U.S. Congress. House. Committee on Banking, Finance & Urban Affairs. Sub. on Financial Institutions Supervision, Regulation and Insurance.

CONTINENTAL ILLINOIS NATIONAL BANK: REPORT OF AN INQUIRY INTO ITS FEDERAL SUPERVISION AND ASSISTANCE

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STAFF REPORT
TO THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS SUPERVISION,
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CONTENTS

CHAPTER I

INTRODUCTION

Six months before the failure of an Oklahoma City shopping center bank revealed profound deficiencies in the credit-management system of the Continental Illinois National Bank, the federal regulatory agency responsible for examining and supervising the bank rated its overall condition "good" and its management "excellent". Twenty-four months later Continental was fighting for its life. Its credit management problems had become insurmountable, and private sector confidence in the bank had evaporated. By early May 1984, financial market rumors about Continental's deteriorating condition were resulting in weekly deposit outflows totalling billions of dollars. Without massive external aid, Continental could not survive.

As a first step in assisting Continental, the FDIC, the Federal Reserve and the Comptroller of the Currency, on May 17, announced an interim assistance program consisting of private bank funds and agency credit and attempted to assure the depositors and general creditors of Continental that they would incur no loss when a final assistance package was put in place. This action coincided with the FDIC curtailing its experiment in requiring uninsured depositors to incur a partial loss in a bank failure even if the bank were merged with another. As dramatic and sweeping as the federal agency assurance to Continental depositors and creditors was, withdrawals from Continental continued virtually unabated.

Through the rest of May, June, and most of July, round-the-clock negotiations among agency officials, attorneys representing various interests, investment bankers, and other banks were pursued in a search for a purchaser of Continental and failing that to construct a permanant assistance program. A purchaser could not be found, and on July 26, the FDIC announced a permanent assistance package consisting of installation of a new management team, removal of $4.5 billion in problem loans, infusion of $1 billion in new capital, and maintenance of credit lines from major banks and the Federal Reserve.

On the same day, House Banking Committee Chairman Fernand J. St Germain announced hearings into the circumstances that led to the need for assistance and the structuring of the assistance program itself. In his statement, Chairman St Germain explained:

> The rescue of Continental dwarfs the combined guarantees and outlays of the Federal Government in the Lockheed, Chrysler and New York City bailouts which originated in this Committee. More important is the fact that the Federal Government provided assistance to these entities only after the fullest debate, great gnashing of teeth, the imposition of tough conditions, and ultimately, a majority vote of the House and the Senate and the signature of the President of the United States.
> (Statement from the Floor of the House of Representatives, July 26, 1984)

The inquiry into Continental's need for assistance and the assistance package was carried out by the Subcommittee on Financial Institutions Supervision, Regulation and Insurance and utilized a staff team consisting of Full Committee, Subcommittee, and several General Accounting Office auditors assigned to this Subcommittee. The inquiry team conducted an extensive review of examination, supervision, and assistance plan documentation in the possession of the Office of the Comptroller of the Currency, the Federal Reserve, and the Federal Deposit Insurance Corporation. The inquiry team also interviewed agency and Continental Bank officials responsible for the examination, supervision, management and audit of Continental, and individuals who participated in the development of the assistance plan.

Hearings began on September 18, 1984 with the testimony of the three individuals responsible for examining Continental Bank from the mid-1970s to the present, and a Continental Bank loan officer familiar with Continental's lending practices. On September 19, the head of the agency responsible for examining and supervising all national banks, C. T. Conover, Comptroller of the Currency, appeared before the Subcommittee. Two weeks later, FDIC Chairman William Isaac provided testimony on the assistance plan and the need for Congressional consideration of deposit insurance reform measures. In addition to formal testimony and questioning by Subcommittee Members, numerous documents and reports were placed in the hearing record during the course of the hearings to broaden the information available to the public about Continental, its supervision by federal regulatory agencies, and the structure and cost of the assistance program.

This report is an effort by the staff inquiry team to bring together in one place the principle findings of the Inquiry drawing on witness testimony, documents reviewed by the Subcommittee, and information provided for the record by entities such as the Congressional Budget Office and the General Accounting Office. This report reflects the views of the staff inquiry team only and should not be interpreted as representing the views of the Chairman or any Member of the Financial Institutions Subcommittee or full Committee. This staff report, moreover, is not intended to serve as a substitute for a thorough reading of the hearings themselves. The hearings contain much information and documentation that is not contained in this report, and only from reviewing the hearing record can one gain a full appreciation of the complexity and depth of concern about the handling of Continental Illinois National Bank.

CHAPTER II

INQUIRY FINDINGS AND RECOMMENDATIONS

I. **The problems of Continental Illinois National Bank (CINB) were the direct result of decisions made at the highest management level.**

a. In 1976, CINB's top management embarked upon an ambitious program of growth and market expansion intended to raise CINB from the eighth ranked commercial lender to one of the three top commercial lenders in the United States to the third. This goal was reached in 1981. (See Chapter VI, Market Evaluation.)

b. Attaining CINB's management goal involved market expansion, asset growth, and purchased funds dependency, which profoundly affected both the size and soundness of the institution.

(1) From 1977 through 1981, CINB's loan portfolio rose on average 19.9% per year from $15 billion to $32.6 billion, and its total assets grew on average 16.4% per year from $22 billion to $47 billion. This pace placed CINB first among its peers in growth. (See Chapter IV, C. Performance Relative to Peers.)

(2) CINB's equity capital level did not keep pace with loan and asset growth. Its ratio of equity capital to total assets declined and its rank within its bank holding company peer group with regard to capitalization fell from sixth to last place. (See Chapter IV, C. Performance Relative to Peers.)

(3) CINB became increasingly dependent on volatile and relatively more expensive funds. All during the 1976 through 1981 period, CINB ranked last among its peers in net liquidity. Asset and liability composition and maturities were not adjusted to achieve a relative balance between interest sensitive assets and liabilities. Heavy use of overnight funds and shortened CD and Eurodollar maturities were

used to support the aggresive loan policy. Deposits from commercial banks, particularly foreign banks, were attracted by paying high interest rates. Core deposits from individuals, partnerships and corporations remained constant but lagged behind CINB's peers. (See Chapter IV, C. Performance Relative to Peers.)

(4) After declining from 121% in 1976 to 61% in 1980, the ratio of loan assets classified by examiners as "Substandard," "Doubtful," or "Loss," to gross capital funds turned upward in 1981 to 67% and rose to 219% in 1983. (See Chapter V, B.1. Overview.)

c. In 1979, both the Comptroller of the Currency and the Federal Reserve warned Continental top management about the linkage between asset quality and purchased funds. The Comptroller of the Currency said specifically: "...since the bank is heavily dependent upon purchased funds to support assets and proved liquidity, maintenance of good asset quality is necessary to insure a continued high degree of market acceptance". (See Chapter V, B. Comptroller and Federal Reserve Examiner Findings.)

d. CINB's top management failed to maintain a level of asset quality sufficient to preserve market confidence in the institution. (See Chapter V, B. Comptroller and Federal Reserve Examiner Findings and Chapter VI, Market Evaluation.)

e. CINB top management did not reflect an appropriate degree of regard for Comptroller and Federal Reserve warnings. CINB's 1980 and 1981 quarterly performance evaluation reports contained numerical targets for earnings per share, asset growth, and other performance criteria, but no comparable performance standards for asset quality. (See Chapter IV, A. Strategic Planning.)

f. CINB's top management failed to develop and maintain an internal loan quality control system of sufficient timeliness and thoroughness to balance the risks inherent in CINB's growth goals and decentralized credit extension procedures.

(1) The Comptroller's examiners pointed out that $1.6 billion in loans had not been reviewed on an annual basis as required by CINB's corporate policy. The 1981 examination report stated that the level of unreviewed loans had risen to $2.4 billion. (See Chapter V, B.2. Loan Management and Review.)

(2) CINB's internal audit department failed to function in a manner which could have alerted senior management to the breakdown in internal controls and loan quality in a timely manner.

(a) The internal audit department attempted to resolve weaknesses in internal controls by communicating their findings directly to line management rather than reporting them to the audit committee of CINB's board of directors.

(b) There is no indication that the internal audit department was aware of the material breakdowns in internal controls related to the Penn Square National Bank loans until requested by management to review these loans in late 1981.

(c) There is no indication that the internal audit department notified Ernst & Whinney, CINB's independent certified public accounting firm, of the internal control weaknesses it uncovered relating to the Penn Square National Bank. Had they been informed, Ernst & Whinney may have reviewed loan procedures more intensively during their annual audits or independently reported weaknesses in the lending operations to senior management.

g. Even outside the context a formal control system, there were numerous instances when specific information about problems relating to Penn Square came to light within CINB. This information surfaced in internal memos, notesheets, reports of investigation, and conversations, but there was no mechanism for top level managment to take timely action in response to these warning signals.

2. **The record of CINB's supervision by the Comptroller of the Currency indicates major deficiencies in the agency's examination methodologies and followup practices.**

   a. Despite having noted in examination reports the adverse effects of CINB's high growth goals on the bank's capitalization, the Comptroller took no decisive action to slow the bank's growth and enable capital to increase relative to assets prior to 1983.

   b. Despite having warned CINB's top managment about the need for close monitoring of asset quality in 1979, and having noted documentation, loan rating, and loan review deficiencies in each examination report thereafter, the Comptroller took no decisive action to require CINB to put its loan management system in order prior to 1982.

   c. Aside from mentioning CINB's growing concentration in the oil and gas industry in a portion of its examination reports labeled "For Information Only," the Comptroller did not consistently and forcefully point out to CINB management the potential problems arising from excessive concentrations in any industrial group. While oil and gas did contribute to CINB's profitability in the late 1970s and early 1980s, the possible repercussions of the level of exposure to oil and gas borrowers in the event of adverse conditions were not emphasized clearly and repeatedly by the Comptroller prior to the failure of Penn Square National Bank.

d. Comptroller examination report comments were, at crucial times, ambiguous and difficult to interpret, at least in part because the examiners tempered critical comments with complimentary remarks. The result of this could have been to downplay the significance of the critical comments in a way that prevented timely corrective action.

e. The full severity of CINB's loan quality problems was not promptly detected by the Comptroller's bank examiners in part because the agency's loan sampling methodology depends to a considerable degree on the effectiveness of a bank's own loan quality control system. Rather than employing a fully representative, statistical sample of all loans, the Comptroller's methodology focuses primarily on very large loans and on loans already identified as problems by the bank. For banks with decentralized loan management systems such as CINB had, the Comptroller's loan review procedures are insufficient in scope to test whether the bank's loan review accurately presents the true quality of the loan portfolio.

f. The Comptroller's screening system that identified deviations in financial ratios from the peer group norm listed CINB ratios as conforming to the peer group norm because the peer group's financial ratios shifted downward along with CINB's. Thus, no anomalous CINB ratio behavior was reported.

g. The Comptroller's data processing examination manual requires that examiners review the quality of the output of a computer as well as the physical equipment and its management. In 1980, 1981, and 1982, the Comptroller's examiners found CINB's data processing system to be sound and well-managed. These findings contrast sharply with evidence and commentary from other sources that the computer's loan management information reports were unreliable. (See Chaper V, B.3. Capital.)

h. The Comptroller allowed an unacceptable amount of time to pass -- up to eight months -- before requiring CINB to respond to examination comments. An effective examination program requires banks to respond promptly to supervisory correspondence concerning adverse examination findings.

3. The record of the Federal Reserve's supervision of Continental Illinois Corporation indicates deficiencies in that agency's holding company supervision practices and expansion approval policies.

a. The Continental Illinois Corporation (CIC), the holding company of CINB audit affiliates, was examined by the Federal Reserve every year from 1979 to the present. The results of their examinations were set forth in bank holding company inspection reports made available to CIC's top management. The Federal Reserve in 1980 and 1981 did not utilize the inspection report transmittal letters to highlight critical inspection report findings, as they did in 1979, 1982 and 1983. The 1979 transmittal letter warned: "Continental Illinois Corporation continues to rely heavily on volatile funds to sustain growth in assets and earnings. The success of such a policy is dependent on the quality of underlying assets. ... While asset quality control systems appear adequate, we urge continued close attention to this vital area, especially during prolonged periods of high interest rates and retarded capital formation." Despite the fact that the matters raised in this warning actually became more serious in each subsequent year, no mention of this situation was made in subsequent inspection report transmittal letters. This may have conveyed the impression that the warning in the 1979 letter was no longer applicable.

b. The transmittal letters to the inspection reports did not require CIC officials to respond formally to the findings in the inspection reports. Therefore, there was no written mechanism to insure that CIC management had taken remedial action in response to the Federal Reserve's inspection findings.

c. The Federal Reserve approved 34 of CIC's applications from 1979 through July of 1982, and 5 applications thereafter until the Spring of 1984, to expand CIC's operations. Such application approvals may have conveyed to CIC and the public that the Federal Reserve basically approved of the operating and financial characteristics of CIC and its subsidiary bank, CINB. These applications were approved despite the fact that: (See Chapter V,C. Federal Supervision Weaknesses.)

(1) Both the Comptroller's CINB examination reports and the Federal Reserve's CIC inspection reports during this time frame contained numerous critical comments expressing concern about capitalization, volatile funding and asset quality; and

(2) CIC's nonbank subsidiaries were not a meaningful source of financial strength to CIC or CINB. (See Chapter IV, D. Nonbank Subsidiaries.)

(a) From 1974 through 1980, CIC's nonbank subsidiaries paid no dividends to the parent company while at the same time the parent company advanced $388 million in loans to these subsidiaries; and

(b) From 1981 through 1983, the nonbank subsidiaries made contributions to the parent company through dividend payments, net income, and loans; however, these contributions were offset to a significant degree by increases in equity investments and loan advances from the parent back to the nonbank subsidiaries.

4. **A review of the audit findings of Ernst & Whinney, Continental's independent certified public accountants, indicates that the methodology of the auditing profession as applied to large commercial banks needs to be improved.**

5. **The need for added disclosure of bank financial and operating information as a means of providing increased market discipline is clearly demonstrated by the Continental experience.**

   a. Neither bank debt rating companies or security analysts had an accurate understanding of CIC/CINB's true portfolio condition.

   b. More disclosure, such as through the FDIC Reports of Condition and Income (Call Reports), is an important first step in improving market discipline.

6. **The Continental Assistance Program developed by the FDIC and the other federal bank regulatory agencies indicates that, under current policy, certain banks are "too big to fail".**

   a. This policy is the result of:

      (1) A conscious policy of avoiding potential alledged ripple effects in the economy from a large bank failure, and

      (2) The FDIC's professed administrative inability to quickly pay off accounts in failed large banks.

   b. A federal "failsafe" policy leads to serious safety and soundness concerns, since management in "failsafe" banks could lack fundamental incentives to limit riskiness. The "failsafe" policy is inequitable in that:

      1. Stockholders in "failsafe" banks are more likely to see their investments protected than are stockholders in banks that are allowed to fail;

2. Under current policies, depositors with more than the insured amount in their accounts are in effect fully insured in "failsafe" banks, in contrast to their treatment when a small bank fails and they are forced to endure delay and less-than-full recovery of their deposits;

3. Investors, depositors, creditors and borrowers are more likely to be impressed with the solidity and stability of a "failsafe" bank, resulting in a competitive disadantage in the funding and ultimately the profit arenas for banks that are not "failsafe."

7. The combination of current law, which provides no limitation on the amount of assistance to a bank found to be "essential" under Section 13(c) of the Federal Deposit Insurance Act, and the FDIC's announced commitment to provide whatever capital assistance Continental may need, means that the potential cost of saving Continental could be even larger than the CBO estimate of $3.8 billion.

8. The Continental Assistance Program suggests that undue discretion has been vested in the FDIC to provide aid under section 13(c) of the Federal Deposit Insurance Act.

   a. The explanation provided by regulators in justifying the need to amend section 13 (c) to bring about the present text of this section was expressed in terms of assisting thrift institutions, not assisting depository institutions generally.

   b. The wording of recent legislative changes to make assistance more easily accessible to institutions deemed "essential" to their "communities" has led to confusion over whether the FDIC has authority in effect to guarantee all depositors in banks it assists, notwithstanding the $100,000 thousand statutory limit on deposit insurance.

c. A fundamental rethinking by Congress of the purposes of section 13(c) is needed, with consideration given to:

(1) equipping the FDIC with the resources to liquidate large depository institutions;

(2) clarifying Congressional intent regarding the meaning of "essentiality";

(3) establishing clear procedures for providing federal assistance to depository institutions including cost test standards, consultation with Congress, and supervisory documentary access by the appropriate committees of Congress and the General Accounting Office.

d. One of the appropriate actions that FDIC may take in providing assistance under section 13(c) is to attach conditions to the extension of assistance. In CINB's case, several top officers of the bank received lucrative separation packages (so-called "golden parachutes"), even though those same officers' policy decisions led in great degree to the conditions that resulted in CINB's need for federal assistance. FDIC was hesitant to take action to void these agreements, at least in part because of the lack of clarity in the standards that apply in such cases. A standard that focuses on whether such agreements are fair and equitable under the particular circumstances and do not threaten the loss of public confidence in the entire banking industry may be an appropriate standard for FDIC to apply, rather than simply whether the agreement adversely affects the institution's safety and soundness.

CHAPTER III

POLICY COMMENTS

The circumstances that led to Continental's difficulties and the ensuing federal rescue effort, in one fashion or another, touch upon every banking policy question of significance today. At the heart of concern about the handling of Continental is the controversy over whether a bank is more a private enterprise or a public utility. Related to this are the questions that can be raised about the equity of permitting in the U.S. banking system a category of "failsafe" or "no risk" banking institutions which compete directly with all other banking companies. That Continental needed to be rescued at all reflects a banking risk situation in this nation which for a variety of reasons appears to be serious and has broad implications for evaluating deregulation proposals. Lastly, the need for a rescue and the rescue itself has made deposit insurance reform, and possibly agency reorganization also, a matter deserving Congressional attention.

Role of Banking in the U.S. Economy

Continental is one of the oldest and was one of the most venerable banking enterprises in this nation. Its one hundred thiry-year history is a recapitulation of the best and worst in American banking. The relationship of Continental to the Insull utilities empire in the 1920s is a thoroughly studied and often cited example of why the legal separation between banking and commerce must be maintained. Continental's rescue in the 1930s by the Reconstruction Finance Corporation is in turn an example of effective government intervention. To its credit, modern, high technology companies such as Apple Computer can point to Continental as early providers of essential financial support. To its detriment, Continental permitted an excessive concern about growth and "performance banking" to cloud and eventually undermine its credit judgments and management practices.

The Continental rescue itself is a reflection of far older elements in the history of banking. Since its earliest beginnings, banking and governing have been inextricably intertwined. The financial relations between the Vatican and Florentine bankers, and those of King William III and the newly formed Bank of England, were no less close than those of modern governments and their central and large private banks. Responsibility for monetary security, a critical element of national economic health and growth, has been borne for centuries by governments and banks together and still is.

The special role of commercial banks in the U.S. economy is traceable to the original charter of the Bank of England in 1694. In that charter, Parliament provided a bank with corporate privileges and specified "banking powers" in return for raising capital for national purposes. When the first banks were chartered in the U.S., they were established in the image of the Bank of England. The public responsibility of a bank, particularly a bank chartered by the federal government, was clearly stated in early court cases involving the National Banking Act:

> National banks are instrumentalities of the federal government, created for a public purpose...
> (Smith v. Witherow, C.C.A.Pa. 1939, 102 F.2d 638)

> National banking corporations are agencies or instruments of the general government, designed to aid in the administration of an important branch of the public service, and are an appropriate constitutional means to that end. (Pollard v. State, 1880, 65 Ala. 628)

> The national bank system was devised to provide a national currency secured by a pledge of United States bonds, and national banks are agencies or instruments of the government for that purpose. (Davis v. Elmira Savings Bank, N.Y.1896, 16 S.Ct. 502, 161 U.S. 275, 40 L.Ed. 700)

The centuries old relationship between banks and the governments which charter them has always involved the imposition of some measure of government supervision and the availability of government assistance should a bank fall into financial jeopardy. Discount window credit from the Federal Reserve and financial assistance from the FDIC are the first-line sources of aid to commercial banks in the U.S. In Continental's case, support from private banks, the Federal Reserve, and the FDIC were combined in an assistance package for which the FDIC had overall responsibility and in which it had the greatest investment.

The Federal Deposit Insurance Act authorizes the FDIC to provide assistance to a failing bank within two general categories. First, the FDIC is directed to provide assistance, if providing aid would reduce the FDIC's overall cost of handling the failure. Second, the FDIC is authorized to provide assistance if the bank is "essential" to attaining the "public purposes" of banks, that is, in the words of the statute, "essential to provide adequate banking services to its community."

The aid extended to Continental was in the second category — Continental was deemed "essential" and therefore deserving of assistance regardless of whether a cost analysis focusing narrowly on Continental alone indicated that the FDIC's costs would be lower by not providing assistance. Whether the FDIC properly utilized its "essentiality" assistance authority and adequately documented that Continental is indeed "essential" were matters which received the Subcommittee's close attention. The Subcommittee's detailed review of these matters was motivated by concern about the potential long term costs of creating an adverse incentive system for banks versus the perceived short run benefits of containing a potential banking crisis. Clearly some banks, or depository institutions generally, are essential for national, regional, or local economic well-being. What is not clear is the merit of permitting the present degree of FDIC discretion in determining which institutions are "essential" and which are not, to continue.

"No Risk" Nature of Large Bank Deposits

On May 17, when the agencies attempted to assure all creditors of Continental bank that their interests were secure, the FDIC's modified payoff experiment was brought to an end. That experiment was an effort to introduce a greater degree of market discipline in banking by requiring investors with amounts on deposit in a failing bank above the insurance coverage limit to incur a loss proportional to the liquidation value of the bank.

The FDIC's experiment is an important milestone in contemporary U.S. banking history. Theretofore, the sequence of aid extensions to the United States National Bank of San Diego, Franklin National Bank, and First Pennsylvania National Bank, by our government and to major banks in other countries such as National Westminster Bank by the British government, had established a widespread belief that the very largest banks in any country were "failsafe" and could be invested in without fear of loss.

The FDIC perceived that this view was contributing to increased banking risks in the U.S. and that it would ultimately have to bear the cost. First with the closure of the Penn Square National Bank and then with the implementation of an experimental modified payoff program, the FDIC attempted to limit the "no risk" expectations of large depositor/investors. It was expected that large depositors would be more reluctant to invest in riskier banks if they perceived a meaningful potential for loss. The termination of the modified payoff experiment accompanied by assurances to Continental creditors and financial aid for the institution, could only be interpreted as a reinstatement of the "no risk" expectation with the possible refinement that "essentiality" rather than sheer size is the appropriate investment criterion.

It is important to keep in mind that the "no risk" or "failsafe" in this context does not mean that the institution cannnot or will not be permitted to fail. The Franklin National Bank ultimately failed, and there is no guarantee that Continental will be a long term commercial success. What it means is that an "essential" banking firm will not be permitted to fail in a manner that would cause widespread economic hardship through an abrupt curtailment of banking services or cause a calamitous decline in public confidence in the banking system.

While ultimate failure may have many of the benefits market advocates praise, that is, management and equity investors incur losses with appropriate disciplinary lessons to others, for large depositors there is no meaningful difference between no failure and delayed failure. So long as the government prevents precipitous bank closures, large uninsured depositors will have time to get out of a troubled bank without loss. From their perspective, slow failure is the same as no failure and also the same as 100% deposit insurance.

The competitive implications of this fact are important. A small bank in an isolated community might qualify as an "essential" bank and be eligible for aid. Several such banks have been provided "essentiality" assistance by the FDIC. For all practical purposes, however, it appears that a banking institution would have to be larger than the Penn Square National Bank to be deemed "essential", and thereafter, the larger a banking institution is, the more "essential" it would seem to be. For large investors the decision is simple, place uninsured funds only in the largest institutions.

This suggests that over time large banks will be able to attract capital at a lower cost than comparably sized nonbanking companies and smaller banks. There will, no doubt, always be a place for the locally owned bank in isolated communities, banks which have taken on very specialized purposes for themselves, and so called "boutique" banks. However, in those market areas and product lines representing the bulk of banking and related financial services, the advantage of lower capital costs for the largest institutions is an advantage the confirmation of which should be weighed carefully.

In a world where banking institution size and "essentiality" are virtually synonymous, all large banks and companies of any type affiliated with a large bank will have a capital cost advantage. Over time that advantage may result in preventing U.S. banking customers from receiving the full benefit of an actively competitive banking structure. Eliminating the competitive advantage of large institutions requires as a first step that consideration be given to proposals which would eliminate the "no risk" protection for large depositors, or extend "essential" status to depository institutions of all sizes.

Before reviewing some of the proposals advanced to achieve constructive modifications in the deposit insurance system, Continental's problems need to be looked at in the context of banking risk generally.

Banking Risk

Since 1980, the ratio of loans classified by examiners as "substandard," "doubtful," or "loss," to gross capital at all federally insured banks rose from an average of 28% to 58% in 1983. Over the same period, the number of problem banks rose from 217 to 642, and number of banks failing in a year rose from 10 to 48 (See Table 18.)

The trends suggested by such evidence are not what regulators or legislators would prefer to see. The apparent upward trend in risk may have several causes. The transition from the inflationary economy of the late 1970s to the low inflation environment of today, rendered obsolete many management practices and portfolios structured to minimize risk in a high inflation environment. The 1981-1982 recession weakened many previously sound borrowers, and the high dollar exchange rate and the resulting trade deficit continue to put pressure on many U.S. firms. The competitive pressures released by deposit interest rate deregulation in the late 1970s, required many banking institutions to take on greater portfolio and operating risks.

In addition to these macroeconomic forces, institutional factors are also cited as causes of the risk trends. Academic observers, such as Professor Edward Kane at Ohio State University, point to the very existence and structure of federal deposit insurance itself, as an inducement to greater risk-taking by insured institutions. Others, such as Professor Anthony Santomero at the Wharton School, have suggested that raising bank capital adequacy standards causes banks to make riskier, higher yielding loans in an effort to maintain a satisfactory return on equity levels. The consequences noted by observers such as Kane and Santomero are explained to be the result of the profit maximization goals of banks and bank holding companies.

The macroeconomic and institutional forces that have contributed to greater banking risk generally do not fully explain or excuse Continental's problems. Other large U.S. banks have and are coping with these forces and adapting to them. One aspect of these larger forces is particularly worthy of concern. In the mid-1970s the banking industry as a whole and Continental in particular had in operations, capitalization, and earnings, a capacity to cope with major economic disturbances that is reflected to a significant degree in the earnings, capitalization and asset quality ratios that prevailed during those years. The decline in those ratios since the 1970s suggests that the banking industry has less adjustment capacity than it did in earlier years.

Risk and Deregulation

The examination and supervision of Continental raise difficult questions about whether the federal regulatory process is capable of assessing and restraining the trends noted earlier. Factors which ultimately led to Continental's difficulties were noted in the late 1970s by examiners and supervisors but were not viewed as significant enough to warrant active regulatory intervention in the early 1980s when aggressive action might have caused or enabled Continental to correct the problems which later overwhelmed it.

Considered together, the "no risk" nature of large banks and the seeming difficulty of federal supervisors to assess and act on undue risk before it manifests itself in costly failures, highlights the long standing Congressional concern about whether expanding the list of permissible bank holding company powers would worsen the risk situation in banking. That such a potential exists is reflected in the fact that the most widely considered proposals to permit new activities specify that they can be engaged in only by holding company affiliates and not by the subsidiary banks themselves. It is argued by supporters of such proposals that the use of affiliates is an effective way to separate the risks of the new powers from a holding company's bank subsidiaries.

This line of reasoning is disputed by the relationship between Continental bank and its holding company. Regarding that relationship, Margaret Eggington, Acting FDIC General Counsel, commented, "...for all practical purposes each of the two entities is the other's alter ego..." (FDIC Memorandum to: Board of Directors, From: Margaret Eggington, Acting General Counsel, Subject: Legal Authority for Section 13(c) Assistance to Continental National Bank and Trust Company, July 25, 1984, p. 5) The covenants in Continental's holding company debt instruments which forced the FDIC to provide its assistance to the bank through the holding company, are not unique to Continental and weigh against claims that a bank subsidiary is financially separable from its parent or its nonbank affiliates.

This does not necessarily mean that banking organizations should be prohibited from engaging in new activities. Professor George Benston has argued that many of the new activities banking organizations propose to enter may be less risky than commercial banking and that their participation in these activities might strengthen the banking system, rather than weaken it. In an increasingly competitive environment, the risks of relying soley on business strategies developed in a time when money market conditions were more predictable are likely to be greater. Until the ability of the regulatory system to oversee the pursuit of a multitude of business strategies is enhanced, every conceivable course is likely to entail an uncomfortable degree of risk. The failure of Continental served as a warning that the task of improving the system of regulating depository institution holding companies and their affiliates should be actively pursued.

Viewing the separability question broadly, the FDIC in its 1983 deposit insurance report to Congress said,

> Although no precise tabulation has ever been made, the weight of opinion seems to be that it is impractical to think that the future of the bank can be separated from the future of the company of which it is a part. The public, it is argued, will inevitably view the institution as one.
> (Deposit Insurance in Changing Environment, Federal Deposit Insurance Corporation, April, 1983, p. xiii)

Former Citicorp Chairman Walter Wriston addressed the separability question quite bluntly in 1981 congressional testimony:

> ...It is inconceivable that any major bank would walk away from any subsidiary of its holding company. If your name's on the door, all of your capital funds are going to be behind it in the real world. Lawyers can say you have separation, but the marketplace is persuasive, and it would not see it that way.
> (Financial Institutions Restructuring and Services Act of 1981, Hearings before the Committee on Banking, Housing, and Urban Affairs, United States Senate, October, 1981, pp. 589-590)

If risk separability within a holding company is not an operative concept, the focus of governmental attention shifts from the bank subsidiaries alone to the holding company generally, and the historically important responsibility for national monetary security shifts from the shoulders of government and banks to government and bank holding companies. For those holding companies that could be deemed "essential" to national, or even international, economic well-being, the financial support resources of the government would be available. For such companies, capital could be obtained at a lower cost and their competitors would be at a disadvantage unless they too were, or were affiliated with, an "essential" bank holding company.

The implication of Mr. Wriston's statement in the new powers debate is clear: a statute which expands bank powers within a holding company affiliate constraint, will not affect the true allocation of risk within the company nor the market's perception of that risk. If this is true, new powers legislation should reflect this reality and bank holding companies should be regulated and supervised accordingly.

Deposit Insurance Reform

Of all the issues touched upon in the course of the Continental inquiry and in the public debates concerning Continental's rescue, deposit insurance reform has been the most often pointed to as an area in which Congressional action could have concrete and beneficial results. The reforms most often cited are ones designed to introduce greater market discipline into the banking supervision process. Broadly categorized, these proposals include: increasing the disclosure of problem conditions within a banking organization directly or through published changes in risk-related federal insurance premiums; limiting FDIC payments to uninsured depositors in a failed or assisted institution to the liquidation value of the institution; reducing the current level of federal deposit insurance while providing for utilization of private insurance for deposits over the federal coverage level; and extending the use of subordinated debt as a form of bank capital. All of these proposals merit close attention and will probably receive them. They are not, however, the reforms that were discussed most extensively during the Continental hearings.

In those hearings, the Subcommittee Members expressed a need for a variety of changes in the way in which federal assistance is provided to problem banking institutions. Among the items cited in colloquies between the Members and witnesses were needed statutory changes to provide for: clarification of what constitutes an "essential" banking institution, a more structured assistance review and decision process, thorough cost justification standards, equal treatment of all banking institutions, and if "no risk" banking is undesirable, FDIC acquisition and development of the ability to liquidate a large banking institution.

These reforms represent refinements of the existing insurance and assistance system and reflect a basic belief that assistance had to be and should have been extended to Continental. They also reflect a sense that proposals to reform the federal insurance and assistance system in major ways may not attain the intended goals. In the academic literature proposing and analyzing major reform proposals, one of the most telling statements on the subject of deposit insurance reform appears in a footnote which says:

> Interestingly, just as policy makers have now picked up the arguments of the academics, there are now signs that at least some (academics) may now be having second thoughts.
> (Market Discipline and the Prevention of Bank Problems and Failures, R.A. Eisenbeis and G.G. Gilbert, mimeograph, August 1984, p. 1)

For the most part, proposals for major insurance reforms depend for their effectiveness on banking institution stockholders, bondholders, and/or uninsured depositors being required to incur losses if the institution fails or requires assistance. In the past, the market disciplines inherent in such reforms were viewed as unambiguously desirable. More recent analysis and the Continental experience suggest that the "market" does not always discipline, it sometimes punishes, and some of the reforms regarded as attractive in the past,

> ...involve increasing a particular kind of discipline which increases the likelihood that runs will occur. This holds the potential, both to destablize the banking system and to increase the costs of individual failures to the insurance agency.
> (Ibid, p. 16)

Nevertheless, if any benefits of market discipline are to be obtained, appropriate disclosure of material information is essential to restrain managers who might otherwise be tempted to expose institutions to excessive business risk. Differences in accounting and disclosure practices among various segments of the depository institutions industry will limit the ability to effect changes in a timely manner. Therefore, appropriate changes in the deposit insurance system should be adopted in sufficient time to permit them to take effect in an orderly way.

The Continental rescue has changed the course of modern banking history. It has reestablished and clarified the need to actively examine and supervise banking institutions of all sizes and diminished the expectations of relying heavily on market forces. If anything, the Continental experience was a very impressive demonstration of the marketplace at work. The fact that in the current era, neither the banking industry nor its regulators were willing to let the market have its way is a revealing statement about how much the wellbeing of our society and banking are interlinked and how much deregulation the banking industry and this government are really prepared to permit.

CHAPTER IV

MANAGEMENT

A. Strategic Planning

An essential element to the management of a large organization such as Continental Illinois Corporation is an effective strategic planning process. A strategic plan is an enterprise's definition of its objectives and business. It establishes its program and priorities and integrates the impact of the operating programs on its income, expenses, and cash flow. Continental Illinois Corporation(CIC) appeared to have relied heavily on strategic plans as did other large entities. CIC prepared an annual Three Year Strategic Plan which set forth numerical targets and goals. In 1976, CIC's overall goal, as announced by its chief executive, was to achieve a position as one of the top three U.S. banks as perceived by U.S. and foreign multinational corporate markets in 1981.

In implementing the goal to become a major lender to corporate customers, CIC revamped its organization and adopted a strategy of decentralized lending, delegating major responsibilities to lending officers in the field and encouraging them to respond to customers and make more loans more quickly and competively. Such an approach required fewer controls and fewer levels of review. In conjunction with the loan expansion, CIC adopted a strategy of specifically targeting the energy sector for its most aggressive lending expansion. During the late 1970's, CIC outperformed its peers in growth, earnings, and market acceptance and its loan loss record gave an excellent appearance (for further detail see section D).

By 1981, five years after announcing its goal, CIC became one of the largest corporate lenders in the U.S. From 1976 through 1981, CIC's total assets increased $22.5 billion from $18.6 to $41.1 billion. The growth was made possible by a management accountability framework that gave individual loan officers more lending authority than is generally found in other money center banks and that encourage rewards loan growth.

The management objectives of CIC/CINB were clearly reflected in the 1980 and 1981 corporate plan "Performance Relative to Corporate Goals," Internal Competitive and Performance Analysis." CINB's corporate goals were ranked as follows:

1. Earnings per share
2. Average assets growth
3. Average earning assets growth
4. Return on average stockholders equity
5. Return on average assets
6. Return on average earning assets
7. Average assets/Average total capital
8. Average earning assets/Average total capital
9. Average risk assets/Average equity and reserves
10. Average debt/Average total capital
11. Dividend payout
12. Internal funding rate

Associated with each corporate goal was a specific and clear numerical target. In light of CINB's later problems and the practices of other money center banks, it is noteworthy that there was no specific target for loan quality.

Ultimately the very strategies that brought about this growth turned against CIC. In mid-1981, the economy entered a deep recession, and the quality of available lending opportunities declined. Nevertheless, CIC continued to increase its corporate lending, inevitably making loans to weak borrowers.

By mid 1982, it became clear that Continental's problems stemmed from management strategies and policies of achieving rapid growth, that depended on a strong economy in general and the energy industry in particular, at the expense of asset quality.

B. Internal Controls

The American Institute of Certified Public Accountants (AICPA) defines a system of internal controls in its statements on "Auditing Standards" as:

> as the plan of organization and all the methods and procedures adopted by the management of an entity to assist in achieving management's objectives of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.

An accounting system supplemented by effective internal controls can provide mangement with reasonable assurance that assets are safeguarded from unauthorized use or disposition and that financial records and statements are reliable.

The environment in which internal control operates has an impact on the effectiveness of the specfic control procedures. A strong control environment, for example, one with tight budgetary controls and an effective internal audit function, can significantly complement specific control procedures. However, a strong environment does not, by itself, ensure the effectiveness of the overall system of internal control. As stated in the AICPA's "Statements on Auditing Standards," the internal control environment may be affected by three factors discussed below.

