	13,606	10,446	8,441	7,425	6,541	5,891	4,851	4,964	4,183	
Furniture and equipment—depreciation, rental costs and servicing.....	4,629	4,973	4,666	4,094	3,536	2,883	2,307	1,821	1,592	1,301	
Provision for loan losses.....	12,488	8,100	7,200	3,067	285	4,752	6,883	12,933	7,438	2,641	
Other operating expenses.....	19,416	18,388	18,542	17,572	14,486	11,124	9,855	8,424	6,449	5,970	
Total operating expenses.....	330,779	188,243	182,347	191,916	154,470	130,121	110,169	91,973	69,943	52,766	
Income report taxes, securities transactions and extraordinary item.....	13,205	12,079	16,462	26,681	27,268	18,174	10,572	2,454	5,027	9,374	
Applicable income tax.....	(285)	(1,050)	(1,740)	2,354	5,359	1,842	(1,733)	(4,346)	(2,266)	738	
Total.....	13,490	13,129	18,202	24,327	21,909	16,332	12,305	6,800	7,293	8,636	
Less dividends on preferred stock of the bank.....	870	920	920	920	920	920	920	920	920	920	
Income before securities transactions and extraordinary items.....	12,620	12,209	17,282	23,407	20,989	15,412	11,385	5,880	6,373	7,716	
Net securities cost (less) (less applicable income taxes).....	195	536	206	(1,771)	(937)	(105)	(612)	(685)	140	(554)	
Extraordinary items.....		1,483									
Net income.....	12,815	13,228	17,488	21,636	20,052	15,307	10,773	5,195	6,513	7,162	

Gain on sale of building, less applicable income taxes of \$539.

Note: The above is based upon annual reports of Franklin New York Corp., for the years 1969 to 1973 and Franklin National Bank for years prior thereto and does not include certain other information such as that shown in notes to financial statements.

EXHIBIT D  
FRANKLIN NEW YORK CORP.  
[Percentage of total operating income]

Consolidated statement of earnings for the year ending Dec. 31—										
	1973	1972	1971	1970	1969	1968	1967	1966	1965	1964
Operating income:										
Interest and fees on loans:										
Commercial.....	54.8	48.1	47.5	49.3	52.4	45.1	43.1	52.2	48.8	44.5
Personal and installment.....	8.0	11.7	11.8	10.6	10.0	10.1	10.6	7.9	8.6	8.8
Mortgage.....	7.4	9.4	8.7	8.8	10.1	10.3	11.7	11.0	9.4	11.1
Total.....	70.2	69.2	68.0	68.7	72.5	65.5	65.4	71.1	66.8	64.4
Interest and dividends on investments:										
U.S. Treasury securities.....	.5	.9	2.5	4.9	7.4	12.8	11.6	6.2		
Securities of other U.S. Government agencies and corporations.....	2.4	3.7	3.1	2.0	.9	1.7	1.8	1.4		
Obligations of States and political subdivisions.....	3.6	7.1	10.1	10.3	9.5	10.8	13.0	13.1		
Other securities.....	1.9	2.4	1.2	.6	.5	1.2	.8	.3		
Total.....	8.4	14.1	16.8	17.8	18.3	26.5	27.2	21.0	22.1	23.9
Other interest income.....	13.2	4.4	3.6	3.6	.5					
Trading account income.....	2.6	5.2	4.4	3.9	2.2					
Service charges on deposit accounts.....	1.7	2.8	2.9	2.6	2.9	3.2	3.5	4.1	4.7	5.1
Foreign exchange trading income.....	2.3	.2	.2	.1	.1					
Other operating income.....	1.6	4.1	4.1	3.3	3.5	4.8	3.9	3.8	6.4	6.6
Total operating income.....	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Operating expenses:											
Staff expenses:											
Salaries.....	11.0	18.7	18.0	14.9	14.7	14.3	13.4	12.9	14.9	15.0	
Profit sharing, pension, and other benefits.....	1.8	2.8	2.7	2.3	2.3	2.3	2.1	1.9	1.9	2.0	
Total.....	12.8	21.5	20.7	17.2	17.0	16.6	15.5	14.8	16.8	17.0	
Interest expense:											
On deposits.....	45.4	35.6	39.8	31.6	30.3	41.7	48.1	48.4	44.0	41.6	
On Federal funds purchased and securities sold under agreement to repurchase.....	20.9	11.9	8.6	17.2	21.4	11.4			5.2	3.7	
On borrowed money.....	2.2	2.5	2.1	6.5	2.1	1.0	7.0	4.6			
Total.....	68.5	50.0	50.5	55.3	53.8	54.1	55.1	53.0	49.2	45.3	
Occupancy expense of bank premises (net of rental income).....	4.3	6.8	5.3	3.9	4.1	4.4	4.9	5.1	6.6	6.7	
Furniture and equipment—depreciation, rental costs, and servicing.....	1.3	2.5	2.3	1.9	1.9	1.9	1.9	1.9	2.2	2.1	
Provision for loan losses.....	3.7	4.0	3.6	1.4	.2	3.2	5.7	13.7	9.9	4.2	
Other operating expenses.....	5.6	9.2	9.3	8.1	8.0	7.5	8.1	8.9	8.6	9.6	
Total operating expenses.....	96.2	94.0	91.7	87.8	85.0	87.7	91.2	97.4	93.3	84.9	
Income before taxes, securities transactions, and extraordinary items.....	3.8	6.0	8.3	12.2	15.0	12.3	8.8	2.6	6.7	15.1	
Applicable income tax.....	(.1)	(.5)	(.9)	1.1	3.0	1.3	(1.4)	(4.6)	(3.0)	1.2	
Total.....	3.9	6.5	9.2	11.1	12.0	11.0	10.2	7.2	9.7	13.9	
Less dividends on preferred stock of the bank.....	.3	.4	.5	.4	.5	.6	.8	1.0	1.2	1.5	
Income before securities transactions and extraordinary items.....	3.6	6.1	8.7	10.7	11.5	10.4	9.4	6.2	8.5	12.4	
Net securities gain (loss) (less applicable income taxes).....	.1	.3	.1	(.8)	(.5)	(.1)	(.5)	(.7)	.2	(.9)	
Extraordinary items.....		.2									
Net income.....	3.7	6.6	8.8	9.9	11.0	10.3	8.9	5.5	8.7	11.5	

Note: The above is based upon annual reports of Franklin New York Corp. for the years 1969 to 1973 and Franklin National Bank for years prior thereto and does not include certain other information such as that shown in notes to financial statements.

EXHIBIT E  
FRANKLIN NEW YORK CORPORATION

[In thousands of dollars]

	Consolidated changes in capital funds for the year ended Dec. 31—									
	1973	1972	1971	1970	1969	1968	1967	1966	1965	1964
<b>TOTAL capital funds:</b>										
Beginning of year .....	198,096	194,272	187,986	176,721	170,018	148,244	120,796	124,661	123,064	122,077
<b>Increases (decreases):</b>										
<b>Operations:</b>										
Net income .....	12,815	13,228	17,488	21,636	20,052	15,307	10,773	5,195	6,153	7,162
Cash dividends .....	(9,404)	(9,404)	(9,404)	(9,352)	(8,646)	(8,691)	(4,962)	(3,860)	(3,766)	(3,675)
Transfer from (to) reserve for loan losses .....			(3,023)	(1,488)	(5,246)		90	4,650	(1,150)	(2,500)
<b>Net.</b> .....	<b>3,411</b>	<b>3,824</b>	<b>5,061</b>	<b>10,796</b>	<b>6,160</b>	<b>6,616</b>	<b>5,901</b>	<b>5,985</b>	<b>1,597</b>	<b>987</b>
<b>Capital transactions:</b>										
Issuance of convertible preferred stock .....							20,523			
Exercise of common stock options .....			1,225	469	637	76				
Sale of common stock .....						15,039				
Retirement of convertible preferred stock .....	(615)									
Redemption of debentures .....	(1,500)									
<b>Net.</b> .....	<b>(2,115)</b>		<b>1,225</b>	<b>469</b>	<b>637</b>	<b>15,115</b>	<b>20,523</b>			
<b>Other:</b>										
Restatement for 1962 and 1963 gain on sale of buildings .....								(9,850)		
From merger .....							1,260			
Organization costs .....					(94)					
Other .....						43	(236)			
<b>Net.</b> .....					<b>(94)</b>	<b>43</b>	<b>1,024</b>	<b>(9,850)</b>		
<b>End of year</b> .....	<b>199,392</b>	<b>198,096</b>	<b>194,272</b>	<b>187,986</b>	<b>176,721</b>	<b>170,018</b>	<b>148,244</b>	<b>120,796</b>	<b>124,661</b>	<b>123,064</b>

Note: The above is based upon annual reports of Franklin New York Corp. for the years 1969 to 1975 and Franklin National Bank for years prior thereto and does not include certain other information such as that shown in notes to financial statements.

## EXHIBIT F

FRANKLIN NATIONAL BANK—LIST OF BRANCHES OPENED OR DISAPPROVED, JAN. 1, 1970, TO DEC. 31, 1973

Date branch approved or disapproved: Branch	Rating of bank at date of last completed examination		Recommendation for approval by—			
	Condition	Capital	Regional examiner	Regional administrator	Director bank organization division	Deputy comptroller of currency
<b>Branches opened:</b>						
Sept. 14, 1964: World Trade Center	Fair.....	Adequate.....	Favorable...	Favorable...	Favorable...	Favorable.
May 24, 1967: Lake Success Quadrangle	do.....	Inadequate...	Unfavorable	Unfavorable	do.....	Do.
Jan. 30, 1968: 535 7th Ave.	do.....	do.....	Favorable....	Favorable....	do.....	Do.
June 27, 1968: Motor Parkway	do.....	do.....	do.....	do.....	Unfavorable	Do.
Feb. 4, 1969: Smith-Haven	do.....	Strengthened	do.....	do.....	Favorable....	Do.
Apr. 7, 1969: Lefrak City	do.....	do.....	do.....	do.....	do.....	Do.
May 5, 1969: 475 Park Ave. South	do.....	do.....	do.....	do.....	do.....	Do.
July 10, 1969: Paragon Bldg	do.....	do.....	do.....	do.....	do.....	Do.
Nov. 5, 1969: 111 Livingston St.	do.....	do.....	do.....	do.....	do.....	Do.
Jan. 13, 1970: 450 Park Ave.	do.....	Borderline....	do.....	do.....	do.....	Do.
Jan. 22, 1970: West Babylon	do.....	do.....	do.....	do.....	do.....	Do.
Feb. 16, 1970: Farmingdale Drive-In	do.....	do.....	do.....	do.....	do.....	Do.
Feb. 18, 1970: Veterans Memorial	do.....	do.....	Unfavorable	do.....	Unfavorable	Do.
Mar. 11, 1970: Southampton	do.....	do.....	Favorable....	do.....	Favorable....	Do.
Apr. 16, 1970: 800 3d Ave	do.....	do.....	do.....	do.....	do.....	Do.
June 10, 1970: Centereach-Selden	do.....	do.....	do.....	do.....	Unfavorable	Do.
June 22, 1970: Columbus Circle	do.....	do.....	Unfavorable	do.....	Favorable....	Do.
Aug. 4, 1970: Great Neck Plaza	do.....	do.....	Favorable....	do.....	do.....	Do.
Aug. 31, 1970: Bayport	do.....	do.....	do.....	do.....	do.....	Do.
Nov. 4, 1970: Lynbrook	do.....	do.....	do.....	do.....	do.....	Do.
Mar. 27, 1973: Hewlett	Unsatisfactory	Inadequate	do.....	do.....	do.....	Do.
<b>Branches disapproved:</b>						
Feb. 27, 1970: Mitchell Field vicinity	Fair.....	Borderline....	do.....	do.....	Unfavorable	Unfavorable.
Apr. 1, 1970: Islip	do.....	do.....	Unfavorable	do.....	do.....	Do.
Nov. 9, 1970: Oceanside	do.....	do.....	do.....	do.....	do.....	Do.
Feb. 19, 1971: Malverne	Poor.....	Inadequate	Favorable...	Unfavorable	do.....	Do.

## EXHIBIT G

## FRANKLIN NEW YORK CORP.

SUMMARY OF FOREIGN EXCHANGE POSITIONS AS OF DATES OF EXAMINATIONS BY NATIONAL EXAMINERS

[In thousands]

	Foreign currency				U.S. dollars			
	Assets—Long	Liabilities—Short	Net—Long (short)	Limitation (note)	Assets—Long	Liabilities—Short	Net—Long (short)	Estimated profit (loss)
<b>Pounds sterling:</b>								
Aug. 31, 1970.....	330	300	30	100	786	716	70	-----
May 17, 1971.....	699	632	67	250	1,668	1,501	167	-----
Mar. 6, 1972.....	35,373	35,218	155	250	90,172	89,698	474	-----
Dec. 11, 1972.....	116,625	117,387	(762)	250	279,637	283,076	(3,439)	(1,306)
Nov. 14, 1973.....	94,323	98,025	(3,702)	-----	226,727	237,152	(10,425)	-----
May 14, 1974.....	353	76,843	(76,490)	-----	3,861	175,560	(171,699)	(19,150)
<b>Swiss francs:</b>								
Aug. 31, 1970.....	10,899	7,477	3,422	1,000	2,535	1,744	791	-----
May 17, 1971.....	24,221	22,687	1,534	2,000	5,737	5,312	425	-----
Mar. 6, 1972.....	90,046	88,200	1,846	2,000	23,476	23,079	397	-----
Dec. 11, 1972.....	452,006	451,700	306	2,000	121,311	121,193	118	30
Nov. 14, 1973.....	322,109	341,283	(19,174)	-----	105,549	112,632	(7,083)	-----
May 14, 1974.....	82,320	103,258	(20,938)	-----	29,781	32,012	(2,231)	(8,503)
<b>Dutch guilders:</b>								
Aug. 31, 1970.....	28	-----	28	1,000	8	-----	8	-----
May 17, 1971.....	998	1,500	(502)	1,000	281	423	(142)	-----
Mar. 6, 1972.....	10,958	13,541	(2,583)	1,000	3,443	4,255	(812)	-----
Dec. 11, 1972.....	240,202	240,851	(649)	1,000	75,475	75,851	(376)	146
Nov. 14, 1973.....	147,983	160,455	(12,472)	-----	57,310	62,580	(5,270)	-----
May 14, 1974.....	895	3,528	(2,633)	-----	1,642	1,379	263	(2,261)

## FRANKLIN NEW YORK CORP.

[In thousands]

	Foreign currency				U.S. dollars			Estimated profit (loss)
	Assets—Long	Liabilities—Short	Net—Long (short)	Limitation (note)	Assets—Long	Liabilities—Short	Net—Long (short)	
<b>Deutsche marks:</b>								
Aug. 31, 1970	12,304	6,363	5,941	1,000	3,331	1,748	1,583	
May 17, 1971	19,020	18,537	483	1,000	5,358	5,116	242	
Mar. 6, 1972	202,239	199,802	2,437	2,000	62,629	62,071	558	
Dec. 11, 1972	526,639	529,037	(2,398)	620	167,774	168,704	(930)	232
Nov. 14, 1973	1,103,049	1,112,392	(9,343)		438,268	452,285	(14,017)	
May 14, 1974	11,647	7,286	4,361		5,421	10,808	(5,387)	(4,259)
<b>Lire:</b>								
Aug. 31, 1970	3,507		3,507	10,000	5		5	
May 17, 1971	1,912,211	1,900,000	12,211	10,000	3,038	3,019	19	
Mar. 6, 1972								
Dec. 11, 1972								
Nov. 14, 1973	23,888,577	32,091,045	(8,202,468)		40,644	55,026	(14,382)	
May 14, 1974	428,624	6,622,353	(6,193,729)		789	10,612	(9,823)	(1,621)
<b>French francs:</b>								
Aug. 31, 1970	32		32	250	6		6	
May 17, 1971								
Mar. 6, 1972	14,323	14,073	250	1,000	2,804	2,750	54	
Dec. 11, 1972								
Nov. 14, 1973	584,403	602,754	(18,351)		134,000	141,788	(7,788)	
May 14, 1974	10,018	226,590	(216,572)		2,540	44,688	(42,148)	(6,836)
<b>Yen:</b>								
Aug. 31, 1970	926,707	926,700	7	None	2,608	2,609	(1)	
May 17, 1971								
Mar. 6, 1972								
Dec. 11, 1972								
Nov. 14, 1973								
May 14, 1974	62,581	600,000	(537,419)		232	2,039	(1,807)	(186)
<b>Belgian francs:</b>								
Aug. 31, 1970	589		589	2,000	12		12	
May 17, 1971								
Mar. 6, 1972	30,599	29,965	634	2,000	743	730	13	
Dec. 11, 1972								
Nov. 14, 1973	179,495	260,025	(80,530)		4,576	6,772	(2,196)	
May 14, 1974	15,959	27,500	(11,541)		446	637	(191)	(156)
<b>Canadian dollars:</b>								
Aug. 31, 1970	57		57	250	54		54	
May 17, 1971	2,408	2,550	(142)	250	2,366	2,509	(143)	
Mar. 6, 1972	28,060	27,758	302	500	27,958	27,668	290	
Dec. 11, 1972	33,681	34,363	(682)	500	34,242	34,820	(578)	(113)
Nov. 14, 1973	30,629	31,797	(1,168)		30,667	32,121	(1,454)	
May 14, 1974	8,666	8,100	566		8,850	8,411	439	(51)
<b>Other minor currencies:</b>								
Aug. 31, 1970 (Australian Dollar)	21		21	None	23		23	
May 17, 1971, various small positions not reported								
Mar. 6, 1972, Spanish pesetas	1,606		1,606	1,000	24		24	
Dec. 11, 1972, various small positions not reported								
Nov. 14, 1973, various small positions not reported								
May 14, 1974, various small positions not reported								11
<b>Total:</b>								
Aug. 31, 1970					9,368	6,817	2,551	
May 17, 1971					18,448	17,880	568	
Mar. 6, 1972					211,249	210,251	998	
Dec. 11, 1972					678,439	683,644	(5,205)	1,601
Nov. 14, 1973					1,037,741	1,100,356	(62,615)	
May 14, 1974					53,562	286,146	(232,584)	(43,012)

Note: The limitation is on the net long or short position.

