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THE FDIC AND FRANKLIN NATIONAL BANK: A REPORT TO THE CONGRESS AND ALL FDIC-INSURED BANKS

Presented by

Frank Wille, Chairman
Federal Deposit Insurance Corporation

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of the

Savings Banks Association of New York State

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It is now a matter of history that Franklin National Bank ("FNB"), the nation's twentieth largest bank nine months before, was declared insolvent by the Comptroller of the Currency at 3:00 p.m., Eastern Daylight Time, on Tuesday, October 8, 1974. Pursuant to law, the Comptroller of the Currency simultaneously appointed the FDIC receiver of the Bank. The FDIC Board of Directors (Frank Wille, Chairman; James E. Smith, Comptroller of the Currency; and George A. LeMaistre, Director) convened immediately thereafter at the Federal Reserve Bank of New York to accept one of the bids received earlier that day from four sound banks for the assumption of all of Franklin's deposit liabilities (then approximately $1,369,000,000), the assumption of certain other designated balance sheet liabilities (amounting to approximately $266 million), and the purchase of Franklin assets of equal value (less the purchase price bid), including a right of first refusal on each of Franklin's 104 offices.

The winning bid of $125 million, the highest of the four submitted, came from European-American Bank & Trust Company ("European-American"), an FDIC-insured State nonmember bank owned jointly by six large European banks with combined assets in excess of $90 billion. Since European-American, like the other three bidders for FNB's banking business, declined to accept FNB's trust business on the terms offered by the receiver, the FDIC accepted a contingent bid of Bradford Trust Company, an FDIC-insured State nonmember which was already servicing a large portion of FNB's corporate trust business, to purchase all of the Bank's trust department. Further approval was given to the European-American transaction by the FDIC Board of Directors as the responsible agency under the Bank Merger Act, and the necessary State approvals for both transactions were received shortly thereafter from the New York State Banking Board, which had commenced a special meeting at 1:00 p.m., and from the New York State Superintendent of Banks. The FDIC then petitioned The Honorable Orrin G. Judd, the judge previously assigned to the matter by the United States District Court for the Eastern District of New York, for his approval of each of the proposed transactions under applicable provisions of the National Bank Act. After an *ex parte* hearing at which all of the final documents were entered into the record and sworn affidavits were received from the Comptroller of the Currency and myself, the court approved both purchase and assumption transactions.

The next morning, European-American reopened all of FNB's 104 offices, thereby providing uninterrupted banking service for all FNB customers, while Bradford Trust Company similarly continued the Bank's trust business without interruption. In all, some 630,000 FNB depositors, including 6,000 whose individual deposits exceeded the $20,000 insurance limit, and the beneficiaries of some 3,000 trust department accounts at FNB were fully protected with no apparent interruption in the banking services provided them.

The transfer of FNB's deposit and trust business went so smoothly, it looked easy. But the events of October 8 were in fact the culmination of five months of activity in which five Federal agencies, the New York State Banking Department, the New York Clearing House Association, some twenty different commercial banks or their parent holding companies, and even Franklin National Bank itself participated. My purpose in this report is to detail for the record FDIC's participation in the events of those five months.

May and June

The FDIC was informed Thursday evening, May 9, by the Comptroller's Office that public announcements to be made the next day by FNB's parent ("Franklin New York") might well precipitate a crisis of confidence in the Bank. I was told that Franklin New York would announce the passing of its regular quarterly dividends, that the Bank also had sizeable foreign exchange losses of undetermined amount, and that there existed the possibility of a serious, adverse reaction which might include a "run" on the deposits of the Bank.

Franklin New York's press announcement, coming on the heels of an April release reporting first quarter earnings down sharply to only two cents per share and the Federal Reserve's May 1 denial of Franklin New York's proposal to acquire Talcott National Corporation, provoked an immediate public, or at least institutional, reaction. Large scale withdrawals on Friday, May 10, coupled with the inability of FNB to borrow significant amounts in the Federal Funds market, forced the Bank to the Federal Reserve discount window later the same day, where it remained continuously thereafter through October 8. Franklin New York followed its Friday announcement with a Sunday press release indicating substantial foreign exchange losses due to "unauthorized" trading, a plan to raise $50 million in new capital through a rights offering, and the likelihood of significant management changes on Monday. In a special release issued Sunday, May 12, the Vice Chairman of the Federal Reserve Board of Governors, announced that the Federal Reserve System, having been assured of the solvency of Franklin National Bank by the Comptroller of the Currency, stood ready to advance to FNB the liquidity funds it needed "within the limits of the collateral that can be supplied." On Monday, Franklin New York announced the firing of its president and chief administrative officer, who also held similar posts at FNB, and the resignation of its chief international executive. This contributed to a further erosion of public confidence and by the close of business Wednesday, May 15, less than four business days after the first of these series of announcements, FNB's loan at the Federal Reserve discount window had reached $780 million. A steady stream of adverse newspaper comment, including allegations that the true extent of the Bank's deteriorating condition was being suppressed by incomplete and inaccurate statements issued by the Bank's management and successive management requests for the SEC to suspend trading in Franklin securities, only made matters worse as institutional depositors and foreign banks with maturing CDs refused to renew them.

On May 14, the Comptroller of the Currency commenced a new evaluation of FNB's loan portfolio in order to update the results of a November 1973 examination which had shown a significant adverse change in the condition of FNB's loan portfolio compared with the 1972 Report of Examination and in order to assess the full extent of the foreign exchange losses which had not been discovered in the November examination. Shortly before the end of the month, the Comptroller announced that he had asked the members of the New York Clearing House Association to examine FNB's operations and to make recommendations to strengthen its earnings performance.

By the end of May, FNB's loan at the Federal Reserve window had climbed to $1.2 billion.

During May and June, Franklin's management attempted to generate interest in a prompt merger or acquisition without any special FDIC financial assistance. The Comptroller of the Currency and representatives of the Federal Reserve System put out feelers to the same end, but to no avail, possibly because the financial community was generally aware that the New York Clearing House members had reached a tentative conclusion that an immediate infusion of approximately $250 million from the FDIC would be desirable in any effort to restore public confidence in FNB and to reverse its dismal earnings performance.*/

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*/ That tentative recommendation was relayed to me by the Comptroller, but he was fully aware of the limited statutory power of the FDIC to grant such assistance and the recommendation was not pressed. An extended discussion of this statutory power was contained in my letter of October 3, 1974, to The Honorable Wright Patman in connection with the proposal submitted by FNB's management in September for FDIC financial assistance to remain an independent, Long Island-based institution.