<u>Organization Structure</u>
The organizational structure of an entity serves as a framework for the direction and control of its activities. An effective structure provides for the communication of the delegation of authority and the scope of responsiblities. It should be designed, insofar as practicable, to preclude an individual from

overriding the control system and should provide for the segregation of incompatible functions. Functions are incompatible if their combination may permit the commitment and concealment of fraud or error. Functions that typically are segregated are access to assets, authorization, execution of transactions, and recordkeeping.

- Personnel

  The proper functioning of any system depends on the competence and honesty of those operating it. The qualifications, selection, and training as well as the personal characteristics of the personnel involved are important features in establishing and maintaining a system of internal control.

- Management Supervision

  Management is responsible for devising and maintaining the system of internal control. A fundamental aspect of management's stewardship responsibility is to provide shareholders with reasonable assurance that the business is adequately controlled. Additionally, management has a responsibility to furnish shareholders and potential investors with reliable financial information on a timely basis. An adequate system of internal accounting controls is necessary to management's discharge of these obligations."

Of the three items mentioned above, management supervision may have the most impact on the internal control environment. In carrying out its supervisory responsibility, management should review the adequacy of internal control on a regular basis to ensure that all significant controls are operating effectively. In accomplishing such a task, management will in most cases have audits performed by their internal audit department and independent public accountant.

I. Internal Audit and Independent Public Accountant

a. Internal Audit Role

Internal auditing for a banking entity is defined by the Bank Administration Institute as "an independent evaluation within that entity to review accounting, financial, and other operations for the primary purposes of fraud prevention and detection." According to CIC's internal audit manual, the internal audit function had primary responsiblity to safeguard corporate assets for the shareholders and depositors by ascertaining whether the procedures and methods used to record and process transactions were in accordance with policies prescribed and internal control standards authorized by management. The Internal Audit Department reported directly to the Audit Committee of the Board of Directors as well as to the Corporate Office. The Department was organized along the lines of a public accounting staff and was functionally divided into areas of responsibility such as Bond and Treasury, Commercial and Real Estate Lending, Personal Banking, Loans, Trust, International (foreign branches and subsidiaries), and Electronic Data Processing. These functional lines tended to follow the organizational structure of the Corporation, which afforded the auditor the opportunity to specialize in a segment of the organization and to interact with smaller groups. Worldwide internal audit consisted of a staff of approximately 200 by 1983. They were located in Chicago (staff of 160 to cover domestic operations and the Americas), London (staff of 30 co[illegible]ng Europe and the Middle East), and Hong Kong (staff of 10 covering the Far East units).

In accomplishing its objective, CIC's internal audit department's policy was to examine all branches, departments, and subsidiaries on an unannounced basis. Major concerns of the auditing department included a review and evaluation of the system of internal controls; the accuracy of financial records, as well as the activity for compliance with corporate policies and regulatory guidelines. Although the internal auditing department recommended control changes, they could not actually implement them. The purpose of this policy was to retain the independence necessary to continuously evaluate controls and point out any weaknesses or potential weaknesses. It should be noted that the adequacy and maintenance of controls was the reponsibility of the divisional/unit management charged with performing that function.

Thus, the internal audit function as represented in CIC was viewed as a separate component of internal control undertaken by specifically assigned staff within the entity with the objective of determining whether other internal controls were well designed and properly operated.

b. Independent Public Accountant's Role

From 1970 to October of 1984, Continental Illinois Corporation (CIC) had engaged Ernst & Whinney as their independent public accountant to perform an examination of its financial statements. The primary objective of an examination of financial statement made in accordance with generally accepted auditing standards leads to the expression of an opinion on the fairness of those statements in conformity with generally accepted accounting principles consistently applied. As part of each financial statement audit, the independent public accountant is required by generally accepted auditing standards to perform a proper study and evaluation of the existing internal control. The independent public accountant's objective in studying and evaluating internal control is to establish the reliance he can place on those controls in determining the nature, timing and extent of his substantive auditing procedures.

In complying with this standard, the auditor is interested primarily in the reliability of data and the safeguarding of assets and records. This emphasis stems from the auditor's need to determine whether the financial statements are fairly presented in accordance with generally accepted accounting principles. Although the auditor emphasizes controls concerned with the reliability of data for external reporting purposes, he should not disregard controls concerned with operational efficiency and adherence to prescribed policies. If an entity fails to follow the rules and procedures set forth by management or is highly inefficient, it is less likely to have accurate financial records.

In accordance with generally accepted auditing standards, the study and evaluation of CIC's system on internal control are used by the independent public accountant to perform the following functions:

- Determine Whether an Audit Is Possible.
  The adequacy of the system of internal control is crucial to the accumulation of accounting data for preparation of the financial statements. If the system is inadequate or nonexistent, it is virtually impossible for the independent public accountant to evaluate whether the financial statements are fairly presented.

- Determine the Audit Evidence to Accumulate.
  The system of internal control is an essential consideration affecting audit procedures, sample size, timing of the tests, and particular items to select.

- Inform Senior Management and the Board of Directors.
  When the independent public accountant identifies significant weaknesses in the system affecting the control over assets or any other aspect of internal control, including instances of inefficiency in operations, there is a professional responsiblity to inform the entity of the findings. The entity is informed by a letter (required SAS 20) which must be sent to senior management and the board of directors or the audit committee.

c. Relationship Between and Internal and Independent Public Accountants

The role of the internal audit function within CIC was determined by management, and its prime objective differed from that of the independent public accountant who was appointed to report independently on financial information. Nevertheless, some of the means of achieving their objectives were often similar, and thus, much of the work of the internal auditor could be useful to the independent public accountant. The independent public accountant in turn should, as part of his audit, evaluate the internal audit function. Ernst & Whinney stated in its work papers that they performed a detailed evaluation of CIC's internal audit function and believed that internal audit was the strongest and single most important element of internal control within the Corporation. The number of staff had increased steadily to 200 over the years, as well as the quality, and audit's scope, and performance. Thus, Ernst & Whinney believed that the internal audit function, as an element of internal control was quite strong. As a result, Ernst & Whinney had reduced its audit work significantly by relying quite heavily on the work performed by the internal audit function.

Although an adequate internal audit function will often justify a reduction in procedures performed by the independent public accountant, it can not eliminate them. An internal audit function is part of the entity, and irrespective of the degree of its autonomy and objectively, can not meet the prime criterion of independence which is essential when the independent public accountant expresses his opinion on the financial information. The report of the independent public accountant is his sole responsibility which is not reduced by any use he makes of the internal auditor's work. Thus, all judgements related to the audit of the financial information must be those of the independent public accountant.

In addition, other auditors should not rely upon an unqualified opinion issued by the an independent public accountant as a substitute for evaluating the banks internal controls and systems.

B. Loan Quality, Management and Evaluation

CIC's principal earning asset was the overall loan and lease portfolio of CINB. In connection with any type of loan activity, management should be greatly concerned with the quality of those loans. An analysis of loan quality is of particular importance to institutions which assume both a credit and an interest rate risk on their loans. Loan quality is mainly concerned with the level, distribution, and severity of classified loans; the level and distribution of non-accrual and reduced rate loans; the adequacy of valualton reserves; and management's ability to administer and collect problem loans.

CIC's Corporate Plan from 1976-1980 included as one of its specific financial goals a section dealing with asset quality. The goal as stated in the plan was "to upgrade systematically the quality of the asset portfolio consistent with the precepts of prudent bank management and the protection of our depositors and suppliers of capital." The annual strategic plans from 1977 through 1979 stated that one of its goals was "to maintain the historic high quality of the asset portfolio."

In meeting this overall objective, management had further stated in policy statements that the Corporation must maintain a loan portfolio of the highest quality borrowers with a view towards balancing the size of the loan portfolio against the corporate net worth, the cost of captial, the degree of risk represented, and the return on the assets utilized as compared to other alternative investments. To ensure these objectives were achieved, CIC placed the loan portfolio under the general supervision of the Credit Policy Committee (CPC).

The CPC consisted of ten executive or senior vice presidents from General Banking Services and Real Estate Services. The Committee met once a week and had the responsibility for establishing policies and procedures with respect to the pricing and quality of all loan credits. These policies and procedures could be viewed as internal controls which provide reasonable assurance that the corporation's objectives were achieved.

According to CIC's policies and procedures, the decision to issue credit initiated activity within the loan cycle. The Corporation's principal credit issuance controls focused on the delineation of lending authority as presented in the Loan Guidance Memorandum. The Loan Guidance Memorandum, which was prepared by the CPC established lending grades for each lending officer and maximum credit authorizations for each lending grade. Also, the memorandum stated that at least two lending officers must approve each credit regardless of the size. Once a credit was approved, a loan analyst in Loan Operations would prepare a credit summary, containing financial and credit information applicable to the loan. The credit summary was then submitted to the Loan Rating Committee. This Committee, which consisted of five vice presidents of diverse credit experience, met twice weekly to rate credits. Individual credits were rated as follows: "A" prime quality; "B" satisfactory from a credit standpoint; "C" more than normal risk; and "D" poor quality.

After the rating was assigned, the loan was placed on the CPC agenda and was reviewed and approved at the next CPC meeting. The CPC reviewed all C and D rated credits and all other credits over $1 million. In addition, some credits needed prior CPC approval. Such examples were fixed rate credits in excess of $1 million, C, or D rated credits in excess of $20 million, and all subordinated credits.

The loan review process also included maintaining a "Watch List" of credits with higher than normal risk. Quarterly, "Watch List Reports" (WLR) were submitted to Loan Administration for tabulation and reporting to senior management and the Board. A loan was scheduled to be placed on the Watch List in several ways. The primary input was from the individual lending officers, who had an ongoing responsibility for monitoring the quality of the credit and identifying any deteriorating situation. Any "D" rated credit was to be automatically placed on the list. Credits rated "C", which were to be regularly reported to CPC, may have been added if CPC decided it should be so classified. Further, any credit criticized in an examination report was required to be in the WLR system. All credits, once put into the system, were presented quarterly for re-review by the rating committee. Loans could be deleted from the WLR system by lending officers, except those put into the system by examiners of the CPC. Quarterly reports were made to the Board reflecting "C" and "D" rated WLR credits as they related to capital and total loans. These WLR's also provided input for determining the provision necessary to maintain the adequacy of the Reserve For Possible Loan Losses.

Although the above mentioned policy and procedures were established, material weaknesses occurred in the system of internal control and specifically with the loan evaluation activities. Significant asset quality problems in the Bank's oil and gas lending department were highlighted by the Penn Square failure in July 1982.

In 1983 and 1984, significant credit quality and documentation deficiencies were revealed in all aspects of the Bank's loan operations. As a result, more and more loans were labeled as nonperforming. By June 30, 1984, nonperforming loans amounted to $2.8 billion as compared to $444 million as of January 1981.

3. Internal Control Breakdowns

CIC's established internal controls had not prevented the purchase of massive amounts of problem loans. The bank's management was more concerned with its aggressive growth strategy and appeared to dismiss the need for compliance with adequate safeguards even though management was made aware of the deteriorating conditions on a number of occasions. One of the first occasions was the OCC's 1979 and 1980 examinations of CINB. In particular the examinations revealed that

- A reappraisal of the credit rating process and system is appropriate;
  deficiencies disclosed relating to the identification and rating of problem loans;
  other loans were found to have eluded the credit rating process.

- Capital adequacy and asset quality require continued director attention
  ratio of equity capital to total assets has decreased significantly from its already poor base;
  classified assets have increased during each examination, and is considered high at 122% of gross capital funds.

- Credit file completeness is in need of improvement
  missing note sheets, memos, and pertinent data on watch list.

A second alert came from a July 29, 1981 memorandum to management prepared by Kathleen Kenefick, Vice President in the Bank's Mid Continent Division. In the memorandum, she stated that the status of accounts particularly at Penn Square Bank is a cause for concern and corrective action should be instigated quickly. She complained that potential credit problems could be going unnoticed because initial credit write-ups were not done correctly, or at all, and other necessary documentation often was incomplete.

A third alert was the OCC's 1981 examination findings of CINB. In general the results revealed:

- deterioration in the level of classified assets and criticized assets;
- classified/critized credits were not appearing on the Watch List Report;
- no formal charge-off policy for installment lending;
- decline in return on assets;
- concern over the capital adequacy on asset quality levels.

In particular the examiners noted that approximately 375 credits aggregating $2.4 billion had not been reviewed in accordance with specified control procedure of one year. Also, it was noted that fifty-five of these credits were not reviewed within two years. Based on this examination, OCC concluded that it was evident that no one was monitoring the situation to ensure that all credits were receiving timely reviews as required by the corporate office.

The fourth alert occurred on November 4, 1981 when two oil and gas engineers notified the Senior Vice President of the Oil and Gas Group that reserve evaluations were being ignored because other collateral was used to justify lending more than the loan value of the reserves. They also discussed concern about the high volume and low quality of the Penn Square participations being purchased.

A fifth alert came from two internal audit investigation reports dated October 26, 1981 and January 4, 1982 on the loan participations at Penn Square Bank. In the report dated October 26, 1981, the auditors noted that the outstanding principal balance of participations purchased from Penn Square as of September 30, 1981 was 56% of the entire portfolio of the Mid Continent Division. Continental's purchases exceeded 90% of the original Penn Square Bank advance for 80% of the notes and dollar amounts. CINB's records of transactions with Penn Sqaure Bank were incomplete and inaccurate and the quality of CINB's security interest in certain loans was questionable. The report cited OCC's severe negative comments directed at Penn Square for inadequate loan documentation and procedures. The auditors also mentioned Arthur Young's qualification of First Pennsylvania's 1980 financial statements due to its loan participations with Penn Square where a lack of sufficient loan documentation existed to rate loan quality and thus the adequacy of the reserves for possible loan loss. Furthermore, the auditors noted that CINB's purchased participations were 134% of Penn Square Bank's net loans and at least twenty times Penn Square's total equity.

During the second audit of Penn Square the auditors noted additional areas of concern: there were situations in which CINB's lien position or collateral had been put into question by transactions directly between Penn Square and its customers; and there were twelve loans for which CINB had apparently purchased more than the outstanding balance booked by Penn Square Bank. This audit also uncovered that one of CINB's executives had received personal loans totalling $565,000 at preferential interest rates from Penn Square.

A sixth alert was the OCC's April 30, 1982 examination. In general the results revealed continued deterioration of the 1981 findings. In particular, examiners noted that 456 credits had not been reviewed within 12 months and an additional 76 credits were not reviewed within 24 months. Also an exception report concerning loans not rated for March, April, and May, 1982 reflected 86, 89, and 79, respectively of which 62, 59, and 48, respectively were in the Mid-Continent Division. Of more concern to the examiners was the fact that 119 credits criticized or classified totalling approximately $1.4 billion had no WLR's prepared. Based on this examination, OCC concluded that the function and operation of the rating system and WLR system was staffed by inexperienced personnel. Therefore, the independence, and thus credibility must be questioned.

The seventh alert was a bank initiated review of unrated and stale-rated credits. A review of the Special Industries Division for the fourth quarter of 1981 showed $592 million of unrated loans which increased to $893 million by the first quarter of 1982. Also, at June 30, 1982, approximately $143.5 million, 13.4% of the $1.1 billion of Penn Square-related loans and participations were unrated, and $186.7 million, 17.4% were stale-rated.

Finally, on July 5, 1982, the system's ineffectiveness was surfaced to the public when Penn Square Bank of Oklahoma was declared insolvent and closed by the Federal regulators. On that date, CINB had approximately $1.2 billion of outstanding participation loans from Penn Square Bank, of which a significant portion was determined to be non-performing. For a detailed explanation of CINB's Penn Square energy lending see Chapter 7.

The evidence appears very clear that there were breakdowns in internal controls. CIC/CINB's own investigation reported in the Special Litigation Report

> loans were disbursed without the approval of officers having the requisite lending authority; that the creditworthiness of borroweres was not sufficiently checked; that loans secured by reserves were disbursed without confirmation by CINB's engineers of the value of the reserves; that loans which could not be justified by proven reserves were approved through the use of additional types of collateral which were insufficent and not in accordance with corporate policies; that in a number of instances security interests were not perfected, that groups of Penn Square participations were purchased without proper credit investigation; that there were severe problems of lack of loan and collateral documentation and past due payments in connection with Penn Square loans; that the past due notices and exception reports generated as a result of these deficiencies were largely ignored and that management had knowledge of or at least warning about many of these matters and that no effective action was taken until the situation had severly deteriorated.

Internal audit failed to notify senior management in a timely manner that the internal controls were not operating in compliance with established policies and procedures. Internal audit was not aware of material breakdowns in internal control until management had requested specific investigations and even when aware they failed to notify senior management and the independent public accountant of such weaknesses in a timely manner. As a result, senior management was not able to take the appropriate action necessary to prevent the purchase of massive amounts of problem loans, which ultimately led to Continental's demise.

Continental's Special Litigation Report indicated that CIC's own internal audit's investigation regarding the General Banking Services Division's treatment of loan exception reports as of July 25, 1981 concluded that loan operations were accurately reporting documentation exceptions. Nevertheless the same report pointed out that the Bank's management, direct lending line officers, and members of General Banking Services loan operations staff generally recognized that Loan Operations was issuing reports that contained many errors.

Also, the report indicated that internal audit was not sufficiently aware of the problems raised prior to the Kenefick memorandum dated July 29, 1981 or the complaints raised by the Oil and Gas engineers on November 4, 1981. Not until internal audit was requested to conduct a special review on loan participations with Penn Square were any concerns raised. After the review, Mr. Hvlaka, Senior Vice President and Auditor of the Bank, personally thought the level of Penn Square participations was too high and that the Bank was "too close to Penn Square for comfort." However, Hvlaka never informed his nominal supervisor, Vice Chairman of the Board of Directors, Ernst & Whinney, the Bank's independent public accountant, or the Audit Committee of the Board. Furthermore, internal audit staff members assured Ernst & Whinney that Penn Square problems related to processing and that collectability was not an issue. As a result, the vast bulk of the participations were purchased, increased, or renewed between last quarter 1981 and July 5, 1982.

On the other hand Ernst & Whinney, the Corporation's independent public accountant, had not discovered weaknesses in its examination of CINB's statements. As mentioned earlier, Ernst & Whinney rendered an unqualified opinion on the Corporation's financial statements during this time period stating that in their opinion the financial statements fairly presented the financial performance of the Corporation. The opinion also implied that no weaknesses in internal control were discovered that would materially affect the fair presentation of such financial statements. Although the independent auditor is not required to detect errors and irregularities he does have a responsiblity to search for those errors which have a material effect on the financial statements. Thus the independent auditor should approach an audit with an attitude of professional skepticism.

According to Price Waterhouse, in its investigation concerning Ernst & Whinney's performance of its auditing duties, there was inadequate compliance with the system of internal accounting control at Continental. In the opinion of Price Waterhouse this inadequate compliance was a material weakness in the system of internal accounting control as defined by Generally Accepted Auditing Standards in Statements of Auditing Standards No. 20 as issued by the American Institute of Certified Public Accountants.

Price Waterhouse's review of Ernst & Whinney work papers revealed that Ernst & Whinny had placed significant reliance on the work of CINB's Internal Audit Department who, as mentioned earlier, failed to assure effectiveness of Continental's internal controls. Also, it was determined that Ernst & Whinney's testing of CINB participations purchased or sold appeared to have been limited to only a review of Internal Audit Department reports. With respect to past due and non-accrual of loans, the Ersnt & Whinney work papers included only a comparative analysis of past due loans by profit center even though the analysis revealed a significant increase in the past due loans of the Mid Continent Division.

Furthermore, the Ernst & Whinney work papers included a memo dated July 10, 1982 (after the failure of Penn Square) which stated that no Penn Square loans were included in Ernst & Whinney's sample of the watch list process and concluded that after Ernst & Whinney learned of the past due situation regarding Penn Square generated loans, Ernst & Whinney spoke with internal audit representatives who assured Ernst & Whinney that the situation was only a processing problem that was being corrected.

Based on the facts uncovered by Price Waterhouse coupled with the deteriorating conditions mentioned earlier, it would appear that Ernst & Whinney's audit procedures while perhaps in accordance with professional standards, did not detect weaknesses in CIC's and CINB's system of internal accounting controls, specifically in the area of loan management.

C. Performance Relative to Peers

In analyzing CIC financial condition from 1976 to 1983 13 financial ratios were selected under 5 major categories used to measure an institution's financial performance. For each ratio CIC was compared to two peer groups: (1) 16 of the largest multinational banking organizations and (2) 4 of the Chicago area's largest bank holding companies. (See table 1 for a list of companies.) The ratios used in the analysis were obtained from financial information as filed by bank holding companies with the Federal Reserve. The data obtained are based on year-end financial data which has not been adjusted for prior year restatements. To supplement the Federal Reserve data, comparative ratios from an outside consulting firm and reviewed data from the Office of the Comptroller of the Currency, including bank examination reports of Continental Bank from 1976 through 1983 were reviewed. (See table on page 49 for the ratio performance of Continental as compared to other multinational banks.)

Listed below are the 5 major categories used to measure an institution's financial condition. Included in these categories are the 13 selected financial ratios.

Profitability/Earnings

Ratio 1	Return on Equity
Ratio 2	Return on Assets

Asset Quality

Ratio 3	Net Charge-offs to Total Loans, Net of Unearned Income
Ratio 4	Allowance for Possible Loan Losses to Total Loans, Net of Unearned Income
Ratio 5	Nonperforming Assets to Total Assets

Capital Adequacy

Ratio 6	Equity Capital + Allowance for Possible Loan Losses to Total Assets + Allowance for Possible Loan Losses
Ratio 7	Equity Capital + Allowance for Possible Loan Losses + Subordinated Notes and Debentures to Total Assets + Allowance for Possible Loan Losses
Ratio 8	Equity Capital + Allowance for Possible Loan Losses to Total Loans, Net of Unearned Income

Liquidity

Ratio 9	Total Loans, Net of Unearned Income to Total Assets
Ratio 10	Liquid Assets - Volatile Liabilities to Total Assets

Growth

Ratio 11	Growth in Loans
Ratio 12	Growth in Assets
Ratio 13	Growth in Earnings

The remainder of this section analyzes each performance category and provides specific information about CIC's financial condition as it relates to other multinational organizations. Table I lists performance measures for CIC and its peer group for the period 1976 through 1983.

Profitability

Profitability ratios are designed for the evaluation of an organization's operational performance. The ratios an indicator of an organization's efficiency in using capital committed by stockholders and lenders. The ratios analyzed are return on equity capital and return on assets.

Return on equity capital

Return on equity capital (ratio 1) is the most important measure of profitability for shareholders because it relates net income to the book value of their claims. An analysis of the multinational and regional data revealed that CIC's return on equity capital for the period 1976 to 1981 was high and very stable, averaging 14.31 percent, almost 2 percentage points above its multinational peer group. This high return on equity capital was a result of continued improvement in net income due primarily to a significant increase in interest and fee income from an increasing volume of loans.

In 1982 and 1983, CIC's return was 4.56 and 5.95 percent, respectively. This was 7 and 5 percentage points below the average of the multinational peer group. In the analysis, Continental ranked last and next to last. The extremely low return was due primarily to a significant increase in the provision for loan loss expenses, a result of Penn Square National Bank's failure and the bankruptcy and near bankruptcy of several of the CIC's large Midwest and manufacturing corporate borrowers.

Return on assets

Return on Assets (ratio 2), which measures the average profitability of the institution's assets, is designed to indicate the effectiveness of management in employing its available resources. An analysis of both the multinational and regional data revealed that CIC's return on assets for the period 1976 to 1981 was high and very stable, averaging .55 percent, approximately .06 percentage points above its multinational peer group. This high return on assets was due primarily to the continued increase in the dollar level of domestic and foreign earning assets. Also, CIC channeled a large amount of funds traditionally held in the form of short term money market investments into loans offering higher yields but less liquidity.

In 1982 and 1983, CIC's return was .18 and .26 percent, respectively. This was .31 and .26 percentage points below the average of its multinational peer group. The low return was due primarily to an increase in loans designated as nonperforming. CIC's loan loss reserve to total loans and net charge-offs to total loans increased significantly from .89 and .29 percent in 1981 to 1.24 and 1.37 percent by the end of 1983, respectively. Also, CIC's net interest margin, the total cost of all its funds contributing to earning assets subtracted from the yield of all its assets, was as much as three-quarters of a percentage point below the average for its multinational peers.

This financial analysis coupled with a review of bank examination reports from 1977 through 1983 showed increased earning assets in the period leading up to 1981. These higher levels of earning assets were the result of a substantially increased loan volume which increased interest and fee income. Also, non-interest income was increased with the expansion of the credit card operation in 1978. However, in mid-1982, poor asset quality, as evidenced by an unprecendented volume of nonperforming loans, dominated CIC's condition. CIC's earnings became severely depressed resulting in a significantly reduced return on assets.

Asset Quality

An analysis of asset quality is of particular importance to institutions which assume both a credit and an interest rate risk on their assets. Asset quality is mainly concerned with the level, distribution, and severity of nonperforming assets; the level and distribution of non-accrual and reduced rated assets; the adequacy of valuation reserves; and management's ability to administer and collect problem credits. The asset quality ratios analyzed are: net charge-offs to total loans, allowances for possible loan losses to total loans, and nonperforming assets to total assets. These asset quality ratios (3, 4, and 5) focus on indicating areas of concern in the loan portfolio, since assets of a financial institution are represented primarily by loans.

During the period 1978 to 1981, the asset quality ratios of the multinational and regional peer groups revealed the following. CIC's ratio of allowance for possible loan losses to total loans was as much as .09 and .25 percentage points below the average for the peer groups. CIC's ratio of net charge-offs to total loans was consistently below its peers, averaging .29 percent as compared to the peer group's average of .43 and .46

During 1982 and 1983, Continental experienced a severe deterioration in its asset quality ratios as compared to the multinational peer group. The Bank's allowance for possible loan losses to total loans increased significantly from .89 percent in 1981, to 1.15 and 1.24 percent in 1982 and 1983, respectively. The Bank's net charge-offs to total loans increased dramatically from a low of .29 percent in 1981 to 1.28 and 1.37 percent in 1982 and 1983, respectively (.73 percentage points above its peer group average of .55 and .64 for those years). Finally, Continental's ratio of nonperforming assets to total assets also increased dramatically from an average of 1.30 in 1979 to 1981, to 4.6 percent in 1982 and 1983 (2.4 percentage points above the peer group average of 2.2 percent).

Capital Adequacy

The primary function of bank capital is to demonstrate the ability to absorb unanticipated losses. Capital ratios represent the primary technique of analyzing capital adequacy. The capital ratios analyzed are: equity capital to total assets and equity capital to total loans.

Equity capital to total assets

Equity capital to total assets (ratios 6 & 7) indicates the percentage decline in total assets that could be covered with equity capital and, where applicable, subordinated notes and debt. The ratios are inversely related to the size of the bank. This reflects the more conservative stance of small banks and the ability of larger banks to reduce their need for capital because it is believed they can reduce the adverse effects of the default risk and market risk through the law of large numbers. An analysis of the multinational peer group data revealed that CIC's equity capital to total assets (ratios 6 and 7) declined from 4.88 percent in 1976 to 4.22 percent in 1981. During this period, CIC's rank among its peers for ratio 6, which includes primary equity fell from seventh to thirteenth. On the other hand the analysis of ratio 7, which includes primary equity plus subordinated notes and debentures, ranked CIC constantly next to last during the period averaging .74 percentage points below the peer group. Also, an analysis of the regional data ranked CIC last averaging .62 percentage points below the peer group for ratio 6 and .75 percentage points below the peer group for ratio 7.

that could be covered with equity capital. However, [illegible] denominator based on the belief that the majority of the risk in total assets is in the loan portfolio.

An analysis of the multinational peer group data revealed a steady decline in CIC's ratio from 7.13 percent in 1976 to 5.26 percent in 1982. During this period, its rank fell from sixth to last within the peer group. Regional data also placed Continental last during the period, averaging 2.43 percentage points below the peer group average.

This financial analysis along with a review of the bank examination reports from 1976 to 1982 reveals that CIC's level of equity capital over the period did not keep pace in relation to the extremely high volume of loan and asset growth. According to OCC examinations, Continental's 1976 capital base was not sufficient to support a rapid loan expansion. Also, the 1976 examination pointed out that unlike most other large national banks, Continental had no definite capital growth plan. Despite Continental's efforts to remedy the situation, the bank's strained capital base that existed in 1976 failed to keep pace with the asset growth and continued to decline through 1981. Continental was able to assume the additional risk and maintain a strained capital base, whereas others in the same peer group could not, because of its successful track record from the early 1970's of substantial increases in earnings performance. However, in 1982 and 1983, when the quality of Continental's assets was determined to be poor and the earnings on those assets were depressed, the risk of insolvency significantly increased.

Liquidity

An individual bank's liquidity is its ability to meet deposit withdrawals, maturing liabilities, and credit demands and commitments over two time periods: (1) the short-run, a period of less than 1 year and (2) the long-run, a period influenced from cycles in economic and financial activity and the growth in deposits and loans. Liquidity ratios provide the primary means of judging a bank's liquidity position. The two liquidity ratios analyzed are loans to assets, and liquid assets minus volatile liabilities to total assets.

Loans to assets

Total loans net of unearned income to total assets (ratio 9) is a measure of an institution's liquidity. An analysis of the multinational and regional data revealed that Continental's loans continued to increase, becoming far and away its major source of assets. During the period 1976 to 1983, the Bank's ratio rose significantly from an average of 58 percent for 1976 to 1978, to 62.8 percent for 1979 and 1980, and to 71.6 percent for 1981 to 1983, approximately 1.5, 5.85, and 10.3 percentage points above its peers. In general, this ratio revealed the existence of a poor liquidity position which dictates the need to further evaluate other liquidity ratios.

Liquid assets minus volatile liabilities to total assets

Liquid assets minus volatile liabilities to total assets (ratio 10) measures the net liquidity of a bank's total asset portfolio after making deductions for volatile liabilities. The numerator is reduced because a significant portion of the liquid assets are pledged against Treasury and other public debt.

An analysis of both the multinational and regional data revealed that Continental's ratio was extremely poor during 1976 to 1983, averaging - 45.97 percent, or at least 21 percentage points below its peers. Not only did Continental rank last during the entire period, but its ratio also increased significantly (from an average of -37.7 percent for 1976 to 1978 to - 46 percent for 1979 to 1980 to - 54.2 percent for 1981 to 1983).

During the period of this analysis Continental was increasing its assets with heavy loan volume and had to finance them with more volatile, more expensive money. Continental was not adjusting its maturities and asset and liability composition in order to achieve a relative balance between interest sensitive assets and liabilities. For example, to support its aggressive loan policy, Continental maintained a high degree of rate sensitivity through the heavy use of overnight funds and shortened CD and Eurodollar maturities. In addition, Continental began attracting deposits of foreign institutions, particularly foreign banks, by in some cases paying them more interest than other domestic banks. At the same time, core deposits from individuals, partnerships, and corporations remained constant during the period, lagging behind the 8 percent growth rate reported by Continental's peer group.

Growth

Steady and controlled growth is a desirable characteristic for an institution. The examination of growth ratios reveals useful information about an institution's overall performance. The three ratios analyzed are growth in loans, growth in assets, and growth in earnings.

A high correlation existed among all three ratios, growth in loans, assets, and earnings (ratios 11, 12, and 13). Assets which represented Continental's use of funds had been primarily driven by a growth in loans whose interest income has stimulated a growth in earnings.

An analysis of these ratios from 1977 to 1981 revealed a steady growth in earnings averaging 14.8 percent. This consistent earnings growth, mandated by Continental's management, was driven by a 16.4 percent steady growth average in assets which was maintained by a significant growth in loans averaging 19.9 percent. During this period, Continental outperformed its multinational peers in both asset and loan growth by 3.4 and 5.2 percentage points, respectively. However, the growth in earnings considered strong by management was as much as 3.6 percentage points below its peer group.

In 1982 and 1983, rapid growth trends were eliminated. By mid to late 1982 significant concern centered on the quality of CIC's assets. This caused management to take an extremely cautious approach in acquiring additional loans. Also, a number of loans were classified as nonperforming and were written off. As a result, earnings from interest and fees on loans were severly depressed.

The data confirm an increase in the growth of loans, assets, and earnings for CIC during the period 1976 to 1981. As mentioned earlier, growth in loans was a major reason for the growth in assets and earnings. An example of the growth in loans was shown by Continental's loan portfolio increases in overseas loans, energy loans, and loans to lesser-developed countries. From 1976 to early 1982, CINB's loans grew from 60.4 to about 79 percent of total assets. Particularly, growth was shown in energy, specifically oil and gas loans.

In summary, from 1976 through 1981 CIC's financial condition, while generally consistent with its peer group, was gradually deteriorating. As mentioned in other sections, CIC's asset growth was the result of a goal to become one of the leading domestic wholesale banks. However, this goal was driven by a need to show higher earnings to the marketplace. Although earnings growth (in dollars), during the period 1976 through 1981 had been impressive, it had not kept pace with asset growth. Therefore, in order to show better earnings (in dollar terms) management adopted the strategy of generating more assets, especially during 1980 and 1981.

CIC's asset growth was based primarily on growth in loans. During the period 1976 through 1981 CIC's loans as a percentage of total assets always exceeded its peers. By 1981 this ratio reached 67.4 percent as compared to 60.3 percent for its peers. In general this situation placed Continental in a poor liquidity position. CIC's liquid assets minus volatile liabilities as a percentage of total assets was extremely poor during 1976 through 1981, averaging 20 percentage points below its peers. This situation occurred because Continental had to finance its heavy loan volume with more volatile more expensive money.

Associated with generating a substantial volume of loans over an extended time period is the high probality of encountering problem loans. Statistically greater lending results in greater losses. However, CIC's reserves for potential losses as a percentage of total loans and the actual amount of charge-offs net of recoveries as a percentage of total loans decreased substantially from 1978 through 1981, averaging approximately .13 percentage points below the peer groups.

Banks experiencing fast growth will need to retain a greater portion of their income than banks experiencing slow asset growth if they intend to maintain their capital ratio level. Continental, however, sacrificed a high capital ratio level to enable greater earnings per share. From 1976 through 1981 CIC's equity capital which included subordinated notes and debentures as a percentage of total assets decreased averaging .75 percentage points below the peer group. This reduced capital position would make it difficult to absorb any losses encountered in the future.

Table I

Peer Groups

16 Largest Bank Holding Companies

1) Bank of Boston Corporation
2) BankAmerica Corporation
3) Bankers Trust New York Corporation
4) Chase Manhattan Corporation
5) Chemical New York Corporation
6) Citicorp
7) Crocker National Corporation
8) First Chicago Corporation
9) First Interstate Bancorp
10) Irving Bank Corporation
11) J.P. Morgan & Co. Incorporat
12) Manufacturers Hanorver Corporation
13) Marine Midland Banks, Inc.
14) Mellon National Corporation
15) Security Pacific Corporation
16) Wells Fargo & Company

4 Largest Bank Holding Companies in the Chicago Area

1) Exchange International Corporation
2) First Chicago Corporation
3) Harris Bankcorp, Inc.
4) Nortrust Corporation

D. **Nonbank Subsidiaries**

Through its nonbank subsidiaries, CIC was engaged in a variety of activities including leasing, energy development lending, commercial lending, real estate lending servicing, venture capital investing, and domestic and international trust activities. While CINB accounted for the majority of the Corporation's assets and earnings, non-bank subsidiaries of the holding company made some contribution to CIC's profitability in 1981, 1982 and 1983.

The impact of nonbank subsidiaries on a bank holding company depends on the scale of nonbank operations and the performance of those subsidiairies over time. Thus, the analysis of the nonbank subsidiaries impact on CIC's consolidated financial position focused on such items as total nonbank assets to total consolidated assets, nonbank income to consolidated income, parent company loans to the nonbank subsidiaries, nonbank loans to the parent, dividends paid to the parent from both the bank and the nonbank subsidiairies, and investments by the parent in nonbank and bank subsidiaries. Tables 2 and 3 provide this analysis from 1974 to 1983.

An analysis of CIC's consolidated assets during the period 1974 through 1983 revealed that CIC was highly dependent upon CINB's growth. Total nonbank assets as a percent of total consolidated assets were 2.98 percent in 1974 increasing to slightly over 5 percent in 1982 and 1983. The increase was not due to an increase in nonbank subsidiary assets, but rather to a significant decrease of $4.8 billion in CIC's consolidated assets, due to CINB's deteriorating financial condition. Without taking 1982 and 1983 into consideration, the average ratio of nonbank assets to consolidated assets for the years 1974 to 1981 amounted to only 3.2 percent.

Net income from nonbank subsidiaries were primarily dependent upon CINB during the period from 1974 to 1983. Nonbank income increased progressively from a loss of $12.9 million in 1974 to a gain of $41.7 million in 1981 and $43 million in 1982, before falling back to $33 million in 1983. Consolidated income for CIC also increased steadily from $95.7 million in 1974 to $254.9 million in 1981 before plunging to $77.9 million in 1982 and $108.3 million in 1983. Nonbank net income as a percentage of CIC's consolidated net income reflected a steady increase to 6.1 percent in 1980. By 1981, nonbank income increased to 16.38 percent due primarily to Venture capital subsidiaries. Although these particular subsidiaries represented less than one percent of CIC's consolidated assets at year-end 1981, they contributed $30 million or 11.6 percent to consolidated revenues. In 1982, nonbank subsidiaries contributed over 55 percent of CIC's consolidated net income. This increase was due primarily to a significant reduction in CINB's earnings, which were severly impacted by a large extraordinary addition to the loan loss provision as well as by increasing levels of nonperforming assets. In 1983, as income from CINB increased, the percentage of nonbank net income to consolidated net income decreased to 30 percent of total net income.

