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United States National Bank

Statement by

Frank Wille, Chairman
Federal Deposit Insurance Corporation

before the

Subcommittee on Bank Supervision and Insurance
Committee on Banking and Currency
House of Representatives

November 27, 1973

This statement is in response to the Subcommittee's request for a discussion of the activities of the Federal Deposit Insurance Corporation incident to the transfer of certain assets and certain liabilities of the United States National Bank, San Diego, California ("USNB") to Crocker National Bank, San Francisco ("Crocker"). Based on the inquiries contained in your Chairman's letter dated November 12 and questions addressed to me during my recent appearance before the Subcommittee on November 5, my statement covers the following matters:

- (1) FDIC's consideration of the alternative methods available to it to protect a bank's depositors and other creditors (pp. 6-11);
- (2) Steps taken to insure that this particular transaction would be accomplished through competitive bidding (pp. 11-15);
- (3) FDIC's position with respect to the demands for payment currently being made by holders of certain standby letters of credit issued by USNB, the majority of which are financial institutions located outside the United States (pp. 15-21);
- (4) FDIC's involvement with USNB since its identification by the FDIC as a "problem" bank (pp. 21-33); and

(5) The current status of the USNB receivership (pp. 33-34).

I. GENERAL BACKGROUND

It would be useful in understanding this Statement to describe at the outset some of the basic elements of the "purchase and assumption" transaction that was entered into by FDIC, as Receiver of USNB, with Crocker National Bank. As you know, United States National Bank, an institution with approximately \$1,265,868,000 in total assets and approximately \$932,000,000 in deposits, was closed by the Comptroller of the Currency at 3:00 p.m., Pacific time, on Thursday, October 18, 1973. Pursuant to the applicable provisions of the Federal Deposit Insurance Act, the Comptroller of the Currency immediately appointed the FDIC Receiver of USNB. Approximately 300 FDIC examiners and liquidators thereupon took physical control of the 63 offices of USNB from 165 national bank examiners who had entered the bank prior to closing and, working throughout most of the night, these men and women verified the cash, collateral and safekeeping items held by USNB and supervised the closing out of the day's business.

While this was taking place, the three members of FDIC's Board of Directors (Frank Wille, Chairman; James E. Smith, the Comptroller of the Currency; and George A. LeMaistre, Director) were meeting in San Francisco where a call for bids pursuant to predrafted documents

was issued shortly after 3:00 p.m. Three envelopes submitted in response to this invitation to bid were received at 4:00 p.m., and were thereafter opened and analyzed. By 4:30 p.m., the FDIC had accepted Crocker National Bank's bid of \$89.5 million, the highest bid submitted, and FDIC lawyers standing by in San Diego were instructed to proceed immediately to petition U. S. District Court Judge Neilsen, who had been previously assigned to the case, for the necessary court approval to the proposed transaction. After an ex parte hearing at which sworn testimony was received, the court approved the proposed purchase and assumption.

The entire transaction, together with all necessary approvals, was consummated by 6:15 p.m. -- only three hours and fifteen minutes after the largest bank failure in the nation's history. Friday morning all USNB's offices, except its Nassau, Bahamas office, reopened at their usual business hours as branches of Crocker National Bank.

In all, 335,000 depositors with almost \$920 million in deposits, including 3,300 whose individual deposits exceeded the \$20,000 insurance limit, and about 200 holders of other liabilities amounting to approximately \$130 million were fully protected with no perceptible interruption whatsoever in banking service. It might be noted that because of FDIC's concern that banking services previously offered by USNB not be interrupted, the

purchase and assumption agreement required Crocker to keep open all banking premises of USNB, with the exception of the bank's branch in Nassau, for at least 30 days.

Under the terms of FDIC's agreement with Crocker, it was necessary for FDIC to advance to the Receiver \$130 million in cash on October 19 so that the Receiver could make up the difference between the liabilities assumed by Crocker of approximately \$1,070,000,000 and the USNB assets of approximately \$850 million also transferred to Crocker, less its purchase premium of \$89.5 million. An additional \$30 million was paid by FDIC as Receiver to the Federal Reserve Bank of San Francisco to satisfy USNB's obligation to it, thereby obtaining for the receivership estate the release of assets which USNB had pledged to that Bank as collateral for the liquidity advances it had made. In addition, Crocker exercised the option it had under the FDIC's invitation to bid to place a five-year \$50 million note with FDIC, at 7 1/2 percent per annum, an option designed to enable it to increase its capital account to support the very large increase in its liabilities which occurred by virtue of the purchase and assumption transaction. It is our understanding that this note will be retired whenever Crocker finds market conditions favorable for raising more permanent capital, but in no event later than October 22, 1978.