EXHIBIT H  
FRANKLIN NEW YORK CORP.  
CLASSIFIED AND CRITICIZED LOANS, AS OF DATE OF EXAMINATIONS BY THE NATIONAL BANK EXAMINERS  
[Dollar amounts in thousands]

	May 14, 1974	Nov. 14, 1973	Dec. 11, 1972	Mar. 6, 1972	May 17, 1971	Aug. 31, 1970	Sept. 29, 1969
Loss.....	\$13,359	\$10,439	\$6,759	\$9,305	\$12,421	\$6,001	\$1,445
Doubtful.....	36,620	39,541	21,666	15,415	20,660	10,257	3,712
Substandard.....	97,240	90,102	77,334	92,319	72,531	90,394	24,599
Total classified.....	147,219	140,082	105,759	117,039	105,612	106,652	29,756
Special mention.....	155,672	148,571	83,645	94,088	100,436	126,570	57,035
Total classified and criticized.....	302,891	288,653	189,404	211,127	206,048	233,222	86,791
Other loans not classified or criticized.....	2,310,894	2,295,147	1,839,389	1,614,598	1,419,040	1,606,144	1,506,840
Total loans.....	2,613,785	2,583,800	2,028,793	1,825,725	1,625,088	1,839,366	1,593,631
Percent of total loans represented by loans categorized as:							
Loss.....	0.51	0.40	0.33	0.51	0.76	0.33	0.09
Doubtful.....	1.40	1.53	1.07	.84	1.27	.56	.23
Substandard.....	3.72	3.49	3.81	5.06	4.46	4.91	1.54
Classified.....	5.63	5.42	5.21	6.41	6.49	5.80	1.86
Special mention.....	5.96	5.75	4.12	5.15	6.18	6.88	3.58
Classified and criticized.....	11.59	11.17	9.33	11.56	12.67	12.68	5.44
Other loans not classified or criticized.....	88.41	88.83	90.67	88.44	87.33	87.32	94.56
Total loans.....	100.00	100.00	100.00	100.00	100.00	100.000	100.00
Total capital.....	\$250,913	\$228,638	\$230,820	\$231,472	\$201,657	\$182,161	\$182,829
Percent of total capital represented by loans categorized as:							
Loss.....	5.32	4.57	2.93	4.02	6.16	3.29	0.79
Doubtful.....	14.60	17.29	9.39	6.66	10.25	5.63	2.03
Substandard.....	38.75	39.41	33.50	39.88	35.97	49.62	13.45
Classified.....	58.67	61.27	45.82	50.56	52.38	58.54	16.27
Special mention.....	62.04	64.98	36.24	40.65	49.80	69.48	31.20
Total.....	120.71	126.25	82.06	91.21	102.18	128.02	47.47

EXHIBIT I  
ANALYSIS OF RESERVE FOR LOAN LOSSES  
[In thousands of dollars]

	1973	1972	1971	1970	1969	1968	1967	1966	1965	1964
Balance beginning of year.....	30,398	31,115	31,115	31,115	20,000	20,000	16,000	25,300	23,000	18,000
Deductions:										
Loans charged off.....	15,080	11,301	15,493	7,523	2,424	6,335	8,364	13,842		
Less recoveries.....	2,515	2,484	1,869	1,674	2,139	1,583	1,481	909		
Net loans charged off.....	12,565	8,817	13,624	5,849	285	4,752	6,883	12,933	7,438	2,641
Total.....	17,833	22,298	17,491	25,266	19,715	15,248	9,117	12,367	15,562	15,359
Additions:										
From merger—Federal Bank & Trust Co.....							4,180			
Charged to earnings.....	12,488	8,100	7,200	3,067	285	4,752	6,883	12,933	7,438	2,641
Transfer from (to) retained earnings.....			3,023	1,488	5,246		(90)	(4,650)	1,150	2,500
Deferred taxes related to transfer.....	(2,965)		3,401	1,294	5,869		(90)	(4,650)	1,150	2,500
Total.....	9,523	8,100	13,624	5,849	11,400	4,752	10,883	3,633	9,738	7,641
Balance end of year.....	27,356	30,398	31,115	31,115	31,115	20,000	20,000	16,000	25,300	23,000

## EXHIBIT J

## INVESTMENTS, AS OF DATES OF EXAMINATIONS BY THE NATIONAL BANK EXAMINERS

[In millions of dollars]

	May 14, 1974	Nov. 14, 1973	Dec. 11, 1972	Mar. 6, 1972	May 17, 1971	Aug. 31, 1970	Sept. 29 1969
<b>Carrying values:</b>							
U.S. Government and government agencies.....	425.6	212.3	112.1	190.9	152.7	131.4	144.9
General obligations of States and political subdivisions.....	235.6	145.6	148.2	213.8	289.9	204.1	236.2
Investment securities.....	191.9	232.0	184.2	175.0	184.3	187.3	171.3
Trading account securities.....	46.6	59.6	47.3	52.9	116.9	36.2	41.4
Other.....	3.3	.8	3.3	3.8	2.6	2.5	2.5
<b>Total.....</b>	<b>903.0</b>	<b>650.3</b>	<b>495.1</b>	<b>636.4</b>	<b>746.4</b>	<b>561.5</b>	<b>596.3</b>
<b>Market values:</b>							
U.S. Government and government agencies.....	399.1	209.1	108.6	190.1	149.5	121.9	131.3
General obligations of States and political subdivisions.....	187.1	113.9	126.3	180.3	264.2	156.0	182.0
Investment securities.....	159.4	205.2	157.7	151.5	154.4	136.7	132.1
Trading account securities.....	44.6	62.9	44.9	52.8	114.2	36.5	41.1
Other.....	2.4	.8	2.3	2.8	1.3	1.4	2.6
<b>Total.....</b>	<b>792.6</b>	<b>591.9</b>	<b>439.8</b>	<b>577.5</b>	<b>683.6</b>	<b>452.5</b>	<b>489.1</b>
<b>Depreciation (appreciation) in values:</b>							
U.S. Government and government agencies.....	26.5	3.2	3.5	.8	3.2	9.5	13.6
General obligations of States and political subdivisions.....	48.5	31.7	21.9	33.5	25.7	48.1	54.2
Investment securities.....	32.5	26.8	26.5	23.5	29.9	50.6	39.2
Trading account securities.....	2.0	(3.3)	2.4	.1	2.7	(.3)	.3
Other.....	.9	-----	1.0	1.0	1.3	1.1	(.1)
<b>Total.....</b>	<b>110.4</b>	<b>58.4</b>	<b>55.3</b>	<b>58.9</b>	<b>62.8</b>	<b>109.0</b>	<b>107.2</b>

## EXHIBIT K

## INVESTMENT MATURITIES, AS OF DATES OF EXAMINATIONS BY THE NATIONAL BANK EXAMINERS

[In thousands of dollars, par value]

	May 14, 1974	Nov. 14, 1973	Dec. 11, 1972	Mar. 6, 1972	May 17, 1971	Aug. 31, 1970	Sept. 29, 1969
<b>U.S. Government and Government agencies:</b>							
Up to 1 yr.....	18,865	13,626	35,678	71,200	63,480	2,220	9,500
Over 1 yr, not over 5 yr.....	105,191	98,692	49,426	91,636	64,083	11,6481	110,327
Over 5 yr, not over 10 yr.....	234,108	46,608	14,858	18,998	10,272	0	12,300
Over 10 yr, not over 20 yr.....	18,159	14,363	9,364	2,364	14,943	5,556	5,556
Over 20 yr.....	53,245	43,104	3,000	7,000	301	7,300	7,300
Subtotal.....	429,568	216,393	112,326	191,198	153,079	131,557	144,983
<b>General obligations of States and other political subdivisions:</b>							
Up to 1 yr.....	18,197	5,209	4,620	34,360	121,725	1,040	2,224
Over 1 yr, not over 5 yr.....	14,349	14,067	20,144	45,906	26,993	21,209	43,409
Over 5 yr, not over 10 yr.....	34,457	21,390	19,625	16,926	19,881	29,237	43,810
Over 10 yr, not over 20 yr.....	102,565	41,630	70,066	65,309	59,959	78,510	70,066
Over 20 yr.....	70,631	65,763	35,715	52,855	62,606	76,446	74,810
Subtotal.....	240,199	148,059	150,170	215,356	291,164	206,442	234,319
<b>Investment securities (primarily revenue obligations of State and political subdivisions):</b>							
Up to 1 yr.....	440	435	395	265	375	590	759
Over 1 yr, not over 5 yr.....	2,410	2,930	3,481	2,700	855	3,940	9,313
Over 5 yr, not over 10 yr.....	8,375	9,160	8,960	6,102	8,917	9,641	10,447
Over 10 yr, not over 20 yr.....	32,303	50,332	53,032	50,010	59,909	43,171	32,911
Over 20 yr.....	149,459	170,579	120,064	119,449	119,134	132,298	122,808
Subtotal.....	192,987	233,436	185,932	178,526	189,190	189,640	176,238
<b>Total:</b>							
Up to 1 yr.....	37,502	19,270	40,693	105,825	185,580	3,850	12,483
Over 1 yr, not over 5 yr.....	121,950	115,689	73,051	140,242	91,931	141,630	163,049
Over 5 yr, not over 10 yr.....	276,940	77,158	43,443	42,026	39,070	38,878	66,557
Over 10 yr, not over 20 yr.....	153,027	106,325	132,462	117,683	134,811	127,237	108,533
Over 20 yr.....	273,335	279,446	158,779	179,304	182,041	216,044	204,918
Total.....	862,754	597,888	448,428	585,080	633,433	527,639	555,540

## EXHIBIT L

## INVESTMENT MATURITIES, AS OF DATES OF EXAMINATIONS BY THE NATIONAL BANK EXAMINERS

[Percentage of total investments at par value]

	May 14, 1974	Nov. 14, 1973	Dec. 11, 1972	Mar. 6, 1972	May 17, 1971	Aug. 31, 1970	Sept. 29, 1969
<b>U.S. Government and Government agencies:</b>							
Up to 1 yr.....	2.19	2.28	7.96	12.17	10.02	.42	1.71
Over 1 yr, not over 5 yr.....	12.19	16.50	11.02	15.66	10.12	22.08	19.86
Over 5 yr, not over 10 yr.....	27.14	7.80	3.31	3.25	1.62	0.00	2.21
Over 10 yr, not over 20 yr.....	2.10	2.40	2.09	.40	2.36	1.05	1.00
Over 20 yr.....	6.17	7.21	.67	1.20	.05	1.38	1.32
Subtotal.....	49.79	36.19	25.05	32.68	24.17	24.93	26.10
<b>General obligations of States and other political subdivisions:</b>							
Up to 1 yr.....	2.11	.87	1.03	5.87	19.22	.20	.40
Over 1 yr, not over 5 yr.....	1.66	2.35	4.49	7.85	4.26	4.02	7.81
Over 5 yr, not over 10 yr.....	3.99	3.58	4.38	2.89	3.14	5.54	7.89
Over 10 yr, not over 20 yr.....	11.89	6.97	15.63	11.16	9.47	14.88	12.61
Over 20 yr.....	8.19	11.00	7.96	9.04	9.88	14.49	13.47
Subtotal.....	27.84	24.77	33.49	36.81	45.97	39.13	42.18
<b>Investment securities (primarily revenue obligations of State and political subdivisions):</b>							
Up to 1 yr.....	.05	.07	.09	.05	.06	.11	1.4
Over 1 yr, not over 5 yr.....	.28	.49	.78	.46	.13	.75	1.68
Over 5 yr, not over 10 yr.....	.97	1.53	2.00	1.04	1.41	1.83	1.88
Over 10 yr, not over 20 yr.....	3.75	8.42	11.82	8.55	9.46	8.18	5.92
Over 20 yr.....	17.32	28.53	26.77	20.41	18.80	25.07	22.10
Subtotal.....	22.37	39.04	41.46	30.51	29.86	35.94	31.72
<b>Total:</b>							
Up to 1 yr.....	4.35	3.22	9.08	18.09	29.30	.73	2.25
Over 1 yr, not over 5 yr.....	14.13	19.34	16.29	23.97	14.51	26.85	29.35
Over 5 yr, not over 10 yr.....	32.10	12.91	9.69	7.18	6.17	7.37	11.98
Over 10 yr, not over 20 yr.....	17.74	17.79	29.54	20.11	21.29	24.11	19.53
Over 20 yr.....	31.68	46.74	35.40	30.65	28.73	40.94	36.89
Total.....	100.00	100.00	100.00	100.00	100.00	100.00	100.00

## EXHIBIT M

## SUMMARY OF BANK LIQUIDITY AS OF DATES OF EXAMINATIONS BY THE NATIONAL BANK EXAMINERS

[In thousands of dollars]

Description	May 14, 1974	Nov. 14, 1973	Dec. 11, 1972	Mar. 6, 1972	May 17, 1971	Aug. 31, 1970	Sept. 29, 1969
1. Total liabilities (exclude valuation reserves and capital).....	4,347,695	3,653,428	3,507,707	3,019,828	2,918,844	2,925,172	2,314,769
1.A. Less: Deductions (Liabilities secured by U.S. Governments and other eligible assets. Interest collected not earned.).....	1,416,863	392,414	279,970	443,517	496,579	653,030	243,405
2. Net liabilities.....	2,932,812	3,261,014	3,227,737	2,576,311	2,422,265	2,272,142	2,071,364
3. Cash and due from banks.....	774,202	476,345	821,543	490,601	421,797	392,697	241,306
4. Unpledged U.S. Governments (market value).....	73,419	62,095	55,463	47,663	36,212	68,658	-----
5. Other unpledged securities—2-yr maturities or less (market value).....	8,361	3,909	22,350	43,123	52,957	6,209	376,362
6. Federal funds sold; U.S. securities and other securities with up to 2 yr maturities purchased under agreements to resell.....	50,000	-----	200,700	140,864	197,013	183,025	40,450
7. Gross liquid assets (sum of lines 3, 4, 5, and 6).....	905,982	542,349	1,100,056	722,251	707,979	650,589	658,118
4. Less: Deductions (reserve requirement (do not deduct vault cash)).....	491,679	176,246	169,558	186,719	191,472	182,005	166,346
9. Net liquid assets (line 7 minus line 8).....	414,303	366,103	930,498	535,532	516,507	468,584	491,772
10. Percent of net liquid assets to net deposits and un-subordinated short-term liabilities (line 9 as a percent of line 8).....	14.1	11.2	28.8	20.7	21.3	20.6	23.7

## EXHIBIT N

[Dollar amounts in millions]