An analysis of parent company loans to and borrowings from the nonbank subsidiaries indicated that nonbank subsidiaries were dependent upon the parent from 1974 through 1979. As of December 31, 1979, nonbank subsidiaries' loans advanced from the parent had a balance outstanding of $378 million. However, from 1980 through 1983, the balance outstanding of loans to and borrowings from the nonbank subsidiaries approached equal levels, with a balance of $623 million and $521 million respectively. Thus, the parent was just as dependent upon the nonbank subsidiaries as they were on the parent.

The parent company's investments in nonbank subsidiaries as a percentage of total investment in all subsidiaries was insignificant for the period from 1974 to 1979 averaging only 4.5 percent. However, the parent's investments in nonbanks doubled in 1980 from $82 million to $163 million, and doubled again by 1983 to $340 million. The parent's investment in nonbank subsidiaries as a percentage represented 9.54 percent in 1980 and 15.55 percent by 1983. These increases were due primarily to a $50 million initial capitalization of Continental Illinois Overseas Finance Corporation, N.V. in 1980 and further capital injections of $35 million in 1981 and $102 million in 1982. These capital injections were made to this subsidiary even though CINB was encountering unfavorable condition.

An analysis of dividends paid to the parent during the period 1974 through 1983 revealed that CINB was the primary contributor. According to CIC's Corporate Treasury Group, which recommended the payment of dividends from subsidiaries to the parent nonbank subsidiaries were not able to make dividend payments from 1974 through 1980 based on their capital position relative to their size and growth expectation. Prior to 1981, CINB was the only subsidiary upstreaming dividends to the parent. In 1981, however, the parent received 26.5 million in dividends solely from the nonbank subsidiaries. Overseas, Leasing and Mortgage paid dividends of $13 million, $8 million and $2.5 million, respectively with an additional $3 million in dividends from liquidating Advisors. According to the Federal Reserve, no dividends were paid by CINB in 1981 in order to enhance the Bank's capital position and increase its legal lending limits. In 1982 and 1983, CINB resumed its dividend payments to the parent contributing $62 million and $50 million, representing 82 and 77 percent, respectively. The remaining dividends received by the parent during this period were paid solely by the Overseas nonbank subsidiaries which contributed $14 and 15 million, respectively.

This analysis also highlights the effect CIC's dividend payout goal had on CIC's ability to retain earnings. During 1974 to 1977 CIC retained a portion of the dividends received from CINB since it paid out less than that to its shareholders. From 1978 to 1983, however, CIC paid out more in dividends to its shareholders than it received from all of its subsidiaries. CIC's goal of maintaining a steady increase in dividends paid to its shareholders caused CIC to reduce the amount of earnings it could retain. Had CIC maintained a policy of limiting its dividends paid out to the amount of dividends received from bank and nonbank subsidiaries reductions in retained earnings of 15.3 million in 1978, $8 million in 1979, $34.7 million in 1980, $46.6 million in 1981, $3.4 million in 1982, and $ million in 1983 would not have occurred.

In summary it is clear that the nonbank subsidiaries had a negative impact on CIC from 1974 through 1980. During this period, the nonbank subsidiaries did not pay any dividends, averaged only $3.4 million in net income, and were advanced $388 million. From 1981 through 1983 however, it appears that the nonbank subsidiaries made some contributions with $56 million in dividends, an average of $19 million in net income, and $541 million loaned to the parent company. On the other hand, the parent during this period increased its investment in the nonbank subsidiaries by $177 million and its loans to the nonbank subsidiaries increased by $234 million. The following two tables show the impact of nonbank activities on CIC during the period 1974 through 1983.

IMPACT OF NONBANK ACTIVITIES ON CIC
(In thousands)

Year End	Balances of Assets		Nonbank Assets as a % of CIC's Assets	Net Income		Nonbank Net Inc. as a % of CIC's Net Income
	CIC	Non Bank		CIC's	Non Bank	
1974	19,640,747	585,483	2.98	95,690	(12,868)	N/A
1975	20,225,633	559,790	2.77	112,890	(1,376)	N/A
1976	21,984,899	576,889	2.62	127,804	1,463	1.14
1977	25,800,280	768,213	2.98	143,123	7,230	5.05
1978	31,058,665	921.475	2.97	167,817	5,479	3.26
1979	35,790,119	1,320,596	3.69	195,807	10,190	5.20
1980	42,089,408	1,741,022	4.14	225,941	13,702	6.06
1981	46,971,755	1,667,000	3.55	254,623	41,707	16.38
1982	42,899,424	2,199,000	5.13	77,887	43,000	55.21
1983	42,097,371	2,129,000	5.06	108,319	33,000	30.47

IMPACT OF NONBANK ACTIVITIES ON CIC
(In Thousands)

Year End	Balance of Loans to Nonbank from Parent	Balance of Parent Borrowings from Nonbank	Dividends Paid to Parent from		Dividends Paid by CIC	Balance of Investment by Parent in		Nonbank Inv. as a % of Total Investment
			Bank	Nonbank		Nonbank	Bank	
1974	183,626	—	49,195	—	37,137	25,505	806,661	3.06
1975	159,411	—	60,194	--	38,754	38,853	867,041	4.48
1976	180,134	—	46,996	—	40,938	43,817	1,012,141	4.15
1977	252,681	--	51,081	—	43,699	56,399	1,101,721	4.87
1978	278,563	—	33,996	--	49,336	62,017	1,225,954	4.82
1979	377,677	—	49,995	—	58,001	82,515	1,359,826	5.72
1980	388,220	147,437	29,997	—	64,757	163,304	1,549,093	9.54
1981	660,530	245,844	—	26,465	73,081	230,000	1,747.403	11.60
1982	773,435	540,694	61,994	14,053	79,434	322,600	1,794,271	15.24
1983	622,520	540,694	49,996	15,000	80,035	340,248	1,847,194	15.55

CHAPTER V

SUPERVISION

A. Federal Supervisory Framework

1. Agencies

Three Federal agencies -- the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve System (FRS), and the Office of the Comptroller of the Currency (OCC) -- are responsible for regulating and supervising 14,780 commercial banks and 5,371 bank holding companies in the United States:

-- OCC supervises all federally chartered national banks which are required to be both FDIC insured and members of the FRS.

-- FRS supervises all State-chartered banks that are FDIC insured and are members of the Federal Reserve, and all bank holding companies; and

-- FDIC supervises all State-chartered banks that it insures which are not members of the Federal Reserve;

Each agency maintains its own structure, including a separate, nationwide network of regional offices, field offices, and examiners to supervise banking institutions.

The Government's involvement with banking has led to a unique system of regulation dispersed among the 50 States and three Federal agencies. While the structure of the three Federal bank regulatory agencies is similar, each agency is responsible for a distinct set of institutions. As of 1984, the number and type of institutions supervised were as follows.

Type of Institution	Regulator	Number
National Banks	OCC	4,823
State Member	FRS	1,107
State Nonmember	FDIC	8,850
Bank Holding Companies	FRS	5,371
TOTAL		20,151

To assist the regulators, commercial banks and bank holding companies are required to file a variety of reports with their regulator. The Federal Financial Institutions Examination Council (FFIEC) prescribes the content and form of the reports for banks and monitors the data gathering activities while the Federal Reserve performs the same function for bank holding companies. Regulators use the data to monitor the institutions financial condition through offsite screening systems. The offsite systems provide data which assist examiners in onsite bank and bank holding company examinations. At the culmination of each bank examination, the examiners give each bank a rating, called a CAMEL rating (for bank holding companies it is called a BOPEC rating), which indicates in general the financial soundness of the institution. Those banks or holding companies with low ratings, generally 3, 4, or 5, are examined more frequently than institutions rated 1 or 2.

The regulators are also responsible for enforcing compliance with applicable laws and regulations. Bank examinations or bank holding company inspections are the factfinding arm which the regulators use in discharging these responsiblities. The regulators use various types of bank examination programs and inspections to meet their responsibilities. The most common type of examination is called a commercial or safety and soundness examination and is used to analyze such financial institution operations as deposit-handling, loan-making, securities investment, liquidity, capital adequacy, earnings, and management. Commercial bank examinations and bank holding company inspections are also used to monitor internal controls, policies, procedures, and compliance with laws and regulations. Additionally, the regulators have developed special programs for examining trust and international departments, electronic data processing services, and compliance with consumer protection laws and regulations.

2. Early Warning Systems

Until 1975 the three bank regulators -- FRS, FDIC, and OCC — determined the financial condition of banks solely through onsite examinations. However, by the mid-to-late 1970s, each of the regulators had researched, developed, and implemented an early warning computer screening system. The primary goal of these systems is to aid the examination process by identifying changes in the financial condition of banking organizations between examinations.

The computer screening systems are used to analyze quarterly bank data and semiannual bank holding company data. The FDIC and FRS use their systems to detect changes in bank and bank holding company financial data which indicate emerging weaknesses. The OCC uses a different methodology to achieve the same purpose. OCC uses analysts to monitor about 100 large national banks and a combination of computer screening and human analysis to monitor the remainder. In those cases where computer screening is used and where banks have been previously identified as a problem, all three agencies provide additional monitoring and in some cases computer screening. Because each of the agencies has researched and developed its own screening system, each system is unique to the respective agency. The regulators have been working to make the process more uniform and have recently approved a proposal that would provide for uniform screening of financial data.

Early warning screening systems are not intended as substitutes for existing bank examinations, nor are they designed to predict bank failures or to identify all unsound banks. They are intended only to highlight major changes in the financial condition of individual banks. Additional analysis, inspection, or examination is needed to determine whether the flagged banks are weak or potentially unsound. If, after additional analysis, questions remain about a bank's soundness, a special examination may be conducted or scheduled examination accelerated.

Because the automated screening systems are based on computer programs that are limited to certain calculations, the major one being that they will not flag all problem banks. A computer screen is only as good as the financial information used to generate the data and the ratio's used in the screen. Moreover a screen will not normally identify those banks subjected to fraud, embezzlement, or other theft nor will it readily identify understated amounts on the financial statements. And since screens are based on predetermined ratios, they will not necessarily identify problems from an emerging industry trend, such as problems caused by bad energy loans, unless a special program has been included in the system.

The screens also have limited capacity to identify changes in management philosophy which affect bank soundness. When a bank's management philosophy changes in subtle and unannounced ways, such changes are not easily captured by financial ratios. A change in mangement philosophy of objectives affecting the bank's riskiness, profitability, and eventual soundness, may become apparent to examiners or analysts from other data before it affects the screen's financial ratios.

Finally, the screening systems have limited value when the scores used by the agency for comparative purposes are too high or too low. If the passing score is too high, a large percentage of banks may fail the screening tests, resulting in a high percentage of banks that require follow up or additional analysis.

a. OCC's Anomaly Severity Ranking System (ASRS)

Unlike FRS and FDIC, the OCC divides the banks it regulates into two groups and uses different methods to monitor changes in the financial condition of banks of each group. The Comptroller's Anomaly Severity Ranking System is designed to identify financial changes in most OCC regulated banks, but a different approach is used for multinational and large regional banks. These banks, which number about 100, are monitored daily by OCC analysts. The analysts review stock prices, public pronouncements, and other information on each bank and enter the information into a computer. These data are used to produce a quarterly internal document, called a fact sheet, which is distributed to examiners, other regulators, and OCC bank supervisory personnel.

For those banks that are not monitored by analysts on a daily basis, OCC uses a combination of computer screening and human analysis to track the banks. For tracking purposes, OCC divides the banks into two groups according to the CAMEL ratings received by the banks. Banks rated 3, 4, and 5 are assigned to analysts in the Multinational and Regional Bank Analysis Division where close attention is given depending on need. Those banks that are rated 1 and 2 are tracked using a combination of ASRS and human analysis.

In OCC's surveillance section, one or two analysts are assigned for each region to track banks that have been screened by ASRS. In addition to being screened by ASRS, which is an automatic process using set ratios, the 1 and 2 rated banks receive special attention from the assigned analysts. As an example, if the agriculture industry is having a bad year, analysts may be asked to determine how many banks have a certain amount of agricluture loans or, if interest rates are rising, the analysts may check bank margin requirements. Thus, OCC's system includes ASRS as well as special screens by assigned analysts. Banks flagged by either the special screen or ASRS are reviewed to determine whether emerging problems exist.

The ASRS calculates basic ratios and a number of variants of these ratios. Year-to-year changes in seven critical balance sheet measures are reflected in two summary ratios which are the principle indicators of bank condition and the primary determinants of which banks warrant further investigation. All the measures used in ASRS are converted into relative values where each bank is compared to other banks in its peer group. There are 21 such groups defined by asset size, branching status, and rural/urban location.

A list of banks flagged by ASRS is forwarded to each region. Regional specialists evaluate each bank's recent examination reports and the statistical data contained in quarterly reports on bank performance to determine what problems caused the ASRS flag. In the process the specialist may also telephone or write to the bank to obtain new information on areas of particular concern. Information developed by the specialist is entered into a system called Action Control along with any weaknesses uncovered during examinations. Responses to the flag by the OCC regional office and by banks are also entered into Action Control. A list of all banks in the system, along with their status, is updated every day.

b. **Warning System Deficiency**

ASRS is more complex than the FRS and FDIC systems. As implied by the name, anomalous (unusual) behavior of any sort relative to peers flags a bank for analysis by an OCC analyst. A fundamental ASRS principle is that a bank which deviates from its peers, either above or below the peer norm, is worth investigating. A perfect score under ASRS would be zero, that is, close to the peer group norm for every ASRS measure.

The fundamental weakness in the OCC's surviellence system was starkly highlighted by the Continental experience. Because the ASRS is based on spotting individual national bank deviations from its peer group, if the peer group's financial ratios shift downward together, no anomolous behavior will be reported. CINB's peer group, the other large, money center national banks, was in the late 1970s and early 1980s registering financial pressures very similar to CINB. So similar in fact, CINB's loan quality, capitalization, and earnings ratios were not sufficiently different from the peer group averages to trigger aggressive OCC action.

3. **Bank Examinations**

On-site examinations have been for many decades and remain the regulators basic tool for exercising their supervisory responsibilities. Examinations arose out of the need to ascertain the financial condition of banks. The growing complexity of the banking business, however, and the increase in consumer protection legislation have enlarged the scope of bank examinations beyond the purely financial area and have led to the existence of several types of bank examinations. Today, separate examinations may be made of commercial departments, consumer protection laws compliance, electronic data processing systems, trust departments, international branch operations, and bank holding companies.

Despite the expanded scope and the different types of examinations, the primary concern of the regulators remains the financial condition of institutions. Thus, the most important examination is focused on bank soundness. In its Comptroller's Handbook for National Bank Examiners, the OCC states that the essential objectives of an examination are:

> (1) to provide an objective evaluation of a bank's soundness; (2) to permit the OCC to appraise the quality of management and directors; and (3) to

identify those areas where corrective action is required to strengthen the bank, to improve the quality of its perfomance, and to enable it to comply with applicable laws, rulings and regulations.

In conducting an examination, examiners use a variety of techniques and focus on a variety of subjects. Questionnaires are used to test the adequacy of a bank's internal controls in providing institutional protection and in assuring adherence to management's policies. Bank employees are interviewed and observed as they carry out their duties. Sampling techniques are applied to a variety of bank records to accomplish such goals as ascertaining the effectiveness of audit systems, assessing the quality of various types of assets, and checking compliance with laws and regulations. More complete review may be made of such items as past due loans, loans previously classified in a subpar category, and investment securities.

Over the last two decades or so, as both the volume and types of activities engaged in by banks have increased, the emphasis in examinations has shifted from detailed audit and verfication procedures by examiners to review of the adequacy of a bank's planning and control measures. The objective of this shift was to have a bank police itself. Problems such as excessive bad loans, inadequate capital, and concentration of credits are said to receive considerable attention, but substantial attention it is claimed is now also given to the competence of a bank's board of directors and management and their involvement in the affairs of the institution. Accordingly, examinations are said to include an analysis of a bank's policies, practices, procedures, and controls with the view towards identifying managerial weaknesses that could lead to the kinds of problems that were the focus of attention in the past.

An examination results in a comprehensive report that is reviewed at higher levels in the regulatory agency and that serves as a basis for discussions between examiners, bank management, and the board of directors. An examination also results in a rating under the Uniform Interagency Bank Rating System. Problems that cannot be resolved to the satisfaction of the regulators by informal meetings and discussions may result in formal enforcement actions.

The OCC's current examination policy for sound banks is an examination every 12 months for banks with assets of $300 million or more and every 18 months for banks with assets under $300 million. The maximum interval FDIC will allow between examinations of sound banks is 36 months. More frequent examinations are the norm, however. In addition, when an examination is not conducted, at least one visitation or off-site review must be performed in each 12-month period. FRB's policy is for an examination every 18 months provided that there has been no material deterioration in financial condition since the last examination and no change in ownership or control at the policy making level during the time. For banks that do not meet criteria for sound financial condition, each of the agencies conducts more frequent examinations.

4. Bank Holding Company Supervision

The Federal Reserve supervises bank holding companies using an on-site examination (inspection) process as the primary means to verify holding company soundness. The Federal Reserve had not been active in examining bank holding companies until the mid-1970s. In 1975, for example, only 13 percent of the holding companies were inspected, and most of these inspections were made by 3 of the 12 Federal Reserve district banks.

Since 1975, the Federal Reserve has standardized its holding company inspection procedures, reports, and rating system. It has implemented a computerized surveillance system and has designed special training courses for holding company inspectors. More recently, it revised the frequency criteria for making onsite inspections to improve flexibility.

The Federal Reserve's program for supervising bank holding companies includes the following principal features:

-- A headquarters responsible for suggesting holding company supervision policies and procedures and for coordinating and evaluating district bank activities.

-- A headquarters-level computer-based system for monitoring financial data reported by holding companies.

-- Uniform criteria concerning the timing, performance, and reporting of periodic on-site inspections of bank holding companies. On-site inspection of bank holding companies that exhibit problem characteristics are conducted on an annual basis or more frequently, if needed. Annual inspections are generally conducted on all bank holding companies. Bank holding companies that have total consolidated assets of less than $100 million and not requiring special supervisory attention are inspected once every three years.

-- Some form of organizational subgroup at each of the 12 Federal Reserve district banks with staff responsible for making onsite holding company inspections and for performing additional holding company monitoring activities considered to be appropriate by district bank management.

-- A requirement to file periodic reports. All bank holding companies are required to file Form F.R. Y-6, Annual Report of Domestic Bank Holding Companies, on an annual basis. The report requires the submission of consolidated and parent only financial statements of the bank holding company, financial statements of nonbank subsidiaries, an organizational chart, and information on principal shareholders, officers, and directors. Bank holding companies that have total consolidated banking assets of $100 million or more are required to submit financial statements certified by an independent accountant.

5. Soundness Ratings

After each bank examination and holding company inspection, regulators rate the soundness of the institutions based on specific predetermined criteria. The rating for banks, called CAMEL, is based on five factors -- Capital, Assets, Management, Equity, and Liquidity. The holding company rating, called BOPEC, is also based on five factors --the condition of Bank subsidiaries, Other subsidiaries, Parent company, Earnings, and Capital. A discussion of each rating system follows.

a. CAMEL Rating

The determination of a bank's financial condition is not an exact science. Banks take in funds from a variety of sources and place them in a variety of investments, or assets. The funds being taken in, liabilities, a good portion of which are deposits, are merely on loan to the banks. If all or a substantial number of those who made such loans to a bank decided to ask for the return of their funds at the same time, the bank would be unable to comply. The bank could not liquidate, or call in, its investments fast enough.

This problem makes it difficult to decide what constitutes soundness in a practical sense. There being a great many opinions on this topic, it was natural that each of the federal banking agencies developed its own view. In response to Congressional directives in the 1978 Financial Institutions Reform and Interest Rate Control Act and a General Accounting Office study criticizing the existence of divergent approaches, the three federal banking agencies adopted the CAMEL System in 1979. This system provides a general framework for a uniform approach to rating financial institutions. Given the substantial degree of subjectivity inherent in judging the components of soundness, however, the CAMEL System has not brought, and most likely will not bring, complete uniformity to the approaches of the regulatory agencies. The CAMEL System is also more formally known as the Uniform Interagency Bank Rating System (UIBRS) or the Uniform Financial Institutions Rating System (UFIRS).

The CAMEL System has two principal elements. First, an assessment is made of five critical aspects of a bank's operations and condition. These factors are: (1) adequacy of capital; (2) quality of assets; (3) ability of management and effectiveness of administration; (4) quantity and quality of earnings; and (5) liquidity, or the capacity to meet the demand for payment of obligations. The five factors produce the acronym CAMEL - Capital adequacy, Asset quality, Management, Earnings, and Liquidity. Each of the factors is rated on a scale of 1 through 5 with 1 being the most favorable.

A detailed description of the rating guidelines for each of the factors would be quite lengthy. Several general observations can be made, however. First, peer group comparisons in such matters as capital ratios and earnings are of importance. Second, access to capital markets and other sources of funds can offset to an extent certain negative elements; thus larger banking organizations having ready access to capital markets generally have been permitted by the regulators to have lower capital ratios than smaller banks. Finally, the management factor can significantly influence the other factors. For example, demonstrated ability to manage lower quality assets can result in a higher asset quality rating than would normally be the case.

The second element of the CAMEL system is the combination of the five factor ratings into a composite rating. Again, the range of ratings is 1 through 5 with 1 being the most favorable. Composite rating 1 indicates a sound bank in almost every respect, and composite rating 2 indicates the fundamentally sound institution that may have modest weaknesses correctable in the normal course of business. Composite rating 3 indicates a combination of weaknesses ranging from moderately severe to unsatisfactory. Banks with this rating are considered to be only nominally resistant to the onset of adverse business conditions. Composite rating 4 indicates an immoderate volume of asset weaknesses, or a less than satisfactory combination of other conditions. A potential for failure of the bank is present but not pronounced. Composite rating 5 indicates that immediate corrective action and constant supervisory attention are necessary. There is an extremely high immediate or near-term probability of failure.

The three banking agencies usually do not begin to give banks extra attention until composite rating 3 is reached. Thus, composite ratings 1 and 2 indicate financially sound institutions in the sense that these institutions do not receive any extra regulatory attention.

The composite CAMEL ratings given to CINB by OCC for 1979 through 1983 were:

1979	1980	1981	1982	1983
2	2	2	3	4

The potential for different interpretations of the financial factors in the CAMEL rating by different agencies is illustrated in the dispute that arose in 1983 between the OCC and the FDIC concerning whether CINB should be given a CAMEL rating of 4 or 3. According to FDIC officials, the FDIC assigned Continental a 4 CAMEL rating in 1983 because in their views there was an immoderate volume of asset weaknesses or a combination of other conditions that could impair CINB's future viability. FDIC officials said there existed a potential for CINB failure.

The OCC analysts disagreed with FDIC's rating. OCC said CINB warranted a 3 CAMEL rating because it was not likely to fail in the near term and it had made a $4.82 million extraordinary loan provision to cover losses and still had an $81 million profit for the year. In the OCC's view, CINB's 1983 overall financial condition warranted a 3 rating. Although these two agencies discussed their disagreement, neither was willing to change its rating. For copies of FDIC and OCC memoranda discussing this debate see Continental Bank hearings before the Subcommittee on Financial Institutions, Supervision, Regulation and Insurance, House Banking Committee, pp. 330-332.

b. BOPEC Ratings

The bank holding company rating system (BOPEC) is a management information and supervisory tool developed by the Federal Reserve which defines the condition of bank holding companies in a systematic way. The system adopts the "component" approach by: (1) evaluating the financial condition and risk characteristics of each major component of the bank holding company; (2) assessing the important interrelationships among the components; and (3) analyzing the strength and significance of key consolidated financial and operating performance characteristics.

In order to arrive at an overall assessment of financial condition, the following elements of the bank holding company are evaluated and rated on a scale of one through five in descending order of performance quality:

B - Bank Subsidiaries

O - Other (Nonbank) Subsidiaries

P - Parent Company

E - Earnings - Consolidated

C - Capital Adequacy - Consolidated

The first three elements of the rating, i.e., the bank, other subsidiaries, and parent company, reflect the contribution of each to the fundamental financial soundness of the holding company. The rating of consolidated earnings and capital recognizes the importance that regulators place on these factors and their crucial role in maintaining the financial strength and supporting the risk characteristics of the entire organization.

The ability and competence of holding company management bear importantly on every aspect of holding company operations and, consequently, is included as a major factor in the evaluation of each of the five principal elements of the bank holding company rating, as well as in the assignment of an overall holding company rating.

In addition to the individual elements described above, each company is accorded an overall or composite rating, comprising both a financial and managerial component. The financial composite rating is predicated upon an overall evaluation of the ratings of each of the five principal elements of the holding company's operations as defined above. The financial composite rating is also based upon a scale of one through five in descending order of performance quality. Thus, 1 represents the lowest and 5 the highest degree of supervisory concern. The managerial composite is predicated upon a comprehensive evaluation of holding company management as reflected in the conduct of the affairs of the bank and nonbank subsidiaries and the parent company. The managerial composite is indicated by the assignments of "S," "F," or "U" for, respectively, management that is found to be "satisfactory", "fair", or "unsatisfactory".

The complete rating represents a summary evaluation of the bank holding company in the form of a rating "fraction." The "numerator" reflects the condition of the principal components of the holding company and assessments of certian key consolidated financial and operating factors. The "denominator" represents the composite rating, including both its financial and managerial components. While the elements in the "numerator" represent the essential foundation upon which the composite rating is based, the composite does not reflect a simple arithmetic mean or rigid weighting of the individual performance dimensions.

B. Comptroller and Federal Reserve Examiner Findings

1. Overview

CINB was examined by the OCC once every year from 1976 through the present except 1978. CIC was inspected by the Federal Reserve every year from 1979 through the present. In the sections which follow the principal findings of OCC and Federal Reserve examiners are presented in summary form with attention given first to a brief overview of CINB's recent financial history, then to a close review of examination findings concerning CINB's loan management, capitalization, management information system, and response to examiner comments. The boldface emphasis in some quotations has been added by staff.

In 1976, CINB's ratio of classified assets to gross capital funds was 121%. This level was viewed by examiners as troublesomely high and meant that the volume of Continental's loans classified as "substandard", "doubtful", or "loss", was well over the loss absorption ability of the bank. This was particularly worrisome because Continental's classified assets to gross capital funds ratio had risen from 30% in December 1973 to 63% in September 1974, and to 109% in June 1975.

OCC examiners rated CINB's 1976 condition as only Fair and cited as matters requiring attention:

> **Classified assets amount to $1.2 billion which is 121% of gross capital funds versus 109% at the time of the previous examination.**
>
> **Gross capital funds amount to 5.5% of total resources, down from 6.1% last examination.**
>
> **The bank continues to rely heavily on purchased funds to carry its assets. As of the examination date, 46% of net assets, as compared to 49% last examination, were supported by funds whose cost was a money market rate. This matter and the related issue of liquidity are of continuing concern.**

> Credit files are missing, or incomplete in comments, in cases where swaps have been entered into.

In the confidential section of the report, the OCC examiner evaluated CINB's capital position as:

> Inadequate. Gross capital funds are loaned 10.5 times which is unchanged from last examination and the capital/asset ratio is 5.5% versus 6.1% last examination. However, the volume of classified continues high at 121% versus 109% last examination. Management is seriously considering going to the capital market before year end but nothing is definite at this time.

The examiner, however, rated both Continental's management and future prospects as "Excellent".

Though examiners expressed concern in every examination report about capital adequacy and credit quality, the outward signs of portfolio soundness as bank examiners measure it seemed to be improving steadily. Continental seemed to simply outgrow its level of classified loans. The problem loan to capital ratio declined to 86% from its 1976 level of 121%, and continued to decline to 80% in 1979, and 61% in 1980, but in 1981 rose to 67%.

In 1981, Continental became one of the largest corporate lenders in the U.S. From 1976 to 1981, Continental's total assets increased from $ 18.6 billion to $ 41.1 billion, a compound annual growth rate of about 15%. This remarkable size increase was the result of a heavy dedication throughout the Continental corporation to loan expansion, reflected clearly in Continental planning and budgeting documents. The growth was made possible by a management responsibility and accountability framework that gave individual loan officers more lending authority than is generally found in other money center banks and that encouraged and rewarded loan growth.

The risks inherent in CINB's growth oriented planning became apparent in 1982. The economic recession that gripped the U.S. economy in that year hurt all the money center banks badly. The lending and management practices that Continental had to adopt in order to reach its corporate goals, however, made it particularly vulnerable to the effects of the recession.

Significant credit quality and loan documentation deficiencies in Continental's oil and gas lending were spotlighted by the Penn Square National Bank failure in July 1982. But problems were not limited to oil and gas lending alone. Continental's 1982 examination report classified \$ 3.6 billion in loans as "substandard", "doubtful" or "loss". Of these, \$ 1.2 billion were oil and gas loans with Penn Square related classified loans totalling \$ 620 million.

The causes of CINB's problems were explained in the 1982 OCC examination report to be the result of CINB's management:

> Although the level of credit problems is related, to some degree, to the general downturn in economic activity both nationally and on a global basis, the magnitude of existing problems must be viewed as a reflection upon management's past decisions regarding growth and the system of decentralized authority and responsibility/accountability.
>
> This management style has allowed, and may in fact have fostered, many of the problems at hand, as adequate systems to insure that responsibility was being taken were not in place....
>
> The asset growth was partially the result of a goal to become one of the leading domestic wholesale banks, but was also driven by a need to show higher earnings to the marketplace. Although earnings growth, in dollars, has been impressive, it has mirrored asset growth. Earnings efficiency has remained relatively unchanged over the past five years. Therefore, in order to show better earnings (in dollar terms) more assets had to be generated. Recent asset growth, especially over the past year, was not

generated in concert with strategies necessary to insure that the growth was controlled from the standpoint of quality and the organization's ability to handle the increases efficiently. It had become increasingly difficult to maintain asset quality for a combination of reasons. First, the quality of the pool of available assets had decreased due to economic conditions. Secondly, the internal support staffs (operational and lending) were insufficient to properly handle the loan volume involved.

The Federal Reserve's bank holding company inspectors also pointed directly at CINB's management:

> Management is rated as less than satisfactory under the premise that it was management's policies of agressive lending (during the 1976-1982 pre-Penn Square period) in a decentralized environment which directly contributed to the Penn Square situation and other problems in the energy portfolio. These policies as promulgated by Chairman Anderson, plus weak domestic economy, contributed to classifications at CINB increasing to an unacceptable level. CINB is presumed to have the highest level of classified assets among its peers plus the highest level of nonperforming assets.

The information in the examination reports regarding the volume and range of classified assets was not known to the financial markets, and through the rest of 1982 and 1983, financial analysts tended to view Continental's difficulties as limited to Penn Square related loans or to oil and gas lending generally, It was not until Continental's year-end financial statements became available that the size of the loan loss writeoffs and their effect on income became clear.

In the Spring of 1984, financial market concern about the true condition of Continental became serious. Rumors abounded about potential bankruptcy, and market confidence in Continental's financial strength declined despite the assurances of regulators. The resulting outflow of funds necessitated quick development and implementation of a multibillion dollar FDIC assistance plan. It is clear that without the federal assistance program, Continental Bank would have gone out of existence.

2. Loan Management and Review

The OCC examiners confirmed in staff interviews what is generally accepted--that the problems associated with a bad loan generally do not appear until a year or two after the loan is made. If a bank is growing rapidly, its problem loan levels will lag behind its loan growth by a few years. If its loan management system is effective, the problems will be detected early and kept within acceptable ranges. At the same time, if capital levels are kept up as the bank grows, it will have the capacity to absorb the greater losses that are inevitably associated with making more loans.

In CINB's case, however, high capital levels were sacrificed to enable greater earnings per share, and in their drive for asset growth, CINB executives ignored setting corporate loan quality standards. Consequently, as loan growth got underway and the paperwork increased, loan management deteriorated and credit problems went undetected. Statistically, greater lending would have resulted in greater losses in any case, but the delays in detection and treatment of credit problems caused loan losses to be even greater. The reduced capital position made it difficult to absorb the losses associated with both greater lending and a deteriorating loan management system. Adding to this, the losses associated with an economic downturn placed an impossible burden on CINB's capital.

The failure in OCC's supervision of CINB was not appreciating the potential for harm inherent in the combination of high growth policies and lax credit practices and not detecting the severity of the degree of loan deterioration. The examiners' comments regarding loan management year-by-year are set out below.

Commenting in 1977, the examiner said:

Management of the loan portfolio is considered excellent. Senior positions are staffed with well seasoned lenders and considerable depth is evidenced throughout the various divisions. An informative system of performance evaluation is employed for personnel and divisional units that encompasses the entire lending operation. The committee system employed is considered sound with a majority of the members drawn from senior levels. Sound hiring practices are pursued and a comprehensive training program is in operation.

The underlying causes of the present burdensome volume of criticized loans stem from external conditions primarily. The majority of loan criticisms reflect the effects of a period of rapid inflation followed by an economic recession. It is now evident these external conditions are improving with a resulting direct effect upon the troubled loan area; however, many credits have fallen into a workout condition and will take considerable time to fully resolve. In all such cases it is evident your bank management is moving to resolve these situations as quickly as conditions permit.

The examiner also said:

The initial review of credit files revealed numerous instances of incomplete or non-current information. As this material was made available during Divisional loan discussions, it is apparent that an improved system to monitor the flow of credit information from the lending areas to the Credit Department is needed.

At the time, the examiner did not view the credit file situation as serious and did not include it in his letter to the Continental board of directors. In hindsight, it may have been the first sign of future loan management problems.

Two years later, in his 1979 examination report transmittal letter to Continental's board of directors, the OCC Deputy Comptroller for Multinational Banking raised the issue of credit administration more pointedly and related it to Continental's heavy dependence on purchased funds and its need for a strong market reputation.

Our review of the credit administration system disclosed deficiencies relating to the identification and rating of problem loans. Some loans were not reviewed by bank staff in keeping with system objectives. In addition, several loans which are internally rated "B", and which have traditionally been regarded as sound from a review evaluation standpoint, are criticized in the report of examination. The importance of reliability of internal loan evaluation procedures as an early warning mechanism to control credit quality in a growth environment cannot be overemphasized.

The examiner-in-charge of the 1979 examination, provided more detail on internal credit management in his letter to the board of directors:

> Several credits which were rated "B" by the system, and therefore expected to possess the qualities to preclude criticism, are criticized in this report. Other credits, which are subject to review, were found to have eluded the credit rating process. These factors combined with the 15% growth goals cited in the strategic plan suggest that a reappraisal of the credit rating process and systems is appropriate. Additionally, since the bank is heavily dependent upon purchased funds to support assets and provide liquidity, maintenance of good asset quality is necessary to insure a continued high degree of market acceptance.

The all-important relationship between asset quality and CINB's funding capability was also pointed out in the letter transmitting the Federal Reserve's 1979 CIC inspection report:

> Continental Illinois Corporation continues to rely heavily on volatile funds to sustain growth in assets and earnings. The success of such a policy is dependent on the quality of underlying assets...While asset quality control systems appear adequate, we urge continued close attention to this vital area, especially during prolonged periods of high interest rates and retarded capital formation.

By mid-1980, Continental's total assets reached $ 39 billion and its net income was well on its way to another annual record. Its ratio of problem loans to capital also declined significantly from 80% the year before to 61%. In his 1980 letter to the board of directors, the OCC examiner said:

> While it is recognized that management is capable of successfully working down the listing of criticized assets - and in fact has demonstrated such - it should be recognized that the present level is still somewhat above traditional standards.

Concerning the deficiencies he had cited the year before in the area of credit management, the examiner wrote:

> Our review of the loan approval and review process was more comprehensive this examination than in previous years and included the use of both judgmental and statistical sampling. The results of these efforts were favorable to the bank and revealed what is considered to be a generally efficient loan process.

However, the examiner felt it necessary to warn CINB officials about an inherent weakness in their loan management system:

> ...the results of our examination do not point to any material deficiencies in either the original accuracy or timeliness of reports on asset quality. However, since the integrity of these reports is partially dependent on input (Watch Loan Report) from officers around the world, a means of periodically checking the performance of lending personnel in this matter might be considered. This point is raised because the existing procedure followed by the Rating Committee does not include any "on-site" or interim independent review. Once a credit is assigned a quality rating, unless subsequent negative press/knowledge or a watch loan report is submitted, a deteriorating situation may go unnoticed until the next rating period.

In light of CINB's later problems, this warning was very significant. CINB's decentralized, growth-oriented loan management system gave individual loan officers a great deal more independent lending authority than was or is found in other money center banks. This was a significant competitive advantage because a borrower could get a quicker approval from a CINB official than could be obtained from loan officials of other money center banks who needed approvals and confirmations from higher management. If a loan developed problems, it was the responsibility of the CINB loan officer to put the loan on a "watch list". If the loan officer chose not to put the loan on the watch list, senior management would not know the loan had problems until it was independently reviewed and rated by the Loan Review Division.