The Receiver's agreement with Crocker provided for the purchase by Crocker of all of the "clean" assets and liabilities of USNB. This included virtually all assets, deposits and other liabilities which were not related to USNB's control shareholder, Mr. C. Arnholt Smith, his business associates and their various affiliated interests. Because of the uncertain market value of such USNB assets as real estate, leased premises and the securities portfolio, these assets were transferred to Crocker at their book value subject to a later adjustment to reflect fair market value at the close of business October 18, 1973.

These provisions have left approximately \$420 million in USNB assets at book value in FDIC's hands as Receiver, against which the following claims must be satisfied: an FDIC claim in the current amount of \$160 million on account of cash advanced to the receivership estate, the claims of 39 holders of so-called "standby" letters of credit issued by USNB in the apparent aggregate amount of \$91,268,222.98, the claims of approximately 120 Smith-related depositors who held aggregate deposits of approximately \$8.8 million at the time the bank closed, the claims of future judgment creditors against USNB which cannot at this time be estimated as to amount, a number of miscellaneous claims of minor amount, and the claims of holders of USNB's subordinated capital notes and debentures (outstanding at the time of closing in the amount

of \$14,750,000). The recoveries on these various claims will obviously depend on the collectibility of assets held by the Receiver and the final aggregate amount of proven claims against the receivership estate. For the special position in which the 39 holders of USNB's standby letters of credit find themselves, you are referred to the section of this Statement which begins on page 15.

In addition, FDIC has indemnified Crocker against all liabilities of USNB not specifically assumed under the purchase and assumption agreement and against any damages which might be assessed against Crocker as a result of the purchase and assumption transaction, other than those arising out of Crocker's own actions. Such an indemnity is standard FDIC procedure in purchase and assumption transactions, since judgments arising out of lawsuits not yet started when an insolvent bank closes, and other unknown claims against an insolvent bank, are not the type of risks an assuming bank is willing to accept.

With this background, I shall now respond to the more specific inquiries contained in your Chairman's letter of November 12, 1973.

II. ALTERNATIVES TO SEIZURE

FDIC has available to it three basic alternatives for dealing with an insured national bank which is in serious financial difficulty.

- It can pay off the insured deposits up to the statutory ceiling of \$20,000 and act as receiver in a subsequent

liquidation after the Comptroller of the Currency has declared the bank insolvent.

-- It can, where the necessary statutory findings can be made, undertake a program of direct financial assistance to such a bank in order to keep it operating.

-- It can, where the necessary statutory findings can be made, provide financial assistance to facilitate the bank's merger or consolidation with another insured bank, or to facilitate the purchase of assets and assumption of liabilities by another insured bank.

In the case of USNB, a payoff of insured deposits in a \$1 billion bank with 63 offices and 335,000 depositors, in the judgment of the FDIC's Board of Directors, would have shaken public confidence in the nation's entire banking system, with especially severe repercussions in the State of California. This conclusion was supported by the California banks with whom we later spoke, who made it clear to us that a payoff of this magnitude was in their opinion "unthinkable." We anticipated for example that an insurance payoff would have necessitated an initial FDIC outlay of approximately \$700 million and would have

resulted in an immediate loss of the use of approximately \$230 million in depositors' funds to approximately 3,300 unsecured depositors whose deposits exceeded the \$20,000 insurance limit (although in due course these depositors would undoubtedly have recovered some of this amount from liquidating dividends).

Considering such a payoff to be the very last resort after all the other alternatives had been discarded, we determined to explore completely the possibilities, within the framework of the Federal Deposit Insurance Act, of providing financial assistance to protect as many USNB depositors and creditors **as possible as soon as** we discovered that the failure of the bank was imminent.

Direct assistance to USNB was quickly rejected due to the FDIC's inability to force a change in USNB's ownership and the clear monetary benefit such direct assistance would have provided, at FDIC's expense, to the control shareholder and his associates who were responsible in the first instance for the bank's unsound condition. We also were unsure as to the amount of such financing that would be necessary to solve USNB's problems and were determined to avoid becoming involved in a continuing financial rescue effort that might extend over many years. It appeared, moreover, that a key finding required by the statute, i. e., that the continued operation of USNB was "essential to provide adequate

banking service in the community," could not be made and that the prospects of eventual repayment of any FDIC advance were speculative at best. Thus, we turned to the third alternative to determine if we could provide financial assistance for an acquisition transaction.

