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PREPARATION OF REPORTS OF CONDITION WITH EMPHASIS ON ITEMS PERTINENT TO COMPUTATION OF ASSESSMENT

By

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Mr. Chairman, Ladies and Gentlemen, the Federal Deposit Insurance Corporation sincerely appreciates your invitation to provide a speaker at this meeting of the local chapter of NABAC and I deem it a pleasure to be chosen as the emissary for the task.

When talking with Mr. George W. Hirshman about this we felt that it would be pertinent to provide some interpretation of reports of condition, at least certain parts, and assess some of the background responsible for the present changes in the rules and the forms. Before plunging into this highly technical subject with careless abandon a confession or two is in order. I am a bank examiner and appear before you in essentially that capacity. I am not an attorney, able to give legal interpretations to questions that may be bothering you. Neither do I have technical experience in working with the Assessment Audit Branch of the Corporation. I shall endeavor on the other hand to give you my understanding of the matters comprising the field of the subject.

This might very well be termed a "bikini speech." Oh yes! there are bikinis in speeches too, at least by this definition of a bikini -- what it reveals is important; what it conceals is vital.

In July, 1960, the Federal Deposit Insurance Act was amended to provide for a simplified method of determining deposit insurance assessments from Reports of Condition and for other purposes, which became effective January 1, 1961, and was applicable to assessments due after January 15, 1961.

In January, 1961, the Corporation's Rules and Regulations were amended to implement the new method of determining deposit insurance assessments for other purposes. Further amendments were made effective January 1, 1962.

Under this law assessments are now based on the average of deposit liability reported by insured banks on two Reports of Condition in each semi-annual period with authorized deductions of 16 2/3 per cent of demand deposits and 1 per cent of time and savings deposits. A technical matter like deposit insurance assessment does not lend itself to complete simplification, nevertheless information received by the Corporation shows that in the over-all the banks are finding that the new method of determining deposit insurance assessments is a definite improvement and that most questions arising at present will be resolved within a relatively short time. Perhaps some of your questions will be resolved this evening as we are able to discuss these problems. Frankly, we wish that there prevailed here the concise simplicity of the little boy who was asked to write a brief essay on the life of Benjamin Franklin. He came up with this gem:

> "He was born in Boston, traveled to Philadelphia,
> met a lady on the street, she laughed at him,
> he married her and discovered electricity."

As a prerequisite to arriving at an understanding of the new assessment method there is needed an understanding of the following:

1. Section 3(l) of the FDI Act defining the term "deposit."
2. Section 7(a) of the Act relating to Reports of Condition by insured banks and prescribing the deposit liabilities to be reported thereon.
3. Section 7(b) of the Act which sets forth the assessment requirements and the method of determining the assessment base.

4. Part 327 of the Amended Rules and Regulations of the Corporation which is applicable to all insured banks whose books do not reflect in deposit controlling accounts in the general ledger as of the close of business each day all debits and credits.

5. Revised instructions for the preparation of Reports of Condition which include detailed information concerning the reporting of items for assessment purposes.

As you know, Call Reports of Condition required to be made to the Comptroller of the Currency, the Federal Reserve Banks, and the Federal Deposit Insurance Corporation, now serve as a basis for determining deposit insurance assessments.

These Reports of Condition have now been revised to conform with the new provisions of the statutes and the amended Rules and Regulations relating to the new method of determining deposit insurance assessments.

Section 7(a) of the Federal Deposit Insurance Act now requires each insured bank to make not less than four Reports of Condition annually upon the dates selected, two of such dates to be within each semi-annual period of the calendar year. Four such calls and reports were made in 1961, as you recall, the dates being April 2, June 30, September 27, and December 30.