An early sign of future credit problems appeared in 1980. The level of non-accrual loans increased to $ 402 million from $ 191 million in 1979. Non-accrual loans are those on which interest or principle payments are 90 days past due but which appear to be well secured and are in the process of collection.

By the 1981 examination, the ratio of problem loans to capital began to rise again. From the 61% 1980 level, it rose to 67%. Regarding this, the examiner in his letter to the board of directors wrote:

> The majority of our efforts were again directed toward evaluating asset quality with particular emphasis on the loan account. The reversal of an earlier trend of decreasing classified ratios was observed across the board. In aggregate, this examination showed the level of classified assets increasing from 61% of gross capital funds to 67%. A more detailed analysis revealed that doubtful assets now equate to nearly 10% of gross capital, with directed and voluntary losses this examination aggregating $29 million. The addition of specifically mentioned items increases the level of total criticized to 99% of gross capital funds.

This examination is interesting because of two anomalies in it which cast a shadow over its credibility. The first relates to the examiner assessment of the significance of a near doubling in the loans going unreviewed by the bank, and the second concerns the accuracy of the examiner review of oil and gas lending.

Regarding the first matter, the examiner wrote:

> A review of these internal reports for domestic credits only reflects a significant increase in old-rated credits from last examination. In analyzing this report, it was determined that approximately 375 credits, aggregating $2.4 billion had not been reviewed within one year, with fifty-five of these credits not reviewed within two years. This compares to approximately 270 credits over one year, totalling $1.6 billion in June, 1980, with twenty-five credits not rated within two years. Responsibility currently rests solely with the divisions to provide information for re-review. However, it is evident that no one is monitoring this situation to ensure that all credits are receiving timely reviews, as required by the corporate office.

Failing to review first $1.6 billion one year and then $2.4 billion the second year, would seem to represent a significant and worsening situation in CINB's credit review and quality control mechanism. The examiner in his letter to the Board of Directors, however, said nothing more strongly than:

> ... the issue of timeliness or frequency of review is noted since bank records indicate a general increase in the number and volume of loans not being reviewed in accordance with the wishes of the Corporate Office. Although this list is up from last examination, it has not adversely impacted the reported results from Loan Administration. It seems clear however, that any success in reducing the number of these exceptions is dependent upon the voluntary positive responses of the many division managers.

Regarding the system overall, the examiner said:

> We found it to be functioning well and accurately reporting the more severely rated advances to the Board and senior management.

When the staff interviewed the examiners, questions were posed regarding such situations. The examiners responded that absent detailed information concerning the loans not reviewed, a situation such as that described sounded significant. The examiner responsible for the 1981 examination pointed out that he viewed the matter as significant in retrospect, but at the time in light of CINB's overall declining classified loan levels and asset growth, he did not view it as an overriding problem.

The second anomaly is the examination report's description of the oil and gas division:

> One of the primary growth areas within the bank over the past two years is the Oil and Gas (O&G) division within the Special Industries Group. Domestic O&G loans now total $2,862 million and represent over 10% of the bank's total loan portfolio. Significant growth has occurred since early 1979 to date, with O&G loans up 65% from year-end 1978. CINB is adequately staffed with both sound lending officers and scientific (engineers and geologists) personnel to handle current relationships and meet continued strong growth anticipations. The bank has developed a presence in most of the active areas in the industry through the establishment of regional offices in Texas (which have generated loans representing 38% of O&G credits), Denver, Colorado and Calgary, Alberta, Canada. No significant problems are evident as noted by the fact that only two O&G credits were classified herein.

In contrast, Kathleen Kenefick, a loan officer in the oil and gas division, described the situation this way in July 1981:

> The status of the Oklahoma accounts (particularly Penn Square Bank) is a cause for concern and corrective action should be instigated quickly to

stem any future deterioration. Potential credit problems could be going unnoticed, thus possibly missing opportunities to improve our position and/or prevent some losses. Management of credit relationships has not consistently taken place, with minimal forward planning of CINB and/or customer actions occurring. In some cases the initial credit writeup had customer information missing, out of date or incorrect; in other cases there has not been a credit writeup. Followup and accountability have been rare. Thorough monitoring is hindered when both strengths and weaknesses of the customer are not discussed. Housekeeping problems (missing notesheets and approvals, documentation errors and omissions, past due principal and interest, etc.) compound the situation. All of this may result in delayed or possibly lost income to the bank. Potentially missed opportunities both for future business and for correcting possible problems are the result when "reaction" is all we can handle. The Oklahoma calling personnel continually fight to keep their heads above water, with time spent putting out fires, and therefore falling further behind.

Both of the above comments were written in the Summer of 1981. One year later, the financial dimensions of the loan management and credit quality problems in the oil and gas division were clear. From $85 million in 1981, the level of classified oil and gas loans rose to $ 649 million in 1982. The potential deficiency in CINB's loan management system that McCarte warned about in his 1980 report apparently became a real deficiency.

Just before finishing the 1982 examination report, the examiner in an internal OCC memorandum explained what happened to Continental and its relationship to Penn Square this way:

> Although the Penn Square relationship accounts for a relatively small portion of problem loans (less than 20%) the publicity surrounding its closing was surely the one event that has done the most damage.

It is my opinion that there are two inter-related causes of the present situation. First, the aggressive growth philosophy of CIC was not tempered by increased controls (loan quality safeguards) and second, the management style of great authority and responsibility resting in individual unit managers, was without proper supervision from their superiors.

Although in the first instance it can be said the lack of quality control is universal for the bank, the second cause is more localized - particularly in the Special Industries and Real Estate Groups.

Regarding the question of whether Continental loan officers were filing watch loan reports on their loans that had developed problems, the examiner wrote in the 1982 examination report:

Our review of credits criticized at this examination reflects 99 "B" rated credits. Differences are generally due to timing in the rating system (23 had not been rated within one year) and to subjective differences of opinion. It should be noted that many of these credits were added to the WLR system by loan officiers at 4-30-82, and subsequently downgraded by the Rating Committee in the normal rating process. Of more concern is the fact that 119 credits criticized or classified did not have WLR's. These totaled approximately $1.4 billion, compared to 34 such credits totalling $299 million at the previous examination. The totals of these exceptions are of such magnitude to conclude that WLR's and updated ratings are not being provided on a timely basis.

Before turning to a review of what examiners said over the years about CINB's capitalization, one final piece of evidence concerning CINB's loan management needs to be presented. This evidence consists of what Chemical Bank, First Chicago National Bank, and Citibank found when they went into CINB in the Spring of 1984 to evaluate it prior to making the FDIC a purchase and assumption offer. The individuals overseeing each bank's review of CINB were interviewed by the staff. The findings of each of the banks as reported to the staff tended to be identical with each other and consistent with FDIC memoranda from which the excerpts below are drawn.

The Latin American portfolio was mostly private sector with loans to a number of customers with which the ------ people were not familiar. The same is true for Europe; there were about 100 loans totaling $300 million to customers that ------people had never heard of. There was somewhere between $2 and $2½ billion in charge-offs in the loans they had reviewed, concentrated in the real estate, energy, shipping, corporate and Latin American portfolios.

The internal loan review procedure at Continental is very similar to ------'s. Both use a numbering system of 1 to 8 or 9, with one being the highest rating, and 8 or 9 being the lowest. ------ indicated that on the higher end of the scale, Continental normally treated a loan one better than ------ would have and, at the lower end of the scale, the difference was normally more than one.

------ compared their internal loan rating system (1-9) against the rating system at Continental (1-9) on 21 borrowers which were common to both banks. Only six of the 21 credits were given the same rating by both banks. On another 6, Continental's rating was one better than the rating at ------; on another 5, Continental's rating was 2 better than ------'s and, on another four credits, Continental's rating was 3 or more better than ------'s. Based upon this review, ------ indicated that Continental's internal loan review process was very lenient and that the volume of classified loans was really much higher than that presented by Continental.

On some of the common loans at the two banks, ------ has taken at least partial charge-offs, while Continental continues to carry them at full value and in a performing status. Continental also makes new loans to customers in order to keep the interest payments current. ------ people estimate that there is an additional $650-700 million in loans which should be classified as non-performing. They also estimate an additional $1.6 billion in non-performing loan within 12 months.

Other negative comments regarding Continental's lending areas included the lack of 'credit culture,' all of the reports generated are done for the benefit of the line officers, not for the benefit of upper management. There appears to be a large number of credits (up to $50 million each) to corporations with which the ------people were not familiar.

None of the top level people at Continental are credit people, all have come from the funding or treasury side. There is no loan workout department at Continental; the officers which originally made the loans are also expected to collect them.

------ had found two major problems: the quality of the assets and the funding problem, which they indicated was going to get much worse during the next week or two. They also felt that the total of non-performing loans was considerably in excess of the $2.3 billion which Continental was reporting; probably the total was in excess of $3 billion.

The excerpts presented above indicate that the money center banks which were interested in acquiring CINB found the situation significantly worse than they anticipated. It is also noteworthy that the situation these banks found reflected CINB management efforts and OCC supervisory efforts spanning almost twenty-four months since the Penn Square Bank failure.

3. Capital

In 1976, CINB's capital position was rated "Inadequate" due to its absolute level and its relation to classified assets. Some improvement by 1977 enabled the OCC examiner to write:

Over the last three years, your earnings have allowed the bank's capital accounts to be increased by $225 million through retained earnings and in 1976, $62 million was added to the surplus account from the proceeds of a debt offering by CIC. Equity capital at $1,049 million represents 5.1% of total resources compared to 4.6% at the February 1976 examination. Loans to equity capital at 11.32:1 also shows improvement from 12.11:1 in February 1976. Although these improvements are viewed positively, it must also be noted that your bank's capital ratios still remain below the norm when compared to your peer group of banks.

CINB's subsequent growth led the Deputy Comptroller of the Currency in 1979 to say:

> The growth in earnings has been achieved by virtue of increasing loan and asset volume leverage. The interest margin has remained relatively level since 1977. The ratio of equity capital/total assets has decreased significantly since 1976 in spite of good retention of earnings. If the rate of growth continues to outpace internal capital formation, external sources should be identified to support asset leverage.

In 1980, in his analysis of CINB's capital position the examiner commented:

> During 1979, average equity capital equalled 3.89% of average total assets, representing a 27 basis point decline from 1978's position. Generally consistent with its peer group, CIC's equity capital position has deteriorated each year since 1975, with the greatest decline coming in 1979. The principal reason for the decrease can be attributed to strong asset growth between March 31, 1979, and 1980 (21.3%), ... Loan growth exceeded 26% during this period, which ranked first among the top nine domestic bank holding companies (Continental's definitional peer group). Total equity increased only 10.8%, ... Continued strong asset growth throughout the first half of 1980 further perpetuated the decline in equity capital, which averages 3.65% of average total assets, compared to 3.94% for the first six months of 1979.

In the letter transmitting the 1980 examination report, the Deputy Comptroller said:

Capital is currently considered adequate. However, capital accumulation has not kept pace with asset growth and the capital base is becoming strained. The Directorate should be aware that capital adequacy for banks in general is a growing concern of the Comptroller's Office. While neither the present level of capital nor the current capital planning efforts are subject to criticism, management is encouraged to continue seeking alternative sources of capital and to bring the capital and asset growth rates into balance.

Perhaps the most significant aspect of these comments is the degree to which CINB's capital position was tolerated even though it was continually somewhat less than fully satisfactory. Of additional interest are the references to CINB's "peers". So long as CINB's capitalization was within the ranges of its peers, even though the capital of all the peer banks was steadily declining, CINB's situation was somehow acceptable.

Despite a rise in 1981 in the ratio of classified assets to gross capital funds and a continuation of the upward trend in CINB's dependence on purchased funds, the Deputy Comptroller and the examiner's comments about capital remained mild and only urged the CINB directors to give the Bank's capital their close attention.

> The rapid growth in assets has certainly contributed to earnings levels, but in terms of a return on assets, a slight decline is noted. Continued increase in leverage combined with the high level of classified assets cause increased pressures on capital. In the context of capital adequacy, both balance sheet leverage and asset quality are deserving of the Directorate's close attention.

> It must be realized however, that leverage and risk ratios continue to increase thus placing increased strain on the capital foundation of the institution. While it is recognized and accepted that on a peer group comparison this bank is favorably viewed in the marketplace, the evidence of increased risk is an internal view that management must continually appraise. In light of the above, it is obvious that the topic of capital adequacy is one that should continue to receive the high prioritization currently being given by the Corporate Office.

For the examiners to continue to refrain from outright criticism of CINB's capital position for so many years is difficult to understand. To continue to refrain in 1982, after the revelations that took place that year, begins to undercut one's belief that the OCC was truly concerned about bank capital adequacy.

Before reading the 1982 examiner's comment, it is instructive to compare Continental's 1976 and 1982 capital and problem loan circumstances. Recall that in 1976, Continental's ratio of classified loans to gross capital funds had reached 121% and its ratio of total assets to total capital was 21%. Moreover, in the staff interview, the examiner reponsible for the 1976 examination estimated that CINB was between 60% and 70% dependent on purchased funds. In comparison, in 1982 the classified loan to gross capital ratio had risen to 172%, the degree of asset to capital leveraging had risen to 25%, and dependence on purchased money was up to 80%.

In 1976, CINB's capital was rated a clear and emphatic "Inadequate".

In 1982, CINB's capital was commented upon as follows:

> As a result of the above factors, particularly the underlying strength of management and the recent trend of improving capital ratios, CIC's capital base is presently considered adequate. However, the inordinate level of classified assets and the loss of confidence by the financial community lend definite reservations to this assessment. Capital needs will continue to require close monitoring, with returning the earnings stream to an adequate level imperative to resolve both the loss of market confidence and as a basis for future growth.

This was the same examination in which the examiner said in his letter to the board of directors, "The examination reveals the bank to be in serious difficulty," and the Deputy Comptroller in his report transmittal letter said, "Examination results show the condition of the institution to be seriously deteriorated."

C. Federal Supervision Weaknesses

1. Agency Failure to Halt CINB/CIC Undue Dependence on Volatile Funds

In their 1979 examination and inspection reports and in the letters to top CINB/CIC officials transmitting those reports, the Comptroller of the Currency and the Federal Reserve both highlighted the all-important linkage between asset quality and dependence on purchased funds. Despite this focus of attention and findings in subsequent reports that indicated weaknesses in Continental's loan management system in the context of the institution's aggressive earnings and asset growth goals, neither the OCC nor Federal Reserve took firm, overt actions to get Continental's management to modify their operating practices. In the analyses of bank failures, this circumstance is not novel. A review of every major bank failure indicates that the signs of later problems were clear many years earlier and a pattern of agency acceptance is apparent. In some instances such as Continental, even the specific nature of the later problems were identified years before the actual failure.

2. Examiner Comment Ambiguity

OCC and Federal Reserve examiner comments were, at crucial times, ambiguous and difficult to interpret. On the one hand, the examiners criticized CIC/CINB operations and on the other indicated it was functioning well and accurately. The 1980 and 1981 examination and inspection reports are significant in this respect. Both years were crucial because they were the last two full years before CINB's precipitous decline in the financial world.

In 1980, the Federal Reserve inspection report stated:

Concern is rendered over the deteriorating trend of CINB's capital position. ...the combination of such factors as the high dependency on volatile liabilities to fund assets, the above peer asset growth, and .... earning performance has caused capital to deteriorate at proportionately greater levels than the money center peer average.

The increased dependency of leverage that is not offset with concomitant return in earnings and retention will require capital enhancement if the present trend continues.

> The well above peer asset growth has contributed to the relative decline in CINB's capital position. This adverse trend may require management action to raise equity or target growth significantly under historic trends.

After making these relevant, important points, the examiner seemed to have second thoughts. The report said:

> The apparent improvement in asset quality and the demonstrated ability to work out problem credits appear to mitigate present above peer loan and risk asset volume. However, the declining trend in CIC's capital ratios is of concern and will probably require specific actions <u>if</u> historic operating trends continue.
>
> ...capital is becoming strained, <u>but</u> the deterioration appears to be well controlled within other relative peer parameters. Asset quality has shown continued progress and liquidity appears to be well under control.

The 1981 inspection report again expressed concern about capital and followed it with the statement that CINB's position on capital (which essentially was that no new equity capital injection would be made within the next few years) warranted merit. The report stated:

> Above peer consolidated asset growth is basically responsible for a below peer consolidated capital position. The holding company's capital position is further pressured by the increased consolidated asset classifications, reflected in this inspection report; depressed net interest margins on the parent company's unaffiliated investments; and proposed capital injection for a nonbank subsidiary, Continental Illinois Overseas Finance Corporation N.V. While consoldiated asset growth for the first four months of 1981 has been limited, the consolidated capital position could require enhancement should additional pressures ensue.

Rather than requiring CIC to put its house in order, FRS simply said:

> Management does not anticipate any equity capital injections within the next few years and appears reliant on earnings retention to match asset growth to enhance capital. Void of increased assets, and void of reduced net interest margins or decreased earnings, their position warrant merit; however, a new subsidiary bank or a new bank headquarters could severely complicate CIC's capital position.

OCC examiner comments were similarly ambiguous. In 1981 the OCC examiner said with respect to criticized assets that:

> The reversal of an earlier trend of decreasing classified ratios was observed across the board. In aggregate, this examination showed the level of classified assets increasing from 61% of gross capital funds to 67%. A more detailed analysis revealed that doubtful assets now equate to nearly 10% of gross capital, with directed and voluntary losses this examination aggregating $29 million. The addition of specifically mentioned items increases the level of total criticized to 99% of gross capital funds.

With respect to old-rated credits the examiner said:

> ... a review of these internal reports for domestic credits only reflects a significant increase in old-rated credits from last examination. In analyzing this report, it was determined that approximately 375 credits, aggregating $2.4 billion had not been reviewed within two years. This compares to approximately 270 credits over one year, totaling $1.6 billion in June, 1980, with twenty-five credits not rated within two years. Responsibility currently rests solely with the divisions to provide information for re-review. However, it is evident that no one is monitoring this situation to ensure that all credits are receiving timely reviews, as required by the corporate office.

A 6% increase in classified assets to gross capital funds and CINB's failing to review first $1.6 billion in credits one year and then $2.4 billion in credits the second year, would seem to represent a significant and worsening situation in CINB's credit review and quality control mechanism. OCC's letter to the Board of Directors, however, said nothing more strongly than:

> ...the issue of timeliness or frequency of review is noted since bank records indicate a general increase in the number and volume of loans not being reviewed in accordance with the wishes of the Corporate Office. Although this list is up from last examination, it has not adversely impacted the reported results from Loan Administration. It seems clear, however, that any success in reducing the number of these exceptions is dependent upon the voluntary positive responses of the many division managers.

Regarding the system overall the exam report said:

> We found it to be functioning well and accurately reporting the more severely rated advances to the Board and senior management.

3. Inadequacy in OCC Loan Assessment Methodology

To asess the soundness of a bank's loan portfolio, OCC examiners carefully review a sample of the bank's loans. How the OCC sampled CINB's loans was described in detail in the 1981 examination report: "The scope included a review of all credits over $10 million, all bank rated "C" and "D" loans, and selected non-accrual and past due accounts. Additionally, for domestic credits only, a statistical sample was taken of seventy credits with balances exceed $500 thousand and a sample of thirty credits with balances below $500 thousand." As the description makes clear, the OCC's sampling approach was biased toward reviewing large loans and loans CINB had already earmarked as problems. Sampling bias such as this is understandable -- it focuses limited examination resources on those loans which could cause the bank the most serious difficulties (large loans) and on those lending areas that have already been identified as problematical. The sampling bias is also consistent with the OCC's current examination philosophy which places heavy reliance on a bank's own internal control system and soundness findings.

For banks with thorough, centralized loan management systems, sampling bias toward the portfolio areas of highest apparent risk makes a great deal of sense. The time and resources saved, however, is paid for in the form of a greater risk that the examiners will fail to detect a breakdown in a bank's own loan evaluation system. What is needed to do this is a fully representative, statistically valid sample of loans, and a comparison of examiner ratings of the sampled loans with the bank's ratings of the same loans. Despite the acknowledeged importance of loan management in CINB's specific operating circumstances and evidence of loan management deficiencies, a broader, unbiased loan sample was never analyzed.

Although OCC examiners did not detect the seriousness of the CINB loan classification problems, outsiders were able to see what had been happening in CINB. Officials from banks that visited CINB in the Spring of 1984 for the purpose of considering a purchase offer for CINB said that CINB had overrated its classified loans. They said that CINB continued to carry some loans at full value which they would have partially charged off, that CINB made new loans to customers in order to keep interest payments current, and that CINB's total non-performing loans were considerably in excess of the $2.3 billion which CINB was reporting.

One of the officials compared his bank's loan rating system with CINB's using a comparison of 21 borrowers common to both banks. Only six of the credits were given the same rating by both banks. On another 6, CINB's rating was one better; on another 5, CINB's rating was 2 better; and, on another 4 credits, CINB's rating was 3 or more better. The official indicated that CINB's internal loan review process was very lenient and that the volume of classified loans was really much higher than that presented by Continental.

OCC officials should consider requiring its examiners to review a fully representative, statistically valid sample of the loans of banks with decentralized loan management systems such as CINB's, and of all banks every second or third examination. A statistically valid sample of each major loan category should enable examiners to determine whether a bank has properly accounted for both performing and non-performing loans.

4. OCC Data Processing Examination Deficiency

To the extent that accurate and reliable loan information is available to a bank, its management can adequately monitor and effectively manage trends in earnings, assets, etc. If the information system is not reliable, however, bank management may be lulled into believing that a bank is financially sound when actually major problems can be developing.

The Comptroller's Handbook for National Bank Examiners states that the examination procedures in the Computer Services section are "... designed to assist the examiner to identify computer services used by the bank and to evaluate those services ..." Specifically, the examiners are to determine "... if output is meaningful, sufficient in scope, and timely." Emphasis is to be "...placed on the evaluation of EDP services and related internal controls from a user's standpoint."

The 1980, 1981, and 1982 OCC examination reports did not state whether the examiners checked with users in validating computer output. However, the examination reports had positive comments about CINB's data processing operation. The only negative comments in the EDP section of the exam report related to disaster planning. These comments are significant because CINB's data processing operation was the basis for its information management system. The examination reports stated:

1980

Overall we found well controlled and managed data processing operations. This is evidenced by the few weaknesses commented on in the examination report.

1981

Overall, we find that the data processing function at this bank continues to be sound and well managed.

1982

Overall we find that the bank's data processing function continues to be a sound, well managed operation.

However, officials from one of the banks that considered making an offer for CINB in the Spring of 1984 had this to say about CINB's management information system.

The management information system at Continental is very poor. Top management could not have been kept very well informed about what was going on because the information system is all for the benefit of the line officers and it is almost impossible to create useful mangement information reports.

CINB's internal Special Litigation Report prepared in early 1983 stated that it was well know within CINB as early as 1977 by management and by line managers that loan operation reports contained many errors. The CINB report stated:

> The Bank's management generally recognized that loan operations was troubled by an outmoded computer system. ....There was a general perception among line lenders that the Loan Operations reports contained many errors.

The OCC examination reports did not identify how examiners tested CINB's computer system but whatever the methodology used, it is clear that the examiners came to drastically different conclusions than did others who were familiar with CINB's operations. One way that examiners could have complied with the Comptroller's Handbook and thus fully evaluated CINB's computer and information management systems was to interview users of the system at all levels in CINB and/or select various input and output data and trace it through the system noting the extent and nature of errors.

The OCC should consider providing a more thorough check of the bank's information management systems by interviewing users of the system, testing input and output data, and testing the effectiveness of internal audit work in the area of information management.

5. Timely Reporting Needs Emphasis

Timely responses to OCC examination findings are important so that identified problems do not become unmanageable. The Comptroller of the Currency said that CINB took 7 to 8 months to respond to some of the examination findings. A response to the regulators should be made by the banks within 30 days after notification. As a minimum, within 30 days banks should be required to state what they intend to do to correct deficiencies cited in the examination report. The regulators should establish a followup system to make sure that banks conform to a 30 day limit.

TABLE 4

TOTAL CRITICIZED ASSETS
1975 to 1983
(In millions of dollars)

Category	6/15/75	2/27/76	3/31/77	4/30/79	6/30/80	4/30/81	4/30/82	6/30/83
	Dates of Examinations							
Substandard a/	760	848	806	1,045	921	1,025	2,908	4,113
Doubtful b/	357	381	197	72	81	180	548	485
Loss c/	14	11	28	12	4	29	230	135
Total Classified Assets d/	1,131	1,240	1,031	1,129	1,006	1,234	3,686	4,733
OAEM e/	491	306	429	173	340	597	1,934	2,853
Total Criticized Assets f/	1,622	1,546	1,460	1,302	1,346	1,831	5,620	7,586

a/ A Substandard classification is assigned to those assets inadequately protected by the current sound worth and paying capacity of the obligor, or pledged collateral, if any.

b/ A Doubtful classification is assigned to those assets that have all the weaknesses inherent in an asset classified substandard and their collection or liquidation in full is highly questionable.

c/ A Loss classification is assigned to those assets considered uncollectible and of such little value that their continuance as an active asset of the bank is not warranted. Loss classification does not mean that an asset has absolutely no recovery or salvage value.

d/ Total Classified Assets is the sum of a, b, and c.

e/ Other Assets Especially Mentioned are assets, not including those identified as substandard, doubtful, or loss, that the regulator has some question about or is concerned about for any reason such as lack of loan documentation, that if not corrected or checked may weaken the bank's credit position at some future date.

f/ Total Criticized Assets is the sum of d and e.

TABLE 5

SELECTED SUPERVISORY DATA
1975 to 1983
(In millions of dollars)

Category	6/15/75	2/27/76	3/31/77	4/30/79	6/30/80	4/30/81	4/30/82	6/30/83
	Dates of Examinations							
Gross Capital Funds (GCF) a/	1,038	1,023	1,193	1,410	1,631	1,848	2,144	2,137
Percent of Classified Assets to GCF	109.02	120.97	86.41	80.10	60.88	66.76	171.90	219.42
Percent of Criticized Assets to GCF	136.27	130.85	97.23	92.33	81.30	99.08	262.19	331.72
Reserve for Possible Losses (RPLL)	166	131	144	173	208	233	287	363
Percent of RPLL to Total Loans	1.33	1.41	1.20	.96	.88	.89	.89	1.22
Standby Letters of Credit b/	38	313	343	1,198	2,272	2,937	3,060	4,444

a/ Gross Capital Funds represents total capital plus reserve for possible loan losses.

b/ Standby Letters of Credit represent an obligation on the part of a bank, issuing such a document on behalf of its customer, to a designated third party contingent upon the failure of the issuing bank's customer to perform under the terms of the underlying contract with the third party.

D. Federal Reserve Approvals of Continental Illinois Corporation Expansions

Bank holding companies such as Continental Illinois Corporation must receive prior approval from the Federal Reserve before an acquisition, merger or consolidation of bank shares and assets occurs under section 3 of the Bank Holding Company Act. Also, prior approval of the Federal Reserve is required for bank holding companies seeking to engage in nonbanking activities or to acquire shares of a nonbanking company under section 4 of the Bank Holding Company Act. Applications must likewise be filed with the Federal Reserve by banks seeking to establish foreign branches, to establish an Edge Act Corporation or to make investments in overseas organizations pursuant to Regulation K entitled "International Banking Operations."

Specific procedures are set forth in statutes and regulations requiring bank holding companies, member banks and subsidiaries to obtain the necessary prior approval, preliminary permit, prior notification, or specified consent, depending on the type of application, from the Federal Reserve before engaging in a requested activity. While the approval procedures may vary, there are certain factors which the Federal Reserve considers during the application process to assess the appropriateness and suitability of the activity applied for, not only with respect to its effect upon the community, but also its impact on the financial condition of the applicant and future prospects. For instance, when a bank holding company applies under section 3 of the Bank Holding Company Act for an acquisition, merger or consolidation, the Federal Reserve takes into consideration the antitrust implications and the anticompetitive effects of the new activity, the convenience and needs of the community, and the financial and managerial resources and future prospects of the company or companies and the banks concerned. (12 U.S.C. Section 1842(c))

Similarly, in approving applications to acquire interests in nonbanking organizations under section 4 of the Bank Holding Company Act, the Federal Reserve Board considers the financial and managerial resources of the entities involved. (12 C.F.R. 225.24) The standards for approving international applications pursuant to Regulation K also emphasize the same factors. (12 C.F.R. 211.4 and 12 C.F.R. 211.5)

Federal Reserve publications shed further light and specificity as to what factors are considered in bank holding company applications. According to the Federal Reserve's manual Processing Bank Holding Company and Merger Applications, analysis of the applicant includes an evaluation of the consolidated organization, the parent company, existing banks and nonbank subsidiaries, and the proposed subsidiary. Capital, management, asset quality, earnings, growth, liquidity, leverage and future prospects of the consolidated entity and its component parts are all important considerations in the overall analysis. All potential problem areas are investigated, in some instances by meeting with the applicant or requesting supplemental information.

The way those factors and considerations were applied to Continental applications during the critical time period between 1979 and the Spring of 1984 is of particular interest.

The period from 1979 to the Spring of 1984 represented a crucial time in the history of CIC and CINB. Of significance during this time period is the fact that every Continental application for expansion was approved by the Federal Reserve, with the exception of one delay which was later approved. In total, the Federal Reserve considered 39 separate applications (not including extensions of time) in this period. Thirty-four of these applications were approved between 1979 and the Penn Square National Bank failure in July, 1982; and 5 more applications were approved after July, 1982.

Continental applications the Federal Reserve acted on from 1979 to the Spring of 1984, are listed below:

	Applicant and Type of Application	Other Entity Involved and Activity	Date of Federal Reserve Action
1.	CIC (domestic)	Continental Illinois Equity Corp.	
		To establish a de novo subsidiary to engage in a limited amount of direct lending and investment advisory services.	03/05/79
2.	CINB (international)	Branch in Buenos Aires, Argentina	
		To establish a branch office.	03/12/79
3.	CIC (international)	Continental Illinois Overseas Finance Corp.	
		To acquire all shares at a cost of $50 million.	04/20/79
4.	CIC (domestic)	Continental Illinois Trust Co. of Sarasota, N.A. and Continental Illinois Trust Co. of Florida, N.A.	
		To establish two de novo trust companies before 10/28/80. However activity not completed before deadline. (see #25)	07/30/79
5.	CIC (domestic)	Continental Illinois Leasing Corp.	
		To establish a de novo office in Dallas, Texas.	01/11/80

6.	CINB (international)	Branch in Santiago, Chile	
		To establish a branch office.	02/11/80
7.	CIC (domestic)	Continental Illinois Energy Development Corp.	
		To engage in direct lending activities through a de novo subsidiary located in Houston, Texas. Direct lending activities to consist of loans to finance energy development and exploration projects. Loans generally to be made on a secured basis to smaller energy development and exploration companies that do not qualify for traditional bank financing.	02/19/80
8.	CIC (international)	Continental Illinois (Canada), Ltd.	
		To make an additional investment of $18 million.	03/30/80
9.	CIC (international)	Continental Illinois Leasing Corp.	
		To invest through this subsidiary into Companhia Leasing do Brasil "Leasco" Sociedad de Arrandamento Mercantil, Sao Paulo, Brazil up to $9 million.	07/26/80
10.	Continental International Finance Corp. (international)	Continental Bank, S.A.; Brussels, Belgium	
		To invest in additional shares at a cost of $3 million.	07/29/80
11.	CINB (international)	Edge Corporations	
		To reorganize Edge corporations.	07/29/80
12.	Continental International Finance Corp. (international)	Nigerian Acceptance, Ltd.; Lagos, Nigeria	
		To acquire 26% of shares for up to $4 million.	08/30/80

13.	CIC (international)	Continental Illinois Overseas Finance Corp.	
		To invest an additional $50 million.	09/09/80
14.	CIC (domestic)	Continental Illinois Commercial Corporation	
		To establish a de novo subsidiary to make and acquire for itself and others extensions of credit and to be located in Chicago and Miami serving the State of Florida.	09/29/80
15.	CIC (domestic)	Republic Realty Mortgage Corporation	
		To permit it to continue selling property and casualty insurance directly related to real estate loans not only in the Chicago SMSA but also elsewhere in Illinois.	09/26/80
16.	CIC (domestic)	Republic Realty Mortgage Corporation	
		To engage de novo in providing portfolio investment advice to other persons primarily for real property investment. To be conducted in Chicago, St. Louis, Kansas City, Atlanta and Wawatosa, Wisconsin.	10/03/80
17.	CINB (international)	Branch in San Juan, Puerto Rico	
		To establish a wholesale branch contingent on acquiring the failing uninsured Banco Metropolitano de Bayamon for approximately $7 million.	12/01/80
18.	Continental Bank International (international)	Branches	
		To establish branches in Cleveland, Dallas, Minneapolis, Philadelphia, San Francisco, and Seattle.	12/08/80
19.	CIC (domestic)	Continental Illinois Commercial Corp.	
		To add the State of Illinois to the geographic area served by the activities of the subsidiary.	01/20/81

20.	CIC (domestic)	Drillamex, Inc.	
		To acquire certain assets of it through Continental Illinois Energy Development Corporation.	05/26/81
21.	Continental International Finance Corp. (international)	Continental Bank S.A.; Brussels, Belgium	
		To request separate lending and investment limits with respect to loans and investments involving the Kingdom of Belgium.	06/22/81
22.	CINB (international)	Branch in Hong Kong	
		To establish a branch office.	07/09/81
23.	CIC (international)	Continental Illinois Overseas Finance Corp. N.V., Curacao, Netherlands, Antilles	09/28/81
		To invest an additional $50 million.	
24.	CINB (international)	Continental Illinois Bank (Canada)	
		To invest an additional $17 million (Canadian).	10/26/81
25.	CIC (domestic)	Continental Illinois Trust Company of Sarasota, N.A. and Continental Illinois Trust Company of Florida, N.A.	
		To establish <u>de novo</u> trust companies.	11/02/81
26.	CINB (international)	Branch in Manama, Bahrain	
		To establish a branch office.	11/22/81
27.	CIC (international)	Continental Illinois Overseas Finance Corp.	
		To invest an additional $170 million.	02/02/82

28.	Continental International Finance Corp. (international)	Nigerian Acceptances, Ltd., Lagos, Nigeria	
		To invest an additional amount up to $2.058 million.	02/25/82
29.	CIC (domestic)	Continental Illinois Commercial Corp.	
		To establish de novo office in Los Angeles.	03/01/82
30.	CIC (domestic)	Buffalo Grove National Bank, Buffalo Grove, Illinois	
		To acquire a bank.	03/09/82
31.	Continental International Finance Corp. (international)	Commercial Continental, Ltd., Sydney, Australia	
		To invest an additional $942,000.	03/30/82
32.	CIC (domestic)	Bank of Oakbrook Terrace, Oakbrook Terrace, Illinois	
		To acquire a bank.	04/13/82
33.	Continental International Finance Corp. (international)	Underwriters Bank (Overseas), Ltd.	
		To acquire additional shares for $4 million.	06/23/82
34.	CIC (domestic)	Continental Illinois Commercial Corp.	
		To establish a de novo office in Rolling Meadows, Illinois serving the state of Illinois.	06/28/82

35.	CIC (international)	Decair Corporation	11/08/82
		To retain stock in corporation held in satisfaction of a debt beyond the permissible 2 year period.	
36.	CIC (international)	Continental Illinois Overseas Finance Corporation	
		To invest an additional $180 million (originally submitted in 4/82 but delayed until now).	09/14/83
37.	CINB (international)	Continental Illinois Bank (Canada)	
		To invest an additional $14 million (Canadian).	09/30/83
38.	Continental International Finance Corp. (international)	Continental Illinois Bank Ltd., Cayman Islands, British West Indies	
		To invest an additional $15 million.	12/07/83
39.	CIC (domestic)	Continental Illinois Corporation Financial Futures	
		To expand _de novo_ activities to include execution and clearance for non affiliated customers of financial futures contracts in Chicago, London and Singapore.	03/13/84

The Federal Reserve's review of CINB and CIC applications focused special attention upon the latest OCC examination and FRS inspection reports to assess the financial and managerial conditions of CIC and CINB, respectively. Federal Reserve internal memoranda, in reviewing and in making recommendations upon these applications, referred to various comments appearing in these reports, including adverse comments, and explained their significance.

The central safety and soundness issue facing CINB and CIC was clearly stated in 1979 in both the OCC's examination report and in the Federal Reserve's inspection report. The OCC said:

> Our review of the credit administration system disclosed deficiencies relating to the identification and rating of problem loans. Some loans were not reviewed by bank staff in keeping with system objectives. In addition, several loans which are internally rated "B", and which have traditionally been regarded as sound from a review evaluation standpoint, are criticized in the report of examination. The importance of reliability of internal loan evaluation procedures as an early warning mechanism to control credit quality in a growth environment cannot be overemphasized.
>
> Several credits which were rated "B" by the system, and therefore expected to possess the qualities to preclude criticism, are criticized in this report. Other credits, which are subject to review, were found to have eluded the credit rating process. These factors combined with the 15% growth goals cited in the strategic plan suggest that a reappraisal of the credit rating process and systems is appropriate. Additionally, since the bank is heavily dependent upon purchased funds to support assets and provide liquidity, maintenance of good asset quality is necessary to insure a continued high degree of market acceptance.