In these first two months of Franklin's public ordeal, it was agreed between the Comptroller of the Currency, the Federal Reserve System and the FDIC, that the FDIC should stay very much in the background and avoid public identification with efforts to find a solution for FNB's problems. The concern at the time was, of course, that public disclosure of FDIC's interest in the outcome of the Franklin National Bank situation would lead to a general conclusion that FNB's failure was likely, if not imminent. Coming eight months after the FDIC's very public role in the failure of United States National Bank, San Diego, this type of public reaction was seen as a distinct possibility, and it was felt that any public identification of FDIC's role would feed speculation in the press about the Bank's long-run ability to withstand the massive outflow of deposits it was experiencing and, in all likelihood, would prevent the possible consummation of a merger or acquisition without special Government financial assistance or indemnities. As a matter of prudent contingency planning, however, the FDIC was kept informed on a current basis of developments within the Bank, and a group of its examiners joined a special task force of national bank examiners monitoring daily changes in the Bank's condition and Federal Reserve bank examiners who were reviewing the collateral being provided by FNB for its steadily increasing window loan.

In early June, I suggested that this task force of examiners begin pulling together on a crash basis all of the information which might be needed by a prospective purchaser of Franklin National Bank, including detailed information about its loan portfolio, its securities investments, and its deposit structure. Much of this information had to be developed from work papers in the possession of national bank examiners or from information specifically requested of the Bank's management. This joint information-gathering operation concentrated first on the obvious things a prospective purchaser might wish to know about the Bank's operations, its problem areas and the reasons for its poor earnings performance, but in due course, the information base available to us was expanded with greater and greater detail and continually updated throughout the summer so that all concerned might be working with the latest figures. Not coincidentally, the FDIC itself benefitted significantly from the development of this data base since it gave the Corporation as well as prospective purchasers a far better handle on many of FNB's operations than the usual report of examination.

The FDIC also undertook to develop, strictly on a contingency basis, the opening position it would take if, by invitation of the Comptroller of the Currency and the Federal Reserve Board, it were asked to conduct negotiations with interested banks looking towards an FDIC-assisted purchase and assumption transaction involving all of Franklin's deposit liabilities. For this purpose, we received verbal reports from the three team leaders of the New York Clearing House Association task force which had been analyzing FNB's operations and reviewed all of the information otherwise at hand concerning FNB's condition.

The FDIC's analysis in the development of its negotiating position led it initially to the conclusion that a transaction might be fashioned generally along the lines of the FDIC transaction with Crocker National Bank in October 1973 for the assumption of all the deposit liabilities of United States National Bank, San Diego. There were, however, recognized differences between the two situations. Despite a wide variety of rumors centering on Michele Sindona, Franklin's control shareholder, the Comptroller's reports of examination showed little reason to believe that the Bank's operations were riddled with fraud based on a conscious effort to favor the business interests or overseas banking connections of this shareholder. We saw no reason, therefore, to carve out of the assets and liabilities to be transferred, as we had in the United States National Bank failure, those assets and liabilities related to the Bank's controlling shareholder or his various interests. We anticipated, however, that any FDIC-assisted transaction would have at least three components included in the United States National transaction: (1) an FDIC indemnity against FNB liabilities not specifically assumed by the purchasing bank; (2) a "put-back" provision of undetermined amount whereby the purchasing bank could return to FDIC as potential receiver of FNB classified, low-yield or otherwise undesirable loans and securities; and (3) an FDIC purchase of a capital note issued by the purchasing bank.

The FDIC made two basic decisions at this time which had a significant effect on the subsequent negotiations it would conduct as potential receiver of Franklin National Bank and on the eventual form of the purchase and assumption transaction with European-American. The first was to require competitive bidding by more than one bank on a uniform basis, if this were possible. The second was not to contribute in cash more than the $750 million estimated to be necessary to pay off all insured depositors up to the $20,000 insurance limit then in force.

The reasons for these two decisions were relatively simple. As receiver of a closed bank, FDIC has a fiduciary duty to the creditors of the bank and to its owners to realize the highest price it can get for the going concern value of the closed bank's business. It also has a statutory duty to minimize its own loss. In carrying out these responsibilities, it has been, and continues to be, FDIC's experience that competition between two or more prospective bidders for the assets, deposits and offices of a closed bank is the environment most likely to result in the fairest terms for the FDIC among the myriad of contractual provisions that are possible and the most likely to bring the highest price for the going concern value of the closed bank's business. A negotiated deal with only one institution, or a bidding procedure in which there is known to be only one bidder, almost never produces these benefits. The disadvantage of competitive bidding is that developing a uniform basis on which interested parties with diverse interests can bid at the same time is time-consuming and frustrating as prospective bidders seek to gain advantages for themselves or to impose disadvantages on their opponents by particular contract provisions. In most disputes, however, the competitive bidding process tends to insure that a reasonable allocation of risk between FDIC and the successful bidder will be reflected in the final bid package. As to the price results of competitive bidding, we at the FDIC have seen time and again the wide spread between high and low bids submitted on the same bid package -- the spread in FNB's case amounting to exactly $100 million -- and we know of no fairer way to establish a true value for the proposed transaction.

Our decision not to lay out more in FDIC cash than would be required in a statutory payoff of the $20,000 insurance limit was equally pragmatic. If the maximum exposure of the FDIC fund under its insurance commitment was $750 million, and if the FDIC statute provided, as it does, that we should elect either a payoff of $20,000 per depositor or a purchase and assumption transaction with a sound bank depending on which is most likely to "reduce the risk or avert a threatened loss to the Corporation," we could see no way of justifying to the Congress, or to FDIC-insured banks which have contributed over the years to the FDIC trust fund, a cash outlay, even on a temporary basis, of more than the FDIC might be required to advance in a statutory payoff.