	Return on earning assets, for the year ended Dec. 31—				
	1973	1972	1971	1970	1969
<b>Average earning assets:<sup>1</sup></b>					
<b>Loans:</b>					
Commercial.....	\$1,846.0	\$1,386.0	\$1,179.0	\$1,060.0	\$998.0
Mortgage.....	309.0	256.0	227.0	239.0	253.0
Personal and installment.....	269.0	258.0	254.0	245.0	239.0
<b>Total loans.....</b>	<b>2,424.0</b>	<b>1,900.0</b>	<b>1,660.0</b>	<b>1,544.0</b>	<b>1,490.0</b>
<b>Investments:</b>					
U.S. Treasury securities.....	26.9	45.1	110.3	196.1	243.8
Government agencies.....	120.7	117.1	95.4	65.8	40.1
States and political subdivisions.....	300.1	339.0	457.5	480.4	427.0
Other securities.....	96.6	74.0	42.0	21.7	25.5
<b>Total investments.....</b>	<b>544.3</b>	<b>575.2</b>	<b>705.2</b>	<b>764.0</b>	<b>736.4</b>
<b>Trading account securities.....</b>	<b>112.3</b>	<b>134.0</b>	<b>81.2</b>	<b>64.2</b>	<b>73.1</b>
<b>Others:</b>					
Interest bearing time deposits.....	565.1	301.8	34.4		
Federal funds sold and securities purchased under basic agreements.....	235.4	167.3	155.3	153.1	95.8
<b>Total other.....</b>	<b>800.5</b>	<b>469.1</b>	<b>189.7</b>	<b>153.1</b>	<b>95.8</b>
<b>Total average earning assets.....</b>	<b>3,881.1</b>	<b>3,078.3</b>	<b>2,636.1</b>	<b>2,525.3</b>	<b>2,395.3</b>
<b>Income:</b>					
<b>Loans:</b>					
Commercial.....	189.0	96.0	95.0	108.0	95.0
Mortgage.....	25.0	19.0	17.0	19.0	18.0
Personal and installment.....	27.0	23.3	23.0	23.0	18.0
<b>Total loans.....</b>	<b>241.0</b>	<b>138.0</b>	<b>135.0</b>	<b>150.0</b>	<b>131.10</b>
<b>Investments:</b>					
U.S. Treasury securities.....	1.7	1.9	5.0	10.8	13.5
Government agencies.....	8.3	7.4	6.1	4.4	1.7
States and political subdivisions—tax adjusted.....	23.9	27.5	38.3	46.8	36.9
Other securities.....	6.7	4.7	2.3	1.4	.9
<b>Total investments<sup>1</sup>.....</b>	<b>40.6</b>	<b>41.5</b>	<b>51.7</b>	<b>63.4</b>	<b>53.0</b>
<b>Trading account securities.....</b>	<b>8.9</b>	<b>10.4</b>	<b>8.8</b>	<b>8.4</b>	<b>3.9</b>
<b>Other interest.....</b>	<b>45.4</b>	<b>8.7</b>	<b>7.1</b>	<b>7.8</b>	<b>.9</b>
<b>Total income on earning assets<sup>2</sup>.....</b>	<b>335.9</b>	<b>198.6</b>	<b>202.6</b>	<b>229.6</b>	<b>188.8</b>
<b>Return on earning assets:</b>					
<b>Loans:</b>					
Commercial.....	10.24	6.93	8.06	10.19	9.52
Mortgage.....	8.09	7.42	7.49	7.95	7.11
Personal and installment.....	10.04	8.91	9.06	9.39	7.53
<b>Total loans.....</b>	<b>9.94</b>	<b>7.26</b>	<b>8.13</b>	<b>9.72</b>	<b>8.79</b>
<b>Investments:</b>					
U.S. Treasury securities.....	6.35	4.21	4.53	5.50	5.53
Government agencies.....	6.88	6.32	6.39	6.69	4.23
States and political subdivisions—tax adjusted.....	7.97	8.10	8.38	9.74	8.64
Other securities.....	6.94	6.35	5.48	6.45	3.52
<b>Total investments.....</b>	<b>7.46</b>	<b>7.21</b>	<b>7.33</b>	<b>8.30</b>	<b>7.20</b>
<b>Trading account securities.....</b>	<b>7.93</b>	<b>7.76</b>	<b>10.84</b>	<b>13.08</b>	<b>5.34</b>
<b>Other.....</b>	<b>5.67</b>	<b>1.85</b>	<b>3.74</b>	<b>5.49</b>	<b>.94</b>
<b>Total.....</b>	<b>8.66</b>	<b>6.45</b>	<b>7.68</b>	<b>9.09</b>	<b>7.88</b>

<sup>1</sup> Average represents, except for interest bearing time deposits, a daily average. Average interest bearing time deposits represent an average of the balance at the beginning and end of the year.

<sup>2</sup> The return on investments in obligations of States and political subdivisions, which is per the annual reports of Franklin, has been tax adjusted. The income on such investments, as shown above, has been derived by multiplying the average investment in such obligations by such return.

## EXHIBIT O

[Dollar amounts in millions]

	Cost of funds for the year ended Dec. 31—				
	1973	1972	1971	1970	1969
<b>Average funds:</b>					
<b>Deposits:</b>					
Time and savings.....	\$1,318.4	\$1,112.0	\$1,271.6	\$971.1	\$1,042.9
Foreign <sup>1</sup> .....	851.3	342.0	233.5	189.7	59.5
<b>Total deposits.....</b>	<b>2,169.7</b>	<b>1,454.0</b>	<b>1,505.1</b>	<b>1,160.8</b>	<b>1,102.4</b>
Federal funds purchased and securities sold under repurchase agreements.....	785.6	514.6	363.1	552.2	496.9
Other borrowed money.....	124.1	99.7	106.6	146.8	113.8
<b>Total.....</b>	<b>3,079.4</b>	<b>2,068.3</b>	<b>1,974.8</b>	<b>1,859.8</b>	<b>1,713.1</b>
<b>Interest expense:</b>					
Deposits.....	156.1	71.3	79.2	69.2	55.2
Federal funds purchased and securities sold under repurchase agreements.....	72.1	23.9	17.1	37.7	38.8
Other borrowed money.....	7.6	5.1	4.1	14.2	3.8
<b>Total.....</b>	<b>235.8</b>	<b>100.3</b>	<b>100.4</b>	<b>121.1</b>	<b>97.8</b>
<b>Cost of funds (percent):</b>					
Deposits.....	7.19	4.90	5.26	5.96	5.01
Federal funds purchased and securities sold under repurchase agreements.....	9.18	4.64	4.71	6.83	7.81
Other borrowed money.....	6.12	5.12	3.85	9.67	3.34
<b>Total.....</b>	<b>7.66</b>	<b>4.85</b>	<b>5.08</b>	<b>6.51</b>	<b>5.71</b>

<sup>1</sup> Foreign deposits include both time and demand deposits.

## WORK PROGRAM FOR NATIONAL BANK EDP EXAMINATION

Name of Bank.....	City.....	State.....
National Bank Region.....	Charter Number.....	
Examination Commenced.....	M., on.....	
	Day.....	Date.....
Examination Closed.....	M., on.....	
	Day.....	Date.....
Examiner in Charge.....		

## INSTRUCTIONS

This program sets forth the required procedures for the conduct of an examination of a bank's electronic data processing system. The purpose of the program is to assist the examiner in determining the extent and quality of the bank's EDP internal control procedures. The program is designed to be used in conjunction with the EDP Examination Handbook.

The applicable work program sections should be completed in pencil for each national bank data or service center. If the data center being examined functions as a servicer of other national banks, the examiner should also complete the section of this program regarding examination of computer service centers.

For purposes of this program a data center may be considered to include multiple computers located in the same general area subject to common administration. The work program should comprehend conditions during extra shifts and overtime hours as well as the normal working hours.

The EDP examination should be conducted concurrently with the commercial examination, where possible, especially if a weak internal control situation is anticipated.

The EDP examiner should review the most recent commercial report. If examination of the EDP and commercial examinations are not being conducted concurrently, the examiner should obtain all materials necessary to complete

the questionnaire for each section of the program. In most instances, this material should be retained until the specific examination area is completed. If a step in the work program is marked with an asterisk (\*), the material obtained from the data center or developed by the examiner should be included in the work papers, together with any other material that may be needed in order to fully describe the existent internal controls. Exhibits should be page numbered, indexed and cross referenced to the appropriate work program steps and initialed by the examiner. If the exhibits are voluminous, they should be bound separately from the work program. Exhibits having continuing significance may be carried forward from workpapers of previous examinations.

FRANKLIN NATIONAL BANK,  
October 2, 1969.

To: Division Heads.

From: William B. Lewis, Jr., Senior Executive Vice Pres.

Subject: Loan restraint program.

The purpose of this memorandum is to make sure that our loan policies are thoroughly understood. Please see to it that all loan officers reporting to you are thoroughly familiar with our policies and the program which we are pursuing.

1. New loans are not to be permitted. The only exception to this may be where funds are provided by the borrower through a Certificate of Deposit.

2. Increases in existing lines or approvals are subject to the same restrictions as (1) above.

3. Loans are to be under constant review with the thought of eliminating those which do not hold forth the potential for further growth of the bank. Loans which are marginal in terms of credit, rate or balances, or which require considerable administrative effort are to be eliminated.

4. The Division Head or his Assistant is to initial all notes of \$300,000 or more and he is to delegate the same responsibility for loans of smaller amount.

5. Neither commitments nor disbursements are to be made in advance of approval by the Loan Control Committee.

W. B. LEWIS.

OFFICE MEMORANDUM

U.S. GOVERNMENT,  
COMPTROLLER OF THE CURRENCY,  
March 5, 1970.

To: Mr. William B. Camp, Comptroller of the Currency.

From: Larry T. Gerzema, Assistant Chief National Bank Examiner.

Subject: Franklin National Bank, Mineola, N.Y. Examination report dated 9/29/69; received in this Office 1/22/70. Rank: 12th of all banks, 21st of all National and D.C. banks, 2-B-F/2.

*Condition*

Fair. The loan account continues to improve with both classified and charge-off totals showing a decline from the previous exam. The bank's major problem is a low liquidity position which was computed at only 2 percent on the date of the exam. It was raised to 12 percent at the close of the exam by selling \$100MM in loans to its one-bank holding company. At year end the bank was in a net borrowed position of \$388MM (borrowings, plus federal funds purchased, less federal funds sold). The net borrowings are equal to about 200 percent of the legal reserve balance required with Fed and are equal to 20 percent of deposit totals. Liquidity was 16 percent on January 31, 1970 computed under the new formula but the amount of borrowings is not known. The sharp drop in liquidity between exams was due to a \$290MM increase in loan totals and a deposit decline of \$150MM.

The bank's investment portfolio had a market depreciation of \$107MM which is equal to 52 percent of capital funds. The portfolio's long maturity schedule is the principal cause of the heavy depreciation. The bank's maturity schedule is as follows: (1) only 2 percent of the account comes due within one year; (2)

29 percent in the 1-5 year category ; (3) 12 percent in the 5-10 year range ; (4) 19 percent in the 10-20 year range ; (5) 37 percent out over 20 years. Most of the portfolio is pledged to secure public deposits or is sold under agreements to repurchase. The market depreciation represents a potential problem in view of the bank's tight liquidity position. Comparative figures taken from the last two reports of examination follow :

	Sept. 30, 1968	Sept. 29, 1969
Total resources (thousands).....	\$2,646,445	\$2,602,156
Adjusted capital funds (thousands).....	\$189,503	\$205,927
Total loans and overdrafts (thousands).....	\$1,290,690	\$1,584,293
Total deposits (thousands).....	\$2,017,540	\$1,860,076
Loans times gross capital funds.....	6.6	7.6
Percent of loans to deposits.....	64	85
Percent of classified assets to gross capital funds.....	19	16
Percent of net liquid assets to net deposits.....	23	2
Percent of time deposits to total deposits.....	61	55
Rate paid on saving accounts.....	4	4
Rate paid on majority of CD's.....	5½	5-6¼

### *Management*

Fair. President Gleason is the bank's chief executive officer. His background has been in public relations and administration, however, he is getting increasingly involved in lending and policy matters. The bank's second man is Senior Executive Vice President Lewis, who is in charge of loan administration and branch activities. Vice Chairman Crosse is responsible for investment activities and money market transactions. Chairman Roth resigned from the bank a few days ago.

### *Earnings*

Good. The bank's operating record showed substantial improvement in 1969 with net profits after taxes rising to \$17.1MM, an increase of nearly \$11MM over the previous year. Approximately one half of the increase in profits was due to a decline in loan losses. The dividend policy is not subject to criticism.

### *Capital*

Marginally adequate. Management states that there are plans to raise new money, but the amount and timing are uncertain.

### *Ownership*

Franklin New York Corporation, a one-bank holding company, owns control.

### *Future Prospects*

Good. The subject bank serves all of Long Island and also has 24 offices in New York City. Overseas expansion is going according to plan and should continue.

### *Corrective Action*

Most of the severe asset problems that plagued the bank in recent years are now behind them. Liquidity management is inadequate as evidenced by the sharp growth in the loan account during a period when deposits were declining. The regional office passed the report although it is my opinion that the bank's liquidity position should be followed closely.

LARRY T. GERZEMA,  
Assistant Chief National Bank Examiner.

JANUARY 24, 1974.

Re Franklin National Bank, New York, N.Y.  
MEMORANDUM FOR THE FILES

[In millions]

	<i>Last exam</i>	<i>This exam</i>
Resources -----	\$3,767	\$4,974
Loans -----	2,041	2,584
Capital -----	260	260
Federal funds purchased (\$147 over 1 day) -----	422	917
Repurchase agreement—securities -----	16	124
Borrowed securities -----	47	3
Short sale securities -----	24	0
<b>Total -----</b>	<b>509</b>	<b>1,044</b>
Federal funds sold -----	200	371
Due to banks:		
Demand deposits—domestic -----	63	217
Demand deposits—foreign -----	140	28
<b>Total -----</b>	<b>203</b>	<b>245</b>
Time deposits—domestic -----	3	25
Time deposits—foreign -----	532	931
<b>Total -----</b>	<b>535</b>	<b>956</b>
<b>Total borrowings and due to banks:</b>		
Time -----	1,044	2,000
1973 daily average borrowed:		
January -----		448
February -----		470
March -----		540
April -----		552
May -----		662
June -----		800
July -----		930
August -----		948
September -----		919
October -----		955
November -----		1,075
December -----		1,100

In a telephone conversation this morning, Regional Administrator Van Horn informed me that virtually the entire investment portfolio is pledged and therefore, it offers no liquidity protection.

J. T. WATSON,  
*Deputy Comptroller of the Currency.*

JANUARY, 29, 1974.

Re Franklin National Bank, Brooklyn, N.Y.

MEMORANDUM FOR THE FILES:

Last Friday, Mr. Benjamin Rafanello, Assistant Vice President, Federal Reserve Bank of New York; telephoned the Office to inform us that Mr. Brenton Levitt, Board of Governors, Federal Reserve System, Washington had suggested that it might be helpful in reaching a decision on the acquisition of Talcott by Franklin Corporation if representatives of the Examining Division of the Federal Reserve Bank of New York met with National Bank Examiner Edward B. Lake, who is conducting the current examination of the bank. I told him that this would be agreeable and the meeting was arranged for 9:15 A.M. today in this Office. In attendance were: Mr. Fred Piderit, Vice President; Ben Rafanello, Assistant Vice President; James Booth, Manager, Regulations & Bank Analysis Department; Ed Kipstuhl, Manager, Foreign Banking Regulations Department

and Robert Relyca, Special Assistant. Examiner Lake, Deputy Regional Administrator Lipkin and I also attended.

Examiner Lake outlined the current status of the examination and gave estimates as to the dollar amounts in classified assets (Substandard \$100 million, Doubtful, \$40 million, Loss, \$12-\$15 million, OLEM: \$100 million). The bank's earnings situation; liquidity; and capitalization were also discussed.

The principal concern of the Federal Reserve officials was the strength and depth of the bank's management. Examiner Lake reviewed the status and qualifications of each of the senior officers of the bank. He emphasized that Executive Vice Chairman Peter Shaddick is, in fact, the Chief Executive Officer, operating the bank in accordance with Mr. Sindona's wishes. Examiner Lake feels that while Mr. Shaddick appears to be an able administrator, the bank lacks management depth on both the senior and junior levels.

In view of the management upheaval over the last couple of years, it can only be concluded that a serious management problem exists.

C. M. VAN HORN,  
Regional Administrator of National Banks,  
Second National Bank Region.  
FRANKLIN NATIONAL BANK,  
New York, N.Y., May 15, 1972.

Mr. ROBERT MULLIN,  
Director-International Division, Comptroller of the Currency,  
Washington, D.C.

DEAR MR. MULLIN: We have been making excellent progress in correcting the deficiencies in our foreign exchange operation as reported by the National Bank Examiners during their present examination. Corrective action has been taken in the areas criticized and new systems and procedures are in the process of being implemented.

A copy of Mr. Herrmann's memorandums to Mr. Harld V. Gleason dated April 24 and May 3, 1972 are enclosed. Mr. Walter Schlicht has received copies of these memorandums and made two excellent suggestions which will be included in our final written procedure. They are,

(1) That the written revaluation policies for profit and loss computation be sufficiently detailed to include the area responsible for its preparation, the manner in which rates are set for each currency, etc.

(2) When the monthly revaluation report is prepared, any substantial profits or losses in specific currencies should be explained by means of footnotes. This will give senior management the opportunity to review the performance of the trader and his general trading philosophies.

