STATEMENT ON

THE COLLAPSE OF
BEVILL, BRESLER AND SCHULMAN GOVERNMENT SECURITIES, INC.,
AND THE EFFECT OF THE FAILURE ON FINANCIAL INSTITUTIONS

PRESENTED TO

COMMERCE, CONSUMER AND MONETARY AFFAIRS SUBCOMMITTEE
COMMITTEE ON GOVERNMENT OPERATIONS
UNITED STATES HOUSE OF REPRESENTATIVES

BY

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WASHINGTON, D.C.

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Good morning, Mr. Chairman. I am Robert Shumway, Director of the Division of Bank Supervision at the FDIC. I am here in response to your invitation to Chairman Isaac to report on the impact the Bevill, Bresler and Shulman failure has had on financial institutions throughout the country. We have prepared detailed responses to each of your questions which I will submit to the Subcommittee for the record. It should be noted, however, that our responses relate only to insured nonmember banks. My understanding is that the Federal Reserve and the Comptroller of the Currency will be responding to similar questions regarding state member and national banks respectively. In my opening remarks this morning, I would like to summarize our findings to your original request and then I will be pleased to answer any additional questions you may have.

In responding to your inquiry, we surveyed each of our Regional Offices in an attempt to identify all nonmember banks that had open transactions with any of the securities dealers mentioned in your inquiry. Our survey revealed that 14 institutions had open transactions with Bevill, Bresler, one institution had an open transaction with Brokers Capital, Inc., and one institution had an open transaction with Midwest Government Securities, Inc. All of these transactions were identified as either repurchse or reverse repurchase agreements. Our survey did not identify any insured nonmember banks with open transactions with either Collins Securities, Inc. or ESM Government Securities, Inc.

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A review of the prior two examination reports for these institutions revealed that the banks were either not doing business with those particular dealers at the time of the examination, or if they were, the transactions were not subject to criticism. None of the institutions were under any formal supervisory actions specifically related to securities activities. Based on preliminary estimates available to us, the aggregate total loss for all 16 of the institutions will be no higher than $12.4 million.

Most of the banks have already sold the collateral and have either covered their exposure or will suffer a relatively small loss. Three banks show potential losses in excess of $1 million. Two of those banks are large enough to absorb the losses without serious difficulty. One bank, however, is in serious trouble and it probably will fail unless a suitable buyer is found. Unquestionably, the failure of Bevill, Bresler has had a greater impact on this insured state nonmember bank than on any other.

In view of this, Mr. Chairman, I would like to take a few moments to describe some of the events surrounding this transaction. This is a classic case of how a securities dealer can take advantage of a bank whose management fails to take even basic precautionary measures to protect its own assets. I should preface my remarks by saying that the investigation is still underway and we do not have all the details. However, based on what we have been able to determine, the chronology of events is as follows.

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This bank is a small Midwestern bank with $43 million in deposits and about $4 million in book capital. The bank is located in an area where loan demand is relatively low. Because of the low loan demand, the bank placed a relatively large percentage of its assets in the securities portfolio. Over the last several years the bank had been dealing with a particular bond salesman. That salesman was associated with at least two other securities dealers prior to joining Bevill, Bresler in 1985. Our examiners had criticized some of the bank's trading activities in the past, but those criticisms were primarily related to violations of the bank's own investment policies and the absence of proper accounting procedures for the securities trades. The transactions themselves were not considered unsafe or unsound.

On March 19, 1985, the bank entered into its first reverse repurchase transaction with Bevill, Bresler. Although the transaction was presented to the Board of Directors as one with virtually no risk, it is apparent that management did not consider the risk associated with poor operating procedures, poor judgment and apparent fraud. Based on our analysis, it is apparent that at least four fundamental principles of sound banking were violated . First, the bank failed to take possession of the collateral or ensure that the collateral was, in fact, held by a third party custodian for the bank's benefit. Second, by allowing Bevill, Bresler to monitor the market value of the collateral, the bank, in effect, gave away its responsibility to properly manage its collateral. Third, the bank failed to exercise the basic principle of risk diversification. This transaction is really a loan to one customer that totalled almost 200 percent of the bank's capital account.

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Finally, the bank failed to know its customer. Not only did management fail to adequately review the Bevill, Bresler organization, but apparently too much trust was placed in one salesman. Discussions with bank officials revealed that they thought they were dealing with Bevill, Bresler and Shulman Government Securities Inc., the parent, and not with Bevill, Bresler and Shulman Asset Management Corp.

What are the basic lessons to be learned from this unfortunate case? Clearly there are several, but probably the most basic lesson relates to the old adage of "buyer beware." Banks that choose to engage in relatively sophisticated lending practices must make every effort to know with whom they are dealing and to fully understand all of the potential risks that may be involved. This bank either did not fully understand the risks or chose to ignore them to save effort and gain some extra income.

Mr. Chairman, you asked us to provide you with any outstanding FDIC safety and soundness requirements pertaining to these types of activities as well as any instructions or guidelines provided to our examiners. With respect to safety and soundness requirements, I believe we have already submitted to you a copy of a policy statement addressing future and forward transactions. Additionally, we have included with our response to your questions a copy of the FFIEC policy on securities lending which we recently distributed to insured state nonmember banks. We consistently encourage bank management to develop investment policies that are consistent with normal prudent banking policies.

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With regard to examination procedures and guidelines, we have previously supplied you with appropriate sections of our examination manual pertaining to unusual or improper securities activities. In addition, our call report instructions indicate that repurchase agreements generally should be reported as a secured loan or borrowing and not as a purchase or sale of a security. It is bank management's responsibility to ensure that an adequate margin of collateral protection is obtained and maintained. Moreover, obtaining liens and/or control over collateral is fundamental to any form of secured lending. Our examiners are well-trained to understand this and good bankers know it as well. Yet the absence of such safeguards contributed significantly to the losses suffered by these institutions.

I will now turn to the subject of supervision of secondary government securities dealers. Earlier this year, in a letter to Mr. Gerald Corrigan, President of the Federal Reserve Bank of New York, we supported the Federal Reserve's proposed voluntary capital guidelines as a welcome step toward controlling risk in the government securities market. The subsequent failures in the government securities industry have convinced us that more stringent policies are needed. We have not undertaken an analysis of the issues because studies by the Federal Reserve, Treasury Department and the SEC are already underway. We feel that some form of Federal registration probably is needed and that a Federal agency should be able to exercise some authority over the dealers such as collecting financial reports, conducting periodic examinations and taking enforcement action when necessary. An expansion of the National Association of Securities Dealers to include government securities dealers

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also seems reasonable. However, we would like to see the results of the studies mentioned earlier before making specific recommendations.

In closing, what should not be forgotten in all the publicity surrounding the government securities dealer failures is that a repurchase agreement is an efficient short-term financing vehicle. For a bank that has excess funds, the repo market is an excellent short-term investment vehicle with moderate credit risk if properly executed. For the borrower, who needs short-term funds, the availability, efficiency and rates of the repo market are an attractive feature. It would be unfortunate if regulations that unduly inhibit the efficiency of the market are adopted.

I will be pleased to answer questions.

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