This second decision had one immediate consequence for the Federal Reserve System whose window loan to FNB already exceeded $750 million: we would not under any circumstances pay off this loan in full on the day FNB might be declared insolvent, even though that had been our practice in all recent bank failures that had resulted in an immediate purchase and assumption transaction. Moreover, even without the immediate repayment by FDIC of the Fed's window loan, it appeared quite possible that other provisions of the purchase and assumption agreement might result in an initial FDIC outlay approaching $750 million. FDIC agreement, for example, to purchase a capital note of the successful bidder in the range of $200-$300 million, to buy back unwanted loans and securities in the range of $300-$400 million, and to establish a reserve for possible "errors and omissions" in the scheduling of assets purchased by the assuming bank could well have brought FDIC to the same outlay as a statutory payoff without regard to the repayment status of the Federal Reserve loan. For FDIC to have agreed as well to pay off the Fed's window loan immediately upon its appointment as receiver might thus have required the liquidation of about one-third of the $6 billion fund FDIC had accumulated over a period of forty years. It was our belief that given the economic uncertainties of the times and increasing questions about the stability of the banking system, we would have lost as much or more in public confidence by a $2 billion reduction in the FDIC insurance fund as we would have gained by a speedier resolution of the Franklin National Bank's problems. We felt obliged, in other words, to protect as much of the federal deposit insurance fund as possible against the unknown contingencies of the future, while recognizing at the same time a clear statutory duty to advance $750 million in the event of a statutory payoff up to the $20,000 insurance limit.

This basic decision meant that, if, as and when we were called upon to initiate discussions with banks interested in an FDIC-assisted purchase and assumption transaction, some way would have to be found to pay off the FNB loan at the Federal Reserve window other than with FDIC cash. One obvious possibility was to insist that the purchasing bank assume the responsibility for repaying this FNB liability if it wished to purchase the assets held by the Federal Reserve as collateral for the loan's repayment. In preparation for discussing this possible aspect of the contingency plan we were developing, we solicited and received from the Board of Governors of the Federal Reserve System an expression of its willingness, as well as the willingness of the Federal Reserve Bank of New York, to continue the window loan for some purchasing bank and of the conditions for such an extension of the loan in the event of a successful purchase and assumption transaction.

By July 1, the loans secured by FNB collateral on deposit with the Federal Reserve System had reached $1,455,000,000, while the deposits of the Bank had shrunk to slightly over $2 billion.

compared with $3.2 billion on May 14. Most of this deposit decrease was caused by the withdrawal of uninsured foreign and institutional deposits, although there had been, and continued to be throughout the summer, a steady but much slower rate of outflow in other types of deposits as well. By that date, it was also obvious that efforts to work out a merger or acquisition on a bank-to-bank basis without FDIC assistance had been fruitless.

July 2 - August 12

On July 2, the Comptroller of the Currency informed me by letter that he had concluded that the most constructive approach to be taken, under these circumstances, was to explore the possibilities for an assisted sale of either all or part of Franklin's assets and the assumption of its deposit liabilities. He requested, as the Federal Reserve System had several weeks earlier, that the FDIC initiate discussions with banks in the State of New York and such foreign banks as it deemed appropriate to explore the possibility of consummating such an assisted transaction. The importance of presenting one negotiating posture to potential bidders was obvious, even though the negotiations would clearly require coordination among the three banking agencies in Washington, the Federal Reserve Bank of New York, the New York State Banking Department and the Antitrust

Division in the Department of Justice. It was agreed, therefore, that while each of the bank supervisory agencies could be represented at all negotiating sessions if it wished, only one person could, as a practical matter, lead the Government's negotiating efforts, and I was designated for this purpose.

Immediately after receiving the Comptroller's letter, I communicated with twenty banking organizations headquartered or represented in New York State about their possible interest in such an assisted transaction. In addition, at my request, the Board of Governors communicated with the Bank of England, the Bank of Japan and the Bank of Canada to determine if the larger banks in those countries with offices in New York might be similarly interested. Between July 5 and July 12, I held separate meetings at the FDIC Building in Washington with thirteen of those contacted, and subsequent to July 15, with three others. In these sixteen meetings,*/ each of which lasted approximately two hours, our visitors were

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*/ Held with First National City Bank, The Chase Manhattan Bank, N.A., Manufacturers Hanover Trust Company, Chemical Bank, Bankers Trust Company, Charter New York Corporation, Marine Midland Banks, Inc., The Bank of New York, European-American Bank & Trust Company, Barclays Bank of New York, Algemene Bank Nederland, N.V., Royal Bank of Canada Trust Company, First Commercial Banks, Inc., United Bancorporation, Lincoln First Banks, Inc., and First Empire State Corporation.

provided with as much detailed information about the Franklin's condition as we were then in a position to give them. This information included the open portion of the Comptroller's Report of Examination commenced November 14, 1973, his updated report of May 14, 1974, his most recent Report of Examination of FNB's trust department, the Bank's filings with the Comptroller as to its data processing operations, general information about the Bank's 104 offices, and a compilation of special information prepared by the joint agency task force of examiners which had been at work at the Federal Reserve Bank of New York. This additional compilation included breakdowns of the Bank's statement of condition as of June 10, profit and loss statements of the parent holding company and of the Bank's London branch as of May 31, a detailed breakdown of various accounts on the Bank's balance sheet including a maturity schedule for the Bank's investment portfolio, information as to the average yield on different categories of FNB securities and loans, the cost of its time deposits, schedules of maturities on its certificates of deposits and of the interest rates they carried, a schedule of the Bank's borrowings as of June 21 and of the approximate amount of the collateral pledged to the Federal Reserve for its window loan, information as to FNB's employee benefit plans, certain summary information as to the operations of FNB affiliates, and a listing of certain of the Bank's known contingent liabilities.

In addition to this basic information about FNB, I also discussed in general terms the kind of FDIC and Federal Reserve assistance which might be available in the event of Franklin's insolvency and the kinds of purchase and assumption transactions which FDIC had successfully concluded·in the past. I also placed on the table for each group's consideration our tentative thoughts with respect to a possible purchase and assumption transaction in this instance. This outline contemplated the assumption of all FNB deposit and other balance sheet liabilities, including FNB's liability on its Federal Reserve window loan, and the purchase of essentially all FNB's assets subject to a "put-back" provision to the FDIC in an amount to be negotiated. I made it clear that the FDIC would be prepared to sign its usual indemnity agreement against liabilities which had not been specifically assumed and would be prepared to subscribe to a capital note of the purchasing bank in an amount at least equal to the $50 million provided Crocker National Bank in the United States National Bank failure.