The statutory provision authorizing such assistance (Section 13(e) of the Federal Deposit Insurance Act) requires the Corporation's Board of Directors to determine that this course of action will "reduce the risk or avert a threatened loss to the Corporation" which FDIC would otherwise experience. Mindful of this statutory requirement, the Board, with the assistance of its staff, began to formulate the outline of a transaction which it hoped would permit the transfer of substantially all the banking business of USNB at a price sufficiently high to satisfy the basic statutory requirement that we reduce the financial risk to the Corporation which might occur in a payoff of USNB's depositors up to the \$20,000 insurance limit. Throughout these early internal discussions, as well as our later negotiations with banks interested in a possible purchase and assumption transaction, we bore in mind the possibility that, if the acquisition did not command a sufficiently high price or "premium" we might still be required to utilize the undesirable payoff method. In the weeks before USNB closed, our Liquidation Division was not only assisting

us in formulating a purchase and assumption proposal, but was also formulating a contingency plan for a payoff, including preparing the blank checks and checkwriters for transportation to California. Moreover, preparation for a possible payoff was needed in any event since, having early determined that competitive bidding rather than a negotiated sale with one bank would be most likely to yield the greatest premium, we also recognized that we would not know until after USNB had closed and the bids were opened whether we had obtained a premium sufficient to meet the statutory standards.

As we were formulating our initial outline of a transaction in late August and early September, we began to receive additional information from the Comptroller's Office and from the larger California banks we approached which influenced our thinking. Thus, we learned that USNB's management was itself trying to arrange a statutory merger or consolidation with other banks which had looked over its books and records. We also received, in preliminary form, the results of the Comptroller's special examination of the Smith-related credits which began in July 1973. From our discussions related to these two matters, we concluded that none of the banks likely to be interested in acquiring USNB would be willing to or, for that matter, could do so without significant FDIC assistance. Among other factors, the questionable value of many of

the Smith-related loans meant that they could not simply be transferred to another bank without substantial risk to the acquiring bank. The only arrangement under which the acquiring bank could be expected to accept these assets at book value would be under some form of FDIC guarantee against loss.

III. EFFORTS TO INSURE COMPETITIVE BIDDING

Against this background, serious discussions were begun with Wells Fargo Bank, N. A., Crocker National Bank and Bank of California, N. A., in early September. All three of these banks had expressed interest in acquiring USNB's offices and most of its banking relationships and each was regarded as having sufficient size and management capabilities to take over the operations of a billion dollar bank and 63 offices. Furthermore, none of the three was heavily concentrated in the five counties of Southern California where USNB had branches, or in San Diego County, where USNB's share of the market was the most significant. Our General Counsel and members of his staff, together with local California counsel retained by the FDIC and lawyers assigned by the Comptroller of the Currency, began direct negotiations with the three banks and their counsel in San Francisco to determine if a purchase and assumption agreement satisfactory to all three banks and the FDIC could be drafted.

We were apprehensive, however, that if we limited our negotiations to only three banks, when we had no certainty that all three would stay in the bidding until the end, we would not be able to obtain the highest bid possible. We therefore desired to expand the number of banks that might be interested in bidding. Three of the four other California banks able to assume \$1 billion of liabilities -- Bank of America, NT&SA, Security Pacific National Bank, and United California Bank -- all seemed to present serious antitrust problems. Accordingly, on September 24, prior to entering into discussions with any of these three banks, we solicited the views of the Antitrust Division of the Department of Justice. It was the Division's view that under the Bank Merger Act even an emergency purchase and assumption could be effected with Bank of America or Security Pacific only if there was no other reasonably acceptable alternative. United California Bank posed less of an anti-competitive problem than these two banks, according to the Antitrust Division, but it was sufficiently strong in Southern California to be a less desirable alternative than the three banks with whom we had already had extended discussions. The FDIC's General Counsel and I, together with the Regional Administrator of National Banks in San Francisco, thereupon promptly held discussions with each of these banks, with a full disclosure of the Justice Department's view of their respective

competitive positions. United California Bank considered the matter carefully but determined not to pursue the discussions further. Bank of America and Security Pacific National Bank, recognizing their anti-trust disadvantages, did not participate actively but agreed as a matter of public service to stand "waiting in the wings" to be contacted immediately if no acceptable bid were obtained from some other source.

In the interest of covering all the major California banks, we also contacted Union Bank, Los Angeles, late in September, and it became an active participant in the drafting discussions. We had not previously discussed the matter with Union Bank even though it did not appear to present any anticompetitive problems because we erroneously believed it would not be interested in view of its well-known orientation as a wholesale, rather than a retail, bank.