If there is any further information that you should require, please do not hesitate to contact me directly.

Sincerely yours,

H. P. BARRAND, Jr.

FRANKLIN NATIONAL BANK,  
April 24, 1972.

To: Mr. Harold V. Gleason, Chairman of the Board and Chief Executive Officer.  
From: George G. Herrmann, International Division, Hanover Square.  
Subject: Comptroller of the Currency examination as of March 3, 1972.

The purpose of this memorandum is to provide you with a current status report outlining the steps already taken and those to be taken to correct the serious deficiencies in our foreign exchange operations as reported by the Comptroller of the Currency Examiners at the start of their examination on March 3, 1972. Their principal criticisms can be grouped into the following areas:

#### Organization

The Foreign Exchange trader was responsible for all phases of the trading operation. He originated the transactions and supervised the preparation of the paperwork, the accounting, the follow-up and the preparation of reports. From the standpoint of good controls, this was unacceptable.

#### Corrective action

We have already separated the functions of our foreign exchange operation. The trader's responsibility is now limited to trading and his staff consists of two assistant traders and two position clerks. All of these staff positions have

now been filled, including an assistant trader who will join the bank on May 8. The responsibility for the preparation and confirmation of the contracts, the record keeping, accounting and report preparation is now under the direct responsibility of an assistant operations officer, Mr. John Kruse, who has a strong background in accounting and auditing. Reporting directly to Mr. Kruse will be the foreign exchange operations supervisor. We have interviewed candidates for this position and have made an offer to one person with 6 years experience in this field. He will also be joining our bank on May 8. The remaining foreign exchange operations staff will consist of two clerks, three typists and one file clerk. Their function is to handle the typing and checking of contracts and tickets, maintaining the foreign exchange ledgers, preparing position and gap reports, checking and filing all trade confirmations, running of proofs, preparing monthly P & L calculations and clearing any open items on Nostro accounts pertaining to foreign exchange trading. These organizational changes have been made and are now fully operational.

#### *Foreign exchange forward contracts*

At the time of examination the outstanding forward contracts, both purchases and sales, were not in proof to the general ledger contingent liability control accounts. This was caused by numerous posting errors, improper adjustments, and an inadequate system and lack of proper forms.

#### *Corrective action*

Forward sales and purchase contracts outstanding are now in proof and we are presently verifying the daily transactions to the control account on the general ledger. In addition to the position sheets maintained in the trading room, a foreign exchange journal is maintained by FX operations where purchases and sales are posted daily for each currency and the U.S. dollar equivalent.

#### *Nostro accounts*

The foreign currency Nostro accounts maintained with our foreign correspondents were being posted and reconciled by General Accounting in Westbury. Due to reconciling problems and numerous posting errors by the foreign banks and incorrect accounting entries on our books, there were many open items on the Nostro accounts.

#### *Corrective action*

Our bank maintains 56 Nostro accounts, all of which have now been properly reconciled and almost all of the open items have been cleared. There are no large open items outstanding beyond two months. Mr. Sadlik has given instructions to General Accounting to station in the International Division two employees of the Financial Division handling the reconciling and researching of the Nostro accounts. This should simplify reconciling these accounts and the clearing of open items. We are establishing a new procedure whereby a monthly report is to be submitted by General Accounting to the International Division Head and to the Controller, listing all Nostro account open items which are more than one month old and large foreign exchange open items that have not been cleared within two weeks. This will be followed up weekly by the Controller to insure that research is completed on these items and cleared as quickly as possible. As part of the Systems Department review of our foreign exchange procedures they will also include an analysis and appropriate recommendations for maintaining these Nostro accounts. The target date for the completion of the formal written system is June 15, 1972. The necessary automated bookkeeping equipment for the posting of these accounts will be ordered as soon as the formal system has been approved.

#### *Foreign exchange position limits*

We have for some time had position limits established permitting the foreign exchange trader to maintain open positions up to certain limits established for each currency. However, no formal foreign currency gap limits have been established nor have aggregate limits of foreign currency dealings been set.

#### *Corrective action*

Discussions have been held with Mr. Aloï and Mr. Corcut to consider the establishment of gap limits and aggregate limits. Recommendations will be made based upon our further investigations in this area. Target date is June 15.

*Systems and FOE's*

As a result of our request of July 1971, the Bank Systems Department assigned an analyst in February 1972 to study the International Division needs to handle more efficiently the expanded activity in foreign exchange. The Systems Department was delayed in starting this study due to other priorities including the preparation of procedures for the handling of the New York Clearing House CHIPS system and the Nassau, Bahamas Branch accounting system.

Systems Department have been most cooperative in providing us with an interim system and temporary forms that will greatly improve the efficiency of the operations and reduce the chance of error in our passing of the book-keeping entries. The following points are to be incorporated in the new foreign exchange procedure as agreed to by all units involved, i.e., International, General Accounting, and Auditing.

(1) Clearly defined organizational lines separating trading responsibility from operating responsibility have already been agreed to and established.

(2) In the foreign exchange operations area all contracts should be prepared by one clerk, proof read by another, signed by an operations officer and confirmed by the customer. This procedure is now being followed in the foreign exchange operations area which will be under the supervision of an experienced foreign exchange operations supervisor.

(3) A fanfold form is being designed which will eliminate typing tickets more than once. The fanfold should be serially numbered, with one form for purchases and a separate form for sales. The completed fanfold form should be available by July 1. In the meantime, a temporary fanfold form has been designed to consolidate four separate typings of tickets into one. This form has already been placed into operation. A similar form to meet the requirements of the Bank of England will be designed for use of our London Office.

(4) A written revaluation policy for profit and loss computation will be part of the final procedure which will be ready by July 1.

(5) A system which will utilize a foreign exchange future journal and a customers contingent liability ledger for control of future contracts is being designed. We have already instituted a procedure employing a foreign exchange future journal where outstandings are proved to the general ledger on a daily basis. We expect to have in operation by June 1 a customer contingent liability ledger where all future contracts are posted, initially by hand but subsequently by machine posting.

(6) Deferred settlement accounts for controlling "spot" trades are to be established, together with a related proof procedure. Implementation of this system will be part of the overall final procedure to be put in operation in the International Department. It is hoped that we will have this system in effect by July 1.

(7) A daily report of the trader's position, including a gap report, will be prepared from the accounting records maintained by the foreign exchange operations section and will be submitted regularly to the division head for review. The trader presently provides the division head with a daily position report and regular meetings are held with him to discuss policy and market trends.

(8) Foreign currencies now being handled by the foreign exchange department are to be turned over to a designated foreign current teller. Systems Department will be studying this question and when we move to the World Trade Center we will request that provisions be made to have foreign currency handled at the World Trade Center Branch.

I feel that with the help of the Auditing, General Accounting and System Departments we have made good progress in correcting what can only be described as very serious deficiencies in our foreign exchange operations.

We have met with Ernst and Ernst who have made a number of recommendations which will be incorporated in our final foreign exchange procedure. We plan to review the procedure with them, prior to full implementation, in the event any additional controls are needed.

To help us develop a proper operational system for our London Office which will interface with the bank's domestic operations, we have engaged Peat Marwick Mitchell & Co., both in London and New York, to assist us in this project.

A status report will be sent to you bi-weekly outlining the progress we are making in implementing the procedures and systems that we have outlined above.

GEORGE G. HERRMANN.

FRANKLIN NATIONAL BANK,  
May 3, 1972.

To: Harold Gleason, Chairman of the Board and Chief Executive Officer.  
From: George G. Herrmann, International Division, Hanover Square.  
Subject: Comptroller of the Currency examination as of March 3, 1972.

As a followup to my memorandum of April 24, we are continuing to make excellent progress in the foreign exchange area. Additional developments are as follows:

*Organization*

Mr. John Kruse, Assistant Vice President, was permanently assigned to our division as of May 1 and, as Assistant Operations Officer, is responsible for the foreign exchange operations unit, the cable department, and the International bookkeeping department which includes the posting of the Nostro accounts. On Monday, May 8, an experienced foreign exchange operations supervisor joins our staff, together with an assistant foreign exchange dealer. The foreign exchange operations area now seems to be working smoothly and has been separated from the responsibility of the foreign exchange trader.

*Foreign exchange forward contracts*

There is nothing new to report here since we had already corrected the errors at the time of my last report. All foreign exchange forward contracts outstanding as of March 3 have been confirmed with copies given to the Comptroller of the Currency examiner. All forward sales and purchase contracts are now in proof and are being verified daily to the control account on the general ledger.

*Nostro accounts*

The National Bank Examiners have completed their analysis of the Nostro accounts as of examination date. A recap of their analysis is as follows:

Open items now cleared, resulting in increased income.....	\$325. 2
Open items now cleared which have now been charged to operating expenses covering mostly overdraft interest, telegraphic expenses, commissions, etc.....	\$11, 311
Open items not yet cleared which have been outstanding in excess of 60 days (we have cabled or written letters on all of these items and will clear them as soon as a reply is received from our correspondents). These items are considered as doubtful.....	\$5, 035

General Accounting has now stationed in the International Division two employees of the Financial Division to handle the reconciling and researching of the Nostro accounts. These accounts are now being reconciled as soon as statements are received and the open items checked and cleared as quickly as possible.

*Foreign exchange position limits*

There is nothing further to report in this area. We are studying the establishment of gap limits and aggregate limits and expect to have this matter cleared by our original target date of June 15.

*Systems and forms*

The Systems Department, with the assistance of Peat Marwick Mitchell & Co. are developing systems and forms as reported in my memorandum of April 24. They are making excellent progress in this area and we expect that the target dates outlined in my previous memorandum can be met.

We have just concluded our profit and loss analysis for the period January 28, 1972 to April 21, 1972. Our net profit during that period was \$284,013.36, which has been passed to earnings today. A copy of our analysis is enclosed.

Further status reports will be sent to you bi-weekly as previously indicated.

GEORGE G. HERRMANN.

FRANKLIN NATIONAL BANK,  
INTERNATIONAL DIVISION,  
New York, N.Y., June 9, 1972.

ADMINISTRATOR OF NATIONAL BANKS,  
*Office of the Comptroller of the Currency,*  
Washington, D.C.

Att: Mr. Robert A. Mullin, Director, International Division

DEAR MR. MULLIN: As you will see from the attached memorandum of June 7 addressed to Mr. Harold V. Gleason, almost all of the problems in foreign exchange have now been corrected. We have implemented new systems and procedures and the foreign exchange operation is now running very smoothly.

Copies of future progress reports that are made to Mr. Gleason will, of course, be sent to you as requested.

Very truly yours,

GEORGE G. HERRMANN.

JUNE 14, 1972.

Mr. GEORGE G. HERRMANN,  
*Senior Vice President, Franklin National Bank, International Division, New York, N.Y.*

DEAR MR. HERRMANN: This is to acknowledge your letter of June 9, 1972 enclosing a progress report on the bank's international operations in New York. I am fully satisfied with the bank's foreign exchange operations, as reported. All segments of the operation appear to be operating efficiently and further progress reports will not be required by this office.

Your efforts in correcting a hazardous situation are appreciated.

Very truly yours,

ROBERT A. MULLIN,  
*Director, International Division.*

OFFICE MEMORANDUM

U.S. GOVERNMENT,  
THE COMPTROLLER OF THE CURRENCY,  
*May 31, 1974.*

To: James E. Smith, Comptroller of the Currency.

From: Robert B. Serino, Director, Enforcement and Compliance Section.

Subject: International Banking Department, Franklin National Bank, Investigation into the Foreign Exchange Trading Department.

I. DISCOVERY

On Friday, May 3, 1974, the Franklin Bank was advised by the London Branch that the National Westminster Bank had objected to the volume of Franklin Bank's sterling clearings through their account. Apparently, they had averaged over a period of the prior week between 40 to 60 million pounds sterling per day.

The Executive Vice-Chairman, Mr. Peter R. Shaddick, who was responsible for the International Department of the bank, commenced an investigation and requested that the Senior Foreign Exchange Trader, Vice President Andrew Garofalo, determine what had happened (Exhibit 1). Mr. Garofalo questioned Assistant Cashier Donald H. Emrich, the trader responsible for sterling trading. On May 5 Emrich admitted active trading in sterling in excess of his authorized position and indicated that he had entered into contracts which he neither booked nor reported. Emrich was immediately suspended from the bank.

On May 11, 1974, Mr. George G. Hermann, the Senior Vice President in the International Banking Department, together with Harry P. Barrand, Jr., the Executive Vice President, and others interviewed Mr. Donald H. Emrich con-

cerning this matter (Exhibit 2). Mr. Emrich, the bank's trader in French francs and sterling, admitted that in the middle part of January he started to hide in his desk drawer future contracts for the sale of French francs and sterling. He explained this was done because he had exceeded his authorized limits. He believed that the dollar would increase in value and by making these contracts he would then be able to recoup the bank's losses in these currencies (Exhibit 3).

On May 6 when Emrich was dismissed, a search was made of his desk and it was discovered that there were 12 French franc contracts totaling Fr F. 325MM (equivalent 64,463,692 American dollars) and 27 contracts in sterling totaling 85MM Lb (equivalent U.S. \$132,860,575). Emrich admitted hiding other contracts approximately ten other times and when the contracts matured, he would clear them through the bank's books. Emrich explained that he did not want to take the loss and felt that if he did not disclose his excess position, the dollar would recover and the loss would be eliminated.

Emrich admitted that the profit or loss figures could be manipulated by using the most favorable rates on the Profit and Loss Statement produced at the end of each month's activity.

A review of the profit and loss sheets prepared by the Foreign Exchange Processing Department indicates that the rates inserted by the traders for the future contracts were inserted at figures which were most favorable to the traders and which would reflect a profit or a minimal loss. This occurred not only in the French francs and pound sterling profit and loss statements that were the responsibility of Emrich, but also in several other currencies that Emrich did not trade in. Thus, it is probable that the other traders were responsible for concealing losses. The rates inserted unquestionably were false and Emrich clearly is culpable for inserting false rates for the purpose of concealing the losses.

Based on the concealing of contracts by Emrich and his insertion of false rates in the profit and loss statement, there is no question that he caused false entries to be made in the books and records of the bank and has violated 18 United States Code § 1005. The only question left open at this time is whether or not other traders were responsible for similar acts or whether or not other individuals in the bank participated in and furthered these false reports by Emrich or any other trader.

## II. FUNCTION OF THE FOREIGN EXCHANGE TRADER

The foreign exchange traders negotiate via telephone or telex with banks and brokers all over the world for the purchase and sale of foreign currency. When a contract is completed by a trader, he is responsible for filling out a prenumbered sequential form with the terms of the contract, the foreign amount and the rate at which the purchase or sale was made (Exhibit 4). He then passes the contract, which is in a triplicate form, to the Position Clerk, Mr. Fakhry Hanna. Hanna then posts the contract on a daily activity sheet which he prepares for each currency traded (Exhibit 5). (If a contract is not delivered to Hanna, he would not have any record of its being made, thus if a trader completed a contract and failed to deliver it to Hanna, there would be no record in the bank that a contract existed). After Hanna posts the contract on the daily activity sheet, he delivers the contract to the Foreign Exchange Processing Department, which is physically located outside of the trading room. The Processing Department then completes the contract by inserting the U.S. dollar equivalent, and the payment instructions and returns a copy to the trading room. The Processing Department then prepares a multi-copy form, a portion of which is a confirmation ticket to be sent to the counterparty (Exhibit 6). (The Processing Department also checks out any confirmations that come into the bank from counterparties and verifies any contracts that were made). Copies of the multi-copy confirmation form are also used for posting daily entries to the bank's general ledger.

On the last Friday of each month the Processing Department prepares a profit and loss report for each currency which lists all future contracts by their maturity dates (Exhibit 7).

The purpose of the P & L Sheet is to reevaluate the forward position of the bank at the end of each month. After filling these sheets, they are delivered to the traders in each particular currency. The traders are to insert the present rate for each period of time. The present rate is the rate as established in the

market on the date the P & L Sheet is prepared. Such figures are published in the Wall Street Journal daily and they also come into the bank via telex (Exhibit 8). The rate for the particular date is that established by the market for the future and is not the rate on the contract. The reason for using the market rate is to reevaluate the bank's position as of the P & L date. Rather than using market rates, certain traders inserted rates which were most favorable to them and which would indicate either a minimal loss or a profit. The traders would either insert the rates on the P & L sheet or would insert them on a separate sheet of paper which would be given to the Processing Department. The Processing Department personnel who were interviewed (Arthur Slutzky and Allan Goudey) indicated that they did not check the rates inserted by the traders. The processing people stated that this was the function of the Audit Department. They testified that they would have no knowledge as to the rates. This is incredible to believe as the processing people handle the contracts daily and the P & L Sheets which will be discussed later. The Processing people knew that the rates could in no way be as low as listed. For example, on the sterling sheet prepared by Emrich on April 26, 1974, the contracts coming due for the period April 26-30 have rates listed as 2.09 whereas the spot rate as listed on the bottom of the sheet was 2.43 (Spot rates are contracts maturing in two or three days.)