Each group was asked to analyze the information provided and to relay to me as promptly as possible an expression of its top management's preliminary reaction, whether positive or negative. I indicated that in our own review of these discussions, it would be most helpful to have a candid explanation as to the reasons why each group reacted the way they did. I further indicated that there was considerable urgency in the promptness of their response, since we did not know how fast FNB's deposits would run out or how quickly FNB's window loan might exhaust its eligible collateral. We recognized, however, that since the information we had provided was voluminous and since the proposed transaction was of the magnitude outlined, it would probably take at least a week for most of our visitors to analyze the material presented and to brief key officers and directors before arriving at even a tentative reaction. In fact, although some of these sixteen groups were quite prompt in reporting their reactions, particularly those that were negative for one reason or another, others pursued their analyses more slowly. By the end of July, it was apparent that only one bank was definitely interested in pursuing what we at the FDIC came to call the "$4 billion" proposal for resolving FNB's problems (i. e., by assuming all of FNB's balance sheet liabilities and most of its assets). Many of the banks reporting a negative reaction stressed the magnitude of the proposed acquisition and the effect on their own earnings and their own stock performance of taking over FNB's low-yielding assets, particularly if they were not much larger than FNB itself. Several expressed the view that they could not justify the commitment of management time necessary to work out FNB's problems or the capital commitments necessary for such a transaction. In addition, a number of our visiting banks pointed out that the Federal Reserve Board was demanding, in its bank holding company decisions, a higher standard than heretofore of capital adequacy in the face of holding company growth, and that they already felt under significant pressure to improve their capital positions without the added burdens of an FNB acquisition.

Based on these reactions, which revealed far more interest in parts of FNB than in the whole of FNB, the FDIC proposed to the Federal Reserve System an alternative transaction whereby, in the event of FNB's insolvency and FDIC's appointment as receiver, FDIC in its corporate capacity and not as receiver would assume FNB's liability on its loan from the Federal Reserve Bank of New York and would pay this off over a reasonable number of years as it collected FNB assets of equal or greater book value. Concurrently, a bidding bank would be asked only to assume FNB's deposit liabilities and other nonsubordinated balance sheet liabilities exclusive of the

Federal Reserve window loan. In exchange, a bidding bank would acquire FNB assets of its own choosing, free of any security interest of the Federal Reserve, of a value equal to this smaller total of liabilities to be assumed (value to be measured by fair market value in the case of securities, real estate, furniture and fixtures and by book value in the case of loans and cash-type items) less a premium which would constitute its purchase price for the transaction. The effect of this proposal, insofar as prospective bidders were concerned, was to reduce the magnitude of the overall transaction from something less than $4 billion to something less than $2 billion. This would reduce the magnitude of the earnings risk they were being asked to undertake and the magnitude of the new capital that might be required. If this scaled-down version of an FNB acquisition were presented to those banks which had expressed an interest in some but not all of the Bank's assets and liabilities, it was my belief that five or more banks or bank holding companies might eventually become serious bidders for the total transaction offered. The Federal Reserve System readily agreed to this concept, and in early August, as we were awaiting the last responses from the banks initially briefed in July, this alternative plan was placed before all of them for consideration.

On August 6, acting upon a suggestion from a number of the groups with which we had talked, FDIC solicited the views of the Antitrust Division as to whether and under what circumstances banks interested in some part, but not all, of FNB's assets, deposits and offices might jointly prepare a single bid for the same type of transaction. The FDIC's letter to the Antitrust Division, and the Antitrust Division's prompt response to this inquiry (which was generally favorable so long as no more than one of the five largest retail banks in the New York metropolitan area were included in any one bidding group) were both transmitted to each of the interested banks which had met with FDIC about an assisted transaction.

Meanwhile, the Federal Reserve and FDIC agreed on the basic terms of the agreement which was later entered into between them for the repayment of the Federal Reserve's window loan and for the release of the Federal Reserve's security interest in those assets which might end up in the hands of the purchasing bank as part of its selection of FNB assets (the Federal Reserve's security interest in FNB assets held by FDIC, however, would continue until FDIC disposes of the asset). We agreed, for example, that regardless of the FDIC's collection on the assets it held, the net proceeds of which would be paid to the Federal Reserve on a periodic basis, FDIC would pay off this loan in full at the end of three years. By that time, based on our collection experience in other liquidations, we anticipated a remaining balance of $500 million or less, the payment of which would then represent about one year's net addition to the FDIC fund. Subsequent to that payment, the FDIC would have the right, of course, to continue to collect any remaining assets it held in order to reimburse itself for the final cash payment to the Federal Reserve. We agreed that collections would be applied first to outstanding principal and then to accrued interest, that the rate of interest on the Federal Reserve loan subsequent to FNB's closing would be the average portfolio yield of the System Open Market Account on the day of closing (subsequently determined to be 7.52% per annum), and that FDIC would be able to deduct from its interest accruals out-of-pocket liquidation expenses up to a maximum amount of $5 million per year.

The public policy implication of the FDIC agreement with the Federal Reserve as to the repayment of FNB's window loan is that the risk of loss on asset collections held to repay this loan was shifted from the general taxpayer, who receives the benefit each year of the surplus revenues of the Federal Reserve, to the nation's federal deposit insurance program, which is funded by the nation's

FDIC-insured banks, not the general taxpayer. We considered this entirely appropriate when the risk of loss had been created in the first place by the management errors of an FDIC-insured bank and not by the nation's taxpayers. I might add that once it became clear that it would not be possible to create a competitive bidding situation for a $4 billion transaction in which the Federal Reserve window loan would be assumed by the purchasing bank, there was never any question that as between the Federal Reserve System and the FDIC, the FDIC fund should bear the ultimate risk of loss on this window loan. Our final agreements with the Federal Reserve reflect this view.

<u>August 13 - October 8</u>

Serious efforts to develop the precise form of such a scaled-down transaction, price alone excepted, were commenced by me at the Federal Reserve Bank of New York on Tuesday, August 13, with officers of six banks which had indicated varying degrees of interest in the plan in attendance, as well as their counsel and representatives of the other Federal banking agencies. The intent of these meetings, and of later meetings of counsel and operating officials, was to develop a common set of bidding documents on which each seriously interested contender could bid competitively in the event that FNB were declared insolvent and FDIC became receiver. We also had to coordinate the actions of the public agencies involved, to plan ahead for the logistical support that would be needed on the day of closing, and to predict the kinds of operational problems that would exist thereafter since the winning bank and FDIC were to end up dividing FNB's assets between them.