In addition, in early October a group of private investors with access to substantial funds and bank management capabilities approached the Comptroller of the Currency and FDIC and expressed interest in purchasing USNB's banking business and offices. After full disclosure of the relevant facts to this group, it determined not to participate further in the discussions then being held with the major California banks.

From time to time fundamentals of the purchase and assumption transaction felt to be desirable by the FDIC or by one or more of the

interested banks threatened to drive other banks out of the bidding group. In each such instance FDIC sought that common denominator which would keep the greatest number of potential bidders interested. While it is impossible to state the likely outcome of alternative approaches, it appeared to us on October 18 that the successful bid of \$89,500,000 was substantially above the purchase price we would have received had we not kept as many potential bidders as interested as we did and substantially above the purchase price we would have received had we attempted a negotiated sale with only one of the interested banks.

The final package developed was, of course, the "clean bank" package which would convey only assets and liabilities of determinable value, i. e., excluding virtually all assets and liabilities related to the controlling shareholder, his business associates and their affiliated interests. Under such a package, FDIC as Receiver would retain responsibility for working out such Smith-related assets and liabilities. This, we believed, was in the best interests of both FDIC and the bidding banks, for to have transferred a portion (presumably the best portion) of the Smith-related loans and liabilities would have had, in our opinion, serious adverse consequences to the receivership and to other claimants. For example, many of the companies involved may be responsible, through cross-guarantees and by benefits received, for the loans of

other Smith-related companies. Also, we would have found ourselves, in the collection process, competing with the assuming bank for the same Smith-related assets. Furthermore, given the many hundreds of Smith-related transactions involved, it would have been impossible to sort out the "acceptable" portion of the \$420 million in Smith-related loans and other assets in the few weeks available to us before the transaction.

IV. THE "STANDBY" LETTERS OF CREDIT

At the time of its closing, USNB showed on its books obligations in an amount in excess of \$100 million on account of certain "letters of credit" it had issued. Some of these were traditional letters of credit secured by title documents against goods in transit or yet to be shipped. Such letters of credit were required to be assumed by Crocker under the purchase and assumption agreement which it entered into with the Receiver.

However, approximately \$91 million in letters of credit, representing over 70 transactions, appeared on the bank's records to have been issued to guarantee a primary obligation of one or another Smith-related enterprise or affiliated person. We assumed, because of the manner in which these transactions were booked by USNB (i.e., as contingent liabilities not required to be included on its balance sheet) and because of statements made to us by certain USNB officers, that

these "standby" or "guaranty" letters of credit had been issued to guarantee the payment of loans either made directly to Smith-related interests by the 39 holders of such letters of credit or purchased by them from USNB directly or through brokers. Most of these letters of credit carried maturity dates well beyond October 18, 1973.

As previously stated, we had earlier determined that the "clean bank" to be sold by the Receiver to a successful bidder would not include any Smith-related assets or liabilities. The \$91 million of letters of credit referred to in the preceding paragraph appeared to fall directly into this category and to be intimately connected with other Smith-related credits being retained for work-out in the receivership. Also, the loans underlying the letters of credit were of questionable quality and we were uncertain whether all such letters of credit were actually reflected on USNB's books and records. Because of this, we could not be certain that the \$91 million indicated was the maximum amount of claims in this category that might ultimately be presented against the receivership or whether the underlying USNB asset (the account party's obligation to the bank) would equal the liability on the letter of credit. Furthermore, the FDIC Board of Directors was advised by counsel that under various court decisions, the claim of a beneficiary under a "guaranty" letter of credit which had not matured

at the time of a bank's insolvency might not be a provable claim against the receivership. To have required Crocker to assume these letters of credit automatically, with an additional advance or guaranty from the FDIC of \$91 million or more, could have subjected the FDIC, under the facts known to us at the time of closing, to criticism from the public, from other creditors, and from minority shareholders. You can, of course, appreciate that other creditors of the receivership, including subordinated noteholders and shareholders, are not likely to stay silent for long if the Receiver makes payments out of receivership assets for claims which are not legal obligations of the receivership estate. Accordingly, as USNB's liability on these letters of credit was likely to be a matter of complex litigation involving all the Smith-related assets and liabilities, we determined that the most feasible course was to retain these apparently contingent and unmatured obligations in the receivership. We believed it far preferable to require an individual proof of claim which would allow the Receiver full opportunity to determine the facts of each particular letter of credit transaction.