The Federal Reserve holding company inspectors said:

> Continental Illinois Corporation continues to rely heavily on volatile funds to sustain growth in assets and earnings. The success of such a policy is dependent on the quality of underlying assets. In this connection, it is noted that asset quality appears to be improving, although results of the recent examination of Continental Illinois Corporation's subsidiary bank are not yet fully available. While asset quality control systems appear adequate, we urge continued close attention to this vital area, especially during prolonged periods of high interest rates and retarded capital formation.

Thus, from both the Federal Reserve and OCC, the focus of concern was on the relationship between asset quality, volatile funding, and capital.

The subsequent examination and inspection reports expressed similar concerns about CINB's level of classified assets, dependence on volatile funds, and high loan growth as related to its capital adequacy. Despite these repeated expressions of concern, not one Continental application was denied, or approved subject to conditions requiring CIC/CINB to address the concerns expressed by both OCC and Federal Reserve examiners during this period. While usually acknowledged in Federal Reserve internal memoranda, critical comments in OCC examination reports and Federal Reserve inspection reports were typically counterbalanced with more positive statements, or explained as being of no major concern.

Continental applications to acquire two banks in the Spring of 1982 just prior to the Penn Sqare failure, provide a case in point. The Federal Reserve's analysis of the applications was based upon the 1981 OCC examination and FRS inspection reports. After declining to 60.8% in 1980, CINB classified assets, as a percentage of gross capital funds, rose in 1981. The increase was prominently set forth by the OCC in its 1981 examination report cover letter to the Board of Directors of CIC/CINB:

> The primary focus of the examination again was on an evaluation of the credit portfolio. That credit review revealed a deterioration in the level of classified assets to 67% of gross capital funds (GCF) and criticized assets to 99% of GCF from 61% and 82% respectively the previous examination.

OCC examiners also noted that stale rated credits were increasing and that "no one is monitoring this situation." Despite these observations, the Federal Reserve analysts recommended approval of the bank acquisitions and attempted to explain away examiner concerns:

> Examiners also noted an increase in the severity of those criticized assets as evidenced by the increase in weighted classifications... Primarily, the increase in adverse classifications reflects a general deterioration of both the domestic and foreign economies rather than less stringent credit standards by Continental Bank's management. Furthermore very few credit relationships established during the 12 months preceding the examination were criticized. It appears that Continental Bank's management is capable of handling the problem credits while generating continued loan growth in keeping with corporate philosophy. In the future, extensions of credit will primarily be targeted at the energy industry and multi-national firms, where Continental Bank has had successful ventures.
> (Internal Memoranda of the Federal Reserve concerning CIC's applications to acquire Bank of Oakland Terrace, April, 1982 and Buffalo Grove National Bank, February 24, 1982.)

OCC examination reports from 1979 to 1982 also expressed concern about CINB's high loan growth and its relation to capital adequacy. Many of these adverse comments were reiterated in Federal Reserve memoranda, but rationalized away. Much confidence was placed in the ability of the regulatory agencies to handle Continental's loan growth and its deteriorating capital separately from the actual processing and approving of certain applications (Internal Memorandum of the Federal Reserve on CIC's $50 million investment in Continental Illinois Overseas Investment Corporation, August 19, 1980. The trend of declining capital ratios as "a current money center peer phenomenon" was cited in concluding that CINB was in satisfactory condition in one application (Internal Memorandum of the Federal Reserve on Continental Bank International's

Reserve on Continental Bank International's establishment of 6 branches, November 5, 1980). Furthermore, CINB's management expertise was deemed to be capable of handling CINB's declining capital in the approval of CIC's previously mentioned application to acquire two banks:

> Although examiners expressed some concern with the erosion of Continental Bank's capital with respect to both total assets and risk assets, capital was deemed satisfactory due to the expertise Continental Bank's management has historically exhibited, its consistent earnings, and its adequate loan loss reserve.
> (Internal memoranda of Federal Reserve concerning CIC's application to acquire Bank of Oakbrook Terrace, April 1, 1982 and Buffalo Grove National Bank, February 24, 1982.)

This confidence in Continental's management was expressed once again in 1983. Management's recovery plan is cited in FRS memoranda that recommended approval of two applications:

> It now appears, however, that Continental's crisis stage has passed, and Continental management has established a recovery plan involving improvement of asset quality as a top priority, as well as expense control and expansion of funding sources. While the nonperforming asset levels and provison for loan loss expenses continue at higher than expected levels, Bank's mid-year 1983 earnings improved to an annualized 0.34 percent. More importantly, Bank's traditional funding sources have begun to return and Continental's share price has shown moderate improvement. Also, Bank's primary capital ratio of 5.5 percent as of June 30, 1983, exceeds the 5.0 percent minimum for multinational banking organizations...Staff recommends approval...
> (Internal memoranda of the Federal Reserve concerning CIC's investment of 180 million in Continental Illinois Overseas Finance Corporation, September 9, 1983; and Continental International Finance Corporation's investment of $15 million into a Cayman Islands subsidiary, December 2, 1983.)

Conclusion

The Federal Reserve approved 39 Continental applications involving the Bank Holding Company Act and "Regulation K" (entitled International Banking Operations) from 1979 to the Spring of 1984. In its consideration of these applications, the Federal Reserve considered financial and managerial factors of the entities involved, including such specific factors as capital, management, asset quality, earnings, growth and future prospects. Despite negative comments in OCC examination and FRS inspection reports concerning CINB's level of classified assets, volatile funding, and its loan growth relative to capital adequacy, the FRS approved all applications. These approvals may have conveyed to CIC and to the public that the Federal Reserve basically approved of the operating and financial characteristics of CIC and of its subsidiary bank, CINB.

CHAPTER VI

MARKET EVALUATION OF CONTINENTAL

A. Background

Continental's shift from the conservative institution it was viewed to be in the past, as a provider of safe harbor settings for people and businesses to keep their money, to an institution striving for constant growth at home and abroad, took place during the mid 1960's to the 1980 period. During this time, the Bank developed extensive international operations and created a number of specialized service groups aimed at servicing the Bank's growing collection of oil, utility and finance company customers, as well as a host of other service units. By 1983, the Bank was being characterized as the largest in Chicago and the 7th largest in order of assets and deposits in the U.S. Such growth, however, was not without its problems, and as can now be seen through hindsight, Continental was eventually caught between a past that could not be retrieved and a future that could be barely be discerned.

Given this set of circumstances, it is easier to understand the dilemna of the rating agency, the institutional investment house, and the government regulator, regarding the health of Continental. In some respects, Continental was trading on a market perception that had its origins just beyond the reach of modern memory -- a memory, it might be added, that bears out the observation attributed to G.K. Chesterton that "the one great lesson of history is that we do not learn from history."

Few who examine the trauma of Continental's decline and failure in the 1980's will argue with the accuracy of Chesterton's observation. Indeed, if taken the next step, the chain of events climaxed by Continental's collapse in 1984 implies strongly that those who fail to learn from history are (as the adage goes) condemned to repeat it. In 1951, Jesse Jones, one-time chairman of the Reconstruction Finance Corporation (RFC) had the following comment to make, concerning the Continental of his day:

> Continental Illinois was one of relatively few large banks in which we required a strengthening of the management. Our controlling stock ownership and the

bank's previous management justified these requirements. (Jesse Jones, Fifty Billion Dollars - My Thirteen Years with RFC, New York, 1951, p. 47.)

Jones, of course, was describing events that took place in 1933, involving the RFC bailout of the Continental Illinois Bank of that day. The bank had faced an earlier crisis due to heavy investment losses resulting in the collapse of the Insull enterprises. Samuel Insull, a Chicago utilities magnate of the 1920's-1930's era, was president or chairman of the board of no less than 85 companies. The significant risks associated with interlocking directorates were realized when Insull's financial empire collapsed, bringing down many of the nation's utilities and banks with it.

Continental's Insull losses were no less staggering in impact on the bank than those it would face 50 years later in 1982. In 1932, the bank was obliged to write off $50 million of potential losses. This was followed by $60 million more in 1933. Continental's deposits fell from $1 billion to an estimated $450 million and had it not been for the intervention of Jesse Jones and the RFC, the bank would almost certainly have "gone under completely." In an almost clairvoyant statement, Jones had the following to say about Continental:

> It was a great correspondent -- a bankers' bank -- in which a large portion of the country banks of the Middle West and many in the South and Southwest kept accounts. Had it collapsed, the effect would have been frighteningly felt in fields and towns and cities over a large area of the country. (Ibid, p. 47)

In a manner later to be emulated by William Isaac, chairman of the FDIC, Jesse Jones injected $50 million, an enormous sum in that day, into Continental with the then novel understanding that the RFC would have a hand in selecting the bank's new chairman and other officers as well as board members. Jones' choice to direct the troubled bank was Walter J. Cummings, then chairman of the newly created FDIC. Cummings served Continental well and for the sake of restoring the bank's integrity in terms of public confidence, did what has been heralded as an outstanding job.

Nevertheless, over the decades of his leadership, other echelons of the bank's hierarchy were known to chafe under his conservatism. His replacement by David Kennedy in 1959 signalled the beginning of a new era in the continuing Continental saga. In published reports, Kennedy was identified as a champion of "creative banking" --a term which seems to serve as a financial euphemism for delegation of authority to lower level personnel coupled with a caveat "to go forth and do good" - aggressively. Kennedy's ten-year term as chairman (he left in 1969 to become Nixon's Secretary of the Treasury) prefaced the arrival of the "go-go" atmosphere that was to plague Continental as time wore on, and to eventually cause its second great financial and managerial crisis.

One of the minor, though not insignificant, ironies to be noted regarding the first Continental bailout concerns the financial results of the RFC's action in the 1930's. At the time of the 1933 injection of $50 million into CINB by Jones, the bank's common stock sold at $25 a share. Four years later, those same shares were selling at $225 a share -- a 9-fold increase in their value, and due almost entirely to the RFC presence and guarantee of performance. In the same vein, Cumming's lasting contribution (if lasting can be defined as until 1984) was a Continental that had retired the last of the RFC's preferred stock, and a Continental that was again pronounced healthy as a "going concern."

Continental Illinois National Bank and Trust Company was chartered under the National Bank Act on October 15, 1932. As such, the new institution represented a union of Continental National Bank and Trust Company of Chicago and the Illinois Merchants Trust Company and was the result of a series of earlier mergers and consolidations involving a number of smaller banks, savings associations and trust companies. Historically, CINB's evolution can be traced from 1857 to the present through the growth of small antecedent banks in the region; their merger and consolidation patterns; and the emergence of the modern Continental organization serving a national and international clientele as well as its Chicago-area customers.

The earliest predecessor to CINB was the Merchant's Savings, Loan and Trust Company, established in 1857 by a group of Chicago businessmen and an original subscription of $500 thousand. The bank changed its name to Merchant' Loan and Trust Company in 1881 and functioned as such until its merger with the Illinois Trust and Savings Bank in 1924. One archivist for the bank described the organization of the Merchants Loan and Trust Company in 1857, as taking place during a period of "country-wide folly and irresponsibility" when uniformity and stability had not yet been impressed upon American banking through national law, and the "license for mad financiering had wrought perilous insecurity to trade and finance." Answering the necessity, leading mercantile interests united and established this bank on "sane principles." (Illinois Merchants Bank Building, Illinois Trust Company, Chicago, 1922, n.a., n.p.)

Paralleling the evolution of the Merchants' group into the Illinois Trust component (and thus the "Illinois" in CINB) was the Continental National Bank, chartered originally in 1883, with capital of $2 million -- a record of that day. By the turn of the century, the stage had been set for the development of a large, big-city bank. Chicago was growing. As various forms of regional commerical enterprise expanded, so did their need for capital and lending capacity. Between 1910 and 1927, Continental National Bank went through several additions until in 1927, when it merged with the Commercial National Bank, and formed the Continental National Bank and Trust Company. Two years later, in 1929, it joined with the Illinois Merchants' Trust Company to form the CINB, and so doing, gave Chicago its first billion-dollar bank, with capital funds of $140 million and total resources of $1.162 billion. (For a complete listing of the various mergers and consolidations involved in the eventual creation of, see Moody's Manual of Investments, Part IV, New York (1932), pps. 1169-79. By rough count, at least 12 similar consolidations and mergers led up to the Illinois Merchants Trust Company.)

The current version of the bank, Continental Illinois National Bank and Trust Company of Chicago, received a national charter in 1932. The bank's most recent merger took place in 1961, when City National Bank and Trust Company merged with CINB. The merger completed the growth process by which those who directed CINB felt the bank could best serve the interest of the city, the region, the nation and the world. A review of these market perceptions demonstrates the general nature of confusing assessments that accompanied that transition. First the security analyst's view of Continental.

B. The Security Analyst's Perception of Continental

The February 9, 1976 purchase recommendation made by Morgan Stanley and Company typifies the earlier stages of optimism, reflected through the institutional research of various Wall Street securities organizations:

> Continental Illinois Corporation is a new addition to the list of bank holding companies in our model portfolio. The Company, in our view, possesses several of the characteristics that today's bank stock investor greatly appreciates and wants, including a strong capital position and valuation reserve, relatively low credit-loss experience, and most important, prudent, conservative management.

As 1976 drew to a close, analysts' statements were depicting Continental Illinois as in the midst of a period of consolidation, meaning, in their view, that the corporation was moving to strengthen its position in both domestic and international markets. Continental had reportedly just received a study of its organization done for it by McKinsey and Company, that had concluded that greater overall market penetration could best be achieved by specializing the delivery of services to customers. This meant eventual reorganization of the Bank's lending departments (which was to take place in 1977), with the announced purpose of achieving a position as "one of the nation's top three banks serving business corporations with worldwide operations." (Morgan Stanley, November 23, 1976) The Morgan Stanley stock analyst added:

> We believe that Continental is building on an already strong base and regard this latest initiative as representative of the Company's highly professional and generally very conservative business system (emphasis added). Our contacts with senior management also reveal a similar dedication to thoroughness and conservatism in the Company's international growth plans,

its electronic banking endeavors, and its overall corporate growth objectives. In short, we remain confident that, despite challenging circumstances, the Company will maintain steady earnings progress which will be rewarded with a higher stock price valuation. (Ibid.)

Continental was seen as trying to structure itself to become one of the nation's three top banks serving multinational companies before the end of the decade (1980), and at that time was being viewed as one of the five leading banks serving major corporate customers, along with Citibank, Chase Manhattan, Manufacturers Hanover Trust, and Morgan Guaranty Trust. These same analysts were touting Continental as a realistic competitor by 1980 for third place in the constellation, ranking just behind Citibank and either Manufacturers Hanover or Chase.

Hindsight always provides more than an ordinary touch of irony, and 1976 was no exception for the analysts were then giving added emphasis to Continental's continued stress on cost controls and loan portfolio quality. These were viewed as strong points in the Continental game plan. In their estimation,

> the current planning phase of Continental would be one in which the bank would continue to emphasize cost controls. In turn, that meant particularly good control of staffing levels. (Ibid.)

Based on an extensive discussion held in late 1976 between CINB Chairman Roger Anderson and a number of bank stock analysts, Anderson was quoted as saying that Continental was trying "very carefully not to become enamored with a numbers game, so that we don't wake up five years from now and find we haven't the staff to handle the increased volume of business that we have, and which will be developing."

As is now known, Penn Square demonstrated that CINB emphasized cost control in its staffing priorities rather than concern for maintaining adequate staff levels to administer its growing oil and gas portfolio.

Market analysts of the day were generally uniform in their praise of Continental's 1976-1977 policy of maintaining a strong reserve for loan losses. Much of that condition was due to the Bank's relatively large exposure to the then-troubled real estate investment trust field. The following table depicts the loss reserve/loan ratio maintained by the 10 largest bank holding companies, as of September 30, 1976.

Loss Reserve/Loan Ratio
10 Largest Bank Holding Companies 9/30/76

Continental Illinois	1.40%
Western Bancorporation	1.18%
Chase Manhattan	1.17
J.P. Morgan	1.12
First Chicago	1.00
Chemical	0.98
Manufacturers Hanover	0.95
Bankers Trust	0.91
Citicorp	0.84
BankAmerica	0.81

(Source: Morgan Stanley, Nov. 23, 1976)

By mid-1978, Continental was being praised as a bank destined to rank among the most profitable very large banks in the U.S. with a rate of earnings growth projected to increase to about 15% - up from 9% achieved in 1976-1977. For 1979, profit gain was being projected between 12% and 18%, with the result that Continental stock was being given a very strong "buy" recommendations. One analyst noted the following:

> Our confidence in a strong two-year earnings outlook for Continental is buttressed by the Company's well-defined strategies and documented progress in raising its basic profitability. In particular, we believe Continental will achieve further ROA and ROE improvement in 1978 and 1979, partially as a result of continuing managerial emphasis on four areas: the improvement of its relative position in various commercial lending markets;

the expeditious cleanup of remaining problem real estate assets; the more efficient control of noninterest operating expenses; and asset liability management geared toward minimizing the effects of fluctuating interest rates and sector credit demands on the bottom line. (Morgan Stanley, June 2, 1978)

Some of this optimism was based in part on early analyst acceptance of the ambitious corporate goal of 15% annual growth for CINB, outlined by George R. Baker (CINB executive vice president) at a November 1977 meeting of the New York Society of Security Analysts. At that meeting, Baker cited CINB lending to energy-related industries and multinational companies as among those expected to produce the highest rates of return to the bank. Energy-related industries such as mining, petroleum, gas, and public utilities, underscored Continental's increasingly strong position in the energy-lending business -- an activity dating back to the mid-1950's, and one which had achieved substantial investor recognition as the bank moved aggressively into these fields. Continental's expertise was then viewed as very broad, and as having been developed in a gradual, careful manner characteristic of most of the Company's significant undertakings.

A distinguishing mark regarding Continental's growing preeminence in the lending field was its opting for more and better customer service - or so the impression was made upon various analysts. The bank's announced goal of adding 300 people to its staff, over the three year period of 1978-1980, primarily in the lending area, was met with glowing comment:

> How has Continental achieved the competitive edge in personnel quality implied by recent independent surveys of large corporate borrowers? On a recent visit to Chicago headquarters, we asked several top-level officers for the answer to this question. Two basic factors consistently emerged in their explanations: a strong dedication to training and development and delegation of responsibility. The commerical lending department's training program has been established since the Forties and has received the strong support of top management. Continental's strategy has been to satisfy its people needs through recruitment and internal development, offering very competitive compensation to obtain highly qualified university graduates. As a rule, the

> Bank takes a long-term view of individual performance. Specifically, individuals are generally given three to five years to learn the Bank's operating and lending philosophies and develop as credit officers. The development of instant successes is neither sought nor encouraged. The other factor which promotes the growth and retention of good loan officers is the Company's policy of delegating a relatively high (based on industry standards) degree of credit authority to junior officers by eliminating the committee process of decision making on all but the most significant credits.
> (Ibid.)

Some of the ramifications stemming from the bank's policy of delegating a relatively high degree of credit authority to "junior" loan officers were to result in the Penn Square mishap. Had lower authorized levels of credit action been maintained, some set of checks or balances might have emerged. Given the choice, Continental felt it more justified to eliminate the bureaucracy it believed dominant in large organizations. This may have led to retention of personnel, but it must also be recognized, however, that this degree of delegation clearly led to some of the more irregular aspects of CINB's relationship to Penn Square, and in turn, may also have led to the downfall of the management of Continental following the collapse of the bank's financial base in 1984.

There was little visible disagreement among market analysts, regarding the attractiveness of Continental stock. Continental was held in fairly high regard during 1979. As an issue especially suited to investors to whom long-term capital appreciation potential was of paramount interest. E.F. Hutton rated the stock as one of two new "Buy" recommendations added to its list. The bank was seen paralleling the growth and development record of Citicorp, and making a major push domestically to build its consumer lending (at that time comprising only 5% of the loan portfolio). Hutton's November 1979 staff notes stressed that bank market strategy of the day was being set in anticipation of "sharply higher consumer-related earnings in coming years, when interest rates and loan loss levels are expected to recede." (Hutton, November 1979)

The analysts continued to hold Continental up as a well-managed unit throughout 1980, pointing out that charge-offs in 1980-1981 were more or less a reflection of the recession, and that loss provisions were likely to increase due in part to the continuing expansion of the loan portfolio. (Hutton, May 13, 1980) Throughout 1981, Continental continued to be viewed as a stock for the conservative investor, interested in the preservation of capital, high current income, and moderate growth in value, and was seen as one of the steadiest performers among wholesale banks, with earnings growing at an average annual rate of a little over 11%. The following comment by Bache on, May 7, 1981 reflected overall industry sentiment at that time:

> Continental Illinois continues to excel in gaining market share and prestige in domestic corporate lending. Their momentum has taken them to a position among the top three U.S. banks in polls of corporate treasurers, surpassing in the process several larger and better known banks. Chairman Roger Anderson has done a superb job of increasing market penetration without commensurate increase in loan losses.

Then came 1982, and with it, the hints of trouble. On February 17, 1982, Hutton wired the following observations to its subscribers:

Continental Illinois
(CIL-30K)

ALL WIRES #104
FEBRUARY 17, 1982

> There was an article in this morning's paper about Continental Illinois' rise in non-performing loans which indicated that Continental's non-performing loans increased $100 million from the third quarter and now equal 1.9% of outstanding loans. A few remarks are in order: The article pointed out that non-performing loans peaked during the last economic cycle at 5.8% of loans, so Continental is about a third of where it was then. Continental has been one of the more aggressive commercial lenders particularly since its

primary competitor, First Chicago was burdened by internal turmoil and was essentially out of the market for some while. I believe Continental will get more than its share of non-performing loans and charge-offs due to its aggressive lending policies. In terms of an industry perspective we are at the point now where non-performing loans and charge-offs will be increasing. I think they will be manageable but could exert a negative effect on the prices of bank stocks. As far as Continental is concerned, I think there may be more risk in its earnings due to credit problems than say, First Chicago, but not of sufficient magnitude to cause major earnings problems. I think there is a better opportunity to make money with First Chicago, however, since FNB has started from a modest base and should improve while oil may have more pressure to maintain at least an excellent record. This is a good swap idea.

Additional information is available upon request. End.

By mid 1982, Hutton's analyst was moved to observe the following, including a warning that all energy lending is not bad (alluding to Penn Square), but there are some questionable characters in the field:

INVESTMENT SUMMARY

July 16, 1982

Continental Illinois (CIL-20) / Chase Manhattan (CMB-39) (7/7) Harold Levine

Lowering 1982 estimates for Continental Illinois and Chase Manhattan in connection with loan participations with former Penn Square Bank. Assuming, at this point, roughly 20% of these loans will be charged off. Based on its $1.2 billion exposure, believe Continental's potential losses are $240 million which, assuming management will make provision for this amount, will contribute to an after-tax loss of $63 million or $1.60 per share. Full year earnings now estimated at $3.80-$4.00 per share versus prior $6.80 projection. For 1983, lowering estimate $0.10 to $7.50. Using same charge-off assumptions for

Chase, its $250 million exposure would result in after-tax charge of roughly $0.50 per share. This brings second quarter loss to $1.00 and full year estimate down to $8.70 from $9.20. Changing Chase Investment rating from 4-2 to 4-3. Continental rating now 4-3 versus prior 2-2 rating. Each stock certainly capable of snapping back a few points from here, but would avoid this strategy except for traders with strong hearts.

In its July 16, 1982 investment summary, E.F. Hutton toted up the bad news, regarding bank stocks, (that week had witnessed a 3.9% decline by the group, while the market rose 1.3% overall) ruminating that "the pen is mightier than the sword," and in this case various "Penns" had done much more damage to bank stock investors than any sword might have wrought. The reference, of course, was to Penn Central, First Pennsylvania Bank, and as of mid-1982, Penn Square. The 1982 default of the Drysdale Government Securities Corporation had not helped matters at all either. The Drysdale collapse led to money center bank writeoffs (as clearing houses for Drysdale transactions) of at least $270 million by Chase and $20 million by Manufacturers Hanover. The Treasury losses in taxes paid to the U.S. Treasury was estimated to be $135 million.

Hutton apparently saw an unfortunate parallel between Drysdale and Penn Square, but, at the same time, one viewed as isolated and disconnected. And not links in a "chain of financial disasters." The parallel was explained this way:

> In each case, the underlying activity, i.e., government securities trading or energy lending, is not particularly ignoble. However, the operators in each case acted imprudently. The "unfortunate parallel" is that a particular bank in each instance failed to curb or control adequately its dealings with these operators. The problems were avoidable as they related to Chase and Continental Illinois. If there had not been an undue concentration of business by these two banks, the failures of Drysdale and Penn Square would not have caused the stirs they did.
> (Hutton, Investment Summary, July 16, 1982, p. 24)

By now, market perceptions held by the stock analyst were becoming more than clear. They were blunt. "All energy lending is not bad, but there are some questionable characters in the field." (Ibid. p. 19) In one rather glaring understatement, the Hutton analyst was prompted to conclude that he doubted Continental had misjudged the value of oil and gas reserves in the Penn Square case. Rather, he was of the opinion the adequacy of oil reserves was really a matter of documentation, and that Penn Square had obviously gained a great deal of collateral mileage out of the same oil and gas reserves.

A foreboding sense of disaster was finally emerging.

C. The Examiner's Perception of Continental

In a recent study touching on deposit insurance in a changing society, the FDIC concluded that improved disclosure of bank financial and operating information (would) help focus stronger market discipline on risk taking by banks. The FDIC categorized such discipline as an "important supplement to the federal regulation and supervision of institutions." (Deposit Insurance in a Changing Environment, FDIC, April 1983, p. IV-1)

The potential for such disclosure is all the more obvious when viewed through the spectrum of contrasting views of Continental over the period of 1976 through 1981-82, held by the examiners who were most responsible for advising the top level Federal regulators, and those most actively involved in advising the investor in bank stocks.

In 1976, when Continental began its move to become one of the three top U.S. banks, the bank's starting point was not the strongest. Continental's ratio of classified assets to gross capital funds was 121%, and was being viewed by examiners as troublesomely high, meaning that the volume of CINB loans classified as "substandard," "doubtful," or "loss," was well over the loss absorption ability of the bank. In fact, three months before CINB announced (July 1976) OCC examiners had rated the Bank's condition as only Fair, and cited a number of matters as requiring attention:

> Classified assets amount to $1.2 billion which is 121% of gross capital funds versus 109% at the time of the previous examination.

> Gross capital funds amount to 5.5% of total resources, down from 6.1% last examination.
>
> The bank continues to rely heavily on purchased funds to carry its assets. As of the examination date, 46% of net assets, as compared to 49% last examination, were supported by funds whose cost was a money market rate. This matter and the related issue of liquidity are of continuing concern.

When matched against the Morgan Stanley appraisal offered in February, 1976, the starkness of contrast can easily be seen (see p. 114).

In the confidential section of the report the OCC examiner went on to characterize CINB's capital position as follows:

> Inadequate. Gross capital funds are loaned 10.5 times which is unchanged from last examination. However, the volume of classified continues high as 121% versus 109% last examination. Management is seriously considering going to the capital market before year end but nothing is definite at this time.
> (Confidential Memorandum to the Comptroller of the Currency, Report of Examination, April 1976, p. D-c)

The commentary of OCC examiners regarding the loan administration and credit quality systems adopted by CINB are especially significant, and again, for what they might have spelled out to the investment advisor had he or she had access to their content. CINB's decentralized, growth-oriented loan managment system gave individual loan officers a great deal more independent lending authority than was the norm in other money center banks. If a loan developed "problems", it was the responsibility of the CINB loan officer to put it on a "watch" list. If he/she chose not to do so, senior management had no way of knowing the loan was in trouble until it was independently reviewed and rated by the Loan Review Division of Continental. That could be quite late in the process. By 1981, the ratio of problem loans to capital was noticeably on the rise. More important, loan managment review by OCC examiners produced the following assessment of CINB practices:

> A review of these internal reports for domestic credits only reflects a significant increase in old-rated credits from last examination. In analyzing this report, it was determined that approximately 375 credits, aggregating $2.4 billion had not been reviewed within one year, with fifty-five of these credits not reviewed within two years. This compares to approximately 270 credits over one year, totalling $1.6 billion in June, 1980, with twenty-five credits not rated within two years. Responsibility currently rests solely with the divisions to provide information for re-review. However, it is evident that no one is monitoring this situation to ensure that all credits are receiving timely reviews, as required by the corporate office.

An even more harsh assessment of CINB loan management practices can be gleaned from an internal memorandum prepared by Kathleen Kenefick, a loan officer in the oil and gas division of CINB. It will be recalled that a large portion of CINB loan activity was being handled through this division of the bank. Kenefick made the following assessment in July 1981:

> The status of the Oklahoma accounts (particularly Penn Square Bank) is a cause for concern and corrective action should be instigated quickly to stem any future deterioration. Potential credit problems could be going unnoticed, thus possibly missing opportunities to improve our position and/or prevent some losses. Management of credit relationships has not consistently taken place, with minimal forward planning of CINB and/or customer actions occuring. In some cases the initial credit writeup had customer information missing, out of date or incorrect; in other cases there has not been a credit writup. Followup and accountability have been rare. Thorough monitoring is hindered when both strengths and

> weaknesses of the customer are not discussed. Housekeeping problems (missing notesheets and approvals, documentation errors and omissions, past due principal and interest, etc.) compound the situation. All of this may result in delayed or possibly lost income to the bank. Potentially missed opportunities both for future business and for correcting possible problems are the result when "reaction" is all we can handle. The Oklahoma calling personnel continually fight to keep their heads above water, with time spent putting out fires, and therefore falling further behind.
> (Memorandum of Kathleen Kenefick, July 29, 1981, p.1)

A year later the financial dimensions of CINB loan management and credit quality problems in the oil and gas division were clear. From $85 million in 1981, their classified level had risen to $649 by 1982.

Whether making this type of information available to the stock market analyst would be a helpful addition to his/her analysis deserves serious review. Certainly it seems logical to believe that it might have been as persuasive in providing evidence for assessing Continental as those given earlier by Dun's Review in 1978 when the bank's aggressive approach to growth and expansion warranted it being characterized as one of America's five-best managed companies.

> Continental Illinois has achieved one of the best and most consistent performance records in the industry over the past five years. ... Most important to Continental has been the growing impact of its loan business, which soared from $2.6 billion in 1973 to $4.9 billion at the end of 1977. And its domestic loan business was up 19% over a year earlier at the end of 1978's third quarter.
> ("The Five Best-Managed Companies," Dun's Review, December 1978, p. 42)

D. The Rating Agency's Perception of Continental

Rating agency perceptions of Continental are reflected largely through the issuance of credit watch statements such as those published by Standard and Poor's industry outlook studies as well as the issuance of securities ratings prepared by Moody's and other rating organizations. These efforts are aimed at providing potential and existing investors with a fairly uncomplicated system of grading so that the prospective quality of investment in the bank can be weighed. Moody's, for example, maintains throughout the rating process that the rating itself should be used in conjunction with descriptions and statistics carried in their Manual (an annual compilation).* They also maintain that their ratings are not commercial credit ratings, and in no case is default or receivership to be imputed unless expressly so stated in their Manual. S&P operates in much the same manner.**

Moody's amended their generic rating categories (aaa, aa, a, baa, etc.) by including numerical modifiers (i.e. 1, 2, 3 meaning from highest to lowest within the rating scale) and apply them to preferred stock issues offered by banks.* (The modification was completed on May 3, 1982, and is noted below).

*Moody's preferred stock rating symbols and their definitions are as follows:

"aaa"

An issue which is rated "aaa" is considered to be a top-quality preferred stock. This rating indicates good asset protection and the least risk of dividend impairment within the universe of preferred stocks.

"aa"

An issue which is rated "aa" is considered a high-grade preferred stock. This rating indicates that there is reasonable assurance that earnings and asset protection will remain relatively well maintained in the forseeable future.

"a"

An issue which is rated "a" is considered to be an upper-medium grade preferred stock. While risks are judged to be somewhat greater than in the "aaa" and "aa" classifications, earnings and asset protection are, nevertheless, expected to be maintained at adequate level.

"baa"

An issue which is rated "baa" is considered to be medium grade, neither highly protected nor poorly secured. Earnings and asset protection appear adequate at present but may be questionable over any great length of time.

"ba"

An issue which is rate "ba" is considered to have speculative elements and its future cannot be considered well assured. Earnings and asset protection may be very moderate and not well safeguarded during adverse periods. Uncertainty of position characterizes preferred stocks in this class.

"b"

An issue which is rate "b" generally lacks the characteristics of a desirable investment. Assurance of dividend payments and maintenance of other terms of the issue over any long period of time may be small.

"caa"

An issue which is rated "caa" is likely to be in arrears on dividend payments. This rating designation does not purport to indicate the future status of payments.

"ca"

An issue which is rated "ca" is speculative in a high degree and is likely to be in arrears on dividends with little likelihood of eventual payment.

"c"

This is the lowest rated class of preferred or preference stock. Issues so rated can be regarded as having extremely poor prospects of ever attaining any real investment standing.

Rating agencies are also very careful to explain that bank rating factors are very different from criteria used for other industries, and that it is less the **quantifiable or qualitative factor than the so-called external factor that is distinctive and that must be weighed accordingly(emphasis added). Because of this, items such as financial statement analysis (quantitative) and location, public confidence, and market position (qualitative) may be weighted differently when compared or contrasted with what is actually happening in the area of the bank's regulatory, legal, or economic environment.

Evidence of a push to qualify analyses on what is asset protection can be drawn from Moody's March 19, 1982 action to lower its ratings on the senior long term debt of most of the nation's largest bank holding companies (see below, listing of corporations affected by the action)

	From	To
Bank America Corporation...	Aaa	Aa
Chase Manhattan Corporation	Aaa	Aa
Chemical New York Corporation	Aaa	Aa
Continental Illinois Corporation	Aaa	Aa
First Bank System, Inc.	Aaa	Aa
Manufacturers Hanover Corp.	Aaa	Aa
Mellon National Corporation	Aaa	Aa
National City Corporation	Aaa	Aa
Northwest Bancorporation	Aaa	Aa

Moody's noted that other aspects of the BHC's outstanding commercial paper, such as their ratings, subordinated debt ratings and preferred stock ratings, as well as their bond ratings on securities supported by letters of credit of their subsidiary banks, were also reviewed but were unchanged. (Moody's Bond Survey, March 22, 1982)

What these changes in senior long term debt were meant to reflect was that Moody's intended thereafter "to give greater emphasis to that degree of indirect subordination of these securities as holding company obligations, in their claim on the assets and earnings of the underlying banks." (Ibid.) They went on to note that up to that time, they had been wiling to believe that in rating debt of the BHC, the "industry's strengths "had offset this factor, even though BHC bonds were clearly subordinate in their claim on the assets and earnings of the banks.

What prompted this shift in viewpoint? Most of the answer can be found in statements of the rating agency upon the occasion of lowering the senior long-term debt of the major BHC's:

> The effects of fifteen years of inflation on the banking sector and its customers, compounded by regulatory changes and the emergence of strong alternative intermediary markets have permanently altered the competitive environment of the (banking) industry. (Ibid.)

If the climax of events reached in 1982 prompted such an assesment (regarding the competitive environment of banking), other happenings in the period between 1978 and 1982 seemed to reinforce the more conventional view that Continental was quite satisfactory as an outlet for high-grade investment. Certainly that would have appeared the case to the investor had he or she relied on the recommendation conferred through the rating agency's offering of its Aaa rating on $100 million in Continental notes because the bank showed a "continuing high-level of profitability, including the improved performance of nonbank subsidiaries, the quality and diversification of the loan and investment portfolios, the corporation's strong worldwide funds gathering capability and our (Moody's) evaluation of management and its information systems..." (Moody's Bond Survey, April 17, 1978) Three and a half years later, in October 1981, the rating agency would again bestow its highest rating on Continental, this time singling out bank action as having achieved rising earnings in recent years and "...maintained profitability and capitalization relationships in line with those of its peers." (Moody's Bond Survey, October 12, 1981) Indeed, the agency went on to stress that "...sound asset portfolios are supported by a well-diversified liability structure. Management information systems permit careful monitoring of the bank's worldwide operations." (Ibid.) This viewpoint seems to contrast sharply with some opinions that the information system of Continental was less than effective when needed most.

Earlier, in June 1981, and again in September 1981, Moody's stated the opinion that Continental deserved Aaa ratings on a $200 million bond offering, and $100 million of money market notes, because of "...the parent's status as a profitable, soundly managed, world-class institution..." even though the parent's "historically strong capitalization and profitability have come under increasing pressure because of the accelerated growth of the asset base realized in recent years. (Moody's Bond Survey, September 1981). With regard to money market notes, the rating agency concluded that the corporations strong financial condition and performance as a major money center operations, its **informed and competent management** (emphasis added), and its adaptability to changing market conditions, among other factors, warranted the Aaa rating of the agency. And then came 1982 and with it, numerous changes in ratings and what they were intended to reflect.