After the P & L Sheets were prepared and the figures were sent to the ledger as to the profit and loss of the exchange account, the sheets would be sent to the auditors who supposedly were to recapitulate the calculations and to independently obtain the rates. The head auditor, Robert Panapinto, indicated that he did not check the rates at an outside source and that whatever rate the trader set was the rate that was used. The auditor, Panapinto, stated that after the P & L Sheets were prepared, they could be sent to the Auditing Department. The Auditing Department would prepare its own P & L Sheets from the audit copies of the contracts and was supposed to check the rates from an independent source (i.e., N.Y. Times, Wall Street Journal or another bank). Any significant variations were to be called to the attention of the trader for an explanation. Panapinto indicated that on two or three occasions he questioned a trader about rates and on each occasion the trader told him not to worry about it.

Amin I. Amin was the Assistant Auditor and indicates that he questioned the rates on the March 28, 1974 P & L Sheet and was told by Panapinto and others not to worry about them.

### III. FORMS UTILIZED IN THE FOREIGN EXCHANGE DEPARTMENT

Various forms are filled out by the Trading Department clerk, Hanna, which show the contract made in each currency and the position of each trader. These are sent to various people in the bank. If a contract is entered into but is not written up and given to Hanna, the books of the bank will be false.

1. Contract (Exhibit 4)—prepared on a preprinted, prenumbered triplicate form. Prepared by the trader and given to Hanna with the rate, amount, maturity date. This is logged in by Hanna and sent to the Processing Department.

2. Daily Activity Sheet (Exhibit 5)—This is a sheet maintained by Hanna reflecting the contracts and the details. It shows the running position and the position at the end of the day for each currency.

3. Confirmation Contract (Exhibit 6)—Prepared by the Processing Department with copies being sent to the counterparty for confirmation.

4. Nostro Balance Control Sheet—This is kept by Hanna to indicate the future balance maintained by Franklin with other banks (Exhibit 9).

5. Interoffice Letter of Overdraft—This is prepared by Hanna and indicates whether there is an overdraft in any of the bank's Nostro accounts. It is sent to various people (Exhibit 10).

6. Net Position Sheet—This is prepared by Hanna and indicates for each day the Net Position in each currency. It is given each day to each trader so that they will know their position (Exhibit 11).

7. Dealer's Operation Overall Position Sheet—This is prepared by Hanna and indicates the overall position of each currency. This was sent to Messrs. Peter Shaddick, Andy Garofalo and George Herrmann (Exhibit 12).

8. Profit and Loss Statement—This is prepared each month by the operation's personnel to reevaluate the future contract position and determine the profit and

loss (Exhibit 7). The traders fill out the rates. The profit or loss results are posted to the bank's books.

9. Future Diary—Kept by Hanna and indicates for each currency which contracts come due during the week (Exhibit 13).

#### IV. HIDDEN CONTRACTS

When foreign exchange trader Donald H. Emrich (Sterling and French franc trader) was terminated on May 6, 1974, he admitted that he had not booked in in the bank's records many contracts that he had entered into. The reason for this was that he was trying to recoup his losses and did not want to disclose that he had overtraded (been longer or shorter than authorized). By not booking the contracts, the records of the bank were falsified as they did not reflect the true obligation of the bank. Emrich's desk was searched by Garofalo when he was terminated and 39 unbooked contracts were located. Emrich admitted ten other instances where he had unbooked contracts which he would run through the bank's books as "spot" contracts when they matured.

Attached hereto is a list of the 39 contracts located in Emrich's desk which document from December 1973 through May 2, 1974, contracts which were not entered in the bank's records (Exhibit 14). The amount of the contracts are 325 million French francs (64,463,692 U.S. dollars) and 85,387,376 pound sterling (132,086,575 U.S. dollars).

By the failure to enter these contracts in the books and records of the bank, Emrich on each "date of trade" caused the ledger of the bank to be false.

a. *Violation of law.*—For each unbooked contract, this constitutes a violation of 18 U.S.C. 1005. A false entry made to deceive the bank's officers and the Office of the Comptroller of the Currency. The false entry would be the false position of the bank for that day.

b. *Further investigation necessary.*—(1) When a contract was made by Franklin, the Processing Department would prepare confirmation tickets to be sent to the counter party. The counter party would sign and receipt on the confirmation. Likewise the counter party would send to Franklin their own confirmation ticket which was to be receipted for by Franklin and returned. The Processing Department was responsible for checking these incoming confirmations. The counter parties' records are being reviewed to determine whether they had received their own confirmation back and who signed the confirmation.

A request has been made for each of the 39 contracts to see who in the Processing Department had receipted for the contract. Arthur Slutzky has testified that he would check the confirmations with the trader and if the trader said it was o.k., Slutzky would send it back to the counter party.

This is incredible to believe and if it can be established that Slutzky signed counter party confirmation tickets when there was no contract, he could be a defendant because of his actions to conceal the fact that there were unbooked contracts.

#### V. UNBOOKED RECENTLY CONFIRMED CONTRACTS

After May 10, 1974, the bank was notified by counter parties that thirteen (13) other contracts were entered into by the bank (Exhibit 15). These contracts were entered into by the bank, however, no contract was recorded. The contracts were in Swiss francs, Dutch gilder, and pound sterling, with the earliest trade date being December 19, 1973, and the latest being March 29, 1974. Emrich would be responsible for the four contracts in pound sterling. Martin Keroes would be responsible for the two contracts in Dutch guilders. It is believed that the head trader, Andrew Garofalo would be responsible for the seven contracts in Swiss francs. Martin Keroes has testified that it was a mere oversight that he failed to fill out the two contracts in Dutch guilders. The counter party confirmation tickets should be reviewed to determine whether the contracts were acknowledged. Garofalo has yet to testify.

a. If it can be shown that these traders intentionally failed to book these contracts, it would be a violation of 18 U.S.C. 1005. We have no evidence at the present time that it was intentional.

b. (1) Further investigation—same as (b) under hidden contracts (i.e., check counter parties confirmation tickets).

(2) Further investigation: Of the 39 unbooked contracts, several were made with Franklin National Bank's London Office. A review will be undertaken to determine whether these contracts are properly booked in London and whether confirmations were forwarded to Franklin New York.

On May 30, 1974, London National Bank Examiner Kohler indicated that the London office of Franklin holds confirmations on all contracts between Franklin New York and Franklin London. These would include confirmations sent by New York and confirmations originating in London, sent to New York, signed in New York, and returned to London. Mr. Kohler has taken copies of these confirmations and will forward them to the Comptroller's Office. Since these confirmations will include contracts hidden by the bank's former trader, Donald H. Emrich, from December 1973 through May 6, 1974, we may now be able to ask certain individuals in New York how they could sign confirmations for contracts which were hidden in the trader's desk and not on the books of the bank.

Mr. Kohler will also forward copies of the bank's P & L Sheets and the names and addresses of people in New York to whom they were forwarded.

#### A. Sample Unbooked Contract

1. On May 15, 1974, the Bank of America, Amsterdam, by telex, contacted the Franklin National Bank (Trader Martin Keroes) to find out where their 10 million guilders were that were sold by Franklin National Bank on February 13, 1974 (Exhibit 16). The bank reviewed the telex for February and found that a contract had been entered (Exhibit 16-a). The bank searched its files and could not find a written contract. The bank, therefore, filed in a contract (Exhibit 16-b), sent a confirmation (Exhibit 16-c) and sent a telex confirming the delivery.

It is thus apparent that a contract had been entered into, however, no record was made by Keroes. Keroes has testified that he just forgot.

2. On May 15, 1974, the Continental Bank International notified Franklin National Bank that Franklin National Bank had not confirmed a sale to Continental entered on March 11, 1974 for Swiss francs in the amount of 6,000,000 to be delivered on June 13, 1974 (Exhibit 17).

3. On May 13, 1974, the Irving Trust Company notified Franklin National Bank that they had not received a confirmation for a sale by Franklin National Bank on February 13, 1974 of Dutch Guilders in the amount of 5MM for delivery June 17, 1974 (Exhibit 18).

There were several other confirmations from bankers indicating that they had entered into contracts with Franklin National Bank and had not received confirmations or delivery. The auditors of the bank should have a complete list with the documents.

#### VI. FALSE NET POSITION SHEETS

At the close of business each day, the position clerk, Fakhry Hanna, was to prepare a sheet captioned "Overall Position for Major Foreign Currency" (Exhibit 12). This sheet would be submitted to Mr. George Herrmann and Mr. Peter Shaddick. The figures on this sheet showed for each currency what the net position (short or long) was for each currency.

On May 29, 1974, Hanna admitted to Mr. John Kirby of the law firm of Mudge, Rose (representing the bank in its insurance claim) that he was directed by Garofalo (head trader) and Emrich to submit false position sheets to Herrmann and Shaddick. Hanna originally refused and Emrich and Garofalo submitted the false sheets. Hanna then did it when he was told he would be fired.

The law firm has obtained 44 position sheets filed from February 19, 1974 through May 10, 1974 (58 trading days) with Mr. Herrmann and when compared with the daily activity sheet maintained by Hanna (Exhibit 2), there is no question but that the position sheets submitted were false.

Thus, there is no question as to the culpability of Hanna, Emrich and Garofalo and the only question is whether others were involved. It looks like they were trying to hide from Herrmann and Shaddick the fact that they had exceeded their positions.

Garofalo on May 30, 1974, admitted that he directed Hanna to file false position sheets to Herrmann and Shaddick. He indicated that the false sheets were filed in Swiss francs, Deutschmarks and Italian lira. This would indicate that the traders dealing in these currencies were aware of the concealment of positions.

Shaddick cannot be completely ruled out as he was in almost daily telephone contact with Garofalo according to Shaddick's testimony. Likewise Shaddick has, according to his testimony, been in contact at least on two occasions with Garofalo since he was fired.

## VII. PROFIT AND LOSS REVALUATION

The bank as close to the last day of the month prepares profit and loss sheets for each currency (Exhibit 7).

This is prepared by the Foreign Exchange Processing Department (Arthur Slutzky or Allan Goudey). They list on columnar paper all the future contracts that will mature in ten day periods. This is prepared from the Processing Department's copies of the contracts made by Franklin National Bank. For each period they net out the contracts and determine whether the bank is in a long or short position. As shown on the attached P & L Sheets (Exhibit 7), the first column sets forth the period; column number 1 and number 2 sets forth the the purchases in both foreign and U.S. currency; column number 3 and number 4 sets forth the sales in foreign and U.S. currency. Columns number 5-8 set forth whether the bank is long or short.

After this portion of the P & L Sheet is prepared, it will be given by the Processing Department to the trader who deals in the particular currency. The trader is supposed to ascertain from the market or from the newspaper the present rate for the contracts maturing in the future periods. The traders would either insert the rate directly on the P & L Sheet or would write them out on a separate piece of paper. By multiplying the rate times the value, they determine the market value (column number 11) by subtracting the market value from the U.S. dollar value from column number 6 or number 8 the profit or loss is determined for each period. The P & L sheets also have a rate inserted at the bottom for spot contracts (contracts maturing in 2 or 3 days).

After the trader inserts the rates and determines the profit or loss the sheet is then sent to the Processing Department which sends the figures of profit or loss to the general ledger of the bank.

The sheets are then sent to the Internal Auditing Department. The Internal Auditing Department was supposed to prepare their own P & L Sheet from their copies of the contracts and was supposed to independently ascertain the rates. There is much confusion in the Auditing Department as to what they did or were supposed to do.

After Donald F. Emrich was terminated by the bank, he indicated that he had inserted false rates on the P & L Sheets to conceal his losses. A review has been made of the P & L Sheets for March 28, 1974 and April 26, 1974 and it has been determined that many of the P & L Sheets prepared by the traders bore false rates. A high rate shown when the bank was short (net sold position) would put the bank in a better position and a low rate when the bank was long (net purchase position) would put the bank in a better position.

1. Donald F. Emrich, P & L Sheets March 28, 1974—a. British pound sterling (exhibit 19a) P & L Sheet

As well as this sheet failing to list the hidden contracts, Emrich inserted a false rate of 2.16 for the period March 29-31, 1974, and a spot rate of 2.3950. The 2.16 rate was used for all of the periods on the sheet and caused the transactions to reflect a future profit of +4,982,319. When this was combined with the future reversals, spot reversal and Nostro profit it reflected a loss of -626,833.

Outside auditors have recently reevaluated the position with the correct rates as of March 28, 1974, including the hidden contracts and have determined that as of March 28, 1974, the total future loss should have been -5,163,507 as opposed to the profit (+4,982,319) reflected by Emrich (Exhibit 19a-1), a total loss of -10,772,660 rather than -626,833. As can be seen, the rates on the auditing firm's reevaluation are no where near the 2.16 put on the Emrich sheet.

There are blatant problems with the Emrich sheet that should have been detected by the head trader, Garofalo, (Garofalo has testified that he did not review these sheets although this was his responsibility), the Processing Department, Arthur Slutzky or Allen Goudey (Slutzky testified that it was not his job to check the rates—this is an incredible statement—Goudey testified that if he had seen the sheet he would have checked it), or the internal auditors Robert Panepinto—or Amin Amin.

Robert Panepinto indicated that on occasions he would question the traders as to the rates but that this sheet was Amin Amin's job and Amin Amin did not bring it to his attention.

Amin Amin said he worked for Panepinto and that if he questioned an entry, he would speak to Panepinto who was to check with the traders. Amin said he

brought it to the attention of Panepinto as the spot rate was 2.35 even though the March 28 rate was 2.16. Amin said that Panepinto said that he checked and the rate was correct. Amin also testified that he approached Emrich as he was not satisfied. Emrich referred him to Slutzky who said it was alright. Amin believes that Panepinto told Peter Shaddick about the rate. Both Panepinto and Shaddick deny this. Amin Amin's testimony raises substantial questions about this revaluation.

The blatant problems on the sheet are :

- (1) Only one rate of 2.16 was inserted at the top of the sheet. (Amin Amin believes he saw a P & L Sheet with 2.16 filled in throughout).
- (2) The spot rate was 2.3950 whereas the March 29-31 rate was 2.16.
- (3) The statements of Amin Amin should be reviewed and the events and individuals who could corroborate his story should be questioned.

#### 2. Donald F. Emrich, P & L Sheet March 28, 1974—b. French Francs

Emrich's sheet fails to reflect the hidden contracts on this sheet, however, the rates appear to be relatively accurate (Exhibit 19b ; Exhibit 19b-1).

#### 3. Donald F. Emrich P & L Sheet April 26, 1974 (Exhibit 20a)—a. British pound sterling

Emrich's P & L Sheet failed to list the hidden contracts. He likewise used false rates to conceal his losses. For the period 4/26-4/30 he used a rate of 2.09 and reflected spot rates as 2.43. This is impossible and must have been seen by someone.

By using the phoney rates, Emrich reflected a future profit of \$7,108,319 with a total position of a loss of only -527,238. When this was redone by the external auditors on 5/10/74, they reflected a loss of -18,437,278. The April rates should have been for spot 2.41 and one month 2.40, two month 2.39, three month 2.38, six month 2.34, one year 2.28. None of these rates are similar to those used by Emrich which ranged from a high of 2.10 to a low of 2.03. The external auditors have prepared an overlay to show the true rates.

The auditor, Amin Amin, has testified that on the April 26, 1974 reevaluation, he was instructed by Garofalo to prepare a P & L Sheet from his contracts and then give it to the traders for the insertion of the rate. This was different from the normal procedure in which Amin would receive a completed P & L Sheet. While he was preparing the sheet, Arthur Slutzky came and took the position sheets from him. Amin testified that he never again audited this P & L Sheet. Emrich's P & L Sheets are substantially false.

#### 4. Donald F. Emrich P & L Sheet French Franc April 26, 1974 (Exhibit 20b)

The P & L Sheet prepared by Emrich fails to list the hidden French Franc contract. Likewise, the rates used were false. The sheet indicates that the loans maturing on April 29-30 were at a rate of .220 whereas the spot rate was indicated as .200. Using the rates given by Emrich, he came up with a profit of

The external auditors did a reevaluation using the correct rates and determined that \_\_\_\_\_.

#### 5. Martin Keroes P & L Sheet Deutsche Marks (April 26, 1974) (Exhibit 21a)

Martin Keroes was the trader in Deutsche Marks and prepared the rates to be inserted in the P&L Sheets for that currency. The rates he used indicated that he had a future profit of 11,252,122 with a total profit of \$10,111.

He reflected a spot rate on the P & L Sheet of 378 which gave him a spot profit of 181,900 whereas if he used the true spot rate (he obtained these rates after testifying on 5/20/74 (Exhibit 21a-1) for April 26, 1974 he would have used a spot rate of 4065. If he had used this rate, he would have reflected a spot loss of -49,000.