Several developments since the closing of the bank have raised additional questions in respect of these letters of credit, \$76 million of which appear to be held by 24 foreign banks in varying amounts. Within days after October 18, several foreign bank beneficiaries of these letters

of credit notified us that their claims were based not upon a "guaranty" by the bank of an obligation of a third party, but rather that they had placed normal Eurodollar loans or deposits directly with USNB and had no knowledge of or relationship with the underlying borrower or account party specified in the letter of credit. Further, through information obtained from former employees of the bank, it became apparent that all of the records pertaining to these letters of credit were not available to us in the bank's offices but rather were being held in C. Arnholt Smith's personal office in San Diego, an office which was not considered part of the bank's premises and to which FDIC liquidators had previously been denied access. We advised the Chief Assistant U. S. Attorney in San Diego of our knowledge of this fact, and after required court proceedings, a search warrant was issued on November 8, 1973 by a magistrate and executed the next day by the FBI. As a result of this search, over 700 files relating to various letter of credit transactions were discovered. Copies of these documents were requested and immediately provided to us by the Chief Assistant U. S. Attorney. In addition, FDIC has issued subpoenas to certain former bank officers and employees, and to employees of some of the Smith-related companies, to produce records relating to these letter of credit transactions, as well as other bank transactions. These subpoenas have already produced access to many

additional cartons of records relating to letters of credit and other USNB transactions, and our legal staff is presently examining them.

To the extent that these records, when combined with the documentation and other proof of claim submitted by a particular letter of credit holder, show that the relevant transaction was improperly booked by the bank, and thus listed on a schedule of obligations to be retained by the Receiver instead of as a deposit or other liability scheduled to be assumed by Crocker, a correction will be made as required by the purchase and assumption agreement, and the liability will be assumed by Crocker against matching cash or an appropriate guaranty from the Receiver. All other claims of letter of credit holders will be processed in the normal course and, if provable against the receivership, will be entitled to ratable dividends along with other creditors as and when such dividends are declared. If there is a dispute between the Receiver and the beneficiary as to the provability or amount of such claims, the issues presented will, of course, have to be decided in the courts.

Needless to say, any allegation that the structure of the purchase and assumption transaction was designed to prejudice foreign, as against domestic, creditors of USNB is totally without foundation. Such a course of action was at no time even suggested by any participant in the negotiations leading up to the purchase and assumption transaction, and there

are in fact domestic as well as foreign holders of these letters of credit. Actually, some of the banks with whom we engaged in negotiations prior to October 18 believed that the purchase and assumption transaction should cover these letters of credit, whether or not the Receiver might be legally liable for their payment, just because the majority of beneficiaries appeared to be foreign banks. We rejected this approach for the reasons previously stated.

While some of the foreign bank beneficiaries of these letters of credit are understandably concerned about the prospects of repayment, we have made it very clear to their principal spokesmen, at meetings here in Washington on November 9 and November 26 and in a cable I sent to the General Manager of National Westminster Bank Limited on November 21, that if upon review of all the facts, including the documentation in their possession, it appears that a letter of credit they hold merely evidences a direct interbank loan or deposit made in the normal course of business, as many of them are now claiming, it will be assumed by Crocker under the purchase and assumption agreement, and we will, of course, honor our commitment to Crocker to advance any additional funds or guaranties that may be necessary for this purpose. Our position on this complex and difficult issue has not changed in any way by virtue of the class action suit filed against us on November 21 on behalf of the

holders of these "guaranty" letters of credit alleging, in substance, that as to them the entire purchase and assumption transaction was in contravention of applicable statutes and requesting, among other things, that FDIC and Crocker be enjoined from carrying out the terms of our agreement. FDIC intends to contest that litigation vigorously, but we will at the same time review expeditiously, as we have repeatedly assured these holders we would, any proof of claim or documentary evidence filed by them with us in order to determine the standing of their claims. Advice as to the appropriate method of filing these claims and the supporting documentation was sent to each holder of record of these letters of credit immediately after USNB was closed and repeated at numerous meetings in San Diego and at the Washington meetings of November 9 and November 26, as well as in my cable of November 21. As of November 23, only eight holders of these letters of credit had filed such claims with the Receiver.

V. FDIC'S INVOLVEMENT WITH USNB SINCE ITS IDENTIFICATION AS A "PROBLEM" BANK

In your Chairman's November 12 letter regarding my appearance before this Subcommittee, he requested a summary of the "supervisory steps" taken by FDIC from the time United States National Bank first came to our attention as a "problem" bank. At this point a brief description of

the statutory framework for the regulation of national banks and the place of FDIC within that framework appears necessary.