Each insured bank shall report in Reports of Condition the total amount of the liability of the bank for deposits in the main office and in any branch, located in any State of the United States, the District of Columbia, any Territory of the United States, Puerto Rico, Guam, or the Virgin Islands, according to the definition of the term "deposit" in Section 3(l) of the FDI Act, without any deductions for indebtedness of depositors or creditors or any deduction for cash items in the process of collection drawn on others than the reporting bank, except for the following prescribed exclusions:

1. Reciprocal bank demand deposits shall be reported net. In determining the net amount, the reporting bank's book balances and not its collected balances should be used, but such balances should include any cash items in the process of collection, due from, or due to such bank and should not include trust funds deposited by either bank.
2. Deposits received in any office of the bank for deposit in another office of the bank may be excluded from the total deposits in the Report of Condition, but if so excluded shall be separately stated in Schedule FDI.
3. Outstanding drafts, including advices or authorizations to charge the reporting bank's balance in another bank, drawn in the regular course of business by the reporting bank on the other bank need not be reported as deposit liabilities, and,
4. Trust funds held in the bank's own trust department which are kept separate and apart from the general assets and which are not used in the conduct of its business shall not be included in the total deposits, but shall be separately stated in Schedule FDI.

Some banks in the past consistently incorrectly included accounts defined as deposits as "other liabilities" on the Reports of Condition. It is now essential that these deposits be reported as "deposits" and not as "other liabilities." These accounts are, but not limited to, the following:

1. Proceeds from the sale of savings bonds.
2. Withheld taxes, social security taxes, sales taxes and similar items.

3. Cash collateral funds held as dealers' reserves or cash collateral for securities loaned by the bank.
4. Mortgages or other excros funds such as funds received for the payment of taxes, insurance, etc., mortgage deposits, mortgage credit balances or suspense accounts.
5. Incomplete loans representing the proceeds of loans for which borrowers are liable and pay interest thereon, including funds deposited by the borrower in such account, and
6. Special deposits.

Item 3, cash collateral funds held as dealers' reserves needs some clarification as there has been some lack of uniformity among the banks in reporting as deposits "dealers' reserves." I'm not sure that the practices next described are common to banks in this area. Nonetheless, the principles involved are basic, and, with the illustrations, the discussions may remove some present or even future doubt as to the manner of handling. I do realize that there has been a major change in the method of treating this, so these remarks may help to put your mind at rest. The area of misinterpretation is in respect to the so-called "dealers' reserves" and "dealers' differential" accounts. Classification of this type of account as between deposits and other liabilities is <u>whether or not the reserve account is created out of the full purchase price of the paper and not the manner in which it is handled on the books of the bank.</u>

By way of illustration, if the bank purchases $100,000 in notes from a dealer for their face amount ($100,000) and pays to the dealer ninety per cent (less commission) of such purchase price in cash, or credits the same to his deposit account and credits the balance (10%) of the purchase price to the dealer in a contract or dealers' reserve account which account is not subject to withdrawal but is held as collateral security or for other purposes such a reserve account constitutes a deposit liability.

The dealers' reserve in this illustration is a deposit for Reports of Condition and for certified statement assessment rather than an "other liability."

On the other hand where the bank purchases from the dealer $100,000 worth of paper for a total purchase price of $90,000 and pays to the dealer the full purchase price in cash or credits the same to his deposit account and the difference between the purchase price and the face amount of the paper is set up on the books of the bank in a memorandum account as a potential margin of security, such a memorandum account, commonly referred to as a differential account, is not a deposit liability; except that (1) when the payments received on any paper purchased aggregate an amount in excess of the purchase price plus interest or discount, any such excess which is not paid over to the dealer or credited against his indebtedness constitutes a deposit which is subject to assessment; and (2) where an installment payment has been received and a portion of such payment (say 90%) has been credited against the purchase price the remainder (10%) has not been credited against the purchase price, the 90% of the payment which has been applied against the purchase price does not constitute a deposit balance, but the remaining 10% of the payment does constitute a deposit subject to assessment unless and until it is paid over to the dealer or applied against his indebtedness.

To those of you familiar with Federal Reserve Regulations this can be stated in another way--the position of the Federal Deposit Insurance Corporation and the Federal Reserve Board have been the same in respect to determination of deposit status in this matter. I am quoting from the Federal Reserve bulletin of March, 1960, stating four conclusions by the Federal Reserve Board for determining whether "dealers' reserves" or "differential accounts" are deposits against which reserves are required.

"1. If the purchase price of the paper is credited to the dealers' account, the resulting credit obviously is a deposit against which reserves must be maintained.

"2. The uncollected difference between the purchase price and the face amount of the paper is in practical effect a potential margin of security, and does not constitute a deposit against which reserves must be maintained.