The perceptions of rating agencies are also reflected through the issuance of credit watch statements such as those regularly published by S&P. In 1984, S&P issued the following commentary on Continental:

> A complex and comprehensive financial assistance package for Continental has been arranged with the Federal Deposit Insurance Corporation (FDIC). The key components of the assistance include the purchase of $3.5 billion of non-performing loans, the recapitalization of Continental Illinois Corporation with $1 billion of preferred stock owned by the FDIC, and a program of continued liquidity assistance from the Federal Reserve Bank of Chicago...
>
> If the recapitalization plan is implemented, the resulting bank will have improved financial characteristics. Major loan problems are sovereign exposures to Latin American borrowers. Other problem loans totalling $3.5 billion including all of the Penn Square loans, troubled energy credits, and problem real estate loans will be removed. The bank and corporation will by very well capitalized with primary capital to assets exceeding 7%.
> (S&P, Credit Watch, August 6, 1984, p. 1095)

S&P warned the less wary, however, that management had to continue to actively "address overhead expenses in order to improve earnings." Such remedial gestures would position the bank for recovery, but did not and would not assure successful revival of the bank. That, in the words of S&P, will "come only if senior management rebuilds the staff and re-establishes both lending and funding relationships." (Ibid., p. 1095)

It is clear that by 1984, the "go-go" atmosphere in which banking appeared to operate in the 1970's and early 1980's had taken its toll on rating agency perception of banks. S&P reflected on the situation and concluded that the "risks and uncertainties facing the banking industry are heightened to the point where their effect on credit quality is not temporary or limited, but instead is deemed to be material and of a lasting nature." (S&P, Credit Perspective, January 23, 1984, p. 3)

How would these higher risks manifest themselves? According to S&P they could appear in a variety of forms, (1) An increased difficulty for banks to maintain earnings power in terms of return on assets on traditional lines of business and earnings on new business. (2) Greater volatility and declines in predictability of earnings in a less protected and more openly competitive environment. (3) Lesser regulatory protection, both implicit and explicit, of banks as depositories and on non-depository financial institution functions. (4) An increased willingness by banks to undertake market-driven, yet risk oriented business strategies where the alternatives are the risks of doing too little. (5) Increased pressures to utilize financial leverage capacity during a period when the need to strengthen primary capital positions will increase. (6) Asset portfolios which will not improve materially or rapidly in credit quality, relating to expectations that international lending problems will persist, while asset quality in several major industrial sectors will only improve gradually. (Ibid., p. 3)

Given these benchmarks by which to measure safety and soundness, S&P's bank analysis for Continental traceable from July 1982 to November 1984 was as follows (See table on next page.)

TABLE 6

CHANGES IN STANDARD AND POOR RATINGS OF CONTINENTAL ILLINOIS CORPORATION (CIC) AND CONTINENTAL ILLINOIS NATIONAL BANK (CINB)

Issue	Date	Ratings			
		CIC		CINB	
		From	To	From	To
1. Letters of Credit	July, 1982			AAA	AA
2. Commercial Paper		A1+	NC	A1+	NC
3. Senior Debt		AAA	AA		
4. Subordinated Debt		AA+	AA-		
5. Preferred Stock		BBB+	NC		
1. Letters of Credit	Sept., 1982			AA	A+
2. Commercial Paper		A1+	A1	A1+	A1
3. Senior Debt		AA	A+		
4. Subordinated Debt		AA	A		
5. Preferred Stock		NC			
1. Letters of Credit	April, 1983			A+	A-
2. Commercial Paper		A1	NC	A1	NC
3. Senior Debt		A+	A-		
4. Subordinated Debt		A	BBB+		
5. Preferred Stock		NC			
1. Letters of Credit	May, 1984			A-	BBB
2. Commercial Paper		A1	A2	A1	A2
3. Senior Debt		A-	BBB		
4. Subordinated Debt		BBB+	BBB-		
5. Preferred Stock		BBB+	BB		
1. Letters of Credit	June, 1984			NC	
2. Commercial Paper		A2	B	NC	
3. Senior Debt		BBB	BB		
4. Subordinated Debt		BBB-	BB-		
5. Preferred Stock		BB	B+		
1. Letters of Credit	Aug., 1984			NC	
2. Commercial Paper		NC		NC	
3. Senior Debt		NC			
4. Subordinated Debt		NC			
5. Preferred Stock		B+	C		

NOTE: NC = No Change

E. Disclosure

This discussion has centered on the presumption that with regard to Continental, the eye and mind of the regulator, the investment counselor, and the rating agency analyst may have been influenced by a market perception of Continental that had its origins just beyond the reach of modern memory--perhaps as far back as the 1930's and 1940's. Part of the solution yet untested, regarding Continental or any other large financial institutions facing financial ruin, is knowing whether or not additional disclosure of financial and related operational information at an earlier time (to the regulator and the public) could help avert such crises and disasters. If this is shaped in the form of a policy question, the answer seems most often to be: "Yes, but..." A proper response also deserves some understanding of what is meant by disclosure and what are its limitations.

Disclosure has been defined as the "process by which information concerning a bank's financial conditions and performance, its management, and its policies and philosophies is made known to the public at large." (Deposit Insurance in a Changing Environment, FDIC, April 15, 1983, pp. IV-2) The idea of increasing disclosure provisions, concerning any financial and operation information, has been gaining ground -- especially as a suggested technique by which to add stronger "market discipline" to the bank industry. The element of discipline would apply essentially to the risk taking element, and would, in the judgment of its advocates, supply an important degree of meaning to the functions of regulation and supervision by such organizations as the FDIC.

There are a number of caveats that might be noted, if added emphasis is to be given to increased disclosure provisions.

First, there is general agreement among those most involved in investment counselling, rating agency activity and the like, that the already extensive amount of bank financial data is overwhelming in volume and depth. The problem, as they have chosen to describe it, is not one of insufficient data. Rather, the problem is fundamentally related to how existing data are manipulated.

Second, the general view of these same personnel was that improved disclosure would be helpful, particularly if that included greater access to Reports of Condition and Income (Call Reports). Several people interviewed urged the FDIC proceed in its current effort to revise the content of the Call Reports, noting that the market's perception of Continental rested heavily upon information available through management narratives, i.e. CEO letters to stockholders, annual reports etc., and that it was probable that aspects of future content of Call Reports would be a very important part of their operations/financial analyses. In this respect, the February 11, 1985 announcement of the FDIC enforcement actions against banks can be taken as a significant step toward increasing the prospects for effective discipline. The FDIC has indicated that additional disclosure would include the agency's possible intention to terminate bank insurance, to suspend or remove officers or directors, to get a cease-and-desist order against the bank if further action appeared to be heading the bank toward insolvency, and to levy fines or order increased capitalization within a specified time. If taken, all such steps would increase public awareness of possible bad management or marginal operation of the bank, and thus ensure that remedial steps would be taken to restore stability to a more normal pace.

Finally, it should be apparent that despite the plethora of information concerning capital adequacy, asset quality, management, liquidity position, earnings capacity and the like, neither bank debt rating companies, nor security analysts had a clear, accurate understanding of Continental's true portfolio condition. There is, of course, serious question as to whether the Bank's repeated statements about its commitment to asset quality were borne out in actual, day to day practice. Nevertheless, outside experts were and continue to be quite dependent upon this type of information when rendering investment advice. The fable of the blind men being asked to describe an elephant after having touched its tail, its ear, and its trunk, should not be dismissed. Much of what is rendered as investment advice concerning bank stocks would seem to depend very heavily on that part of the industry the advisor has in mind.

CHAPTER VII

PENN SQUARE LENDING AND PENN SQUARE NATIONAL BANK

A popular theory about why CINB encountered the difficulties it did in 1984 is that a small group of CINB employees lured the Bank into an extraordinarily large relationship with Penn Square Bank, N.A. of Oklahoma City. When Penn Square failed on July 5, 1982, the theory goes, the billion dollar relationship between the banks collapsed and the losses incurred by CINB shook investor confidence to a degree that CINB never fully recovered.

While CINB's Penn Square-related losses were factors in the Bank's subsequent problems, it is simplistic to assign so much weight to that one relationship in analyzing what went wrong at CINB. This section of the report discusses CINB's energy lending generally, its activities involving Penn Square Bank, and why the problems at Penn Square were not discovered earlier by CINB.

A. History of CINB Energy Lending

When CINB began to establish its relationship with Penn Square in the late 1970s, the Bank was by no means a novice in the field of energy lending. As the former President of CINB, John Perkins, testified before the Banking Committee in September 1982, CINB had been, since 1954, a "leader among banks in financing the development of this country's oil and gas resources and lending to established and emerging businesses directly engaged in or providing services to the oil and gas industry." In the 1970s, the Bank's affinity for energy lending became even more pronounced. In its 1975 annual report, the Bank explained why this was occurring:

> Growth in the Special Industries Divisions, which number petroleum and other energy-related industries among their clients, will stem from the necessity for the country to attain self-sufficiency in this area. But it will rely heavily on the special expertise of the staff that has been developed through the years in anticipation of increasing emphasis on the market. (1975 Annual Report, p. 9)

Unmentioned in this brief excerpt was the obvious profit potential in a growing energy industry. But even in 1975, the caveat existed in the Bank's plans that growth in the energy area could only occur if highly qualified staff were available.

Already in 1976, the Bank began to see results from this new emphasis. Its annual report said:

> Gains in energy-related industries -- mining, petroleum, natural gas, and public utilities -- contributed significantly to the year's results. These continue to grow at substantial rates and Continental assists that growth through the professional approaches of its banking and engineering specialists and innovative project financing. (1976 Annual Report, p. 6)

The 1976 annual report (p. 7) also noted that during 1977, intensified emphasis would be placed on better market coverage, with Commercial Banking Divisions concentrating on, among other things, specific industries such as oil and gas. Clearly, CINB was putting energy at the top of its priorities.

The Comptroller of the Currency, in examining CINB in 1976, found nothing to criticize in the Bank's energy loans. While criticized loans overall at CINB were running at 121% of gross capital funds in that year, a level OCC expressed concern about, the bulk of the problems were in the real estate area, where CINB was trying to work out its involvement in real estate investment trusts (REITs). No energy-related loan was mentioned for criticism by OCC in the 1976 exam.

The next year, CINB again trumpeted the significant growth in its domestic commercial loans, citing energy-related businesses and industries — mining, petroleum, natural gas, and public utilities — as "a primary factor in loan growth." The importance of staff was again emphasized in the annual report:

> The varied and escalating needs of those customers were matched by the financial skills and geographic deployment of our banker-engineers in financing projects that range from coal mining and power generation to the offshore search for oil. (1977 Annual Report, p. 5)

Immediately following that paragraph, the Bank discussed, in one sentence, a development that was to be an important factor in the energy area. It said, "Although larger corporations increasingly used the commercial paper market for short-term borrowings that formerly took place under bank lines of credit, a substantial volume of additional loans was generated." While it is not clear to whom these additional loans were extended, in part at least the Bank turned more and more to the funding of smaller companies that could not take advantage of the commercial paper market. In 1978 and after, Penn Square became an important source for lending to these relatively small, independent energy operators in the Oklahoma area.

The Comptroller in 1977, again noting that real estate was the major problem area for Continental, cited just one oil and gas loan for criticism, and even that criticism was in the least serious category. Clearly, the Bank seemed to be doing most things right in the energy area.

1978 marked an important year for CINB in energy lending, if only because it marked the beginning of the Bank's relationship with Penn Square. Breaking its precedent of several years, the Bank's annual report did not mention energy lending as a growth area, nor did the Comptroller perform an examination in that year.

The 1979 information from the Bank and OCC shows that CINB continued to be active in the energy area. A new office was opened in Denver to serve business in that region, and a branch of its Canadian affiliate, Continental Illinois (Canada) Ltd., opened in Calgary, Alberta. The Bank also announced a proposal to set up a Houston-based subsidiary, Continental Illinois Energy Development Corporation, "to meet the needs of smaller independent oil, gas and mining exploration and production companies that might not qualify for conventional bank financing." (1979 Annual Report, p. 8).

This 1979 Annual Report contained an interesting follow-on to the comment in the 1977 report about large companies using the commercial paper market. In the 1979 report's financial section, management included the following paragraph:

> A significant portion of the commercial and industrial loan portfolio represents credit to prime borrowers. However, middle-market loans provide a larger proportion of this segment of the loan portfolio than in the early

1970s. This market may be subject to a higher incidence of loss in an economic downturn, but any increase in credit losses related to these loans is not expected to be substantial. (1979 Annual Report, p. 26).

The caution expressed in that statement relating to the size of institutions might also apply to concentrations of credit in particular industries that are subject to severe downturns. Yet at the time, energy was not an industry suffering from those problems. As noted elsewhere in the annual report, world oil prices more than doubled in 1979, fueling inflation but also making energy lending an attractive proposition.

The Comptroller's examination in 1979 continued to find the energy portfolio in generally good condition. Credits to only a handful of borrowers were criticized (virtually all of it classified substandard). This represented about 4% of the total amount of outstanding loans and unused commitments for domestic oil and gas lending in the Bank's commercial lending department. Nevertheless, one disturbing statistic surfaced in this examination report for the first time. In the Concentrations section of the examination report, the total exposure to domestic oil and gas borrowers was listed as $2.162 billion, $1.473 billion of which was in outstanding credits and $689 million in unused commitments. This meant that credits to domestic oil and gas borrowers amounted to 175% of the Bank's total capital funds. Other industry concentrations included minerals (58%); finance companies (independents) (49%); shipping (46%); and securities and commodities dealers (213%, of which over two-thirds was in unused commitments). Oil and gas had clearly become an area of significant exposure for CINB, more so than virtually any other industry.

In 1980, energy remained at the forefront of CINB's expansion. Gone from the annual report was the concern for the country's energy self-sufficiency that had been reflected in the report 5 years earlier. Now the emphasis was on efficiency and profits for CINB. In a section of the report entitled "Allocating Critical Resources," CINB discussed how it needed to make choices on the markets it would enter based on opportunities and competitive realities. Resource allocation was the key, and several industries warranted increased attention:

Businesses believed to have the greatest long-term potential to contribute to profits obviously warrant added emphasis. Our objective in these areas is to increase market share or service levels through appropriately high levels of investment in manpower and capital equipment. Some examples include the Oil and Gas Division of Special Industries Services, Systems and the Treasury. (1980 Annual Report, p. 14).

The Comptroller's examination, reflecting data as of June 30, 1980, showed a continued major expansion in the oil and gas portfolio. Concentrations in that portfolio now totaled 395% of total capital funds, with more than a doubling of the dollar value of oil and gas exposure from the previous year, to $5.708 billion. In contrast, other concentrations were more modest: minerals (76%), securities and commodities dealers (179%); shipping (75%) and automobile manufacturers (48%). Despite the volume of oil and gas loans, as yet the quality had not deteriorated markedly. Total criticized oil and gas loans were under $30 million, and at least half were carry-over credits from the previous year. By 1981, CINB's posture as a preeminent commercial lender among U.S. banks had been widely recognized. There was clearly no doubt in the Bank's mind at least, what had helped fuel that rise to prominence in the commercial arena:

> A primary commitment to wholesale banking, a leading position in key areas such as energy lending, and an aggressive push into attractive markets across the U.S. have made Continental one of the nation's top commercial and industrial lenders as well as the nation's sixth largest bank holding company. (1981 Annual Report, p. 8)

By the fact of its being mentioned in this context, it is apparent that energy lending was a critically important factor in CINB's growth, in dollars and in prestige. The Energy Development Corporation was also mentioned in the same report as being a way "to augment Continental's premier position in the Houston energy market." (1981 Annual Report, p. 9)

When the Comptroller examined the Bank, using April 30, 1981 data, the criticized oil and gas credits still involved only two borrowers, a fact that the OCC examiner in his 1981 report was careful to point out in a glowing account of CINB's oil and gas involvement:

> One of the primary growth areas within the bank over the past two years is the Oil and Gas (O&G) division within the Special Industries Group. Domestic O&G loans now total $2,862 million and represent over 10% of the bank's total loan portfolio. Significant growth has occurred since early 1979 to date, with O&G loans up 65% from year-end 1978. CINB is adequately staffed with both sound lending officers and scientific (engineers and geologists) personnel to handle current relationships and meet continued strong growth anticipations. The bank has developed a presence in most of the active areas in the industry through the establishment of regional offices in Texas (which have generated loans representing 38% of O&G credits), Denver, Colorado and Calgary, Alberta, Canada. No significant problems are evident as noted by the fact that only two O&G credits were classified herein.

No concern was expressed about the still-increasing exposure of CINB in the oil and gas area. The dollar exposure had increased to $7.288 billion, or 452% of total capital funds. Roughly 58% of this total was in outstanding loans, and the remainder in unused commitments. Other concentrations included minerals (85%); securities and commodities dealers (172%); shipping (81%); and auto manufacturers (33%).

1982 was the year when CINB's strategy of rapidly increasing oil and gas credits resulted in severe problems for the Bank. By April 30, 1982, the Bank's concentration in oil and gas had increased to 632% of total capital funds, or a total availability of $11.741 billion, including $6.66 billion in outstanding loans. When Penn Square Bank failed on July 5, 1982, the shock waves quickly spread to CINB. What the Penn Square failure brought to light was not only the exposure to the Oklahoma bank and its creditors, totalling about $1.1 billion, but also the depth of problems in other parts of the Continental portfolio. While the tendency has been to focus attention on Penn Square credits, or oil and gas alone, in fact the problems spread even deeper. In the 1982 OCC examination report, total criticized assets had reached 262% of gross capital funds, 56% of which represented credits from oil and gas and real estate. This continued to leave a wide variety of credits from other areas also subject to criticism.

In terms of CINB's credits actually classified loss that were mentioned in the 1982 OCC examination report, Penn Square loans accounted for nearly 65% of those losses and non-Penn Square oil and gas added another 17%. As to the next category, "doubtful" assets, Penn Square represented 31% of the total, and non-Penn Square oil and gas loans accounted for an additional 15% of total doubtful assets. In the "substandard" category, the picture changed considerably. There, Penn Square loans represented 12% of the substandard assets, and non-Penn Square oil and gas loans added another 22% in that category. The conclusion from these statistics is that, in the Comptroller's view in 1982, Penn Square was a major contributor to the most severe categories of criticized assets, but that well over $2 billion of assets rated substandard, doubtful or loss were in fact not oil and gas-related.

1. The Reasons for CINB's 1982 Losses

CINB's loan problems that came to light after the Penn Square failure have been analyzed by many people from a variety of different perspectives. Perhaps it is only fair to begin with the CINB's own explanation. In its 1982 annual report, the Bank said the following:

> Coming on top of the general economic problems in other industries, the timing and unique character of the Penn Square situation made our overall credit problems much more severe. Our strong position in domestic commercial and industrial loans, especially our longtime leadership in energy credits, of course tended to heighten our position in areas under pressure. (1982 Annual Report, pp. 4-5)

Further, the Bank added the following:

> The major credit problems that developed in 1982 in part reflect the prolonged worldwide recession and Continental's position as a leading lender to U.S.-and international-based business. (1982 Annual Report, p. 8)

The Comptroller's office, in its 1982 examination report, gave a different view. While mentioning CINB's policy of aggressively pursuing dominance in domestic corporate lending, and the decentralized approach to management, OCC's Deputy Comptroller for Multinational Banking, William Martin, also pointed out that "Several large lending relationships raise prudency questions given that one of the most basic fundamentals of banking is the diversification of risk." The Comptroller's examination went on in much greater detail to describe breakdowns in the internal controls at the Bank, excessive concern for earnings growth and hence asset growth, and other management weaknesses. At one point, the report noted that "The Penn Square situation is largely the result of a breakdown in controls, but management must be held accountable for not detecting the situation, and reacting, sooner." Further on, the examination report states:

> The problems in these (Penn Square Oil and Gas) loans are economy-related, but are also the result of improper supervision, as discussed fully elsewhere in this commentary.

The most detailed discussion by OCC was in the following quote:

> As reflected in the previous examination, the primary growth area in the bank over the past several years has been the Oil and Gas (O & G) divisions within the Special Industries Group. From 4-30-81 to 4-30-82, outstandings for this group increased from \$2.8 billion to \$5.2 billion and now represent over 15% of the bank's total loan portfolio. Throughout 1981, the oil and gas industry exhibited strong growth overall. Lending by numerous financial institutions to this industry continued to be strong, with the apparent belief that this industry

was recession-proof. However, reduced demand for oil products, reductions in oil prices, over-expansion in various segments of the industry, and the effects of high interest rates on this capital-intense industry have seriously affected cash flows and also the viability of many firms, both large and small. As a result, total criticisms at CINB have increased from $85 million at the prior examination to $1.2 billion, or approximately 30% of the O & G portfolio net of the Penn Square credits.

A few common threads run through these various explanations of what happened to CINB. It is apparent that the Bank had become overexposed in the energy area, not only in Penn Square but in other energy lending as well. This caused the Bank to be vulnerable to changes in the economic picture overall and to fluctuations in energy prices in particular. One central question is how specifically CINB's exposure to the oil and gas industry, and particularly through Penn Square, came to be. For this, it is useful to look into the corporate structure in CINB as it related to energy lending, and then to describe the evolution of its relationship with Penn Square.

2. The CINB Structure for Oil and Gas Lending

The organization of oil and gas lending within CINB prior to July 1982 is reflected in the two organizational charts on the pages that follow. General Banking Services, which was headed during that time by Executive Vice President George R. Baker, had responsibility for all the Bank's wholesale lending except for that relating to real estate. Baker reported to Roger Anderson, Chairman of CINB's Board. Under Baker, Executive Vice President Gerald Bergman headed the Special Industries Department, which in turn was divided into groups organized generally along industry lines. The Oil and Gas Group, headed by Senior Vice President John Redding, was divided geographically, and included the Mid-Continent Division under Vice President John Lytle that was the source for the lending relationship with Penn Square. Also under Bergman organizationally was the Continental Illinois Energy Development Corporation, a subsidiary created in 1980 and headed by E. G. Jackson, Jr.

Although this precise organizational arrangement was not in effect during the entire period from the mid-1970s onward, it did operate during the time that the dramatic increase in oil and gas lending was taking place in the late 1970s and early 1980s. In particular, a significant position relating to Penn Square lending, head of the Mid-Continent Division, was held by John Lytle from August 1980 until just prior to Penn Square's failure on July 5, 1982. Prior to Lytle's occupying that office, he had served as a loan officer in that Division responsible for independent oil companies.

The mechanism by which this relationship between Penn Square and CINB was carried out was the participation, a device whereby a lead bank (in this case Penn Square) would arrange with a borrower for financing, to be jointly funded by the lead bank and one or more participating banks. With respect to Penn Square, CINB not only served as a participating bank but also in at least one case (Michigan National Bank) encouraged other banks to join in participations involving Penn Square.

It is important to clarify the role that a participating bank plays and the degree of its involvement in the details of participation loans. When a loan is arranged on a direct basis by a bank with a borrower, without other banks participating, the lending bank's loan officers, engineers and other personnel have direct contact with the borrower, the bank's lawyers draft and review contractual documents, and all documentation is processed and kept at the lending bank. Responsibility for the loan rests directly with the employees and the lending processes in the lending bank.

In a participation, that responsibility is more diffused. There is no set model for the degree of involvement of a participating bank in such a loan. Who holds the collateral documentation, or the collateral itself; whose lawyers review the contractual documents; whose engineers examine the proposed collateral for sufficiency; who actually receives the borrower's payments under the loan -- these are all issues that in effect distinguish direct loans from participations, but as to which there is some fluidity in actual practice. It is certainly fair to say, however, that to the degree a participating bank grants its lead bank discretion to do all or part of these tasks, the participating bank remains responsible for knowing that the lead bank is in fact doing an adequate job on its behalf. When warning signs arise that there are problems in the lead bank's actions, a participating bank is obliged to take prompt steps to protect itself. Whether CINB did that in the case of Penn Square is the issue to which this report next turns.

B. The Evolution of the Penn Square Relationship

From relatively modest beginnings in the mid-1970's, the relationship between CINB and Penn Square Bank and its holding company grew to be a significant part of CINB's energy-related activities by the early 1980's. The bulk of the CINB dollar exposure came in the form of CINB participations in loans originated by Penn Square Bank, a rapidly growing, aggressive energy lender in Oklahoma City, Oklahoma. From a small shopping center bank, Penn Square grew in a matter of a few years in the late 1970's and early 1980's into a major actor in the energy lending field in the Southwest, focusing primarily in Oklahoma's oil- and gas-rich Anadarko Basin. In its meteoric rise and fall, Penn Square grew to be a bank with more than $500 million in assets, but perhaps more significantly for this report, became the source of over $1.1 billion in energy loans sold upstream to CINB. This represented loans to a few borrowers, many of them small, independent oil and gas operators in the Oklahoma oil patch.

The relationship between CINB and Penn Square began in 1978. According to Lytle, he was introduced to Penn Square Vice President Bill Patterson by Dennis Winget, then head of CINB's Oklahoma section in the Mid-Continent Division and later an employee of Penn Square. The relationship began relatively modestly, starting in 1978 and growing to approximately $50-$55 million in early to mid-1980; to $200 million by December 31, 1980; to $600 million by September 30, 1981; to $900 million by December 31, 1981; and to $1.5 billion by June 30, 1982, just days before Penn Square failed.

Aside from the dollars and cents value that Penn Square's and gas loans had for CINB, there is no question that some of the colorful characters at the Oklahoma bank intrigued the Chicago-based CINB bankers. Episodes involving Bill Patterson, Penn Square's Executive Vice President in charge of oil and gas lending, have been widely reported in the press, but other instances of interesting behavior were described in reports by CINB personnel. In one case in May 1979, in a notesheet relating to a CINB loan to

Penn Square's holding company, CINB's loan officer in the Southwest Division reported the following:

> Jennings (Penn Square's Chairman) in his own inimitable fashion has devised a rather ingenious scheme for landing new deposits at Penn Square. The bank is offering a 1979 Silver Shadow Rolls Royce in return for the deposit of $1 million for six months. One Rolls has already been taken with a second prospect likely.

In February 1982, George Gronskis, a member of the operations staff in CINB's General Banking Services who visited Penn Square to look into operations problems between the banks said, in a memo to his superiors, "PSB cooperated fully in not only providing all that we had asked of them, but also showing us what Oklahoma hospitality is all about on two occasions."

Clearly, there was a little bit of excitement associated with this bank that operated in a very different environment from the more staid Chicago banking community.

Aside from this major relationship as a participant in energy loans from Penn Square, CINB also had another type of banking relationship with Penn Square's holding company, First Penn Corporartion. In 1980 and 1981, CINB provided a line of credit to First Penn, beginning at $1 million and peaking at $10 million (of which $3 million was participated out to another bank), the proceeds of which the holding copany used to augment the bank's capital.

In fact, the financial relationship between CINB and First Penn began even earlier than 1980.According to CINB notesheets, First Penn had had an account with CINB since 1976. The formal loan relationship between the two banks, which increased periodically up to the $10 million level in September 1981, began in January 1980. At that time, CINB participated, in the amount of $1 million, in a $4 million term loan to First Penn agented by Fidelity Bank of Oklahoma City. CINB's participation increased to $3 million in June 1980, to $4.5 million in December 1980, and finally to $7 million in September 1981 when CINB replaced Fidelity as agent for the loan. Following a First Penn payment in early 1982, CINB's exposure under the loan was reduced to $6.825 million, the level at which it remained until Penn Square failed in mid-1982.

Each of these CINB loans to First Penn was downstreamed to Penn Square as an injection of capital to the bank. These injections were generally in response to criticisms by the Comptroller of the Currency relating to Penn Square's inadequate capital position. To some degree in this period, Penn Square also increased its capital by selling new stock and enhancing retained earnings. Yet, it is certainly true that CINB played an important role in 1980 and 1981 in helping Penn Square respond to serious problems with its capital.

1. Warnings from the First Penn Relationship

Apparently the earliest indications of serious problems at Penn Square began to surface in connection with its lending to First Penn Corporation, rather than through its purchase of participations in Penn Square's energy loans. As early as April 1980, CINB was aware of many of the problems Penn Square had had with the Comptroller of the Currency and the bank's external auditor.

Beginning in 1980, CINB began to lend to First Penn Corporation, the parent company of Penn Square Bank. Whenever borrowings were proposed, notesheets were prepared by loan officers in the CINB Dallas regional office describing the financial and operating condition of Penn Square. Those notesheets indicate that CINB personnel had full knowledge of the results of Comptroller examinations and customer-specific data from Penn Square.

Notesheets relating to proposed loans from CINB to First Penn Corporation, as early as April 14, 1980, reflected an awareness of Penn Square's difficulties. The April 14, 1980 notesheet discussed a dramatic increase in criticized loans at Penn Square found during a Comptroller's examination. CINB asked Penn Square to provide a list of accounts that were classified to help CINB monitor Penn Square's progress in resolving the problem. (The list was received at a June 27, 1980 meeting.) An April 25, 1980 notesheet indicated that CINB would not provide additional funding until it had access to the results of the soon-to-be completed Comptroller's examination of Penn Square.

In June 1980, another notesheet proposing a $2 million increase in CINB's loan to First Penn described the Comptroller's concerns about capital adequacy and classified loans at Penn Square, and noted that a team from CINB would be going to Penn Square in June to discuss the Comptroller's examination with Penn Square management. Specifically, the Comptroller was requiring that Penn Square increase its capital to 7.2 - 8% by year-end 1980, which was a justification in part for the increased assistance from CINB to the holding company. The notesheet pointed out that an official at Fidelity Bank (then the agent bank on the loan to Penn Square) was supporting the proposed increase in the loan because he believed that the Comptroller was putting considerable pressure on Penn Square to increase equity and that this pressure by the banks and the Comptroller was sufficient to make Penn Square "work to maintain reasonable fundamentals at the bank."

Even at this early stage of its relationship with Penn Square, CINB had developed a somewhat avuncular attitude toward the Oklahoma bank. In the June 20, 1980 notesheet, in a section called "Forward Planning," CINB's loan officer wrote the following:

> First Penn has rapidly outstripped the internal ability of its staff to plan for the near and intermediate term future of this fast growing aggressive bank. As a result, it has been proposed that Continental provide its expertise in the areas of Financial Advisory Services and Corporate Finance to provide a structure within which to grow over the next 1-5 years.
>
> Jennings (Penn Square's Chairman), having already agreed to talk to Corporate Finance, received the suggestion enthusiastically with an initial meeting planned to lay the groundwork.

Clearly, CINB was not only willing to provide financial help to enable Penn Square to deal with its regulatory problems, but it also perceived some significant management deficiencies and was willing to provide help in those areas as well.

In June 1981, when CINB's exposure to First Penn was at $4.5 million, a CINB notesheet discussed the Arthur Young qualified audit of Penn Square for 1980. Arthur Young had said it could not accurately assess the adequacy of Penn Square's reserves due to a lack of sufficient documentation to enable a judgment to be made about the quality of a number of reviewed accounts. The CINB notesheet acknowledged that documentation exceptions had been the subject of criticism by Comptroller examiners, and said that Penn

Square management attributed the problem to "an acute shortfall of support personnel and adequate internal controls." The notesheet pointed out that Penn Square had been recruiting senior administrators from other banks to deal with this, and concluded that "This area is expected to remain a primary focus of attention of First Penn management and of regulators and First Penn creditors." This final category presumably included CINB itself. In summary, the notesheet said that Penn Square was continuing "to take a very aggressive position in energy-related lending in Oklahoma," that its "rapid growth" was requiring "a stepping up in the staffing of loan production and documentation positions and other support and control functions," and that "the Comptroller of the Currency's office "was continuing to monitor Penn Square closely."

This mid-1981 time period was a critical one for CINB's relationship with Penn Square. At that point, CINB had something over $200 million in participations with Penn Square, meaning that the vast bulk of the loans purchased (reaching a total as high as $1.1 billion) came on CINB's book in the year after these comments were written. Therefore, it is important to see what improvements in Penn Square's operations were noted by CINB to justify the rapid increase in the two banks' relationship in late 1981 and early 1982.

A September 14, 1981 notesheet, supporting a proposed increase in CINB's lending from $4.5 million to $7 million, discussed at some length the results of Penn Square's early 1981 Comptroller's examination. After meeting with Penn Square's management, the CINB loan officer concluded:

> (Penn Square) was severely criticized in the bank examiner's I Q 81 report. Principal areas of concern were poor documentation and loan procedures, high level of classified assets ($16.6 million, 77% of gross capital funds at 12/31/80), high rate sensitive funding sources and insufficient equity.

The notesheet went on to say that hiring new managers and certain other actions had gone a long way to resolving the criticisms in the examination and in the August 1980 written agreement with the Comptroller's office. The bank was also working on reducing problems with certain oil and gas loans that were inadequately documented and with insider loans, notably to director Carl Swan, the notesheet said.

One area where the bank was continuing to have problems was in reaching the Comptroller's required capital adequacy level, and, to help deal with that, $2.5 million in additional funding was requested and granted by CINB. Thus CINB was continuing to perform a major service for Penn Square in assisting the smaller bank in meeting its requirements imposed by the Comptroller.

A January 5, 1982 notesheet discussed the Comptroller's interim examination, in late 1981, which required Penn Square to charge off significant numbers of loans, although not primarily in the oil and gas area. Later that month, on January 20, another CINB memo described the CINB loan officer's meeting with John Baldwin, head of the loan review function at Penn Square. Baldwin had organized a complete review and rating system for Penn Square's portfolio, and was planning to get to the oil and gas portfolio in the second quarter of 1982, after reviewing the commercial and real estate portfolios. CINB took some comfort in the fact that, although classified loans remained high at Penn Square, a more effective loan review process was underway.

On March 4, 1982, the CINB loan officer met with Chairman Jennings and President Beller of Penn Square to discuss more fully the Comptroller's interim examination of late 1981. Progress had been made in certain areas, and the loan review function was particularly commended. But the notesheet said that areas identified by the Comptroller as needing additional work included improper structuring of certain loans and out-of-town lending practices. In summary, the notesheet said that the tenor of the Comptroller's report was similar to what CINB had been told by Penn Square manaagement, "which was that serious efforts were being made to install those internal systems that had been neglected or did not exist, and that, given the bank's tremendous growth, were now very much required. Clearly, however, much additional progress needs to be made." The aura, then, is that CINB found some hopeful signs but was not at all convinced all was well by any means.

A further visit with Penn Square officials occurred on March 18, 1982, and the first real glimmer of concern about the oil and gas portfolio specifically is reflected in this notesheet. While recognizing that the internal loan review of non-oil and gas loans was complete, the notesheet commented, "We are, however, more interested at this time in determining the results of Baldwin's review of the oil and gas portfolio which has only just begun and is due to be completed in the middle of the third quarter." The notesheet also says that CINB's oil and gas group indicated CINB had about 140 letter of credit deals involving Penn Square with a median loan amount of about $1 million. The CINB oil and gas group had visited with Seattle First National Bank, another upstream bank for Penn Square. SeaFirst was planning on reducing some of the $458 million in overlines it had with Penn Square. According to the notesheet, SeaFirst's loans involved a certain number of rig loans and undeveloped lease acreage lines of credit such that the overall credit quality was not apparently as high as CINB's loans.

In view of the general uncertainty, CINB decided not to meet Penn Square's request to establish a secured liquidity line to make up for timing differences between the holding company's placement of CD's in the bank and their sale of shorter term commercial paper. Clearly, at this point, CINB had adopted a wait and see attitude about further help to Penn Square.

Peat Marwick's unqualified audit of Penn Square for 1981 led to another notesheet being prepared on April 24, 1982. While still noting that the oil and gas portfolio was yet to be reviewed internally, and that the quality of that portfolio depended on the effects of the slowdown in the oil patch, the notesheet found that progress was being made to address many of the Comptroller's concerns. Perhaps more importantly, the notesheet states that CINB had "conducted a collateral review of our participated loans and confirmed that the underlying collateral appears adequate and in line with overall lending policies." Thus, despite the overall uncertainty, CINB apparently felt it had some security in its position.

After this notesheet, two other memos appear in the files. On May 17, 1982, Penn Square's access to the $4 million Fed funds line that CINB provided was made subject to prior approval by one of two CINB officers. Then, on June 25, 1982, the Fed funds line to Penn Square was canceled. These were two ominous signals that things had gone seriously awry at Penn Square. By July 5, Penn Square had failed.

In 1981, the Mid-Continent Division, in which the Penn Square loans were booked, began to show up on CINB's internal reports, indicating that that Division had problems with documentation exceptions and past due loans. Lytle, the head of that Division, blamed the situation on errors in CINB's Loan Operations office, which was troubled by an outmoded computer system, rather than on any failings of the Mid-Continent Division. To the extent these exceptions and past due reports were an early indication of the problems to be encountered with Penn Square credits, their credibility was undercut by arguments relating to the inadequacy of the operational office, and a valuable signal may therefore have been overlooked. Indeed, according to the Special Litigation Committee report

2. Signals from the Oil and Gas Relationship

Even aside from the warnings being picked up in the Southwest Division, indications were emerging from the Mid-Continent Division that there were problems at Penn Square. In 1981, the Mid-Continent Division, in which the Penn Square oil and gas participation loans were booked, began to show up on CINB's internal reports, indicating that that Division had problems with documentation exceptions and past due loans. John Lytle, the head of that Division, blamed the situation on errors in CINB's Loan Operations office, which was troubled by an outmoded computer system, rather than on any failings of the Mid-Continent Division. To the extent these exceptions and past due reports were an early indication of the problems to be encountered with Penn Square credits, their credibility was undercut by arguments relating to the inadequacy of the operational office, and a valuable signal may there fore have been overlooked. Indeed, according to the Special Litigation Committee report prepared by CINB, the Bank's own audit of the Loan Operations function confirmed the accuracy of those documentation exception reports. Nevertheless, in mid-1981 the debate about the validity of those reports seems to have deflected concern from the real issue of the underlying quality of the loan in the Mid-Continent Division. Since these debates were occurring at meetings in the presence of George Baker, head of General Banking Services, they could have served as an early warning to very senior management of problems to come.