The primary function of FDIC with respect to an insured national bank is that of an insurer of the bank's deposits. It is not, with respect to national banks, a supervisory or regulatory body. Thus, even when a national bank is in financial difficulty, FDIC's role has been carefully limited by the Congress.

For example, under Section 10(b) of the Federal Deposit Insurance Act, Congress conferred upon FDIC the power to conduct a special examination of a national bank if "in the judgment of the [FDIC] Board of Directors such special examination is necessary to determine the condition of any such bank for insurance purposes" (emphasis added). The legislative history of the 1950 amendment to this section indicates that FDIC's power to examine national banks was intended to be exercised with great restraint. Indeed, based on concern expressed in this regard by some members of Congress, there was incorporated in the legislative history a letter from the then FDIC Chairman Harl to Senator Maybank, then Chairman of the Senate Committee on Banking and Finance, which stressed that FDIC would not exercise its examination powers merely to duplicate examinations conducted by national bank examiners. As my later testimony will indicate, from the time FDIC first began to learn

the extent of the serious financial difficulties facing USNB, the bank was under almost constant surveillance and examination by the Office of the Comptroller of the Currency. Further, throughout this period, FDIC was receiving information regarding USNB's problems from the Comptroller's Office. Based on this flow of information, FDIC did not believe that an independent examination by its examiners was necessary, or that any useful purpose would be served by having a second team of examiners go over the same ground the Comptroller's examiners were already covering.

It should be noted, however, that in the last few weeks before USNB was closed, and when the structure of the purchase and assumption transaction was beginning to take shape, six FDIC employees went to San Diego for the purpose of obtaining specific and detailed financial information to be utilized in discussions with banks interested in acquiring USNB's offices and banking business and to gather data to be used in the preparation of the schedules which had to be attached to the purchase and assumption agreement. These FDIC personnel obtained the information they needed primarily through requests made of national bank examiners then in the bank.

FDIC also has the power under Section 8(a) of the Federal Deposit Insurance Act to terminate a national bank's status as an insured bank. However, as I am sure this Subcommittee is aware, a formal proceeding

to terminate insurance is a long, drawn-out and complicated procedural affair which requires at least one year to complete. Also, the corrective action which FDIC can secure under Section 8(a) is similar to the corrective action the Comptroller of the Currency can order a national bank to take under the Financial Institutions Supervisory Act and which the Comptroller did in fact order USNB to take in May 1973.

Under Section 7 of the Federal Deposit Insurance Act, FDIC has access to the Comptroller's examination reports on national banks. For many years we have had an arrangement for the cooperative exchange of information with his Office, so that we may review these reports in order to measure our insurance risk.

Since national banks included on the Comptroller's list of banks in need of special supervision are those most likely to present the greatest potential of financial risk to the federal deposit insurance fund, FDIC is automatically provided all reports of examination of these banks. Other national bank examination reports are made available to FDIC upon specific request. Review of such national bank reports of examination is made on a random sampling basis so FDIC may be informed as to their condition on a more current basis. Under this program about 15 percent of the examination reports of national banks are reviewed annually.

Where circumstances warrant, the bank is accorded problem bank status by FDIC's Division of Bank Supervision and a written analysis of the situation summarizing the specific difficulties, contributing factors, and corrective action being taken by the Comptroller of the Currency is prepared for the information of FDIC officials. A copy of this analysis is also provided to the Comptroller's Office.

FDIC utilizes three categories of problem banks. The most stringent of these is designated "Serious Problem -- PPO" (Potential Payoff), which is assigned when a bank is considered to present at least a 50 percent chance of requiring financial assistance from FDIC in the near future. Next in severity is the "Serious Problem" status which includes banks which threaten ultimately to involve the Corporation in a financial outlay unless drastic changes can be brought about. Finally, banks which have not deteriorated to a point where assignment of one of the two foregoing categories is in order, but nonetheless have substantial weaknesses requiring prompt corrective action, are designated "Other Problem." Generally, elements which cause a bank to be classified as a problem include, among other things, a rapid rate of asset deterioration, an extraordinarily low adjusted capital position, pronounced management deficiencies, or other adverse factors.