"3. Where, however, an installment payment has been received and a portion of such payment (say 90%) has been credited against the purchase price, and the remainder (say 10%) has not been credited against the purchase price, the 90% of the payment which has been applied against the purchase price does not constitute a deposit balance, but the remaining 10% of the payment does constitute a deposit balance unless and until it is paid over to the dealer or applied against his indebtedness.

"4. Whenever the payments received on any paper purchased aggregate an amount in excess of the purchase price, plus interest or discount, any such excess which is not paid over to the dealer or credited against his indebtedness likewise constitutes a deposit against which reserves must be maintained."

There is also needed an explanation of why officers' checks issued for the bank's own purposes are subject to assessment. Officers' checks, including cashiers' checks and money orders issued for money or its equivalent, have always been insured deposits and assessable, but officers' checks issued for the bank's own purposes have heretofore not been insured deposits, nor assessable. Since officers' checks are not identified when issued as insured or noninsured it would be a rare instance when even the first holder of such a check would know whether or not his check is insured. Without prior inquiry, subsequent holders certainly would not know if such check was insured or uninsured. Another reason for including all officers' checks as deposits for insurance assessment purposes is that such treatment simplifies the preparation of Reports of Condition and eliminates the need for adjustment.

Because Reports of Condition are the basis for determining the assessment base, it becomes increasingly important that deposits in Reports of Condition are properly segregated between Demand Deposits and Time and Savings Deposits. This is particularly essential because of the uniform deductions permitted under the new method of 16 2/3 per cent of Demand Deposits and 1 per cent of Time and Savings Deposits. Section 327.2 of the Rules and Regulations of the Corporation prescribes the proper classification of deposits between Demand Deposits and Time and Savings Deposits for Reports of Condition purposes, and Section 329.1 gives the definitions for the various classes of deposits. These, I believe are familiar to all, having always been in effect. There is no purpose in restating these or discussing them here other than to observe that a good understanding of the provisions will enable the banks to be accurate in the preparation of the Report of Condition.

The total deposits reported as deposit liabilities in the Report of Condition form the bank's assessment base, and to this must be added certain assessment base additions, and there may be deducted certain assessment base deductions to arrive at the deposit for assessment purposes.

Let us first consider the assessment base additions which are:

1. Uninvested trust funds (cash) held in the bank's own trust department, and
2. Unposted credits.

Schedule FDI of the Report of Condition is provided for reporting these assessment base additions.

Trust funds received or held by the bank, whether held in its own trust department or in any other department of the bank, are deposits for insurance and assessment purposes; whereas, such funds held in its own trust department which the bank keeps segregated and apart from its own assets and does not use in the conduct of its business, are not deposits required to be included in the total deposits of the Report of Condition, but shall be separately stated in Item 1 of Schedule FDI. Generally this consists of only a small amount of cash held in the Trust Department at the end of the business day.

Experience with reports of the first calls for last year have indicated that a substantial number of banks have entered in Item 1 of Schedule FDI the amount of trust funds on deposit in the commercial department of the bank and have also included such trust funds as deposits in the deposit schedules. The trust funds on deposit in the commercial department of the bank should not be included in Item 1 of Schedule FDI, but should be reported as deposits in the deposit schedules.

Some banks have included in Item 1 of Schedule FDI trust funds deposited in other banks. The term "Trust Funds" as defined in Section 3(p) of the Federal Deposit Insurance Act as amended in 1960, includes only trust funds held by an insured bank in a fiduciary capacity and includes without being limited to, funds held as trustee, executor, administrator, guardian, or agent. Therefore, trust funds redeposited by the fiduciary bank in other banks cease to be deposits of such fiduciary bank for deposit or assessment purposes and should not be reported in Item 1 Schedule FDI or in the deposit schedules. These trust funds redeposited in another bank are insured and assessable in the other insured bank. Item 1 in Schedule FDI should include only uninvested trust cash held in the bank's own trust department which trust cash the bank keeps segregated and apart from its general assets and does not use in the conduct of its business.