From August 13 to October 8 was precisely eight weeks. While we had anticipated reaching a common set of predrafted bidding papers earlier in September than subsequently proved to be the case, there were four particularly troublesome aspects of the transaction which had to be fully explored before either the bidding banks or the FDIC were prepared to go forward. In addition, all six banks wished to have the benefit of a new evaluation by the Comptroller of the Currency of FNB's loan portfolio in view of what they believed to be a deteriorating situation within FNB and in the creditworthiness of certain classes of FNB borrowers. This review was promptly undertaken by national bank examiners on August 14 and completed in final form prior to the end of the month, but there was about a week's hiatus in our deliberations as we awaited the results of that new examination. The four troublesome areas to which we then turned our concentrated attention in September were as follows:

1. FNB's Foreign Exchange Exposure. Franklin National Bank ceased its heavy speculation in foreign currencies as soon as irregularities in its foreign exchange department were discovered and publicized, but the uncovered forward contracts resulting from these activities remained with FNB for workout throughout the summer. Fortunately, the Bank's management was able to obtain the services of Edwin A. Reichers, an experienced and highly regarded foreign exchange trader who had recently retired from First National City Bank, and his success during the summer in reducing the Bank's exposure from an astronomical figure to an increasingly more manageable figure was one of the few bright spots in an otherwise dreary summer for FNB. By early September, however, he reported that he was finding it increasingly difficult to find other foreign exchange dealers, either in the United States or overseas, who were willing to enter into foreign exchange contracts with FNB that might assist the Bank in winding down its exposed position. Moreover, numerous FNB foreign exchange contracts remained to be performed and there was a risk, not easily quantifiable, that parties to contracts favorable to Franklin might find a reason not to honor them.

The disposition of FNB's foreign exchange exposure in any purchase and assumption transaction was thus of considerable importance. The Federal Reserve System, which had been particularly concerned about the international implications of a precipitous failure of FNB from the beginning, considered it imperative for stability in the foreign exchange markets that FNB's unexecuted foreign exchange contracts be honored. FDIC shared that view, but pointed out that if these unexecuted contracts ended up in FDIC's hands as possible receiver, FDIC might have a fiduciary duty to FNB's creditors and owners not to honor those which were unfavorable to the Bank, and to demand performance of those which favored the Bank. We felt, accordingly, that we could give no assurances that all of these contracts would in fact be honored by the FDIC as FNB's receiver. Moreover, any use of the FDIC fund to work out the possible loss involved in an insured bank's foreign exchange position would have come as a great surprise to many who had a different view of the purpose of the fund. Similarly, we doubted the propriety of any explicit FDIC indemnity to an assuming bank against loss in the assumption of FNB's liabilities or risks in the foreign exchange area.

Given this situation, it seemed imperative that either (i) FNB's foreign exchange position and the risk of loss be assumed by the successful bidder without special FDIC indemnities or (ii) that the Federal Reserve System itself take over FNB's foreign exchange position prior to a possible closing. Three of the four bidding banks, however, refused to assume any part of FNB's foreign exchange risk, fearing not merely the monetary consequences of such a takeover (which could have been reflected in the premium bid) but also the likely market reaction to news that they had taken over any portion of the activities which had obviously caused FNB such trouble. Concentrated attention was then given to the ways in which the Federal Reserve Bank of New York could legally take over these unexecuted contracts for performance by its own experienced foreign exchange trading department. The foreign exchange experts of the bidding banks gave individual opinions to the Federal Reserve Bank of New York as to the likely market risks it would incur in covering the limited number of currencies which concerned Franklin, as well as the credit risks of nonperformance on contracts favorable to FNB by parties overseas. The Federal Reserve Bank of New York staff compared these estimates with its own and determined that with a high enough deposit from FNB itself to cover these various risks, the Federal Reserve Bank of New York could undertake full responsibility for working out FNB's foreign exchange position prior to a potential receivership so long as FNB agreed to make up any short fall in the deposit. Lawyers for the Federal Reserve Bank of New York then drafted the necessary papers by which that agency and FNB could agree to the transfer of FNB's foreign exchange position, including unexecuted contracts and related foreign currency balances, from FNB to the Federal Reserve Bank of New York.

Fortunately, disposing of its foreign currency operations neatly dovetailed with the plan FNB's own management had to retrench to Long Island and withdraw from the international arena. FNB in fact had sought the assistance of the Federal Reserve Bank of New York earlier in the summer in working out its foreign exchange position. I understand that the outline of an agreement to transfer FNB's foreign exchange position to the Federal Reserve Bank of New York was presented to FNB's management at a routine meeting of its top officials with the staff of the Federal Reserve Bank of New York on Monday, September 23, and that the final contracts were fully executed by both parties on Thursday, September 26.

It was agreed that the amount of FNB's deposit to cover the Federal Reserve's risks would be $15,645,000, of which a substantial portion would be paid back to FNB promptly upon confirmation by third parties to these various contracts that they were prepared to perform such contracts with the Federal Reserve Bank of New York rather than FNB. The Federal Reserve Bank of New York thereupon contacted central banks of those European countries in which these third parties were located and sent cables directly to each of the third parties involved explaining the novation and requesting confirmation of their obligations under the contracts the Federal Reserve Bank of New York had assumed. By Tuesday, October 1, virtually all of these third parties had confirmed their willingness to accept the Federal Reserve Bank of New York as the contracting party on these outstanding contracts, and the Federal Reserve Bank of New York immediately released to FNB $5,908,000 of FNB's deposit. The Federal Reserve Bank of New York promptly covered FNB's open positions and all of the contracts are now being executed, some at a profit and some at a loss to the Federal Reserve Bank of New York. As of November 15, the Federal Reserve Bank of New York still held a reserve of $6,088,000 against possible future losses in the performance of the remaining contracts, the last of which will not fall due until August 1975. The Federal Reserve Bank of New York continues to believe that it will be successful in honoring all of these outstanding contracts without fully depleting the remaining balance of the deposit it received from FNB. In the event that there is a surplus left in this deposit when the last contract has been executed, the remaining amount will be returned to FDIC as FNB's receiver.

The successful resolution of these outstanding unexecuted foreign exchange contracts was a key requirement before the Federal bank agencies were prepared to move on a possible purchase and assumption agreement involving the rest of Franklin's business. Once this matter was resolved, it should be noted that the agencies did move one week to the day after the receipt of all but a handful of the required confirmations on FNB's outstanding contracts.