In the case of USNB, the reports received prior to the report of the June 1972 examination gave no cause for alarm and the bank was not classified as a "problem" bank. Then, in late October 1972 FDIC received a copy of the June 26, 1972 Examination Report of USNB, the so-called Martin I Report (based on the name of the national bank examiner in charge of the examination which was completed on September 12, 1972). On November 9, 1972, after a review of the Martin I Report, FDIC's supervisory staff classified the bank as a "serious problem." Classified assets had risen from 25 percent of capital and reserves as of the September 13, 1971 examination to 371 percent of capital and reserves as of June 26, 1972; 86 percent of the classified assets were obligations of business entities which C. Arnholt Smith and his family and business associates controlled; and standby letters of credit totalling \$113,000,000 had been issued in favor of these entities. The majority of the classified assets were in the "substandard" category -- the least serious of three adverse classifications, the other two classifications being "loss" and "doubtful."^{*/} Thus, the Martin I Report did not indicate that there was

^{*/} It is generally assumed that assets classified "loss" are virtually uncollectible, those classified "doubtful" are, on the average, 50 percent collectible and those classified "substandard" are in need of aggressive management servicing and attention to prevent further deterioration and potential loss.

immediate concern for USNB's solvency, although a severe liquidity strain appeared possible if USNB were forced to fund its standby letters of credit. This report also noted, for the first time, that C. Arnholt Smith had deliberately concealed credit information relating to the classified loans in order to hide their true quality.

At about this same time the Washington Office of FDIC began to receive reports from some of its Regional Directors indicating that they had discovered USNB letters of credit issued to guarantee loans made to Smith-related companies in State nonmember banks examined by FDIC. In some cases these loans amounted to alarmingly high percentages of the capital and reserves of the nonmember banks in question. As a result of further investigation, FDIC determined that USNB, working through a broker, had sold these Smith-related loans, attaching its letter of credit as a "guaranty" of their payment, to many banks and other financial institutions.

Members of the FDIC's staff immediately began consultations with their counterparts in the Office of the Comptroller of the Currency to determine what supervisory steps were being taken with regard to USNB and in order to be kept advised of its financial condition. Of primary concern in these consultations was USNB's liquidity position. At that time, FDIC was advised that the Comptroller of the Currency's Office

planned to examine the bank again in early January 1973 and this examination was commenced during the first week of January 1973.

During January and February we also became aware of the investigation by the Securities and Exchange Commission into the C. Arnholt Smith empire. No details of that investigation were then available to us except that USNB was "involved."

In late April of 1973 various members of the FDIC and Comptroller's staffs were invited to attend a meeting called by the staff of the SEC's Enforcement Division. At that meeting the SEC's staff advised those present that it had concluded an investigation of Mr. Smith and the various companies controlled by him, including USNB. As a result of the investigation, which was based in part on information made available to the SEC by the Comptroller's Office from the January 5, 1973 examination of USNB, the SEC's staff had found that USNB was heavily involved in various allegedly fraudulent transactions and that as a result of these transactions the value of the Smith-related loan portfolio was extremely questionable, more questionable even than the Comptroller's June 1972 Examination Report had indicated. The SEC's staff further advised that it was considering requesting an "equity receivership" for both USNB and Westgate California Corporation, a major Smith-controlled affiliate, in order to protect minority shareholders. The SEC's staff

invited the Comptroller's Office, as the bank's supervisory authority, and FDIC, as insurer of the bank's deposits, to comment on what they believed would be the effect of the proposed court action and whether, in their judgment, the proposed action was contrary to the public interest or in conflict with their regulatory responsibilities.

The representatives of the banking agencies at this meeting advised the SEC's staff that naming USNB as a party to or as a conspirator in the proposed fraud action might cause a run on the bank and frustrate the possibilities of an orderly transfer of its assets and liabilities to another insured bank. There was also an extended discussion of whether the SEC or the court had any legal authority to appoint an equity receiver for a national bank and whether the SEC's enforcement objectives could be attained without naming the bank as a party or as a conspirator. In this regard, the FDIC staff suggested that the SEC should, in order to balance the protection of depositors and other creditors with the rights of minority shareholders, distinguish between USNB as an institution and those persons who involved the bank in the allegedly fraudulent transactions; that, in other words, the prevention of future fraudulent activity could be accomplished even if the bank were not named as a defendant or conspirator. Further, it was pointed out that the Comptroller's Office could force the

responsible wrongdoers out of the bank's management without an equity receivership. At this meeting, the Comptroller's representatives advised those present that he was considering issuing a cease-and desist order against USNB and that his Office had discussed the possibility of a consent order with C. Arnholt Smith. As you know, the Comptroller issued such an order on May 24, 1973. That order required, among other things, that C. Arnholt Smith resign as an officer and director of USNB.