The other base addition mentioned above, appearing in Schedule FDI, is "Unposted Credits." Some banks have shown in Item 2 of Schedule FDI items which have been reflected as deposits in the general ledger and in the Report of Condition but have not been credited to the individual deposit accounts. Since such items are already reported as deposits they should not be included in Schedule FDI. To clarify this further, the term unposted credit means any deposit received in any office of the bank for deposit in any other office of the bank except those which have been included in total deposits in Reports of Condition by an equal amount of cash items in its possession drawn on itself (on the same type of deposit as those offset) and not charged against deposit liability at the close of business on the date as of which the Report of Condition is made.

You will observe from this definition that for the most part we are here talking about inter-branch deposits which are not reflected in any deposit account on the general ledger.

Having considered the assessment base additions, at this point it might be well to go on to the assessment base deductions and then discuss in greater detail the manner of determining and reporting both unposted credits and unposted debits.

The assessment base deductions are:

1. Unposted debits.
2. Deposits included in reported deposit liabilities which are accumulated for the payment of personal loans and are signed or pledged to assure repayment of loans at maturity, and,
3. The uniform deductions of 16 2/3 per cent of demand deposits and 1 per cent of time and savings deposits.

The two last named items are self-explanatory so I shall proceed to discuss "unposted debits."

An "unposted debit" is a cash item in the bank's possession drawn on itself which has been paid or credited to a deposit account but has not been reflected in deposit controlling accounts on the general ledger at the close of business as of which the Report of Condition is made. This does not include items which have been reflected in deposit controlling accounts on the general ledger although they have not been debited to individual deposit accounts. Return items representing checks drawn on the reporting bank and received in clearings or in cash letters and returned unpaid to the bank from which received, and items held by the bank that cannot immediately be charged against individual deposit accounts, are not unposted debits. "Payable if Desired" items drawn on the reporting bank, paid or credited at another bank which are not in the reporting bank's possession do not come within the definition of an "unposted debit." Cash items in the process of collection drawn on other banks are not unposted debits and are no longer deductible because the uniform deductions of 16 2/3 per cent of Demand Deposits and 1 per cent of Time and Savings Deposits are in lieu of all deductions previously permitted.

Unposted debits are to be reflected in Item 1 of Schedule D of the Report of Condition and such unposted debits should be reported in Item 1 regardless of whether or not the bank elects to take such unposted debits as a deduction for deposit insurance assessment purposes. Simply stated, unposted debits include:

1. Cash items drawn on the reporting bank which it holds for charge back against deposit accounts or which may be charged back against deposit accounts without resulting in overdrafts, and
2. Payable through items where the bank either by statute or by written agreement may at its discretion immediately charge such items against the account of the drawer.

The most numerous inquiries received from banks and the most frequent errors in Report of Condition concern unposted debits. A large number of banks have reported as unposted debits items described as cut-backs, return items, throw-outs, bookkeeper's cuts, mis-sorts, and payable if desired. Such items are general terms describing a variety of items not always representing the same transaction or type of item in all banks. If, however, the terms are used to mean items which have been included in the total amount deducted from deposits in the general ledger but which have not been posted as debits on the individual accounts of depositors, then such items may not be considered as unposted debits to be again deducted from the deposits as assessment base deductions. Also, checks drawn on the reporting bank which were received in clearings or in cash letters and are being returned unpaid to the bank or banks from which received may be cash items but are not unposted debits as defined in Part 327 of the Regulations of the Corporation and, therefore, are not deductible from the assessment base.

Payable if Desired items drawn on the reporting bank paid or credited to another bank but not in the reporting bank's possession do not come within the definition of an unposted debit.

Cash items in the process of collection drawn on other banks which are not "Payable Through" items are not unposted debits.

The reporting of unposted debits in Subitems 1(b) or 1(c) of Schedule D of the Report of Condition is optional but if a bank elects to claim a deduction therefor in determining the assessment base such items must be reported in either Subitem (b) or (c). On the other hand, unposted credits are required to be reported on the Report of Condition for assessment for addition to the assessment base, as discussed earlier.