At roughly the same time as these debates were happening, a loan officer in the Oklahoma section of the Mid-Continent Division, Kathleen Kenefick, prepared a memo criticizing documentation and other procedures relating to Penn Square and expressing concern that some potential credit problems might be overlooked. In particular, her memo, typed on July 29, 1981, criticized the lack of management of credit relationships; poor credit write-ups; lack of follow-up on accounts; housekeeping problems such as missing notesheets, documentation errors, and past-due principal and interest; and overworked CINB staff. She attributed the difficulties to a series of causes:

> The explosive growth in the number of relationships, combined with personnel shortages and the organizational structure followed, are the perceived primary causes. In addition, however, the short term transaction philosophy (put the loan on for 30-90 days with either a strategy or more information to follow) adds to the problem. This builds the workload and potentially limits options. The standards of acceptability of work, both here at CINB and from Penn Square Bank, are other causes of the problem. The lack of control exerted over Penn Square Bank "after the fact" is another source of concern as the situation may change without our being aware of it. (Hearings, House Banking Committee)

George Baker was given a copy of this memo in September 1981 and retained it for about eight months, indicating that senior management was aware of internal criticisms about Penn Square nearly a year before that bank failed.

There is substantial dispute over exactly what happened late in 1981 regarding CINB's relationship with Penn Square. George Baker recalls having told Bergman to make all existing Penn Square credits into direct loans, rather than participations, and to make all new credits on a direct basis. This order was given, according to Baker, because of the "unreasonable concentration" of loans emanating from a small bank like Penn Square, as well as the fact that his subordinates, Bergman and Redding, did not seem to be aware of the dollar level of participations CINB had with Penn Square. Those subordinates, Bergman and Redding, do not recall a general order to convert to direct credits, but do recall a desire to switch to direct funding for major credits. Lytle only recalls that he was "encouraged" by Redding to make direct loans for credits over $5 million. (Special Litigation Committee Report, pp. 35-36). An internal CINB notesheet dated January 6, 1982 indicated that Oil and Gas would be "converting the larger borrowers to CINB's own notes where possible as relationships came up for renewal or renegotiation."

Why was it critical whether the Penn Square loans were done directly or through participations, and why did George Baker think that lending on a direct basis would prevent occurrences of the problems then becoming apparent? Perhaps the best explanations came from Continental's employees themselves.

In testimony, John Lytle noted that "Significantly, in the case of participation loans, the loan documentation was initiated and held by Penn Square Bank." (Hearings, House Banking Committee, September 29, 1982, p. 3). This gave Penn Square control over the flow of information to its participating banks, and Penn Square failed, in at least some instances, to provide needed documentation to CINB. In addition, as Lytle also explained, control of the original documentation gave Penn Square, as lead bank, the chance to provide CINB with documentation of collateral in photostat and then release the collateral without CINB's knowledge (Id., p. 40).

Kathleen Kenefick alluded to a similar problem in her July 1981 memo, when she said, "The lack of control exerted over Penn Square Bank 'after the fact' is another source of concern as the situation may change without our being aware of it."

The Continental internal auditors who visited Penn Square in late 1981 also found coordination problems brought about by the participation relationship. In many cases, the auditors found, Continental's loan and collateral documentation did not agree with Penn Square's; interest billings and payments were inaccurate; and collateral positions were not adequately protected. Furthermore, CINB had on 12 occasions purchased a participation that was greater than the outstanding balance booked by Penn Square. To some degree, the CINB auditors cited procedures at CINB as contributing to these problems, but many of the basic flaws seemed to reside in Penn Square. Perhaps the most curious thing to consider, however, is that in most of the loans purchased by CINB as of September 30, 1981, Penn Square retained only a very small portion, if any, of the actual dollar exposure on the loan. For over two-thirds of these loans, CINB had purchased 95% or more of the dollar value of the loan. Looked at another way, CINB's purchased participations from Penn Square amounted to 134% of Penn Square's total net loans (i.e., not just those in which CINB participated but all of Penn Square's net loans), and those participations bought by CINB amounted to over 20 times Penn Square's total equity. Since Penn Square was not a significant sharer of the credit risk on most loans, the value of its activities for CINB seem to have been as a loan originator, giving greater entree to the Oklahoma market, and as a document processor. As the auditors showed, however, the document situation at Penn Square was hardly exemplary.

Another employee of Continental confirmed the problems at Penn Square. G. A. Gronskis, from the CINB operations office, found, in a February 1982 report, numerous areas to criticize in Penn Square's control, production and interpretation of documentation. Gronskis made the following general observation about Penn Square's operations:

> Responsibilities for the preparation of notes and participation certificates, note booking and exception reporting appears to be overly fragmented so that no department has a final document review responsibility. This results in a number of questionable participation certificates sent to and accepted by us, which do not reflect the conditions stated in the note. Additionally, since a very superficial review of the note instrument exists .... numerous notes have severe deficiencies in the signature area and in the rate structure clause. (Gronskis memo, p. 4.)

Gronskis' observations concerning CINB, and particularly its Loan Division, were also revealing:

> While PSB (Penn Square Bank) personnel are willing to act in an agent capacity, they have not, to date, learned the intricate method of volume business as well as we, and to that end, we should develop a more helpful attitude towards the operating unit of PSB as opposed to a critical and demanding one. Because of our large investment in their total loan portfolio (almost 40%), CINB should with their sophistication, carry the brunt of follow-up until such time as PSB matures and gathers experience as a volume agent bank. (Gronskis memo, p. 6.)

At the time, CINB's exposure to Penn Square participations was $887 million, according to Gronskis. This degree of involvement makes the somewhat paternalistic attitude reflected in this quote all the more startling. Again, one must question precisely what it was that CINB felt it was getting from Penn Square and why it felt sufficiently confident to expose itself to the degree it did given the problems discovered in Penn Square's operations.

What emerges clearly from all these descriptions is that a participation relationship raises particular problems that are not encountered when credits are handled directly by a bank's staff. The question of how much confidence one bank can vest in another bank's documentation capacity is certainly raised by the experience between the two banks, and it would be hard to argue that Penn Square's track record was one meriting much confidence by CINB. An even more significant question is whether CINB was allowing Penn Square to substitute its credit judgment for that of CINB in making loans. There has been testimony to the effect that CINB's credit judgment remained in full force throughout its relationship with Penn Square. Nevertheless, some factors tend to indicate that CINB would have had some difficulty doing so. For example, documentation was in some cases in disarray on the Penn Square-related credits; many of those credits were stale-rated or not rated at all; the relationship with Penn Square had led to a significant concentration from that one correspondent bank and had increased substantially in size during the last quarter of 1981 and the first half of 1982; there were indications that staff was being squeezed in its ability to cope with the volume of Penn Square credits -- all these factors suggest that significant pressures were being put on CINB to ensure that its credit judgment was still intact.

It is simply not enough to say that the downturn in the energy market led to the Penn Square debacle and the resulting problems at CINB. The issue really is whether CINB should have gambled so much on a particular economic sector and on a single bank to service it in that sector, and done so without the greatest of caution.

CINB has countered with the statement that the Oklahoma independent oil producers it sought "tended to deal primarily with Oklahoma-based financial institutions." (Hearings, House Banking Committee, Sept. 29, 1982, p. 69). Thus the entree into that market would be more rapid and more effective through a Penn Square. Nevertheless, CINB was already established in the market for lending to independent oil producers, including in Oklahoma (Id.), so that the market sought was one of expanded market share in a market already serviced and, as it turns out, increased lending to insiders and friends of officials at Penn Square. CINB's internal auditors found in October 1981 that 16% of the participations purchased by CINB at that time, amounting to over $93 million, were to individuals (Chairman of the Board or Director), their companies, or partnerships which had a close relationship to Penn Square or its holding company. Again, the question about credit judgment and the purpose of CINB's involvement in this type of energy lending has to be raised.

3. **Was Penn Square Unique?**

Testimony has indicated that CINB maintained no other participation relationship with other correspondent banks that was anywhere close to the magnitude of that maintained with Penn Square. While CINB had been active in correspondent banking for many years, the participations with other banks tended to be in the $20 million to $25 million range, rather than the hundreds of millions as with Penn Square. (Testimony of John Perkins, Hearings, House Banking Committee, September 29, 1982, p. 75). This admission cuts both ways. On the one hand, it may say that CINB acted responsibly by limiting its participation exposure to very small amounts as a general rule. On the other hand, it raises the question why CINB was not more aware of its increasing exposure through Penn Square.

CINB apparently was not fully aware for some time that its participation relationship with Penn Square had increased so dramatically. No regular report to top management disclosed the source of credits on a correspondent bank basis. Thus, the credits were listed by borrower, rather than by the lead bank in the participation. This kind of reporting makes sense so long as the Bank made independent evaluations of each credit to ensure that it met CINB's credit standards. If there were a breakdown in that system such that a correspondent bank would play a more decisive role in committing CINB to the credit, the reporting system that existed was inadequate to protect CINB.

Perhaps in the end, the only real proof whether the Penn Square relationship was uniquely damaging to CINB would be to analyze the criticized asset portfolio to see whether Penn Square-related oil and gas loans were more harshly criticized than other oil and gas loans. The data show that substantial volumes of oil and gas credits that were <u>not</u> Penn-Square related were criticized, but that the bulk of credits <u>most</u> heavily criticized were Penn Square-related. Over $1.2 billion in non-Penn Square energy credits were criticized in 1982, while over $820 million in Penn Square-related credits were criticized. Of these totals, the OAEM (Other Assets Especially Mentioned) and Substandard categories, the two categories of mildest criticism, contained over twice as many non-Penn Square oil and gas credits as Penn Square credits by dollar volume. On the other hand, more than twice as many Penn Square as non-Penn Square oil and gas credits were in the "doubtful" category, and Penn Square had nearly four times as many loans in the "loss" category. On a percentage basis, the Penn Square predominance was even more striking, since Penn Square represented about 20% of all oil and gas outstandings, but over 40% of the criticized oil and gas loans (and much higher percentages in the two categories of strong criticism, "doubtful" and "loss").

In and of themselves, the volume of criticisms of non-Penn Square oil and gas loans would have been a cause for serious concern for CINB, but the effect of that problem was magnified greatly by the more immediately serious problems in Penn Square.

Some have argued that, even had CINB missed most of the signals that something was amiss at Penn Square, there were two instances that should have elicited greater vigilance from the Bank. The first of these was the personal loans that Penn Square Bank made to John Lytle of CINB's Mid-Continent Division. The other instance, the loans made by CINB to First Penn Corporation, Penn Square's holding company, is discussed immediately following this section.

4. The Loans from Penn Square to John Lytle

Prior to becoming head of the Mid-Continent Division in August 1980, John Lytle had been an account officer in that division. It was in the latter capacity that he first came in contact with Penn Square. Beginning in June or July 1980, Lytle began to borrow money from Penn Square, first in the amount of $20,000 and increasing over the next year and a half until the final figure of $565,000 was reached. Originally, the reason for this borrowing was listed as home improvements at Lytle's house; later amounts were justified in Penn Square loan papers as being for stock purchases by Lytle. Lytle has admitted that he told no one at CINB of this loan relationship because he did not consider it a conflict of interest. Lytle contends that he was not an executive officer of CINB; such a relationship with a correspondent bank was common practice in Oklahoma; and he felt his borrowing at Penn Square was good business for Penn Square since he was a solid creditor. Thus Lytle's borrowing from Penn Square was, in Lytle's eyes, good for CINB, since it cemented even further the Bank's relationship with a valued correspondent, Penn Square.

Interestingly, it was from Penn Square, rather than from CINB, that the first hint of concern over Lytle's personal borrowings apparently arose. On October 23, 1981, the Penn Square Credit Policy Committee met to consider a loan consolidating Lytle's other borrowings into a $515,000, 11% fixed rate loan for a three-year term, 30-year amortization, plus 1% fee. The Committee approved the loan, but the minutes of the meeting included the following comment:

> Rick Dunn (Penn Square Executive Vice President, Loan Administration Division) informed the (Penn Square Credit Policy) Committee and the Loan Officer that according to general counsel, due to the relationship with Continental Illinois National Bank and Mr. Lytle's position with Continental, we should obtain from the Chairman, President or Secretary of Continental, a letter certifying:
>
> A. Mr. Lytle is not a director, executive officer or principal shareholder of Continental Illinois National Bank, and
>
> B. They are aware of the terms of this loan and do not object to same.
> Bill Patterson agreed and said he would personally see that this is done.

There is no indication that Patterson ever notified CINB, prior to CINB's becoming aware of the loan in December 1981. Perhaps the most telling aspect of this, however, is that notwithstanding Penn Square's reputation as a "go-go bank", the senior officers of Penn Square on the credit policy committee were troubled enough by the implications of the Lytle loan to want CINB's agreement to it.

When it did find out about Lytle's relationship, CINB acted as though it were tortured by the thought of having to deal with it. The loan first came to CINB's attention, as best it can be determined, in early December 1981, when CINB internal auditors Minnier and Kaar discovered it on their second trip to Penn Square. Word was passed quickly to Bank auditor Edwin Hlavka, and in turn to George Baker (in some detail) and Roger Anderson (apparently in general terms). From December 1981 until April 1982, a series of staff level meetings were held to decide what was to be done about Lytle. Several CINB officials took the position that Lytle should be fired, while others suggested less onerous sanctions such as reassignment. Meanwhile, during those months Lytle remained in his position and the level of CINB exposure to Penn Square borrowers continued to increase significantly. In the first quarter of 1982, while CINB was considering what to do about Lytle, Penn Square-related exposures increased by more than $250 million. It was not until May 17, 1982, fully six months after the Lytle situation apparently first came to light at CINB, that the decision was made by Roger Anderson not to fire Lytle but instead remove him from the Oil and Gas Group and give him no salary increase or incentive compensation for two years.

There is a real question whether the Bank took strong action early enough to deal with the Lytle issue. The Bank's auditor, Hlavka, determined quickly the size of Lytle's loan ($565,000) and that Lytle was living beyond his means. Yet other than telling Lytle that his loans should be taken out of Penn Square, no other actions apparently were taken against Lytle. (As it turned out, Lytle complied by relocating his loans, with help from top officials at Penn Square, to one of Penn Square's correspondent banks, with a guarantee from Penn Square to back up the transfer, thereby retaining a rather significant level of involvement by Penn Square in the loans). Thus, a lending official who had gotten himself overextended with a major correspondent bank in a relationship that certainly raised serious conflict of interest questions was, for six months, permitted by CINB to continue operating much as before. Even conceding that Lytle was a 23-year veteran of the Bank and deserved some due process, and that it is easier in hindsight (after July 5, 1982) to judge just how bad the relationship with Penn Square was, nevertheless there were abundant signals that things were amiss at Penn Square. The fact that two auditing teams and a loan operations team had to be dispatched to clean things up at Penn Square; that the relationship with Penn Square-related borrowers was growing very quickly in a lending sector in which CINB was already significantly concentrated in mid-1981; that orders had already gone from George Baker to change at least some of these Penn Square-related credits from participations to direct credits; that internal sources within the Mid-Continent Division were criticizing the operations in that Division; that exception reports and stale-rated credits were unusually high--each of these alone may not have been a sufficient signal, but cumulatively they pointed to the need for more decisive action than in fact occurred.

This is not to argue that CINB would have escaped its problems with Penn Square if Lytle had been fired in early 1982. Even by that time CINB had a significant number of loans on the books and probably could not have extricated itself before Penn Square failed. Yet a fuller investigation and awareness of Penn Square earlier in 1982 might have helped CINB deal more effectively and with less trauma with the situation that eventually developed when Penn Square failed.

It is clear from this chronological summary of CINB notesheets in the Southwest Division and from warning signals relating to the Mid-Continent Division, that CINB was aware from the start of the serious problems Penn Square was facing. The inadequacies in capital, asset quality, management, and internal controls identified by the Comptroller were fully documented and noted by CINB officials. And yet, in testimony before the House Banking Committee, CINB President John Perkins said:

> It is true that Penn Square had had prior auditing problems and bank examination criticisms, which were known. However, the qualified auditors' letter regarding Penn Square's 1980 audit, which was received in the spring of 1981, appeared to relate primarily to housekeeping matters. The same was true of criticisms made during early 1981 by the national bank examiners. (Hearings, House Banking Committee, Sept. 29, 1982, p. 70) (Emphasis added).

Three points should be made about this statement. First, there is a clear admission that the facts abaout Penn Square were known by CINB. Second, as is clear from the CINB notesheets, the OCC examiner's report on Penn Square, issued in early 1981, contained criticisms of far more than "housekeeping" matters. The Comptroller described the report in these words:

> It disclosed further deterioration in the bank's overall condition. Major concerns continued to be inadequate capital, poor asset quality, ineffective loan administration, inadequate staffing and policy development, weak internal controls, and deficient liquidity, asset, and liability management practices. During 1980, the bank had more than doubled in size. Most of this growth continued to be concentrated in the energy-related businesses. Additionally, violations of banking laws and of the formal Agreement were cited in the report. (Testimony of C. Todd Conover, Comptroller of the Currency, Hearings, House Banking Committee, July 15, 1982, p. 11.)

Third, to the extent CINB took solace in the fact that Penn Square had made efforts to clean up these so-called "housekeeping" problems, it was apparent in CINB's own audits in late 1981 and early 1982 that Penn Square was still not a reliable provider of documentation for its credits. Therefore, it seems apparent that CINB largely ignored some important warning signals about Penn Square from both OCC and Penn Square's independent auditors, downplaying the significance of those problems and feeling they had been cleared up. In making those mistakes, however, CINB may not have been any more in error than Penn Square's auditor, Peat Marwick, or its regulators in finding that Penn Square was making substantial progress in improving itself in late 1981 and early 1982.

C. Continental's Other Energy-Related Activities

In addition to the energy lending that went on within CINB, a separate subsidiary of CINB's holding company also engaged in lending to oil and gas borrowers. The Continental Illinois Energy Development Corporation ("CIEDC") was formed in February 1980 and was designed to meet the needs of smaller, independent oil, gas and mining exploration and production companies that might not qualify for conventional bank financing. (1979 CIC Annual Report, p. 8). It was recognized from the outset that this type of lending held the possibility of greater risk than lending to more established and larger borrowers. CIEDC's authority included lending and the purchase of voting and nonvoting equity interests in these companies. According to Federal Reserve examiners, CIEDC's original activities were directed toward purchasing participation interests in loans advanced by Amex Mineral, N.V., an energy lending subsidiary of American Express, whose assets were eventually purchased by Drillamex, Inc. Later, Continental Illinois Corporation got Federal Reserve approval to acquire the Amex assets from Drillamex, in August 1981. Thereupon, CIEDC began to rapidly expand its energy lending portfolio.

To be sure, the volume of CIEDC's energy portfolio was never sizable when compared with that of the Bank itself. As of the 1981 Federal Reserve inspection, CIEDC had total loans and investments of less than $26 million, compared with the Bank's overall exposure to the oil and gas industry of over $7 billion, as found by the OCC examiners in 1981. Even then, the Federal Reserve was warning about the Corporation's rapid asset growth and pressure on equity capital, cautioning that if earnings did not keep pace, additional equity capital might be required. By 1982's inspection, CIEDC total assets had risen to $94.8 million, with classified assets totalling $35.5 million, slightly over half of which was rated substandard and the remainder, rated doubtful and loss, being almost totally involved with a credit to one borrower. These figures dwarfed CIEDC's total equity of $1.866 million, and its valuation reserve of $922,000.

One offshoot of the purchase of the assets of Amex Mineral, N.V. was that two officials of that company, Edwin G. Jackson, Jr. and John Oliver, became President and Vice President, respectively, of CIEDC. Both were given special incentive contracts allowing them to acquire equity interests in and receive royalty rights from customers of CIEDC, subject to certain contractual limitations. In Jackson's case, this contract was a continuation of the contract he had with Amex. These provisions were cited as being needed to attract and retain high quality executives at CIEDC, but they also had the effect of causing or contributing to certain violations of law by CIEDC. In two instances, once in August 1981 and again in 1982, CIEDC acquired voting shares of common stock in companies that exceeded the 5% limitation in the Bank Holding Company Act. Mr. Jackson also purchased shares in those companies, which had the effect of increasing the prohibited exposure in those companies. The Federal Reserve concluded that "while neither violation is considered willful, management is requested to notify this Reserve Bank of their actions taken which reduces Energy's voting ownership of (the two companies) to the limitations set by Section 4(c)(6) of the Bank Holding Company Act, as amended."

It is interesting that Mr. Jackson's relationship with companies that did business with CIEDC was encouraged, as an incentive for Mr. Jackson to stay with the Corporation (and presumably reap additional personal financial rewards). His situation was presumably much different from Mr. Lytle's, in that Lytle was a debtor to his correspondence bank, while Jackson was a creditor. Nevertheless, there are questions that arise about the evenhandedness of credit and investment decisions in a situation where officers of the lender deal, as individuals, with a borrower. Both aspects of this issue that are raised in the Continental case should receive continued consideration.

Chapter VIII

FEDERAL ASSISTANCE

A. Chronology of Assistance Plan Development

The first sign of real trouble at Continental began with the failure of Penn Square Bank on July 5, 1982.[1] Continental's extensive involvement in the Penn Square debacle, as a supplier of funds and participant in energy-related loans, has been documented elsewhere in this report. For a two-year period following the Penn Square failure, conditions at Continental continued to deteriorate. Loans purchased from Penn Square proved to be worse than was originally anticipated, and other problems at CINB began to surface, particularly in the Special Industries Division. CINB's funding grew more volatile, with the bank having to purchase each day approximately $8 billion, or about 20 percent of its total funding.

Although some management changes were made in an effort to tighten controls, changes at top level management did not take place for nearly two years following the Penn Square failure; and when changes were finally made, replacements were made from inside the organization.

Testimony received by the Subcommittee indicates that the bank's loan chargeoff policy was not sufficiently aggressive, and its dividend was not reduced. In addition, the sale of the bank's profitable credit card operation was perceived by many as a "desperate attempt to raise funds to support the dividend, to the long-range detriment of the bank."[2]

A crisis in confidence in the bank occurred in May, 1984, when rumors began circulating that the bank was near insolvency. It lost $9 billion in funding and there were estimates that it could lose as much as $15 to $20 billion in a short time. Additionally, the funding problem began to affect the markets generally, and the regulators knew that something had to be done quickly to stabilize the situation.

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1 Statement of Wm. M. Isaac, Chairman, FDIC, on Federal Assistance to CIC and CINB before the House Banking Committee's Subcommittee on Financial Institutions, October 4, 1982.

2 Statement of Wm. M. Isaac, p. 2.

In his appearance before the Subcommittee, Mr. Isaac stated that there were four options available to the regulators: (1) close the bank and pay off insured depositors; (2) arrange a merger on an open- or closed-bank basis; (3) grant permanent assistance; or, (4) provide temporary direct assistance to halt the deposit outflows and provide time to salvage the situation and, if necessary, develop a permanent assistance program. The regulators chose the latter.

Option (1) was not adopted because Continental, although it had severe confidence and liquidity problems, was not perceived to be insolvent in that the value of its liabilities were less than the regulators' valuation of its assets. Also, according to Mr. Isaac, closing the bank would have had "catastrophic consequences for other banks and the entire economy."

Option (2) was not viable, since arranging a merger involving a bank of Continental's size within the limited time available was virtually impossible and extremely expensive to the FDIC. Granting permanent assistance, Option 3, was rejected at the time because not enough was known about the bank and its needs. Moreover, in addition to the legal and accounting complexities, the regulators believed that every effort should be made to find a private sector solution before resorting to direct assistance.

The regulators, therefore, decided initially on a temporary assistance program which they announced on May 17, 1984. This was followed two months later by the announcement of the permanent assistance program on July 26, 1984.

1. Temporary Assistance Plan

A financial assistance program, called the "Temporary Assistance Plan," was announced on May 17, 1984. The participants included the FDIC, Federal Reserve, OCC and a group of leading banks. The plan was designed, according to the participating agencies, to "provide assurance of the capital resources, the liquidity, and the time needed to resolve in an orderly and permanent way the bank's problems." It provided a $2 billion loan in the form of a demand subordinated note ($1.5 billion was provided by the

FDIC with the balance provided by a group of major U.S. banks). In addition to funds made available by the Federal Reserve through its "discount window," a consortium of 28 banks made available to the bank a standby line of credit of $5.5 billion. Throughout this period, the FDIC assured the public that "in any arrangements that may be necessary to achieve a permanent solution, all depositors and other general creditors of the bank will be fully protected and service to the bank's customers will not be interrupted."

Between the interim assistance plan and the announcement of the permanent package, the FDIC and Continental permitted a number of potential acquirors of CINB to come into the bank and review its records and documents to decide whether they might be interested in bidding on the bank. Several banks, including Chemical Bank, Citicorp and First Chicago, did so, and in some cases devoted substantial personnel resources to examining Continental's condition to see whether it was a possible acquisition target. None of these inquiries by other banks or other overtures involving private parties such as the Bass Family resulted in formal negotiations working toward an agreement to acquire the bank. Some of the banks that looked at Continental discussed with the FDIC the possibility of assisting FDIC (through fee-generating services) in finding a possible resolution of the Continental problem, but none of these discussions led to any arrangements with these banks.

Concluding that the only practicable solution to the problem was to have the CINB continue as an independent institution, the Federal banking agencies in a joint press release on July 26, 1984 announced a multibillion dollar permanent assistance plan to rehabilitate CINB and restore it to financial health. The release stated:

> "After careful evaluation of all the alternatives, the agencies have decided that the best solution is to provide sufficient permanent capital and other direct assistance to enable the bank to restore its position as a viable, self-financing entity. Factors considered in reaching this determination included the <u>cost to the FDIC, competitive consequences, and the banking needs of the public</u> (emphasis added).

The major components of the permanent assistance program included installation of a new management team, removal of $4.5 billion in problem loans, infusion of $1 billion in new capital, and a continuation of ongoing lines of credit from the Federal Reserve and a group of major U.S. banks.

2. Permanent Assistance Program

The permanent assistance program (the "Plan") which was approved by the Federal banking agencies on July 26, 1984 and which later was favorably voted on and adopted at a special meeting of Continental Illinois Corporation's (CIC) stockholders on September 26, 1984 consists of the following elements:

Loan Purchase. Since CINB had a substantial volume of troubled loans, it was decided that the first order of business was to remove most of those loans from the bank. Accordingly, the first major element in the assistance plan provided for the FDIC to purchase troubled loans with a book value of approximately $4.5 billion. Initially, loans with a May 31, 1984 book value of $3 billion are to be purchased by the FDIC for $2 billion with the bank absorbing a $1 billion chargeoff. Thereafter, the bank may sell to the FDIC for a three-year period additional loans outstanding on May 31, 1984. These loans, having a book value of $1.5 billion, would be sold to the FDIC for $1.5 billion.

The FDIC will pay the $3.5 billion for the purchased loans by paying off the $3.5 billion indebtedness CINB has incurred to the Federal Reserve Bank of Chicago. The Federal Reserve borrowings assumed by the FDIC have a five-year maturity, bearing interest on the first $2 billion indebtedness at 25 basis points over the three-month U.S. Treasury bill rate as established at the beginning of each quarter. The rate of interest on the remaining $1.5 billion of indebtedness will be the same as the rate charged to the bank by the Federal Reserve of Chicago. The FDIC will repay the Federal Reserve borrowings by making quarterly remittances on the troubled loans; and if at the end of the five-year period there is a shortfall, the FDIC will make up the deficiency from its own funds.

The loans will be managed for the FDIC by CINB pursuant to a servicing contract. Either party may terminate the servicing arrangement. The FDIC may do so at any time and the bank may terminate the arrangement upon six months' notice.

The FDIC Option. To replenish the $1 billion chargeoff and in further consideration of FDIC's assumption of the bank's $3.5 billion debt to the Federal Reserve Bank, the plan provides for the FDIC to acquire preferred stock in CINB's parent, the Continental Illinois Corporation (CIC) for $1 billion. This capital infusion, which must be downstreamed to the bank in the form of equity, will be divided into two permanent nonvoting preferred stock issues: the first issue, in the amount of $720 million, is 32 million shares of a new class of junior convertible preferred stock. This issue will pay no dividends except to the extent that dividends are paid on the common stock; the second issue, in the amount of $280 million, will be an adjustable-rate, cumulative preferred in which a dividend will be determined by the highest of three Treasury rates as published by the Federal Reserve. As to the first issue the FDIC is given the option to convert the preferred stock into 160 million shares of newly authorized common stock (which would approximate 80 percent of CIC's common stock). This is to compensate the FDIC for any losses it may incur on the troubled loans it has acquired. The effect of this option, if exercised by the FDIC, may be to wipe out the 40 million shares of common stock owned by the current stockholders and which constitute approximately 20 percent of the equity of CIC. Under the plan, at the end of five years, an estimate of the losses, if any, incurred by the FDIC in the purchase of the troubled loans and assumption of debt to the Federal Reserve will be made. The estimates will be made by three referees, one appointed by the FDIC, one by CIC, and the third appointed by the two referees. If the FDIC suffers any losses, it will be compensated for by exercising its option to acquire common stock in CIC held by the new corporation. Since the shareholders' equity in CIC at May 31, 1984 amounted to $800 million, after taking into account the $1 billion chargeoff, a deficiency or loss to the FDIC of that amount would permit the FDIC the option to acquire all of the shares ofcommon stock of CIC as held by the current shareholders, resulting in the complete elimination of their equity interest. If, on the other hand, the FDIC does not suffer any losses, all remaining loans and other assets acquired under transferred loan arrangement will be returned to the bank.

Rights Offering. The current holders of CIC common stock were given a right to acquire, on a pro rata basis, approximately 40 million shares of common stock at $4.50 per share for 60 days from the Rights Record Date and at $6.00 thereafter for the subsequent 22 months. The equity raised in this offering is to be downstreamed to the bank and the shares it represents are not subject to the "make whole" arrangement under the FDIC option.

Interim Assistance Program and Continuing Funding. Pursuant to the terms of the interim assistance program, the $2 billion subordinated loan to the bank from the FDIC and a group of U.S. banks has been repaid. The Fed continues to meet the liquidity requirements of the bank and the $5.5 billion funding facility provided by major U.S. banks continues to exist.

Assignment of Claims to the FDIC. CIC and CINB have assigned to the FDIC all claims arising out of events occurring on or before September 26, 1984 which either entity may have against any of its present or former officers, directors, employees, bond or other insurance carriers, and others whose conduct may have contributed to any loss incurred in connection with troubled loans purchased by the FDIC. Any recoveries obtained from such claims are to be applied toward payment of the FDIC obligations to the Chicago Federal Reserve Bank.

Management Changes. The boards of CIC and CINB named two new executive officers: John E. Swearingen, as Chairman of the Board and Chief Executive Officer of CIC, and William S. Ogden, as Chairman of the Board and Chief Executive Officer of CINB. Both individuals will serve on both boards of directors.

Day-to-Day Operations. Although certain agreements give the FDIC basic protections as a major investor, the FDIC will not be involved with the bank's day-to-day operations, or participate in the normal business decisions, i.e., hiring or compensation of officers, lending or investment policies. Further, it is the intention of the FDIC to dispose of its stock interest in Continental as soon as practicable, possibly through a sale to a private investor group, to one or more banking organizations, or to the public in an unwritten offering.

B. Concerns About the Assistance Plan

The permanent assistance plan may be an expensive one for the Federal Treasury. Estimates prepared by Congressional budget experts indicate that the cost to the Treasury could reach $3.8 billion, depending on the types of economic and interest rate assumptions one makes for future years. This estimate, however, does not take into account the potential cost of FDIC's assurance that "if, for any reason, the permanent financial assistance package proves to be insufficient, the FDIC will commit additional capital or other forms of assistance as may be required." The extent of this liability is completely speculative.

In contrast to a significant potential loss to the Treasury, the Federal regulators have taken pains to assure the financial community that all depositors and general creditors of Continental would be fully protected.

A lively debate occurred within the government about whether FDIC's proposal to channel the assistance through the holding company, rather than through the Bank itself, was lawful under section 13(c) of the Federal Deposit Insurance Act. The Treasury Department took the position that amendments to that section adopted in the Garn-St Germain Act had not given FDIC the authority to use the holding company for assistance payments, unless the case involved merger-related assistance, which the Continental case did not. As the Treasury's Acting General Counsel said:

> "In my opinion, using the holding company as the vehicle for assistance to the Bank substantially increases the likelihood of litigation and the risk that a challenge will be successful. I strongly recommend against the choice of the FDIC's proposal, in light of the availability of other alternatives, which are clearly legal."

The FDIC argued that section 13(c), as amended, gave them great latitude to structure an assistance package, a position with which the Federal Reserve Board agreed. Both agencies relied heavily on the doctrine that if the plan were challenged, a court would give substantial deference to the interpretation of the administrative agency charged with carrying out the Act.

Because of the controversy, Treasury asked the Justice Department for an opinion on FDIC's approach. While generally upholding that approach, Justice hinted strongly that it was uncomfortable with the supportability of holding company assistance:

> "At the same time, however, we caution that neither the operative statute nor its legislative history is entirely clear on this issue. Assistance through the vehicle of the Bank's holding company, rather than directly to the

Bank, manifestly increases the risk that a court would conclude that the FDIC had exceeded its statutory authority. Moreover, even if the statute does not categorically preclude such assistance, it is possible that a court might conclude that the FDIC had abused its discretion if, for example, the circumstances indicated that it has based its determination to provide assistance in this manner for reasons that were demonstrably inconsistent with its statutory authority, such as a desire to protect existing management, stockholders, or creditors. Channeling FDIC funds to the Bank through its holding company, if there is an equally feasible alternative involving assistance directly to the Bank, simply invites litigation and judicial scrutiny... Notwithstanding some reservations and our preference for a more fully developed analysis of the FDIC explanation for its approach, in light of the broad latitude given the FDIC by the text of the statute, the deference given by the courts to an agency's interpretation of its own statute, the responsibility of the courts to construe the provisions of the statute liberally in light of its purpose, and on the record presented to us in the short time available, we conclude that the transaction contemplated probably would not be held to exceed the FDIC's statutory authority."

The plan could be subject to legal challenge and prolonged litigation, certainly an unsettling prospect for a company like Continental that is seeking to regain public confidence.

While the FDIC has resisted calling Continental a nationalized bank, there is clearly a new competitive reality created by the assistance package. The approach taken in Continental is not one that historically has been taken in cases involving troubled small or even regional banks. If the message of Continental is that a certain class of very large, money center banks cannot be allowed to fail, the handwriting may be on the wall for smaller banks that don't have that assurance. Smaller banks, at the slightest hint of trouble, may find their more volatile funds fleeing to havens in the "fail-safe" big banks. This has enormous implications for the entire banking system in this country, and the regulators must be called to account on the question.

For example, one of the more serious concerns to be addressed is the FDIC's lack of administrative capacity to do a payoff involving a bank the size of Continental, even though under some circumstances, the FDIC in its wisdom may decide that such action is not in the best interests of all concerned. Mr. Isaac testified that it would have taken about a month or more to pay off the 850,000 insured depositors at Continental; and that is simply too long. In contrast, the FDIC could handle over the weekend the processing of checks in a small bank that has perhaps 10,000 accounts. So there presently exists an unfair policy which favors banks "too big to fail," simply because the FDIC lacks the administrative capacity to handle such a situation. What is of even greater concern, however, is the ripple effect of losses to the uninsured depositors and general creditors in a large bank payoff. In Continental, there would have been "uninsured creditors holding $30 billion in claims that they wouldn't collect on for years and years ..."[1]

Again, because of its size, the FDIC current policy would tend to favor large banks over small banks. This one-sided approach to resolving problems sends the wrong signals to management and depositors alike. This "failsafe" policy not only is unfair; but it gives the FDIC an unusual amount of supervisory discretion to determine which institutions are "failsafe" and, most importantly, raises serious concerns about the safety and soundness of this nation's banking system.

I. Assistance Under Section 13(c) of the Federal Deposit Insurance Act (FDIA)

Section 13(c) of the Federal Deposit Insurance Act (FDIA) authorizes the Corporation, in its sole discretion, and upon terms and conditions as its Board of Directors may prescribe, to provide assistance to insured banks that are encountering financial difficulty. Specifically, under Section 13(c)(1), the FDIC is authorized "to make loans to, to make deposits in, to purchase the assets of or securities of, to assume the liabilities of, or make contributions to, any insured bank" in order to prevent (1) its closing, or (2) to restore a closed bank to normal operation, or (3) to lessen the risk to the FDIC "when severe financial conditions exist which threaten the stability of a significant number of insured banks or of insured banks possessing significant financial resources."

Under Section 13(c)(4)(A), the assistance provided to a troubled bank cannot exceed the cost of liquidation, including paying the insured accounts, unless the FDIC determines that the "continued operation of such insured bank is essential to provide adequate banking services in its community."