2. FNB's London Branch. FNB had a well-staffed London branch which had played an important role in FNB's Eurodollar operations and the development of its international business. During the summer, the branch showed on its books more than $600 million in assets, largely Eurodollar loans to overseas borrowers on which the rate of interest was pegged to the London interbank rate on prime quality Eurodollar loans. They were thus among the highest yielding assets in FNB's total loan portfolio and as such were considered a

very significant segment of the assets from which the successful bidder was to be allowed to make its selection of FNB assets to balance off the FNB deposit and other liabilities assumed. The FDIC, as well as each of the prospective bidding banks, therefore, retained through their New York counsel London solicitors to advise upon the impact under English law of the proposed purchase and assumption transaction that was taking shape. In addition, it was essential that the cooperation of the Bank of England be obtained since they held physical custody of many of these assets as agent for the Federal Reserve Bank of New York under a complex security arrangement. So far as any of us knew, this was the first time a United States bank with a full-service overseas branch was faced with a possible finding of insolvency. It was certainly the first time in FDIC history that FDIC might be called on to act as receiver of a bank with a significant portion of its assets overseas.

For a variety of reasons, it appeared desirable that the FDIC's General Counsel and I travel to London in the midst of our negotiations in New York to discuss various ramifications of the proposed transaction with the Governor of the Bank of England and his staff. Accordingly, we made arrangements to visit the Bank of England on Friday, September 20, and utilized the balance of the same weekend to discuss related matters with our English solicitors and their advisers in London. This visit was extremely fruitful, and the Bank of England was generous in its cooperation and support for the proposed transaction we were negotiating. When Franklin National Bank was in fact declared insolvent and the FDIC appointed receiver, the necessary approvals for transfer of the Bank's London assets to the FDIC were immediately forthcoming under the English Foreign Exchange Controls Act, and other necessary governmental approvals were cleared expeditiously.

3. FNB's Domestic Branches. A close examination by special New York counsel for the FDIC and New York counsel for each of the bidding banks revealed that a substantial number of FNB branch offices were financed under special trust agreements in which the beneficial interests were held by independent third parties. Under one of these agreements, it appeared possible that the assuming bank might be required to elect or reject as a group thirty-three FNB branches without regard to individual location, profitability or mesh with existing branches of the successful bidder. This was clearly unsatisfactory to all the potential bidders, even European-American which had no branch system on Long Island and might have been expected to elect all thirty-three branches as part of its asset

selection. Since each of the banks with whom we were then negotiating had entered into our discussions on the good faith assumption that the asset and branch selection we had promised them would be made available to them, a solution to this problem had to be found and special provisions were written into the proposed purchase and assumption agreement in September in order to assure this result insofar as the thirty-three branch offices in question were concerned.

4. FNB's Trust Department. A final problem area between FDIC and the prospective bidding banks related to Franklin's trust department. Each of the final four bidders were concerned with various aspects of Franklin's corporate trust operation and requested special indemnities, never before given by the FDIC, under some of which the successful bidder would even have been protected against liability incurred because of its own acts subsequent to FNB's closing and the consummation of the purchase and assumption transaction. Moreover, it appeared that none of the prospective bidders wished to assume certain of FNB's pension trust activities for employees of companies that had filed Chapter proceedings under the bankruptcy laws. This was a particular problem for the State-chartered banks among the prospective bidders because of a New York banking law provision which provided that an assuming bank

would automatically become successor trustee only if it acquired all of FNB's trust business. Nor was the New York State Banking Department prepared to initiate a waiver of that provision, since it desired all of FNB's trust business to be assumed the same day FNB's deposits and banking business were assumed. Under these circumstances, it was determined the weekend before October 8 that each of the bidding banks would be given an option in the bidding form to accept or reject all of FNB's trust department on FDIC's terms, and contingency plans were made with Bradford Trust Company to assume the entire department in the event that the successful bidder elected not to accept FNB's trust department in its entirety. This in fact was how events later turned out and the reason why FDIC entered into a separate purchase and assumption contract for Franklin's trust business.

During the first week of October, the various strands of the transaction on which we had been working since July 2 finally began to come together. Each of the major items still open in the negotiations at the beginning of September, including final decisions on the terms of FDIC's capital note assistance for the successful bidder, had been resolved, the FDIC had briefed two hundred of its key supervisory personnel as to their responsibilities in the event

Franklin National Bank was declared insolvent and the FDIC was appointed receiver at a special meeting in Washington on Sunday afternoon, September 29, and it appeared that all four of the prospective bidding banks would be ready to proceed on Tuesday, Wednesday or Friday of the week of October 7. From the point of view of the agencies, a Tuesday or Wednesday closing was preferable to a Friday closing because all FNB offices, with the exception of a few drive-in windows, closed at 3:00 p.m. on those days of the week whereas on Monday, Thursday and Friday a substantial number of FNB offices were open until 8:00 p.m., while others closed at 3:00 p.m. On Saturday, October 5, I informed the Chairman of the Federal Reserve Board and the Comptroller of the Currency that I had commitments to bid in accordance with our proposed bid papers from two of the four banks with whom I had been negotiating and that all of the regulatory agencies appeared ready to proceed if FNB were declared to be insolvent. The decision to go forward on the earliest of the three days possible, namely, October 8, was then quickly made. The rest is now history.

FNB's Efforts to Remain Independent.

During August and September, FNB's management became convinced that with enough FDIC and Federal Reserve assistance it could remain independent and again become a viable competitor on Long Island. It formally submitted a plan to this effect to the three Federal banking agencies on or about September 16. By the first week in October, each of the agencies reviewing that plan had reached separate but similar conclusions that the plan was not feasible given FNB's past earnings performance and its likely earnings performance in the future based on realistic assumptions as to FNB's capabilities. In addition, FDIC by law has only limited power to assist an open and operating bank and it appeared to be impossible, in the light of the vigorous competition present in the New York banking market, to make the necessary finding that the continuation of Franklin National Bank, as distinct from the continuation of its offices as part of some purchasing bank, was "essential to provide adequate banking service in the community." The reasons for FDIC's rejection of the Bank's plan for an independent FNB were spelled out in greater detail in two letters which are now part of the public file: the first addressed to the Chairman of the House Banking and Currency Committee under date of October 3, in response to specific questions he had directed to me earlier about the cost of the FNB plan to the Government and the financial benefits FNB might be expected to realize if its proposed plan were effected, and my subsequent letter of October 8 to Joseph W. Barr, FNB's Chairman and Chief Executive Officer, which was delivered shortly before the Comptroller of the Currency served his notice of insolvency on the Bank the same afternoon.