Likewise after utilizing the correct rates, the auditors came up with a total figure in Deutsch Marks of a loss of -4,139,399 rather than a profit of 10,111. Keroes testified he could not understand how he used the false rate. (This is an incredible statement.)

## 6. Martin A. Keroes P &amp; L Sheet Dutch Guilders, April 26, 1974 (Exhibit 22a)

Keroes' P & L Sheet of April 26, 1974 failed to reflect the two contracts that were made by Keroes and not booked. (Both made on 2/13/74 with maturity of 5/15/74 and 6/17/74) (See Exhibit 15). Keroes has testified that he just forgot to fill out a contract form. The telex reflects that Keroes in fact had entered into a contract.

Keroes figures are false for this sheet and he reflected therefore a loss of only —91,105 whereas when this sheet was redone, the loss was —\$1,813,875.

## 7. Andrew Garofalo P &amp; L Sheet Swiss Francs—April 26, 1974 (Exhibit 23a)

Seven contracts made by Garofalo were found to have not been booked and therefore were not reflected on the P & L statement.

The rates he utilized are substantially false. It is noted that his April 25-30 rate was reflected as .310 with his spot being .340. The spot rate at that time was .337. By using the spot rate of .337, he would have reflected a spot loss of —16,146 rather than a spot profit of +23,041. Garofalo reflected a loss of —227,129 whereas the auditors have reevaluated the position and have determined the loss to be —7,548,443.

In evaluating the rates put on the P & L Sheets by the traders and those used by the auditing firm the profit and loss is as follows as of April 26, 1974.

	Traders	Auditing firm same P&L	Auditing firm with total contracts
Swiss francs.....	-227,129	-----	-7,548,443
French francs.....	+224,536	-----	-6,774,950
Pounds sterling.....	-527,236	-----	-18,437,278
Dutch guilders.....	-91,015	-----	-1,613,075
Lira.....	+130,781	-----	-1,558,857
Belgian francs.....	-117,430	-----	-----
Dutch marks.....	+10,111	-----	-----
Canadian dollars.....	-46,619	-----	-46,905
Yen.....	+18,635	-----	+195,707

The external auditors have prepared a reevaluation of all the P & L Sheets in each currency for March 28 and April 26, 1974. When these are compared with the sheets of the traders, they will indicate which of the other traders submitted false rates.

Attached hereto are interviews taken by this Office or by Mr. John Kirby of the law firm of Mudge Rose, Guthrie and Alexander. All interviews taken by the Comptroller's Office were taken after the witness was advised of his constitutional rights and the penalties for false statements 18 U.S.C. 1001. The interviews taken by the Comptroller's Office were taken by Deputy Comptroller of the Currency Robert Mullin and Director of Enforcement and Compliance, Robert B. Serino, except that of Mr. Shaddick which was taken by Messrs. Serino and National Bank Examiner Malay.

Attachment.

## VIII. SUSPECTS AND/OR WITNESSES

Donald F. Emrich : Trader—admitted false rates and bidding contracts.

Andrew Garofalo : Head trader—admitted filing false position sheets.

Fakhry Hanna : Position clerk—admitted submitting false position sheets.

Robert Panepinto : Audit supervisor—denies knowledge of false rates—but see Amin testimony. Perhaps Emrich, Garofalo or Hanna would confirm that he was aware of the false rates.

Amin Amin : Audit clerk—indicates that he tried to have the rates checked.

Martin Keroes : Trader—denies inserting false rates—denies that he intentionally failed to enter contracts.

Paul Sabatella : Trader.

Michael Romersa : Trader—Garofalo has testified that he submitted false position reports in Romersa's currency—lira.

Arthur Slutzky : Processing department—handling of P & L's and incoming and outgoing confirmations. See Amin Amin Testimony.

Allan Goudey : Processing department—handling of P & L's and incoming and outgoing confirmations. See Amin Amin testimony.

Peter Shaddick: Head of International Department. No evidence at this time that he was aware of the false rates or false position. Garofalo and Panepinto could give information in this area.

George G. Herrmann: Senior Vice President—He received the false positions reports but there is no present evidence that he was aware.

Harry P. Barrand, Jr.: Executive Vice President.

Jay Saporta: Position clerk in Trading Room. He has not been questioned. He might be able to confirm Hanna's testimony.

Vincent Franzitta: Proof clerk Foreign Exchange processing department.

Thomas De Feis: Clerk foreign exchange processing department.

I. Franklin National Bank - November, 1973 - October 8, 1974

On November 14, 1973, our Office began a regular examination of Franklin. This examination, which was not to conclude until March 8, 1974, disclosed that Franklin had serious financial problems. These problems included a low-yielding loan portfolio, depreciation in the municipal and investment portfolios, heavy reliance by the bank on short term borrowed funds (so-called hot money) and the bank's poor management. Uncollectable loans totalled \$10 million. The operating income of the bank was poor, which, being public information, affected public confidence in the bank.

Total resources of the bank had grown to \$4,852,999,972, or 29% higher than the previous December 8, 1972 examination. The capital, however, had increased by less than one half of one per cent; demand and savings deposits actually had declined 5.5%. The bank's recent growth had been financed almost entirely by using short term borrowed funds, including time deposits of other banks and money market certificates of deposit. These types of funds totaled \$2.3 billion, or 50% of the bank's liabilities. They had increased dramatically by \$984 million, or 76%, since the last examination. Such borrowed funds are volatile and likely to disappear quickly if creditors have reason to question a bank's stability or soundness.

I instructed Regional Administrator Van Horn by letter of February 22, 1974, to meet with the senior management of Franklin in order to formulate a plan with the bank for remedial action in such areas as reduction in all forms of borrowings, standards of new loan extensions and adjustment of the imbalance between the bank's capital and the size of its operations. Mr. Van Horn met with the senior officers of Franklin on February 28, 1974, and with the Board of Directors on March 28, 1974. The bank agreed to reduce its borrowings

by \$500 million through liquidating \$260 million carried in its bond trading account, selling \$100 million of loans to another bank, reducing new loan commitments, increasing compensating deposits maintained at the bank by borrowers.

On April 18, 1974, Franklin New York Corporation (FNYC) announced net operating income for the first quarter of two cents per share or \$79,000, down from the previous year of sixty-eight cents per share or \$3.123 million. The holding company release stated that income was "adversely affected by the sharp rise in the cost of short-term borrowings needed to carry assets during the 1974 quarter."

On May 1, 1974, the Federal Reserve Board announced its denial of the holding company's application to acquire Talcott National Corporation, a business financing and factoring firm. FNYC had applied for this acquisition on August 13, 1973. The Board decided that "this proposal may constitute an undue drain on Applicant's managerial and financial resources."

On May 10, 1974, the Comptroller's Office and the Federal Reserve Board learned from Franklin that heavy losses in an undetermined amount had occurred in the bank's foreign exchange department. Bank management decided to announce these losses. It was clear that an announcement of this kind would dry up the bank's sources of borrowed funds, thereby creating a severe liquidity crisis. In anticipation, the bank sought from the Federal Reserve Bank of New York a huge loan to cover this expected run-off.

On May 10, 1974, management announced that, in light of the small profit for the first quarter of 1974 and management's estimate for the second quarter, it would recommend that Franklin's Board of Directors not declare the regular dividend on Franklin's common stock and convertible preferred stock.

We advised the FDIC of these events.

Taken together, the bank's April 18 release, the May 1 Talcott turndown, and the May 10 release caused large scale institutional withdrawals and forced the bank to the Fed discount window to obtain the liquidity funds it needed.

At this time, management of the bank and representatives of this Office began exploring merger possibilities. The only possible, immediate merger partner showing serious interest was Manufacturers-Hanover Trust Company of New York. Manufacturers-Hanover in April, 1974 had loaned FNYC \$30 million on a long term basis. After intensive discussions with the officers of Franklin, the management of Manufacturers-Hanover determined on May 12 that an immediate merger was not feasible.

On Friday and Saturday, May 10 and May 11, 1974, an internal review of the foreign exchange department was taking place and by Saturday evening, May 11, 1974, a relatively large loss was estimated. On Sunday, May 12, 1974, Franklin issued a press release, which stated in part:

The bank also reported that its foreign currency exchange department has realized losses since March 31, 1974, of approximately \$2 million. In addition, it has recently been discovered that because of a trader in that department operating beyond his authority and without the bank's knowledge, it will have sustained losses, as of May 13, 1974, of \$12 million, and has potential losses of \$25 million at May 10, 1974 rates.

The bank also noted that earlier in the day on May 12, 1974 Vice-Chairman Mitchell of the Federal Reserve Board, after having been assured by our Office that Franklin was solvent, advised in a press release that "as with all member banks, the Federal Reserve System stands prepared to advance funds to this bank as needed." FNYC asked the Securities and Exchange Commission to suspend trading in its securities. The SEC did suspend trading and conducted an investigation

into the accuracy of FNYC financial statements. Ultimately a lawsuit was instituted by the SEC.

On May 13, 1974, at a special meeting of the bank's Board of Directors, the President of the bank and the head of its foreign exchange department were fired. These events further eroded confidence in the bank so that by close of business on Wednesday, May 15, 1974, the bank's loan at the Federal Reserve window reached \$780 million.

Much of the public attention at that time was focused on Michele Sindona, an Italian lawyer and resident of Switzerland, who had purchased through his holding company, Fasco, 1,000,000 shares of FNYC in July, 1972. This stock constituted 21.6% of the outstanding shares of the common stock of FNYC. Mr. Sindona became a director of FNYC in August 1972.

In view of the public concern over Mr. Sindona's association with the holding company, Mr. Sindona agreed that he would relinquish for one year his rights to vote the FNYC stock held by Fasco and give the sole voting rights to former Treasury Secretary David Kennedy. This was completely agreeable to me and an announcement to this effect was made by Franklin in a press release dated May 12, 1974. Franklin also announced plans to raise additional capital of \$50 million, as well as several major management changes to be put into effect at the bank's Board meeting the next day. On Monday, May 13, the bank accepted the resignations of Paul Luftig, the President and Chief Executive Officer of the bank and Peter Shaddick, Vice Chairman of Franklin in charge of its international department.

On Tuesday, May 14, 1974, a new examination of the bank was commenced in order to update the value of its loans, its securities and foreign exchange position. The May 14 examinations showed large foreign exchange losses, accelerated depreciation in securities and a general lack of improvement in the bank's condition since November 1973.

On May 13, 1974, I requested the member banks of the New York Clearing House Association to explore Franklin's affairs. The purpose of this review was threefold:

- 1) To advise me and my staff as to how other bankers would view the condition of Franklin National Bank;
- 2) To establish a foundation upon which the Clearing House Association members might act to help with Franklin's liquidity problems; and
- 3) To provide information to members of the Clearing House who might be interested in acquiring Franklin National Bank. In this regard, it was agreed that any information received through this processing by members of the Clearing House also would be made available to any non-Clearing House member interested in acquiring Franklin National Bank.

On June 11, 1974, with the encouragement of the Federal Reserve System, an arrangement was reached whereby members of the Clearing House individually would loan Federal funds to Franklin in an amount which aggregated \$225 million.

Meanwhile, efforts had been made to attract stronger management. With my assistance, Mr. Edwin Reichers was brought into Franklin on May 17, 1974, as an Executive Vice President in charge of Franklin's foreign exchange operations. He had for 40 years been with First National City Bank of New York, and headed that bank's foreign exchange operations.

A long search for a new head of Franklin culminated on June 21, when Joseph W. Barr was brought into Franklin as its Chief Executive Officer.

Mr. Barr, who is well known to many members of this Committee as a former colleague in the House, had a distinguished background in the fields of government and finance, having served as Chairman of the FDIC, Under Secretary and Secretary of the Treasury Department, and as the Chairman and Chief Executive Officer of American Security and Trust Company of Washington, D.C. He was well and favorably known by foreign financial institutions, and a man with whom I was confident we could work effectively under most demanding conditions. My confidence in him was fully justified by his performance. Without him and the qualities of integrity, courage, and decisiveness which he brought to bear on the myriad of problems, I frankly doubt that the successful result on behalf of Franklin's depositors could have been achieved.

On July 2, I wrote the FDIC requesting it contact other banking organizations which were potential purchasers of some or all of the business assets of Franklin National Bank. The FDIC developed a plan to assist a prospective purchaser to assume liabilities and purchase assets of Franklin and began negotiations with interested bankers to draft a set of acquisition papers upon which banks could bid competitively in the event the FDIC became the receiver.

In an effort to alleviate further liquidity problems, I requested a meeting of representatives of 17 large U.S. banks to discuss selling Franklin's portfolio of Euro-currency loans. The meeting took place in Chicago on July 22. Some \$300 million of loans were offered for sale. This proved to be an unsuccessful effort, however, because of the interest rates on these credits in comparison with the then prevailing high interest rates, and because of the liquidity problems of all large banks at that time.

In September, Mr. Barr presented the regulatory agencies a plan by which, with substantial assistance from the FDIC, Franklin would retrench, give up most of its national and international business, and become a Long Island bank. I requested the investment banking firm of Blyth Eastman Dillon & Co. to advise us concerning Mr. Barr's proposal. On October 3, the firm advised that the prospects of Franklin's achieving financial viability as an independent banking institution were bleak.

Mr. Barr also suggested that in the event a takeover of Franklin became necessary, it would be beneficial to the interests of the shareholders and to the competitive situation to widen as much as possible the list of potential purchasers. The greatest obstacle to this was the legal situation which limited the list of potential U.S. buyers to New York State-chartered institutions and national banks located in New York. Mr. Barr requested that, not only for this case, but also for the future, Congress should act quickly on legislation which would permit the purchase and operation of banks across state lines where necessary to prevent the probable failure of a large institution. Time did not permit the adoption of such legislation before the end came for Franklin, but I hope that the Congress will soon provide for such a situation.

As a result of continuing negative publicity, continuing deposit decline, and management's continued inability to reduce the loan portfolio, on September 30, Franklin's total borrowings from the Federal Reserve Bank of New York exceeded \$1.7 billion. By the end of September, total deposits were rapidly declining to the \$1 billion mark and total other liabilities, principally borrowings, were rising to nearly \$2 billion. The bank was unable to retain large maturing certificates of deposits or other maturing money market liabilities.

Based on all facts available, including Mr. Barr's proposal which conceded that the bank could not survive without massive government assistance, the Blyth Eastman Dillon report, and the negative reports by the New York Clearing House banks, I concluded that Franklin did not appear to be a viable institution.

On October 4, I wrote to the Federal Reserve bank, briefly reviewing the situation, and asking for the Federal Reserve Bank's views with respect to its continued willingness to lend funds to Franklin. On October 7, the Federal Reserve Bank replied, stating that its emergency credit assistance to Franklin was based on public policy considerations arising from the responsibility of the Federal Reserve System as a lender of last resort and was designed to give Franklin and the concerned Federal bank regulatory agencies a sufficient period to work out a permanent solution to the bank's difficulties. The Federal Reserve Bank also had concluded that the Franklin proposal of September 16, to the FDIC did not offer a feasible means of achieving the continuation of Franklin as an independent, viable bank. The Federal Reserve Bank advised that it would not be in the public interest for that bank to continue its program of credit assistance to Franklin.

It was no longer in the best interest either of Franklin's depositors and other creditors or of its shareholders to wait for further deterioration in the bank's condition, especially when the alternative of the FDIC-assisted purchase of the bank at a price including a substantial premium for a going concern, became available. By October 8, Franklin was no longer the 20th largest bank in the country but had become about the 46th largest bank. Of the 65 banks in its size category (\$1 to \$5 billion in deposits) Franklin had ranked 65th in earning power. This lack of ability to generate earnings, combined with heavy reliance on purchased money, finally created a set of

circumstances which the bank could not bear. On October 8, having become satisfied that Franklin National Bank was insolvent, and acting pursuant to 12 U.S.C. 191, I declared the Bank insolvent and appointed the FDIC as receiver.

In order to protect all of the depositors of Frankl , the FDIC moved immediately to accept bids from several major New York banks upon a pre-negotiated contract wich provided full protection for all Franklin depositors and other normal banking creditors. All bids were opened simultaneously in the presence of the entire FDIC Board of Directors. The high bidder was the European-American Bank and Trust Company, a federally insured, New York State chartered institution owned by six large European banks. The following day every banking office of Franklin was opened at the regular banking hour by the European-American Bank. All depositors in Franklin, including holders of certificates of deposit, savings accounts, time accounts, and checking accounts, automatically became depositors of the European-American Bank. The European-American Bank also assumed all existing liabilities to trade creditors of Franklin. The approval of the purchase and assumption transaction avoided any disruption in service for depositors and increased the chances of subordinate creditors for full repayment of their claims.