To clarify a point about late deposits or after-hour deposits--Deposits received after the normal close of the books of the bank which are to be entered as of the business of the next day, should not be reported as unposted credits or unposted debits. As an illustration, let us say that a bank and its books are closed at 2 P. M. and that a branch or more remains open until 5:30 P.M. or that either may close at 2 P.M. and reopen from 6 to 8 P.M. The after-hour deposit credits and debits received after the bank's normal cut-off time of 2 P.M. and entered on the books as of the business of the next day are to be considered as the business of that next day and not as unposted credits or unposted debits on the date as of which the Report of Condition is required to be made.

Now that the terms "unposted debits" and "unposted credits" are identified and some of the items which may be or may not be included have been discussed, let us next consider the method of determining the reporting of these items in the Report of Condition for Schedule D, Item 1 and Schedule FDI, Item 2.

There are three basic methods. The appropriate one for a bank to use depends upon the records kept by the bank of such unposted credits and unposted debits.

First, there is the method of reporting separate actual amounts of unposted debits and of unposted credits segregated between those applicable to Demand Deposits and those applicable to Time and Savings Deposits. Where the records of the bank show the actual amounts of unposted debits and unposted credits, such actual segregated amounts must be reported. Unposted debits shall be reported in subitems (b) or (c) of Item 1, Schedule D.

On the Report of Condition the bank should separately state in subitem (c)(1) of Item 1 the actual amount of unposted demand deposit debits and in subitem (c)(2) of Item 1 the actual amount of unposted time and savings deposit debits. Unposted credits to demand deposits should be separately stated in subitem (b)(1) of Item 2, Schedule FDI and unposted credits to time and savings deposits in subitems (b)(2) of Item 2. No percentages should be shown in either the case of unposted debits or unposted credits, percentages being used only for experience factor or factors approved by the Corporation.

Secondly, there is the method where the records of the bank separately show actual amounts of all unposted debits and all unposted credits with no segregation thereof between those applicable to Demand Deposits and those applicable to Time and Savings Deposits. In this case the bank shall separately report all unposted debits in subitem (b) of Item 1 of Schedule D for deduction from Demand Deposits on the certified statement and all unposted credits in subitem (a) of Item 2, Schedule FDI, for addition to Time and Savings Deposits unless the segregation is determined by experience factors and reported in segregated amounts as outlined in the first method. Such factor or factors shall be ascertained in accordance with computation methods approved by the Corporation, upon application to the Corporation for permission to compute such amounts.

Third, there is a method where the records of the bank do not show the actual amount of unposted credits either in total or in segregated amounts. In such case the amounts thereof must be determined by experience factor or factors and unposted debits may be so computed.

In such cases the bank is required to signify its intention in writing to the Corporation stating whether it proposes to use separate factors for computing the additions to Demand Deposits and to Time and Savings Deposits and for computing the deductions from such deposits or a single factor for computing deductions in total from demand deposits and whether such factor or factors will be computed on two years' experience or established in the same manner as a newly insured bank. This information is needed so that the FDIC may furnish forms to the bank for making computation. All of this is covered, as you probably recall, in Section 327.1 of the FDIC Rules and Regulations.

There we have the reporting of items of condition which are used in determining deposit insurance assessments. Once the techniques of correct reporting are mastered, it is very simple to prepare the certified statement for assessment purposes for there is only a maximum of six items on each report of condition to be transferred to such certified statement in the following order:

1. Unposted debits.
2. Deposits accumulated for the repayment of personal loans.
3. Total demand deposits.
4. Total time and savings deposits.
5. Uninvested trust funds (cash) held in the bank's trust department.
6. Unposted credits.

The revised Certified Statement clearly shows where each item for determination of assessments is obtained for the Report of Condition. All other figures for the determination of the assessment, including the deduction of 16 2/3 per cent of demand deposits and 1 per cent of time and savings deposits are simple arithmetic computations.

There has been a good deal of technical language and involved explanation in this talk, very likely resulting in an extended and perhaps dry dissertation. Another incident similar to this comes to mind. Following the speech, the Chairman for the evening, being the president of the group, announced that immediately after adjournment a brief meeting of the board would be held in the front of the room. When the meeting did break up one of the audience rushed forward and was the first to meet the president up front. "You must have misunderstood the announcement," said the president. "I announced a meeting of the board." "So I heard," replied the visitor, "and if there was anyone here more bored than I was I would please like to meet him."

I wish to thank you for inviting me here and for the courtesies shown by your attention this evening.