I might say, parenthetically, that the nation's banking system is deeply indebted to Mr. Barr for his stewardship of Franklin National Bank and its parent holding company during this particularly difficult summer. He assumed office late in June after the damage had been done to Franklin, he prevented a bad situation from deteriorating further and he was personally responsible for several important but painful steps the Bank took to improve its operating condition and its future earnings performance. Under his leadership, for example, the Bank ordered additional chargeoffs in its loan portfolio based on the Comptroller's May 14 examination, it wrote off a deferred tax benefit account of increasingly doubtful value, it pursued efforts to work out FNB's foreign exchange exposure, it increased the monthly allocation to FNB's loan loss reserves and it accomplished a significant reduction in force designed to bring under control the Bank's inflated personnel costs and overhead. Although the Bank's loan and deposit business was steadily eroding, many of these steps made FNB in October a more attractive candidate for a purchase and assumption transaction than it was in May. While we obviously disagreed with the long-run feasibility of his plan to keep Franklin National Bank alive as an independent, Long Island-based institution, we fully understood that his primary obligation was to the creditors and shareholders of the Bank. He performed, in other words, a thankless task the benefits of which should now redound to the benefit of European-American and the creditors and shareholders of FNB.

The Terms of FDIC's Capital Note Assistance.

Shortly before the completion of our negotiations, FDIC resolved the final details of the capital assistance it would offer the successful bidder. The principal question, of course, was amount and this had two facets: (i) the total additional capital which the acquiring bank might require by virtue of the proposed transaction, and (ii) what proportion of that total FDIC should agree to supply. Questions of capital adequacy are essentially questions of judgment, and since the group of potential acquiring banks seemed to be narrowing to one national bank, two State member banks and one nonmember bank, I solicited the views of the New York State Banking Department, the Comptroller of the Currency, the Federal Reserve Bank of New York, the staff of the Board of Governors in

Washington, and the FDIC's own staff as to the appropriate level of overall capital support for a transaction which might, by the closing date, range between $1.5 billion and $1.9 billion in liabilities assumed. From these regulatory sources, the lowest estimate of the capital required solely for this transaction ranged from $110 million in the event of a $1.5 billion transaction to a high of $165 million in the event of a $1.9 billion transaction. The capital positions of the negotiating banks differed one from the other, and their own estimates of the total additional capital needed to support this type of transaction ranged from approximately $120 million to $225 million. In due course, given the continuing slow runoff in deposits (which had the effect of reducing the likely total of liabilities to be assumed), the difficulty of raising new bank capital during the summer, and the pressure being applied to all banks of significant size to meet increasingly severe standards of capital adequacy on the part of the Federal Reserve System in its administration of the Bank Holding Company Act, the FDIC determined that it would offer to fund the entire capital support which it felt this transaction should have and established that support figure at a maximum amount of $150 million.

With respect to the other basic terms of the proposed capital note, FDIC took the position from the start that any FDIC assistance would have to carry a rate of interest as close to the market rate for a publicly issued note of similar terms as we could reasonably make it. It was our position that a subsidized rate below market was inappropriate for any sound institution seeking an acquisition of this magnitude. In addition, it was FDIC's opinion that the statutory authorization for any such assistance contemplated a relatively short period of FDIC capital assistance to tide the acquiring bank over until it could arrange a public issue to replace the FDIC note and that each of the four prospective bidders would in due course have reasonable access to the capital markets for this purpose. FDIC, accordingly, took the position that it would accept a five-year capital note, without amortization, as it had in prior transactions, but that if the final maturity of the note went beyond five years, FDIC would require a reasonable program of amortization. The note finally offered to each bidder carried these terms:

a. Maturity. The first $100 million of capital assistance carries a final maturity of ten years, while the additional $50 million offered by FDIC carries a final maturity of eight years.

b. Interest Rate. The note carries a floating rate of interest set every six months at 100 basis points above the average yield on six U. S. agency obligations maturing in 1982, 1983 and 1984, subject to a minimum rate of 8.00% per annum and a ceiling rate of 11.25% per annum. The initial rate, based on this formula and applicable for the six months ending March 31, 1975, was 10.03% per annum. Since interest rates have fallen considerably since October 8, the rate if computed today would be substantially below the 10.03% rate to which European-American is bound between now and March 31.

c. Amortization. On the first $100 million of the total amount made available by FDIC, there is no amortization of principal for the first five years. For the next four years, the amortization required on this portion of the total note is $15 million per year with a balloon of $40 million at the end of the tenth year. Should European-American request additional FDIC capital support in an amount not to exceed the remaining $50 million offered by FDIC, the amortization schedule on this additional amount will be zero the first three years, 15% in each of the next two years, 20% in the sixth year, and 25% in each of the next two years, thereby retiring the full amount of any additional capital support by the end of the eighth year.

d. Prepayment Options. Since the purpose of FDIC capital assistance in this and other purchase and assumption transactions is to tide the successful bidder over until it can successfully refinance FDIC's assistance in the capital markets, the FDIC note provides that there will be no penalty for prepayment at any time and, in addition, provides a cash incentive for optional prepayments beyond the mandatory amortization schedule. This prepayment incentive starts at 3% of any optional prepayment made prior to September 30, 1977, and declines gradually over the ten-year life of the basic $100 million note.

I would reiterate that the interest rate carried by this FDIC note is not a subsidized rate but rather a market rate subject to an 8% floor. By contrast, the average yield on the entire FDIC portfolio has been fluctuating recently around 6.20% per annum while new FDIC funds have been invested during 1974 at an average rate of 8.05% per annum. By either measure, the FDIC has not subjected itself to any loss of potential investment income by agreeing to take European-American's note under the terms outlined.

Was an Earlier Resolution of FNB Possible?

There is absolutely no doubt in my mind that a different transaction could have been pasted together on a rush basis at some earlier point in the five months that transpired between the disclosure of FNB's problems in May and the close of business October 8. But I am equally convinced that such an effort would have been a financial disaster for the trust fund FDIC administers.