In summary, our number one goal was to protect the depositors and the banking system of this country, and that goal was achieved.

[Office correspondence: Strictly confidential]

NOVEMBER 30, 1973.

To: Federal Reserve Bank of New York  
From: David E. Bodner.  
Re Franklin National Bank.

On Wednesday, November 28, Messrs. Page and Weatherstone of Morgan Guaranty called on Mr. Hayes to discuss their concern about the situation that was developing in the foreign exchange market with respect to Franklin. Also present at the meeting were Messrs. Coombs, Timlen, Bodner, and Piderit. Mr. Page said that Morgan had been concerned for some time about the volume of exchange trading being done by Franklin and was no longer prepared to deal in the forward market with Franklin although it was still dealing with them in spot. It was their understanding that a number of banks in New York (mainly foreign banks) also would not take Franklin's name on forward transactions. In addition, they understood that several banks were now refusing to deal with Franklin even on spot exchange. Moreover, it had recently come to their attention that the Deutsche Bank, Frankfurt, had informed Franklin that it would no longer clear for them. In addition, they understood that the Commerzbank, Frankfurt, was considering closing out Franklin and that same day they had received an inquiry from the Dresdner Bank regarding Franklin's credit worthiness. Their understanding was that Franklin had a large forward book which, while balanced overall, contains substantial mismatches in forward dates. In view of the fact that a number of banks now would not take Franklin's name on forwards they were afraid that Franklin could have considerable difficulty in matching up its forward book and might be forced increasingly into the spot market. In addition, they were afraid that the reluctance of other banks to deal with Franklin in forward exchange might spill over into a reluctance by banks to lend Euro-dollars to Franklin, and they understood that Franklin was a heavy user of Euro-dollar funds. With respect to the forward book, Weatherstone suggested that one possibility would be for another bank to, in effect, "take over" Franklin's book and do the necessary offsetting forward transactions for its own account on behalf of Franklin, thereby lending its name. He said, however, that he had not discussed this with Franklin.

At the conclusion of this meeting, it was agreed among the officers of this Bank present that the situation was a potentially explosive one which deserved immediate further investigation to determine the facts. Mr. Hayes then informed Governor Mitchell of the substance of this meeting and also spoke with Mr. Van Horn to coordinate with the national bank examiners. It was also agreed that it would be desirable for me to meet with Mr. Shaddick of Franklin as soon as possible.

I then met with Mr. Van Horn and the foreign examiners of his office who are presently examining Franklin. The examiners were greatly concerned about Franklin's foreign exchange operations in that they felt that Franklin was clearly trading foreign exchange to make a profit rather than to service customers and because they thought the net positions were excessive. In fact, as of the examination date, Franklin had a total book, spot and forward, of approximately \$2.1 billion equivalent with a net over-sold position of about \$60 million. The proportion of business considered spot, that is under ten days, relative to the amount in the forward book was comparatively high. This would tend to confirm that Franklin was having trouble dealing in the forward market and, therefore, was being forced to do more of its business at the spot end of the market. I told the examiners that in my view the total volume of commitments on the books at the examination date did not seem excessive for a bank of Franklin's size compared with what we know about the size of the books of other banks. I also said that trading foreign exchange for profit rather than simply as a service for customers was now common practice among major banks in this country, as it had been for years in Europe, and that, personally, I considered it perfectly appropriate. With respect to the open position, the examiners said that they really had no standards for measuring appropriate size although they were disturbed by Franklin's position. I said that it seemed to me that one would have to look at the potential loss in the position relative to the capital and earnings of the bank, and also that it was important that the senior management of the bank be aware of the size of the position and the potential risks involved. Leaving aside the question of Franklin's relatively low earnings and weak capital position, the

size of the open position relative to the overall size of the bank did not seem to me to be alarming.

Following the above described meeting with the Federal examiners, I met with Peter Shaddick and Howard Crosse at Franklin's head office on Thursday, November 29. I described in a general way the rumors and reports that we have been receiving with respect to Franklin, told them that we were concerned, and that I wanted to get their reaction and discuss how they saw the situation. Shaddick confirmed that many banks will not take Franklin's name on forward contracts and, indeed, spoke of it being virtually impossible for him to do forwards. He said that they had been forced to rely almost exclusively on very short date swaps and that recently he was having trouble doing anything beyond overnight rollover transactions. This of course made it difficult for him to manage his forward position and, in addition, was expensive. He felt that Franklin had not been over-trading and that there was no real justification for banks refusing to deal with him, but he recognized by virtue of the considerable expansion in their foreign exchange activity this year, they had simply used up their lines with most banks. He also recognized that because of Franklin's poor earnings and weak capital position and because of unfavorable reaction in the market place to the Sindona interest in Franklin, banks were reluctant to increase their lines with Franklin. He did not provide me with any figures on his current book except to say that the total contracts outstanding in marks were approximately \$300 million equivalent on each side, with a net over-sold mark position of DM 30 million, and that this was his largest position. I told Shaddick that I had heard from several sources that the Deutsche Bank had refused to clear for Franklin and he confirmed that this was true. He said they had discussed it with Deutsche Bank but were unable to get a clear explanation of that bank's refusal to handle their account any longer except an indication that Deutsche Bank was concerned about the Sindona interest and had become increasingly worried in view of the recent failure of the U.S. National Bank of San Diego. Shaddick recognized that the situation, while merely uncomfortable at the moment, was potentially explosive since there was a risk that banks which now refuse to deal with them on forward contracts could begin to close their Euro-dollar lines and even their Federal funds lines to Franklin. Since Franklin uses about \$1.2 billion in Euro-dollars to fund its London branch operations, a sharp cutback on its ability to get such funds could have serious repercussions on the bank. Shaddick said that their foreign exchange business was almost entirely for their own account and represented a conscious decision of the management to attempt to bolster their weak earning's position and take advantage of tax loss carry forwards through trading in exchange. The exchange operations had in fact been quite profitable and he expected that their current positions would continue to generate profits for the bank.

He did not regard their trading activity as excessive in relation to the size of the bank. I told Shaddick that I agreed that the volume of business on their books and the size of their positions, insofar as he had revealed them to me, did not seem excessive to me given the size of Franklin, I said further that the relevant question clearly was whether his volume was excessive in relation to the willingness of other banks to deal with him, regardless of his judgment or mine on the appropriateness of such position, and from that point of view his volume evidently was excessive, and he agreed that this was the case. I impressed upon Shaddick and Crosse our concern that the situation was a potentially explosive one and that they ought seriously to consider prompt action to rectify it. They said that many of the bad loans that had been made earlier were now off the books, that the fourth quarter earnings would be good, and that they felt there had been a substantial improvement in the overall manner in which the bank was operating. They felt, therefore, that given time the situation would improve significantly. I told them that our concern was precisely whether there would be sufficient time in the absence of positive steps on their part. Shaddick suggested that one possibility that he had been considering was asking one of his friends in the exchange market, such as Lantz of Chase, to do forward transactions on his behalf. This would, of course, involve the willingness of Chase to take Franklin's name for substantially larger contracts than at present. I said that I thought that this might be very useful in enabling them to reduce their presence in the market, but it seemed to me that it might be necessary for them to go beyond that.

We then discussed briefly the question of Franklin's capitalization. They recognize that Franklin is undercapitalized at the moment and that injection

of additional capital would probably help to calm some of the disquiet in the market with respect to Franklin. Crosse indicated that he was in favor of their going to the market even if they have to accept an unattractive price for the stock in order to get funds promptly. At this point, Mr. Luftig joined the meeting. He indicated that he found it very difficult to see how they could go to the market for capital at this point when they would be only able to get a price substantially below the book value of the stock and, moreover, he was concerned as to whether an issue would even be successful. We then reviewed the overall situation once again and I concluded by reiterating our concern about the position and our willingness to be of whatever help that we could. I said that I thought it was essential for them to take some measures to rectify their difficulties in the exchange market and generally reassure the market. I said that it seemed to me that the situation was potentially a very dangerous one for them. How they weighed those dangers against the costs of whatever steps they might consider taking to improve the position was, of course, a management decision for them, but it was my personal view that they ought to seriously consider some early action. I left with the feeling that they recognized the nature of the problem that appeared to be facing them and would attempt to take them in hand soon.

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#### CHANGING CHARTERS—DID THE BANK SWITCH RATHER THAN FIGHT THE FED EXAMINERS?

*First Pennsylvania's Chief Denies Any Such Motive for Move to Comptroller*

##### QUESTIONS ABOUT THE SYSTEM

(By Thomas J. Bray)

First Pennsylvania Bank was for many years a state-chartered institution and a member of the Federal Reserve System. As such, it was regulated by the Fed and the Pennsylvania Banking Department. But in April 1974, not long after an examination by Fed and state officials that produced a strong recommendation for a slowdown in the bank's growth, First Pennsylvania applied for a national charter from the Comptroller of the Currency.

The charter was granted in early June 1974. As a result, the prime responsibility for supervising the bank switched to the Comptroller's office.

High-level Fed officials, some of whom suspected that the switch was prompted by the Fed-state examination, reacted strongly. Arthur F. Burns, the chairman of the Federal Reserve Board, "was furious," says one former insider. Another adds: "We felt it was a pretty clear example of a bank that felt it was getting a little too much criticism from one regulator and thought it might get more consideration from another."

Some sources say it was First Pennsylvania's switch that triggered the remarks Mr. Burns made to a bankers' convention in Honolulu in October 1974 about the present system of bank regulation. Supervision of the nation's 14,000 banks is split among the Fed, the Comptroller, the Federal Deposit Insurance Corp. and state banking authorities. "Even viewed in the most favorable light," Mr. Burns said, "the present system is conducive to subtle competition among regulatory authorities—sometimes to relax constraints, sometimes to delay corrective measures."

##### THE SYSTEM IN ACTION

Whatever the reasons for First Pennsylvania's change of charter, the case offers an intriguing, and relatively rare, view of the bank regulatory system in action.

First Pennsylvania officials reject any implication that the switch was sparked by the Fed-state examination. "That's just plain stupid," says a director of the bank. John Bunting, the bank's chairman, adds: "I don't mean to say that once you've seen one examiner you've seen them all, but the Comptroller's people are just as tough on us as the Fed. Maybe tougher."

Indeed, First Pennsylvania, the nation's 19th largest bank, was listed on the Comptroller's "watch" list of problem banks at the end of 1974. The bank also made the Comptroller's 1975 list.

Mr. Bunting himself says that First Pennsylvania sought a national charter to escape certain aspects of its prior Fed and state supervision, particularly the

state's power over the establishment of new branches. Some sources note that the switch came in the midst of a nationwide Fed campaign to force banks to increase their capital because of worries that the banking system had overextended itself in the boom years of 1972 and 1973. The Comptroller tended to take a more liberal view of capital adequacy.

The story of First Pennsylvania's regulatory relationships also may reflect a conflict between two strong personalities—the Fed's Mr. Burns, an elder statesman who takes a dim view of the growth cult among bankers, and First Pennsylvania's Mr. Bunting, a brash, assertive young executive who was determined to convert an essentially regional bank into a national powerhouse among financial institutions.

#### A HIGH PROFILE

Mr. Bunting, a former economist with the Federal Reserve Bank of Philadelphia, joined First Pennsylvania in 1964. In 1968, he leaptfrogged over several other executives to become president. In 1971, he was named chairman and chief executive of both the bank and its parent holding company, First Pennsylvania Corp.

Mr. Bunting emphasized diversification, aggressive lending strategies and earnings growth. Between 1968 and the end of 1973, assets more than doubled, to \$5.28 billion. Net income increased to \$43.3 million from \$20 million.

First Pennsylvania also adopted a high public profile. Analysts were invited to Philadelphia frequently for rundowns on the bank's successes, and Mr. Bunting traveled often to other cities to spread the word. A favorite pitch: that First Pennsylvania's stock should carry at least as high a price-earnings multiple in trading on the Big Board as the New York banks did.

Fed officials in Washington weren't altogether enthusiastic about Mr. Bunting's attention-getting schemes and banking policies.

#### A DAY OF RECKONING

"Every time you'd pick up the paper," there would be another article about Bunting running off somewhere to give a speech," says one Fed source. "You had to wonder who was running the bank. I remember (one of the Fed's seven governors) saying, 'This guy Bunting is a wild man. We ought to get a harness on him.'"

The opportunity wasn't long in coming. On Sept. 7, 1973, examiners from the Fed, accompanied by Pennsylvania Banking Department examiners, arrived for the annual surprise examination. The findings of that examination are secret, but a look at First Pennsylvania's public financial reports issued around that time indicates what the findings must have been. Loan volume, for example, had been growing 20% to 25% a year since 1971, yet reserves to cover bad loans had actually declined somewhat—fine if management was making only good loans, but risky if it wasn't or if the economy suddenly turned sour.

Moreover, to support the rapid loan growth, First Pennsylvania had become increasingly dependent on such sources of funds as certificates of deposit (negotiable receipts for short-term interest-bearing deposits) and so-called "federal funds" (uncommitted reserves that banks lend one other). Some Fed officials worried that such sources might dry up in a pinch and leave a bank unable to meet its commitments.

Also, as of Sept. 30, 1973, First Pennsylvania's ratio of capital (stockholders equity, subordinated notes and loan-loss reserves) to "risk" assets (total assets, primarily loans and investments, less cash, time balances with other banks and U.S. government securities) was only 8%. The Fed usually regards any bank with a ratio of less than 12.5% as undercapitalized. That's no small matter. Capital is a bank's cushion against disastrous loan losses or other serious reverses.

The examination was completed near the end of the year. When the results circulated in Washington, there reportedly was consternation. "We were very alarmed at that point," a source recalls. "All the ratios appeared under strain."

In early February 1974, a Federal Reserve governor wrote a letter backing a suggestion that the Federal Reserve Bank of Philadelphia meet with First Pennsylvania's directors and review the results of the exam. Fed examiners normally meet with management to review their findings, but in cases where the bank is deemed to have unusual problems, a meeting with directors is also sought. Such a meeting had never before been requested during Mr. Bunting's tenure as chief executive.

Obtaining the meeting apparently wasn't easy. "Bunting used every device he could think of" to avert or put off a meeting, according to a source close to the situation. Finally, a letter was dispatched across town seeking a definite commitment, say several sources. Back came a letter, a source says, saying that "his directors wouldn't understand the technical language" used by examiners and that "he himself should be the one to tell his directors about the results of the exam."

The Fed persisted, however, and in late March a meeting was finally held. The examiners strongly suggested that the bank slow its growth and improve its capital position. Mr. Bunting describes the meeting as "blunt but not acrimonious." A regulatory source says, "The examiners read the riot act and Bunting didn't say a word." Behind the scenes, however, Mr. Bunting was already taking steps to change the bank's regulator. In early March, soon after the Fed began seeking the board meeting, a delegation of First Pennsylvania representatives went to Washington to meet with officials of the Comptroller's office to obtain procedural information about applying for a national charter. And in mid-April, three weeks after the board meeting, First Pennsylvania issued a press release announcing that directors had approved an application for a national charter.

The charter was granted by Currency Comptroller James E. Smith and became effective in early June. The bank's name, formerly First Pennsylvania Banking & Trust Co., became First Pennsylvania Bank. (The holding company's other operations, a small proportion of the total remained under the Fed.)

#### CHAIRMAN'S VERSION

Mr. Bunting, in an interview, denied that he tried to put off a board meeting with the Fed and state examiners. He said he couldn't recall any exchange of letters with the Fed on the subject. He also denied that there was any connection between the meeting and the decision to seek a national charter.

"We'd been thinking about taking a national charter ever since I've been at First Pennsylvania," he said.

The real reason for the switch, Mr. Bunting said, was that branch applications from national banks are judged only by the Comptroller, who historically has favored extensive branching. Branch applications from state banks, however are subject to approval of state banking authorities. Mr. Bunting said that First Pennsylvania had had problems in obtaining state clearance for new branches because Pennsylvania banking officials tended to be protective of smaller banks and other financial institutions.

A branching decision by any regulator, state or national, has to conform with state law. In Pennsylvania's case, that means that banks may branch only in counties adjacent to their headquarters. But in 1973 and 1974, Mr. Bunting noted in the interview, Gov. Milton Shapp was pushing for a law permitting banks to put regulator-approved branches anywhere in the state. The proposal was never enacted, but the prospect of its passage, Mr. Bunting said, spurred First Pennsylvania to switch charters so as to keep up with national banks in the expected competition for new locations.

Also, Mr. Bunting said, "right at that time there was a tripping incident" that made up his mind to seek a national charter. An application by First Pennsylvania for an Allentown branch was turned down by the state, and "two or three weeks later a national bank went in there."

#### A DIFFERENCE OF A YEAR

The Allentown application, however, had been turned down in May 1973, nearly a year earlier. A similar application by First Pennsylvania had been turned down in 1971. Of 19 other First Pennsylvania branch applications since 1969, the state has rejected only two.