In a letter to the SEC dated May 10, 1973 the Acting Comptroller of the Currency asked for an opportunity to review and comment, prior to its release, upon the contents of any court complaint or public announcement proposed to be issued by the SEC which might name USNB as a party in an SEC fraud action. A second letter on this same matter was sent to the SEC by the Acting Comptroller of the Currency on May 25, 1973. Both letters identified the harmful consequences which, in the Acting Comptroller's judgment, could follow the naming of the bank in an SEC fraud action.

I authorized the Acting Comptroller of the Currency to state, in his letter of May 25, that I concurred with the statements he made in both letters concerning the potentially harmful consequences of naming USNB as a party or as a conspirator and concerning the appropriateness

of permitting the Comptroller of the Currency to deal with USNB's management and asset problems without the filing of an SEC lawsuit naming the bank as a party. The SEC apparently concurred in this view, for subsequent to the receipt of these letters, the SEC did authorize the filing of a fraud action against Westgate California, C. Arnholt Smith and others, but the bank was not named as a party to the action.

In early May the results of the January 1973 examination were received by FDIC in preliminary and abbreviated form. Based primarily on this information and its evaluation by both the Comptroller and the SEC, FDIC continued USNB's designation as a "serious problem" and added the designation "potential payoff."

In mid-July 1973 FDIC received a complete copy of the report of the January 5, 1973 examination of USNB (the so-called Martin II Report). At that time FDIC's review examiners indicated that the classified assets were almost 300 percent of the bank's capital and reserve accounts. More alarming, however, was the fact that during this examination the asset classifications assigned were substantially more adverse than in the previous examination. Many of the Smith-related loans were classified as loss or doubtful rather than as substandard, as in the prior examination.

Throughout the period May to mid-July 1973 FDIC's major concern was USNB's liquidity condition and the arrangements being made to improve that condition. During June the liquidity problem worsened and the Federal Reserve Bank of San Francisco was drawn into discussions attended by FDIC personnel, at which meetings it was agreed that the Federal Reserve Bank would provide the immediate liquidity needs of USNB.

Discussions continued in July both in San Francisco and Washington among officials of all three Federal banking agencies concerning USNB's liquidity and a long-run solution to USNB's problems. The Federal Reserve Bank of San Francisco continued its short-term advances. As I noted earlier, during this period there were preliminary discussions between USNB's management, the Comptroller's Office and interested banks looking toward a deposit assumption transaction without FDIC assistance. Also, a re-examination of the entire range of Smith-related credits was begun in July.

In late August 1973 Comptroller of the Currency Smith requested a joint meeting with representatives of the FDIC and the Federal Reserve Board. At that time the Comptroller advised FDIC of the preliminary findings of the limited July examination. The Comptroller also indicated that it was his opinion, based on the most recent examination, that in the very near future insolvency was probable and that there was little

possibility of a takeover by another bank without financial assistance by FDIC. Subsequent to that meeting, FDIC began actively to consider the alternative courses of action available under the Federal Deposit Insurance Act, and ultimately put together the transaction which resulted in Crocker's purchase of designated USNB assets and its assumption of designated USNB liabilities.

VI. CURRENT STATUS OF THE USNB RECEIVERSHIP

I would also like to summarize for you the current status of our liquidation efforts.

FDIC as Receiver is now completing an inventory of the USNB assets assumed by Crocker which are subject to price adjustment during a 210-day settlement period in accordance with the purchase and assumption agreement. This has required separating from USNB's records those files and documents associated with Smith-related loans. Approximately 50 FDIC employees are involved in this process and virtually every relevant document must be inventoried, read and analyzed. Physical assets such as the approximately 20,000 items of furniture and fixtures spread throughout USNB's 63 domestic locations must be located; leases on 33 branches must be analyzed; and the ownership status of the remaining branches must be determined. At present, the receivership has acquired 2,774 assets aggregating more than \$420 million in book value,

including charged off loans of \$6.7 million. This task has been made more difficult by the discovery that records of many transactions were not located on USNB's premises. As I previously indicated, FDIC is using its subpoena powers to recover as many of these records as possible. Further, at the time of closing, there were more than 150 lawsuits by or against USNB relating to its normal banking activities and FDIC as Receiver is in the process of assuming control of those lawsuits.

The liquidation is proceeding in an orderly manner and additional information is being developed daily. Our representatives have been in contact with the majority of debtors and creditors of the receivership and are proceeding to assist debtors in their current problems and to advise creditors of the requirements for filing relevant claims. I would anticipate being able to provide the Congress with more complete information as to the status of the receivership periodically in the future.