Under no circumstances would it have been realistic to expect a major bank to incur significant risks to itself or its shareholders merely to oblige a regulatory request to perform a public service by absorbing FNB and its problems. Indeed, no responsible regulatory agency would have desired that result if it meant a second, and possibly larger, banking crisis a few years from now. The only way to have met both concerns would have been massive FDIC assistance to the acquiring bank.

Thus, if the FDIC had guaranteed an acquiring bank against all risk of loss in the assets of Franklin National Bank, if in addition FDIC had agreed to substitute large amounts of cash for FNB's low-yield assets in order to boost the earnings performance of the resulting bank, and if FDIC had provided much greater capital assistance to support the whole transaction, I suspect a purchase and assumption agreement that would have been equally protective of FNB depositors as the one we achieved could have been effected long before October 8. Similarly, an agreement could have been effected far earlier than October 8 if no effort had been made to insure competitive bidding.

Either type of transaction, however, would have been inconsistent with the statutes under which FDIC operates. In addition, the first would have required a massive invasion of the FDIC fund to solve the problems of only one insured bank. In that depleted state, would the fund have continued to be a significant source of public confidence in the safety of the nation's banking system when the economic climate is so troubled and rumors about particular banks abound? I doubt it. The second type of transaction -- one effected without competitive bidding -- would have been grossly unfair to FNB's remaining creditors, subordinated noteholders and owners.

Fortunately, we had the time necessary to put together a defensible transaction. We knew late in July, for example, that the pace of FNB's deposit outflow had slowed and that most of the bad news was behind us. We further knew that the Federal Reserve Bank of New York held collateral having an approximate face value of $2.2 billion to secure loans then outstanding in the amount of $1.6 billion, and that it estimated that FNB still had potential collateral left of more than $500 million in face amount to cover additional advances. Under these circumstances, I opted for patience and thoroughness in our negotiations with prospective bidders, and I believe this approach later paid off in the purchase price paid by the successful bidder, in the reasoned allocation of risk between European-American and the FDIC that resulted, and in the smooth transition of FNB's business effected on October 8.

An Estimate of the Financial Risks to FDIC.

The FDIC's only net outlay to date as a result of FNB's failure has been $100 million for the capital note issued by

European-American in connection with its purchase of FNB assets and its assumption of FNB's deposit liabilities. We do not expect to lose one cent on the principal amount of that note, nor do we expect to lose one cent of potential investment income since the interest rate which we expect to receive during the life of that note will substantially exceed the FDIC's rate of return on its portfolio of U. S. Government obligations.

FDIC has already been repaid in full out of asset collections for $500,000 more which it advanced in early October for initial liquidation expenses, and it is anticipated that future liquidation expenses will be defrayed on a current basis out of income and principal collected on FNB assets held for FDIC's account.

The most significant contingent liability which FDIC undertook in connection with the purchase and assumption transaction with European-American, of course, is the agreement to pay off within three years the full amount of FNB's loan at the Federal Reserve discount window at the time it closed ($1,723,000,000) with interest at 7.52% (the average rate of return on the System Open Market Account the same day). Prior to the final maturity of that obligation, FDIC will be collecting interest, fees and principal payments on more than $2 billion in Franklin assets. Even if some cash outlay from the federal deposit insurance fund is necessary to meet this liability three years from now, it will undoubtedly be far, far less than $1.7 billion. While it is too early to tell the success of our collection efforts over the next three years, we currently believe that any cash outlay required from the FDIC three years hence will be $500 million or less. Since the FDIC will then be adding about the same amount to its trust fund each year, I consider this obligation to be well within the financial capabilities of the FDIC without a significant invasion of its accumulated trust fund. I would repeat what I said earlier, however, that if any FDIC cash must be paid to the Federal Reserve Bank of New York to meet this liability, FDIC thereafter will continue to collect the assets remaining in its hands in order to reimburse itself for the amount of this payment.

The long-term risk to FDIC, then, comes down to the eventual collectibility of the $2.1 billion of assets on FNB's books which FDIC will have in its hands as soon as European-American has completed its selection of the FNB assets it desires -- a process which is already more than half completed but which must be completed in any event by April 6, 1975. In this speculation, I think it would be fair to assume that virtually all loans adversely classified by the

Comptroller of the Currency at his August 14 examination */ will be included in the FNB loans FDIC will eventually have to administer.

Assuming a 100% loss on all loans classified Loss, a 50% loss on all loans classified Dobutful, and an arbitrary 10% loss on all other loans FDIC receives, including those that were unclassified, FDIC could sustain a loss on loans held of approximately $185 million if $1.6 billion of FNB loans end up in FDIC hands. If the other $500 million of FNB assets in FDIC hands, consisting largely of long-term municipals and other securities and miscellaneous other assets, could then be liquidated at a maximum loss of $100 million, there is some basis for optimism that the Federal Reserve window loan can be repaid in full without loss to the FDIC, since these figures take no account of litigation or bond claims available to the receiver and no account of income earned on the assets held. It is, of course, much too early in the FNB receivership to assess the accuracy of these assumptions (or of any others) or to make predictions of final net loss, if any, either to the FDIC or to subordinated claimants. I cite these figures solely to illustrate the magnitude of the collection

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*/ This examination classified $2.4 million of FNB's loans as Loss, $52.1 million as Doubtful and $145.8 million as Substandard.

problem facing the FDIC as it liquidates FNB assets, and to point out that even mildly different assumptions will produce significantly different loss results because of the large dollar figures involved.

Future Assessments for Deposit Insurance.

Some FDIC-insured banks have already expressed concern about the impact of the Franklin National Bank failure on their deposit insurance assessments for 1975 and future years. While I cannot predict the effect of the FNB failure on assessments in 1976 or later, I can say that the Franklin failure will have absolutely no impact on the level of deposit insurance assessments for the calendar year 1975. We establish our reserves for losses as of December 31 and will be in no position to do that on a considered basis for the FNB failure until European-American completes its selection of FNB assets and we have had an opportunity to evaluate the assets FDIC will then hold. */

*/ A substantial additional loss reserve in 1975 will undoubtedly be required, however, for the United States National Bank failure which occurred in October 1973. We believe it unlikely, though, that the effective rate of assessment in 1975, after credit for the statutory refund, will vary significantly from a figure of 50% of the statutory rate. In the current year, FDIC-insured banks are paying approximately 46.5% of the statutory rate for their deposit insurance protection.