First Pennsylvania's 1973 annual report, issued in March 1974, discusses the possibility of statewide banking and says: "We have a mature branch system which covers Southeastern Pennsylvania thoroughly, a portion of the state we consider the most desirable. This permits us to wait with equanimity for statewide banking." No mention is made of applying for a national charter.

First Pennsylvania did take steps to comply with the wishes of Fed examiners. It began to rein in its growth. Loan growth slowed to 7% in 1974's second quarter and to 3% in the third quarter. The bank's borrowed funds declined slightly in the second quarter in comparison with the first quarter (though they were still nearly

double the year-earlier figure). Applications for approval of the acquisition of two small loan companies were withdrawn in August 1974.

"The examiners' advice was good, and we took it," says Mr. Bunting, who notes that many other big banks were in even more precarious condition.

(Even so, a number of sources close to the Federal Reserve System profess shock that Comptroller Smith—who at that time was presiding over the failure of two large national banks, Franklin National of New York and U.S. National of San Diego—would accept an application from yet another troubled institution. "First Pennsylvania's troubles weren't anywhere near as great," says one, "but if I had been Smith, I would have told First Pennsylvania to stay right where it was until its problems were worked out.")

Some sources close to First Pennsylvania say management felt that, over the long run, regulation by the Comptroller might simply be less confining than Fed and state regulation. One source says:

"I think Bunting was embarrassed by the board meeting and tried to slap back at the Fed by switching charters at that time. But it was something he had been thinking about for a long time."

(Mr. Bunting denies any embarrassment, but agrees that a switch had been under consideration for some time.)

The differences between the Fed and the Comptroller are subtle but important, observers say. For one thing many bankers say it's easier to deal with the Comptroller's office, where decisions are a one-man affair than with the Fed, with its seven governors and 12 quasi-independent branches.

"You can call up Smith and get a reading on a matter you're concerned about," says one Philadelphia banker. "With the Fed, you're never quite sure where you stand until a final order is issued."

Also, the Fed, under the stern traditionalism of Chairman Burns, has projected an image in banking circles of being more restrictive and hostile to innovation than the Comptroller. The Comptroller, for example, allows banks to count subordinated debt as capital; the Fed prefers to leave it out when testing a bank's solvency. The Comptroller also has warmly embraced such technological innovations as remote banking terminals that could be placed in shopping centers. The Fed has been cool to such ideas.

#### CALLS ON CAPITAL

At the time of First Pennsylvania's switch to a national charter, the Fed "was much more concerned about capital adequacy than the Comptroller," says one former Fed governor. In early 1974, numerous calls were made by the Fed's chief of bank supervision, Brenton Leavitt, to banks' chief executives suggesting in no uncertain terms that additions to capital would be welcome in the wake of the rapid expansion of 1972-73. (The phone calls became known in banking circles as Leavitt-tation calls.)

It isn't surprising that a man of Mr. Bunting's aggressive temperament might find the Comptroller more compatible under such circumstances. But many critics of the bank regulatory system fear that the ability to switch regulators leads inevitably to a deterioration in standards. They argue that a unified regulatory system is needed.

Others, Mr. Bunting included, disagree. They say a unified system would likely be a creature—and therefore a captive—of Congress, and thus more subject to passing whims.

As for First Pennsylvania, it has had rocky going since it became a national bank in June 1974. Net income in 1974 declined to \$35.7 million from \$43.3 million; in 1975, it declined again, to \$18.2 million. Recently Mr. Bunting predicted a gain for 1976 as a whole.

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[From the New York Times, Feb. 17, 1976]

#### 63—SAVINGS UNITS ON "PROBLEM" LIST

BANK BOARD SAYS 15 UNITS ARE LIKELY TO REQUIRE AID OF GOVERNMENT; TOTAL WAS 51 IN 1974; 48 INSTITUTIONS ARE SAID TO "GIVE CAUSE FOR MORE THAN ORDINARY CONCERN"

WASHINGTON, Feb. 17 (AP)—A Government agency reported today that 63 savings and loan institutions were listed as "problem institutions" in 1975.

A spokesman for the Federal Home Loan Bank Board said 15 of the institutions were in the most serious category where they are considered as likely to require government financial help unless "drastic changes" occur.

The remaining 48 on the list are in a less serious condition but "give cause for more than ordinary concern and require aggressive supervisory attention," the spokesman said. He declined to name the institution.

#### DEPOSITS INSURED

The bank board is the Federal regulatory agency for the 4,079 state and federally chartered institutions whose deposits are insured by the Federal Government.

The number of institutions on the problems list is up from 1974, when the total was 51, but below the 96 problem institutions reported at the end of 1970.

The spokesman said the current number was not considered by the bank board. He said the board stepped up its supervision of the institutions that were listed as problems.

He also said that since the regulatory system was established in 1934 there had been only 110 cases where the bank board had had to extend aid to a savings and loan institution.

There were only 13 instances where a savings and loan institution actually failed and went into receivership, he said. "The others were either saved or a good part of them saved through merging into stronger institutions," he added.

#### GRANTS MAY BE MADE

The most common form of Government aid to problem institutions is through "contributions," which are grants from the agency do that not have financed by insurance fees paid by the savings and loans [sic].

A total of \$450 million in contributions has been made in 59 different cases, the spokesman said. The agency also makes loans and may purchase questionable assets from institutions in trouble.

The making of a contribution is an avenue of aid that is not available to banks, where several problem institutions to banking regulatory agencies [sic].

The spokesman said Congress granted the Federal Home Loan Bank Board System greater flexibility for providing help because savings and loan institutions could be hurt more by events over which they had little or no control." The 63 problem institutions listed at the end of 1975 had assets totaling nearly \$5.6 billion, which was 1.7 percent of all assets of insured institutions, totaling \$330.3 billion.

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[From the New York Times, Feb. 22, 1976]

#### A 'PROBLEM' BANK GOES UNDER—HAMILTON NATIONAL'S FAILURE WAS THIRD LARGEST

(By Fred Travis)

NASHVILLE—Two weeks ago the Comptroller of the Currency, James E. Smith, told a Senate committee that there were seven national banks in "immediate" danger of collapse. Now there are six.

Last Monday one of the seven—the Hamilton National Bank of Chattanooga—went under. Hamilton was Chattanooga's largest, oldest and most prestigious bank, and the flagship of Hamilton Bancshares Inc., a holding company with interests in Tennessee and Georgia.

Hamilton Bancshares itself filed for bankruptcy four days later, along with three of its non-banking subsidiaries.

The failure of Hamilton National was the third largest bank failure in United States history, surpassed only by Franklin National Bank in New York last year and the United States National Bank in San Diego in 1974.

Rumors of trouble accelerated early this month with reports that the Federal Deposit Insurance Corporation was actively searching for a merger for the Chattanooga bank.

A year before its collapse, Hamilton National Bank was the sixth largest in Tennessee. Before formation of Hamilton Bancshares, the Chattanooga bank had been the flagship of Hamilton Associates—a group of East Tennessee banks that

joined together early in the 1930's to weather the Depression. Hamilton Associates confined itself almost entirely to banking and directly related activities. Hamilton Bancshares started new ventures and just three years ago the organization was cited before the Tennessee legislature as a fine example of what a bank holding company can do to provide a large and flexible supply of credit. But it was these ventures, especially those in real estate investment, that led to the collapse.

During the holiday last Monday 150 F.D.I.C. agents swooped upon the 71-year-old Hamilton Bank in downtown Chattanooga and its 22 branches and seized the assets.

The Comptroller of the Currency's lawyers immediately filed a bankruptcy suit in Federal District Court and an hour later Hamilton's assets were sold to First Tennessee National Corporation, a Memphis-based bank holding company. First Tennessee offered \$16.3 million for selected assets of the bank, but the price is subject to adjustment after more study of the assets and ultimately may be reduced to as little as \$7.5 million. On Tuesday it opened as the First Tennessee National Chattanooga. Top executives of Hamilton National were replaced by new officials from the Memphis holding company but otherwise the institution resumed normal operation.

George W. Hill, chief of the F.D.I.C. Division of Liquidation said the failed bank's stock is virtually worthless.

The Comptroller's affidavit noted: "The poor condition of Hamilton National was directly attributable to the large number of real estate loans originated or acquired from Hamilton Mortgage Corporation." (Hamilton Mortgage was one of the subsidiaries that filed for bankruptcy along with Hamilton Bancshares.)

An examination of bank last September, the affidavit said, showed that assets acquired from the mortgage subsidiary accounted for 87 percent of those assets of the bank which were considered to have questionable value.

The heavy losses of Hamilton Mortgage had also been a drain on the parent company—Bancshares. At one time Hamilton Bancshares controlled about 20 banks, but almost half of them were sold off in a desperate search for cash to offset the mortgage company's losses. By last Monday, Hamilton Bancshares was down to 11 banks, and two of these—in Nashville and Memphis—were sold later in the week to a growing banking group in which the dominant figures are Jake Butcher of Oak Ridge and his brother C. H. Butcher Jr. of Knoxville.

In New York it was reported before the bankruptcy occurred, that Hamilton Bancshares might have to sell some of its remaining banks to reduce its debt to a syndicate headed by Manufacturers Hanover Trust Company of New York. Most of the stock in Bancshares banks had been pledged as security for loans—reportedly less than \$75 million—obtained in an effort to keep the parent and Hamilton National Bank in business.

[Interoffice letter]

To: Mr. Andrew Garafalo, Assistant Vice President, Foreign Exchange.  
From: George A. Hermann, International Division.

AUGUST 27, 1973.

Subject: Foreign Exchange Position Limits.

Mr. Shaddick's instructions of Feb. 15, 1973, cancelling all previous foreign exchange position limits and requiring that approval for overnight positions be given by either Messrs. Shaddick, Barrand or me, is hereby rescinded.

The following overnight foreign exchange position limits have now been authorized by Mr. Shaddick and are to take effect immediately:

Sterling	-----	5 million
Deutsche marks	-----	25 million
French francs	-----	25 million
Swiss francs	-----	25 million
Guilders	-----	10 million
Canadian dollars	-----	5 million
Lira (U.S. \$ equivalent/million)	-----	2.3 billion

If you anticipate being in excess of these overnight position limits please refer the matter to either Messrs. Shaddick, Barrand or the undersigned for approval.

[Interoffice letter]

To: Mr. Andrew Garafalo, Assistant Vice President, Foreign Exchange.  
 From: George G. Herrmann, International Division.

NOVEMBER 29, 1973.

Subject: Foreign Exchange Position Limits.

The limits approved by Mr. Shaddick as set forth in my memorandum of August 27 are hereby cancelled. The following overnight position limits have now been authorized by Mr. Shaddick and are to take effect immediately:

Sterling .....	2.5 million
Deutsche marks.....	12 million
French francs.....	12 million
Swiss francs.....	12 million
Guilders .....	5 million
Canadian dollars.....	2 million
Lira (U.S. equivalent \$2 million).....	1.2 billion

These position limits are to be strictly maintained, but if you anticipate being in excess of these overnight position limits due to unusual circumstances, please refer the matter to either Mr. Shaddick or the undersigned for approval.

OCTOBER 7, 1974.

To: Secretary William E. Simon.  
 Thru: Deputy Secretary Stephen S. Gardner.  
 From: James E. Smith, Comptroller of the Currency.  
 Subject: Sale of the Franklin National Bank.

As you are aware, for the past five months the FDIC, the Federal Reserve Board, and the Comptroller have been searching for a solution to the unstable condition of the Franklin which would protect all depositors of the bank and which would minimize the impact of the bank's probable demise upon the confidence of the public in the banking system. We believe that a solution has been devised which will achieve these two goals. The prospects appear to be good that we will obtain on Tuesday, October 8, satisfactory bids from one or more of four large banking organizations for the purchase of a substantial portion of the assets and all of the deposit liabilities of the Franklin. Deposit liabilities presently approximate \$1.4 billion. The transaction contemplates that the depositors will have uninterrupted use of their funds, with the acquiring bank opening all of Franklin's offices and accounts as their own the next morning.

We are assured of bids from two of the four banks: Manufacturers Hanover (\$18 billion) and European American (an association of six large European banks with combined assets of \$85-90 billion). We believe that two additional banks, Chemical Bank (\$16 billion) and First National City Bank (\$38 billion) will also probably bid on the Franklin.

Citibank has voluntarily suggested that, if it should be the successful bidder, it would divest or close 45 of the branch offices within 24 months to reduce anti-competitive effects. The Anti-Trust Division is not entirely satisfied with this proposal, although it has assured Citibank it will not sue. However, Anti-Trust may endeavor to persuade me, in the conduct of my duties under the Bank Merger Act, or the receivership Court to reject a Citibank assumption if European-American makes an acceptable bid close in amount to Citi's. My present thinking is to approve a Citibank takeover if it is in fact the high bidder. I believe that the Franklin debenture holders and shareholders will have a legitimate complaint if the high bid is not approved.

The procedure for this acquisition will be for the interested banks to submit to the FDIC on Tuesday morning their bids for the assets and liabilities package, on the assumption that I will declare the Franklin insolvent later on Tuesday. If there is a satisfactory bid, I will in fact declare the bank insolvent at 3 P.M. Tuesday, appoint the FDIC as receiver, and the FDIC will immediately proceed to accept the most satisfactory bid. The bid amount will be the premium for the going concern aspects of the purchase. The assuming bank will be allowed to "cherry pick" all of Franklin's assets (including those securing the FRBNY loan) to obtain assets equal to the deposits and other liabilities it will assume. The FDIC will give an interest-bearing note to the Federal Reserve Bank of New York for the release of its \$1.7 billion note of the Franklin and receive in

return the \$2.0 billion in assets of the Franklin being held by FRBNY as collateral. The FRBNY note will be paid out as the assets are liquidated by the receiver. Any balance remaining at the end of three years will be paid in a single payment by the FDIC. Any net return to the FDIC from the premium and the assets, after paying the note to the FRBNY and covering the FDIC's receiver costs, would be applied to the claims of the bank's creditors.

If none of the bids received should meet the FDIC's minimum figure, I would not proceed to the declaration of insolvency on Tuesday. The regulators would have to reconsider the possibility of an expensively-assisted Franklin continuing independently, versus the alternative of a payout. However, on the basis of our present knowledge of the bidding banks' intentions, I consider the possibility of receiving no adequate bid as very remote. The FDIC's minimum figure is required by statute to be sufficient to assure that in all probability the assisted sale will result in a lower cost to the government than a payout on the closed bank. We expect to receive bids comfortably above the FDIC's calculated target.

Assuming that the receiver has accepted a satisfactory bid on Tuesday shortly after 3 P.M., we will proceed to a pre-briefed federal judge who will hear the receiver's and the Comptroller's arguments as to the necessity and fairness of the proposed purchase-and-assumption transaction, and presumably he will approve it. The Comptroller's affidavit will contain an extensive explanation of the circumstances leading to the declaration of insolvency, including the temporary nature of the Fed's financial assistance and their recent determination in a letter to me that it is not in the public interest for the note to continue to remain un-amortized, a condition which the Franklin cannot remedy in the foreseeable future. Also described will be the effort made by all parties concerned to develop a resolution of the problem in the form of the continued existence of the Franklin with certain FDIC financial assistance; after extensive study it was concluded that the cost would be too great for the FDIC. I also had Blyth Eastman Dillon analyze the financial prospects for Franklin if it received substantial FDIC assistance, and they concluded that there was no realistic prospect even then that the bank would become financially viable in the foreseeable future.

Because of the possibility of immediate litigation for a restraining order from some shareholders and creditors, the whole transaction must remain undisclosed until shortly after 3 P.M. Tuesday. The increasing prospect of advance restraining litigation and the possible dissolution of the remaining going-concern value of the bank is one of the key factors in the decision to press ahead with the bidding procedure at the earliest time. We will notify interested members of Congress shortly after 3 P.M. Tuesday.

In conclusion, I should point out that the Franklin situation is a relatively unique one that we do not expect to see repeated. It had a ten-year history of only marginal existence as a New York City bank and an unimpressive management reputation that undercut confidence in it in financial circles. Most importantly, it had expanded in the purchased money area during 1973 at an incredible rate, leaving it no ability to handle the tight money situation and the "move to quality" by money market participants. At the time our November 1973 examination revealed to us the serious state of affairs at the bank, about 50% of its liabilities were in the form of purchased money. We have no other banks in such a drastic and unfavorable configuration as Franklin was, and the greatly heightened awareness of both bankers and examiners to the importance of liquidity should help prevent future over-extension in this area. In addition, our agency's own analytic and predictive skill in the liquidity area is being expanded by an extensive liquidity data collection program, which we will analyze ultimately with computer models. Our Haskins and Sells study will also equip our agency during the next year to better detect and deal with problem banks generally, and particularly to curtail major problems in their incipient stages.