1 Testimony of Chairman Isaac, pp. 231-232 of transcript.

Originally enacted as part of the Banking Act of 1933 which amended the Federal Reserve Act of 1913, the Federal Deposit Insurance Act became a separate law in 1950. It was at this time that 13(c) was added. Although, as originally enacted, 13(c) did not contain any limitation on the amount of assistance the FDIC could provide to a troubled insured bank (i.e., one that was closed or in danger of closing), it did require the Board of Directors of the FDIC, in its discretion, to find that the continued operation of such bank be "essential to provide adequate banking services in the community" before any assistance could be provided. The essentiality test was not included in the bill as introduced in the 81st Congress; and there appears to be no mention of it during hearings held before the Senate Banking Committee. It was later added, however, to the Senate version of the bill, according to a study by Ann Cooper Penning,[1] as a result of the Federal Reserve's concern about the possibility of free-wheeling aid.

The issue was briefly discussed in the House Banking hearings and the House report favored omitting the essentiality test on the ground that to do so would be "of particular benefit to mutual savings banks as these banks cannot be merged or consolidated with commercial banks, and there is only one mutual savings bank in the community." Nevertheless, the Senate version was adopted in conference without any further discussion of the issue in either the conference report or during the floor debates. Accordingly, from 1950 to 1982, 13(c) of the FDIA required the FDIC to find a troubled bank to be "essential" to the community before it was permitted to grant any assistance.

2. Amendment of 13(c) under Garn-St Germain

The economic environment in the early 1980's to the present, especially during 1981 and 1982, was and is characterized by high and variable interest rates, rapidly increasing the cost of funds and causing severe financial problems for many depository institutions. Thrift institutions were especially hard hit. Mutual savings banks and savings and loan associations, burdened by low-yielding mortgages and having to purchase funds at high rates of interest, suffered substantial losses and severe declines in their net worth.

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[1] Penning, Ann Cooper, Aid to Distressed Banks - Yesterday and Today: An Historical Survey of Federal Assistance to Distressed Banks (2 vols., 1968), at 51 (unpublished; available at Amer. Bankers Asso. Library, Washington, D.C.)

The Congress responded to the needs of depository institutions, especially those financial institutions which were or close to failing, by passing the Garn-St Germain Depository Institutions Act of 1982 ("The Act"). For two years prior to the passage of the Act both the House Banking and Senate Banking Committees conducted extensive hearings on the financial problems of depository institutions, especially the thrifts.

Noting the loss experience of, especially, mutual savings banks insured by the FDIC at that time, the House Committee on Banking in its report accompanying H.R. 4603 (the predecessor to H.R. 6267 and which became Title I of the Garn-St Germain Act of 1982) said:

> "FDIC's primary concern at present is the current loss experience of mutual savings banks insured by the Corporation. Mutual savings banks' net deposits, not including credited interest, declined $9.4 billion through August 1981 from approximately $151.1 billion in January 1981. For the first six months of the calendar year, FDIC insured mutual savings banks incurred operating losses of $590 million. Seventy-nine FDIC insured savings banks with deposits of $100 million or more held over 75 percent of all mutual savings banks' deposits. Assuming continuation of present interest rate levels, FDIC staff estimates that the net worth of at least 12 of these institutions holding assets of $25.9 billion will decline below 1 percent of total assets in the next 15 months.

(H.R. Rep. No. 97-272
at 15.)

Summing up the regulators' case requesting that more flexible authority be provided under Section 13(c), former Federal Deposit Insurance Corporation Chairman, Irvine Sprague, said:

> "We have proposed to the Congress and solicit your active and aggressive support for legislation ... to modify the statutory Section 13(c) test to enable us to make capital infusions more easily, particularly in the New York thrifts, and to permit FDIC as a Receiver of a large failed FDIC-insured bank to arrange a Section 13(c) purchase and assumption transaction with an out-of-state institution ..... We are talking today about emergency legislation to meet a specific need. (Emphasis added.)

(H.R. Report 97-272 at 18-19)

Finally, Paul Volcker, Chairman of the Board of Governors of the Federal Reserve System, who served as the regulators' coordinator during the months preceding the introduction of H.R. 4603, urged its immediate adoption. He said: "In my judgment, the legislation before you, limited in objective, modest in scope, and temporary in duration, is needed now, but in no way should prejudice your further examination of more fundamental issues."

(H.R. Rep. No. 97-272 at 19)

Again pressing the case for the regulators in testimony before the House Banking Committee, Chairman Volcker said:

> "I also want to emphasize at the outset that I consider the acute problems of the thrift industry to be transitional in nature .... The bill before you .... simply provides the FDIC and FSLIC, under specified conditions, with more flexibility either to provide transitional assistance to thrift institutions that can survive during a period of financial stress or to broader merger possibilities.... The past record and interest of the supervisory agencies seems to me to provide assurances that this additional margin of flexibility will be utilized with great care and prudence, and with appropriate safeguards to the public interest; it is not a generalized "bail-out" and should not be viewed as such..... The assistance would be provided only in circumstances in which it would, in fact, avoid large potential drains on the insurance funds themselves that would arise in the event otherwise sound institutions needed to be merged or liquidated."

(H.R. Rep. No. 97-272 at 11)

Responding to the volatile economic environment and to the pleas of the Federal banking regulators for help, the House passed H.R. 4603 (the Deposit Insurance Flexibility Act), and the Senate, S. 2879. As reported, both bills included the substance of the amendment to 13(c) that was added to H.R. 6267 (the Net Worth Guarantee Act) and enacted as Title I of the Garn-St Germain Depository Institutions Act of 1982 (P.L. 97-320).

Section 13(c) of the Federal Deposit Insurance Act (FDIA) was amended to give the FDIC additional options to provide assistance to institutions within its jurisdiction to include purchasing securities of and making contributions to insured banks.

In addition to providing assistance to prevent the closing of or to restore to normal operations an insured bank, the Garn-St Germain Act amended 13(c) to provide assistance "if, when severe financial conditions exist which threaten the stability of a significant number of insured banks or of insured banks possessing significant financial resources, such action is taken in order to lessen the risk to the Corporation posed by such insured bank under such threat of instability."

The 1982 amendment also permitted the FDIC, for the first time, to provide assistance to an insured bank having financial difficulty, without first having to make a determination that such institution was essential to the banking needs in the community. A limitation, however, was imposed, which provided that such assistance could not exceed the cost of liquidation, including the paying off of insured deposit accounts. If, however, the FDIC, in its determination, makes a finding that a bank is essential to provide adequate banking services in its community, no limitation on the amount of assistance is provided.

Although commercial banks were obviously going through a most stressful period (from 1981 to 1983, for example, the FDIC handled over 100 bank failures, including 18 of the largest 25 in its history), it is fair to say that the primary focus of attention, as evidenced by the testimony aforementioned, was on providing emergency help to savings and loan associations and the mutual savings banks. No one, including the regulators, appeared to have considered providing expanded or more flexible authority, on the possibility that 13(c) would be used to provide assistance to the failure of one of the top ten largest commercial banks in the United States —assistance which could possibly dwarf in magnitude the cost to the FDIC of all the bank failures that agency has handled in its fifty-year history.

3. Application of 13(c) Assistance to CINB

As noted earlier, the regulators decided on May 17, 1984 to provide CINB with temporary assistance under Section 13(c) of FDIA. The purpose of this assistance was in part to stabilize the rapidly deteriorating funding problem at the bank and to give the regulators additional time to find a permanent solution. The permanent assistance plan, announced two months later on July 26, 1984, also derived its authority pursuant to 13(c) assistance.

One week before the announcement of the temporary assistance plan, in a highly unusual press release dated May 10, 1984, the Comptroller of the Currency publicly denied rumors that CINB was in serious trouble and that regulators were searching for a firm to take over the Bank. The press statement said:

> "A number of recent rumors concerning Continental Illinois National Bank and Trust Company have caused some concern in the financial markets. The Comptroller's Office is not aware of any significant changes in the bank's operations, as reflected in its published financial statements, that would serve as a basis for these rumors."

Yet, despite these assurances, the Comptroller knew, according to the FDIC, as early as April 2, 1984, if not before, that with the exception of the Federal Reserve Board's Discount Window, the CINB had no significant additional domestic liquidity available at the current pricing premium levels and that major sources of international funding were drying up.[1] This information, in fact, led the Comptroller to write the FDIC on May 17, just seven days after his press release, urging that agency to provide 13(c) assistance to CINB because the OCC had determined that the CINB might not be able to meet its obligations as they became due. Mr. Conover said:

> "On March 14, 1983, the bank entered into a formal agreement wih the Office. However, the bank's condition has continued to deteriorate. An examination as of January 31, 1984, revealed that non-performing assets had reached approximately $2,300,000,000. Although the bank's capital structure appears sufficient to absorb the probable losses in its portfolio, rumors and speculation regarding the bank's condition have received prominent coverage in the news media. As a result, the bank has experienced increasing problems in meeting its short term funding needs. Reflecting this fact, the bank's borrowings from the Federal Reserve System have increased from $850,000,000 on May 9, 1984, to $4,700,000,000 on May 16, 1984. If the bank's ability to obtain funding continues to deteriorate, the bank may become unable to meet its obligations as they become due."

[1] Memorandum to the Board of Directors of the FDIC from Robert V. Shumway, Director, Div. of Bank Supervision: "Continental Illinois National Bank and Trust Company of Chicago Assistance - Sec. 13(c)(2)," dated May 17, 1982.

It was this letter and another from the Comptroller dated July 25, 1984, together with other documentation, that the FDIC used to support its findings as required under 13(c) that assistance be granted to prevent the closing of the bank.

In its decision on the Permanent Assistance Plan, the FDIC also reviewed memoranda prepared by FDIC staff, one of which was submitted for the FDIC Board's meeting on July 25, 1984 by Robert V. Shumway, Director, Division of Bank Supervision for the Federal Deposit Insurance Corporation (similar to an earlier memorandum of May 17, 1984), which concluded that Continental is essential to provide adequate banking services in its community and that the FDIC provide Section 13(c) assistance. It found:

-- that CINB was continuing to experience severe funding difficulties; that in addition to the $2 billion of subordinated notes purchased by the FDIC with participation of large commercial banks (pursuant to the Temporary Assistance Plan of May 17, 1984), borrowings from the Federal Reserve of Chicago continued to increase at a substantial level;
-- that CINB had utilized $4.13 of the $4.5 billion line of credit that the bank had established with 28 large commercial banks; and
-- that the Comptroller of the Currency in letters to the FDIC of May 17 and July 25, 1984, as noted above, urged that assistance under 13(c) be provided.

The reasons given for concluding that Continental was "essential" included the following:

-- It is one of the ten largest banks in the United States, with $34 billion in assets, 57 offices in 14 states and 29 foreign countries staffed by several thousands of people.
-- It provides a full range of commercial, individual and trust services throughout the midwest.
-- It has a major correspondent relationship with hundreds of downstream correspondent banks which rely on Continental for check clearing and other

vital banking services.

-- These downstream correspondent banks and a number of major banks have provided significant funding to Continental, and the potential adverse impact on the liquidity and capital position of these funding banks could be significantly disruptive to the U.S. banking industry.

-- Its failure would cause the domestic and international money markets to be severely disrupted, resulting in an increase in the cost of funds which would affect a broad spectrum of financial institutions.

-- Its many corporate customers which maintain deposit relationships at and have other vital services performed by Continental would be severely harmed. These commercial, industrial and institutional customers would have difficulty reestablishing banking relationships; and, finally, a significant number of Cook County consumer depositors would be left without deposit services until new arrangements could be made.

Thus, the FDIC, for only the sixth time in its 50-year history, made a determination under Section 13(c) that a bank was "essential" to provide banking services to the community.

a. The Essentiality Test

The FDIC, in its application of 13(c), has no set formula as to what factors it uses to determine whether a bank is "essential." In the five previous applications, however, it has relied on a number of factors such as the number of depositors and the relative size of the bank,[1] the location of offices,[2] whether the bank is a significant provider of services (including check clearing and other vital banking services for other banks),[3] and the impact on the economy.[4]

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[1] First Pennsylvania Bank

[2] Bank of the Commonwealth; First Pennsylvania Bank

[3] Bank of Commonwealth

[4] First Pennsylvania Bank and Farmers Bank of the State of Delaware

The FDIC, however, is not limited to these factors. According to a memorandum prepared by the Acting General Counsel of the FDIC to the Board of Directors regarding the legal authority for Section 13(c) assistance to Continental, the Board may consider "such factors as how the failure of one significant bank could affect other banks and how the resulting economic and social tremors would undermine confidence in our country's banking system." The memorandum also takes a rather expansive view of what constitutes a "community" as that term is used in Section 13(c). The "community," the memorandum states, "is the trade area it serves, plus the regional and national banking community." Taking its cue from Corpus Juris Secundum [1] which says the term "community" is a flexible one, taking color from the context in which it appears, the memorandum states that "it can be the trade or service area to be served by the bank, and can extend beyond the geographic limits in which the offices of the bank are located." The broadness of the definition of "community" as applied by the FDIC in the Continental situation clearly raises the possibility that any bank with a significant level of business lending, a retail deposit base, correspondent relationships and a fair amount of lending abroad, would be "essential," meaning cost would be irrelevant. Although the statute apparently does not require any cost estimate to be made when there has been a determination that a bank is essential to the "community" prudence would dictate that some cost analysis be prepared by the FDIC.

Despite the scarcity of legislative history or other congressional guidance on what the definition of "community" is, it is doubtful that the Congress meant to include the possibility that such term could be interpreted as encompassing the globe. To provide some parameters or guidance for the federal regulators, the term community needs statutory clarification.

b. The Cost of Providing Section 13(c) Assistance by FDIC to Continental

Although the total FDIC cash outlay under the permanent financial assistance plan will be $1 billion, ultimately the gain or loss to the FDIC depends on any losses it may incur under the loan purchase arrangement and the price it gets on its sale of CIC stock.

[1] 15 A C.J.S.

The possibility that the FDIC may have a harder time collecting on the troubled loans (and thereby costing that agency more than it may have earlier anticipated) was made evident recently by Continental in a 10-Q filing with the Securities and Exchange Commission for the third quarter, 1984. It said:

> "Because of the mix, type, and volume of the transferred loans in particular and economic conditions in general, recoveries may well be worse than the bank's experience prior to transferring the loan" (emphasis added).

According to the filings, between July 26 and September 25, 1984, FDIC experienced losses of $28 million on its $3.5 billion loan portfolio. At this rate over a five-year period, the losses would exceed the $800 million equity currently held by Continental's shareholders. If the losses continue at this rate, the FDIC option to convert its preferred stock to shares of CIC common stock under the assistance plan would be exercised, thus wiping out all the current shareholders' stake in Continental. Although the success of the assistance plan depends on the overall performance of the transferred loans over the next five years, the general condition of the overall economy, and a number of other factors, the FDIC is prepared, it says, to commit additional capital or other forms of assistance should the permanent financial plan prove to be insufficient. The ultimate cost to the FDIC and the U. S. Government, therefore, continues to be unknown.

(l) CBO's Analysis of the Federal Budget Impact of Assistance to CINB

At the request of Chairman St Germain, the Congressional Budget Office prepared an analysis of the estimated federal budget impact of the assistance provided CINB.[1] A single joint estimate of the budgetary effects of the assistance plan was not feasible due to much uncertainty about key factors in the analysis—especially the value of loans transferred to the FDIC and the future value of stock of the bank's parent, Continental Illinois Corporation.

Based on three scenarios developed by CBO, estimates of net federal outlays over the 1984-1990 period varied between -$0.2 billion and $3.8 billion.

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[1] "Analysis of the Federal Budget Impact of Assistance to Continental Illinois National Bank and Trust Company," Congressional Budget Office, October 3, 1984.

Although the Federal Reserve and the Comptroller of the Currency played a role in developing the assistance plan, the significant budget impact derives from and is related to the activities of the FDIC. The CBO also concluded that the assistance plan could also affect the American and international financial systems and the U. S. economy, although "the budgetary effects are highly uncertain, and there is no reliable way to predict the nature of magnitude of possible secondary effects."

The value of the troubled loans acquired by the FDIC is the major uncertainty in the cost of the plan to the FDIC. As noted earlier, many of the loans are energy-related, real estate, or shipping and are of poor quality. To reflect this uncertainty, CBO's analysis is based on three alternative scenarios:

- an optimistic assumption -- that the FDIC will collect $4.0 billion of principal and interest on the $3.5 billion in transferred loans. (Continental's recent 10-Q filing would seem to dispel any likelihood that this assumption will become a reality);

- a pessimistic assumption -- that the FDIC will collect $2.0 billion of principal and interest on the $3.5 billion in transferred loans; and

- a midpoint assumption -- that the FDIC will collect about $3.0 billion of principal and interest on the $3.5 billion in transferred loans.

Taking the value of the troubled loans as indicated in each scenario and adding the CBO's assumptions on FDIC's receipts from sale of the convertible preferred and common stock using optimistic, pessimistic, and midpoint assumptions, with prices of $7.00, $1.00, and $4.00, respectively, per share of common stock, and including dividend income and loss of interest in the FDIC portfolio, the CBO projected the net effect on FDIC outlays from 1985-1990 to range from -$0.2 billion (using optimistic stock price and loan collection assumptions) to $3.8 billion (using pessimistic assumptions), with a midpoint estimate of $1.8 billion.

As indicated in the CBO analysis, if the FDIC incurs losses in the amounts suggested in the pessimistic and midpoint assumptions, the agency would reduce or eliminate insurance rebates that might otherwise be made. Even without considering the effect of Continental, because of the rise in the number of bank failures, a rebate to banks on their 1985 insurance assessments is not expected. These costs are ultimately passed on to depositors, borrowers, and/or stockholders.

What was even harder for CBO to assess was the potential budget impact of the alternatives available to the FDIC. For example, had the bank been closed, the FDIC would have been named receiver of the bank's assets. Insured deposits were only a little more than $3 billion. After paying off these depositors, the FDIC would begin paying off creditors and others as necessary from liquidation of the bank's assets. Once the FDIC had agreed to guarantee all deposits and general creditors, as Mr. Isaac so announced on May 17, 1984, FDIC's direct liability would have been about $38 billion in the event the CINB failed, although its net liability after recoveries would have been considerably less. Nonetheless, the CBO concluded that "... The failure of a bank of CI's magnitude might have caused a general loss of confidence in American banking institutions, and the long-term budgetary and economic impact, although impossible to measure, could have been enormous."

(2) FDIC's Cost Analysis

Although the Subcommittee eventually had the benefit of the CBO analysis, the Subcommittee was unable to obtain comprehensive and meaningful financial data which it presumed the regulators (particularly the FDIC) had prepared in their effort to arrive at an appropriate decision as to what to do in Continental.

One of the major controversies that erupted during the Committee's inquiry was whether a cost analysis was prepared by the regulators to determine whether indeed the program finally agreed upon would not only help the depositors at Continental, but whether the decision would work well for the U. S. banking system at large and, indeed, whether it was in the best interest of the taxpayers of this country. The Comptroller of the Currency insisted that a cost analysis was done (although the OCC did not have the information). He said it was available:

> "I think what we are talking about are analyses of the impact on the FDIC of alternative ways of handling Continental in terms of a payoff, in terms of the merger analyses with other banks, in terms of the final solution that was put in place."

It is not clear to what analysis Mr. Conover was referring, but there was an FDIC memorandum dated June 19, 1984, prepared at Chairman Isaac's request, titled "Exposure of Downstream Correspondent Banks to Continental Illinois." In that memorandum the FDIC staff identified 2,299 banks which had deposits or funds invested in CINB. Of these, 976 banks had an exposure in excess of $100,000. The amount of this exposure was calculated as a percent of the correspondent bank's equity. Although the staff made no adjustments for deposit insurance coverage for the deposits of the 976 banks or anticipated recovery on CINB's liquidation, they concluded that 66 banks had an exposure to CINB in excess of 100 percent of their capital and another 113 banks had an exposure to CINB between 50 and 100 percent of their capital.

Although the FDIC memorandum does not say so, Mr. Conover, in testimony before the Financial Institutions Subcommittee on September 19, 1984, without identifying his source of information, concluded:

> "If Continental had failed and had been treated as a pay off, certainly those 66 banks would have failed and probably a goodly number of the other 113 would have failed, if not immediately thereafter, certainly within some timeframe afterwards. So let us say that we could easily have seen another hundred banking failures."

In contrast, Chairman Isaac, when testifying before the Subcommittee on October 4, 1984, vehemently denied ever predicting the number of failures that would have occurred if a deposit payoff had been made in Continental:

> "We have never predicted, I have never predicted, this agency has never predicted the number of banks that would have failed as a result of a deposit payoff in Continental.... My point is, Mr. Chairman, the FDIC has never represented that any portion of those 2,300 banks would have failed. We have never stated how many of those 2,300 banks would have failed.... I would be willing to tell you fewer than 25 would have failed in the first round...."

Adding further to the already confusing state of affairs, Mr. Isaac was asked by Chairman St Germain to produce the analyses that Mr. Isaac had stated were done in June and July. Mr. Isaac replied, "...there are no written analyses."

Further testimony follows:

"Chairman St Germain. It was all mental?

"Mr. Isaac. That is correct. Estimates.

"Chairman St Germain. Estimates. Mental estimates?

"Mr. Isaac. That is correct.

"Chairman St Germain. In other words, guesses.

"Mr. Isaac. That is what this business—

"Chairman St Germain. Educated guesses?

"Mr. Isaac. That is what this business is, educated guesses.

"....

"Mr. Isaac. At the point when we were doing this it was a totally moot question. Continental had already been taken care of on May 7. We had decided that the bank would not be permitted to fail on May 17th. "Anything we did in June or July—

"Chairman St Germain. Oh, so you made a decision without ever having any written analyses, right?

"Mr. Isaac. Pardon?

"Chairman St Germain. You made that decision without having ever run these numbers?

"Mr. Isaac. I didn't tell you that. I told—

"Chairman St Germain. That is what you just said. It would have been moot because you said a decision was made on May 17.

"Mr. Isaac. I told you. I told you, Mr. Chairman, that I had some rough numbers that I was given at that time. We could not come up with better numbers. We did not have time.

"Chairman St Germain. You said you got those numbers in June or July.

"Mr. Isaac. No. I got the first numbers in May.

"Chairman St Germain. In May?

"Mr. Isaac. Yes.

"Chairman St Germain. Those are just rough numbers, right?

"Mr. Isaac. Very rough."

The colloquy recounted above may reflect the imprecise statutory language found in Section 13(c). It may be that in its attempt to provide wide latitude and give greater flexibility to the regulators in such emergency situations, Congress may have sacrificed, to some degree, the accountability that such regulators should be called upon to provide. Admittedly, the Congress finds itself on the horns of a dilemma: It is absolutely necessary that the banking regulators be given certain powers (in some instances, extraordinary) not given to other governmental agencies, to provide immediate and broad assistance to troubled financial institutions, which if not provided, could have far-reaching and disastrous consequences for our national economy. However, these powers must in some way be offset by or balanced with equally necessary precautions which absolutely insure that such regulators are accountable for their actions and are subject to intensive Congressional review. There are no adequate procedures, at present, to accomplish this necessity. Hence, the decision by the regulators to provide 13(c) assistance, to declare that the CINB was essential to provide the banking needs in the community in this case, and to do so without having done, apparently, a comprehensive cost analysis or evaluation, and without having to confer with any other authorities, raises substantial questions as to whether the regulators should continue to have such absolute authority and whether such a momentous decision should be left to their "sole discretion." Perhaps, Section 13(c) should be left alone. Perhaps not. At the minimum, however, 13(c) should receive a thorough Congressional review. The issue is whether, in light of Continental, Section 13(c) assistance as it is now written is the most appropriate means to handle all sizes of troubled banks, whether the remedies provided therein are appropriate, whether they truly serve the public interest, and whether, in its desire to provide flexibility, Congress may have also, inadvertently, relieved the regulators of accountability for their actions, or whether, unwittingly, it may have cast its blessings on banks "too big to fail," to the prejudice and detriment of smaller institutions.

In support of its deliberations and findings (and in addition to the Comptroller's letters), the Board of Directors of the FDIC reviewed two memoranda, each of which was submitted to the Board at its meetings on May 17 and July 25, 1984, respectively, by

Robert V. Shumway, Director, Division of Bank Supervision for the Federal Deposit Insurance Corporation. The memoranda concluded that "continued operation of Continental is essential to provide adequate banking services in its community and that the FDIC provide appropriate assistance pursuant to Section 13(c) of the FDI Act to prevent the closing of the bank."

In support thereof, both memoranda, which are similar in content, stated in substance the following:

- that CINB was continuing to experience severe funding difficulties; that in addition to the $2 billion of subordinated notes purchased by the FDIC with participation of large commercial banks (pursuant to the Temporary Assistance Plan of May 17, 1984), borrowings from the Federal Reserve of Chicago continued to increase at a substantial level;
- that CINB had utilized $4.13 of the $4.5 billion line of credit that the bank had established with 28 large commercial banks; and
- that the Comptroller of the Currency in letters to the FDIC of May 17 and July 25, 1984, as noted above, urged that assistance under 13(c) be provided.

Mr. Shumway not only concluded that 13(c) assistance should be provided because there were sufficient facts which indicated that CINB was in danger of closing, he also addressed the issue of the amount of assistance to be provided in the May 17 memorandum, saying that "(w)e have determined that the amount of assistance required to facilitate a merger, consolidation or the sale of assets and assumption of the liabilities of Continental is an amount in excess of that amount reasonably necessary to save the cost of liquidating, including paying the insured accounts, of Continental. However, we believe that the continued operation of Continental is essential to provide adequate banking services to its community." His memorandum of July 25, 1984 advised that

Continental's financial condition had worsened, but again confirmed that Continental was "essential." Reasons given for concluding that Continental was "essential" were stated in the memorandum, dated July 25, 1984:

> "Continental is one of the ten largest banks in the United States, with $34 billion in assets, 57 offices in 14 states and 29 foreign countries staffed by several thousands of people. It provides a full range of commercial, individual and trust services throughout the midwest, has major correspondent relationships throughout the world. For these reasons and others listed below DBS continues to believe that the continued operation of Continental is essential to provide adequate banking services in its communities.
>
> "-- Continental has a major correspondent relationship with hundreds of downstream correspondent banks. These banks rely on Continental for check clearing and other vital banking services. It would be extremely disruptive to these banks and their customers should these services be interrupted. It also would be very difficult to reestablish such a large number of correspondent relationships in a short time.
>
> "-- Many downstream correspondent banks and a number of major banks have provided significant funding to Continental through deposit balances (domestic or offshore) and Fed Funds sold. The potential adverse impact on the liquidity and capital position of these funding banks could be significantly disruptive to the U.S. banking industry.
>
> "-- A failure of Continental would severely disrupt international and domestic money markets. It would cause foreign and domestic investors to avoid bank CD's in general or demand a large premium for them. This increase in the cost of funds would adversely affect a broad spectrum of financial institutions.
>
> "-- Many corporate relationships would be severely disjointed if Continental were to fail. It has domestic commercial and industrial loans of about $13 billion (and financing commitments of about $15 billion). Many of these entities also maintain deposit relationships and have additional vital services such as payroll, performed by Continental. Additionally Continental handles clearing accounts of major commodities exchanges. An interruption of functions provided to commercial customers would severely disrupt the operation of commodity exchanges and harm the commercial, industrial and institutional customers because of the difficulty for these entities to reestablish banking relationships.
>
> "-- A significant portion of consumer deposits in Cook County are held by Continental; if Continental were to fail, these depositors would be left without deposit services until new relationships could be established."

c. Resignation of Continental's Top Three Executives

Despite the fact that the management decisions of CINB's top executives directly contributed to the enormous problems at that institution (as is documented in Chapter II of this report), its board of directors, nevertheless, decided to give very handsome separation packages to its three top executives, Messrs. Anderson, Miller, and Perkins, all of whom agreed to early retirement effective April 30, 1984. Although the termination agreements may not be characterized, by some, as "golden parachutes," in the sense that such packages are normally reserved to protect key executives in a company which may be subject to a hostile tender offer—which is clearly not the Continental case--these particular executives did fairly well by any standards.

In addition to other benefits, Mr. Anderson received a one-time lump sum pension supplement of nearly $270,000, a monthly consulting fee of over $12,000 through July 1986, a cash payment of $77,000 reflecting the value of forfeited shares of restricted stock due him had he retired at age 65, certain financial advisory services, and payment of dues for certain clubs. Messrs. Perkins and Miller also received handsome termination agreements.[1]

An OCC legal memorandum dated July 3, 1984, titled, "Possible OCC Action Against 'Golden Parachutes' at Continental Illinois" concluded that the Comptroller might have difficulty enforcing any action against Continental or the three executives given the difficulty of proving that the termination agreements constituted an unsafe or unsound banking practice considering the bank's size, financial condition, and industry practices regarding termination agreements. However, it cited another internal memorandum from the Assistant Director of Litigation to the Deputy Chief Counsel, which concluded that "... it might be advisable for the FDIC, considering the leverage it now has over

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[1] Hearings, pp. 176 and 188-189

Continental, to 'suggest' that these contracts be rescinded as they are not in the bank's best interest." [2]

This conclusion was further supported by Mr. Conover during his appearance before the Subcommittee on its inquiry into Continental on September 19, 1984. He said:

> "I have talked both to the subsequent management of the bank and the FDIC, about this subject. I believe the FDIC is at least considering taking, and probably will take, some action regarding those contracts... I think the important point is that either the bank, itself, or the FDIC is in a better position to do something about this problem than we are. I think they ought to go ahead and do it."[3]

Recently, the FDIC initiated action to rescind the termination agreements.

As a practical matter, it is unlikely that separation packages would ever adversely affect the safety and soundness of an institution the size of Continental. More to the point, however, such packages as agreed to in the Continental situation could threaten the loss of public confidence in the entire banking industry. In light of the FDIC's apparent difficulty in resolving this issue, the Committee may want to consider a legislative remedy.

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[2] Hearings, p. 187

[3] Hearings, p. 377

CONSOLIDATED STATEMENT OF INCOME
Continental Illinois Corporation and Subsidiaries

Year ended 12/31 $ in thousands	1984 (3/31)	1983	1982	1981	1980
Interest & fees on loans	303,736	3,433,274	4,683,330	4,796,322	3,448,373
Lease financing income	20,979	93,907	123,373	90,327	63,338
Interest on deposits with banks		216,107	499,437	767,149	638,335
Int.& dividends on investment securities					
Taxable income	25,323	103,316	129,363	148,910	133,213
Income exempt from Fed.inc.taxes	10,702	49,739	59,667	66,196	79,931
Trading account interest	9,559	29,182	36,308	36,332	29,307
Int.on Fed.funds sold & securities purchased under agreements to resell	10,149	39,499	47,376	33,231	63,376
Total interest income	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Interest on deposits	373,309	2,191,239	3,100,409	3,316,677	2,397,441
Int.on Fed.funds purch'd & secur. sold under agreements to repurchase	126,932	312,368	1,336,769	1,403,311	1,368,799
Interest on other borrowings	79,066	301,163	400,266	336,993	330,386
Interest on long-term debt	33,319	161,632	131,222	90,993	63,397
Total interest expense	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Net interest income	149,340	830,162	890,600	803,731	730,296
Provision for credit losses	140,200	392,200	492,700	122,200	96,200
Net interest income after provision for credit losses	9,200	437,162	378,600	681,781	636,296
Trust income	13,137	62,368	63,421	33,630	40,109
Secur.trading profits & commissions	5,318	19,648	39,882	27,888	6,122
Foreign exchange profits (losses)	7,226	10,587	(1,428)	31,133	32,286
All other income	77,493	307,222	221,182	209,766	160,412
Total other operating income	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Net int.& other operating income	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Salaries and wages	80,702	309,639	293,373	263,616	227,738
Pension, profit sharing, other employee benefits	21,230	76,730	61,371	76,877	61,473
Net occupancy expense	20,136	87,410	72,726	63,767	33,316
Eqpt rentals,deprec.& maintenance	12,673	46,918	41,295	36,837	36,301
Other expense	33,377	236,443	204,727	130,739	173,376
Total other operating expense	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Income before inc.taxes & securities gains or losses	(107,796)	116,092	46,170	386,336	319,711
Applicable income taxes (credits)	—	16,176	(38,206)	126,019	93,368
Inc.before security gains or losses	(107,796)	99,918	84,376	260,313	226,143
Secur.gains or (losses) less applicable income taxes 1	373	1,243	(6,489)	(3,692)	798
Extraordinary item, net of tax	136,628	7,136	—	--	--
Net income	29,407	108,312	77,187	256,623	223,941
Per common share					
Income before extraordinary item		$ 2.46	$ 1.95	$ 6.46	$ 5.73
Extraordinary item		$ 0.17	$ —	--	--
Net income		$ 2.63	$ 1.95	$ 6.46	$ 5.73
Cash dividends declared		$ 2.30	$ 2.30	$ 1.90	$ 1.70
Average common shares outstanding (in thousands)		40,363	39,777	39,337	39,236

1 Gain on sale of charge card operations.

* Due to the availability of information, certain line items have been rounded or reasonably approximated. Also, inadequate information has prevented certain line items from being stated individually. In some cases, totals were used to maintain consistency for comparative purposes.

CONSOLIDATED STATEMENT OF INCOME
Continental Illinois Corporation and Subsidiaries

Year ended 12/31 ($ in thousands)	1979	1978	1977	1976	1975
Interest & fees on loans	2,437,870	1,476,837	1,022,987	915,372	1,017,396
Lease financing income	39,190	34,294	29,772	24,918	21,330
Interest on deposits with banks	433,931	307,833	224,991	217,617	32,619
Int. & dividends on investment securities:					
Taxable income	73,833	67,970	71,628	69,116	77,397
Income exempt from Fed. inc. taxes	77,368	73,739	70,903	63,607	46,137
Trading account interest	19,310	12,263	11,060	10,326	13,169
Int. on Fed. funds sold & securities purchased under agreements to resell	62,103	39,000	17,300	3,300	[illegible]
Total interest income	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Interest on deposits	1,739,763	1,049,319	696,109	661,192	668,449
Int. on Fed. funds purch'd & secur. sold under agreements to repurchase			233,530	182,784	139,919
Interest on other borrowings	106,611	666,161	27,398	23,603	16,377
Interest on long-term debt	47,920	33,463	23,712	12,389	15,109
Total interest expense	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Net interest income	573,333	506,863	441,892	432,488	433,136
Provision for credit losses	79,300	62,300	33,300	35,200	73,300
Net interest income after provision for credit losses	503,833	444,363	388,392	397,488	360,136
Trust income	37,616	36,331	36,381	33,618	31,153
Secur. trading profits & commissions	13,730	11,233	10,936	17,299	17,282
Foreign exchange profits (losses)	13,383	13,367	13,003	7,133	
All other income	141,983	103,713	79,193	66,993	56,173
Total other operating income	207,730	164,736	139,436	[illegible]	[illegible]
Net int. & other operating income	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Salaries and wages	199,301	164,338	143,600	131,937	119,336
Pension, profit sharing, other employee benefits	31,187	44,436	37,180	32,348	29,606
Net occupancy expense	41,401	33,338	30,228	23,309	25,660
Eqpt. rentals, deprec. & maintenance	27,349	20,889	18,638	14,888	13,367
Other expense	144,196	118,401	91,231	85,398	70,346
Total other operating expenses	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Income before inc. taxes & securities gains or losses	367,331	227,177	204,931	188,230	193,161
Applicable income taxes (credits)	32,923	58,433	63,727	57,468	76,164
Inc. before security gains or losses	194,126	168,726	144,204	130,762	118,997
Secur. gains or (losses) less applicable income taxes	1,681	(907)	(1,081)	(2,938)	(6,107)
Extraordinary item, net of tax	--	--	--	--	--
Net income	195,807	167,817	143,123	127,804	112,390
Per common share:					
Income before extraordinary item	$ 4.99	$ 4.49	$ 4.32	$ 3.63	$ 4.49
Extraordinary item	--	--	--	--	--
Net income	$ 4.99	$ 4.49	$ 4.32	$ 3.63	$ 4.49
Cash dividends declared	$ 1.32	$ 1.32	$ 1.26	$ 1.18	$ 1.23
Average common shares outstanding (in thousands)	39,193	37,336	35,337	35,130	34,736

* Due to the availability of information, certain line items have been rounded or reasonably approximated. Also, inadequate information has prevented certain line items from being stated individually. In some cases, totals were used to maintain consistency for comparative purposes.

CONSOLIDATED STATEMENT OF INCOME
Continental Illinois Corporation and Subsidiaries

Year ended 12/31 ($ in thousands)	1974	1973	1972	1971	1970
Interest & fees on loans	1,249,113	716,490	536,674	518,388	573,238
Lease financing income	19,000	5,000	3,300	3,300	--
Interest on deposits with banks	207,311	133,348	33,738	11,621	2,393
Int.& dividends on investment securities					
Taxable income	73,816	50,513	43,293	63,339	41,837
Income exempt from Fed.inc.taxes	44,638	48,826	43,843	39,303	36,383
Trading account interest	25,074	14,344	6,383	10,733	36,236
Int.on Fed.funds sold & securities purchased under agreements to resell	16,300	13,300	9,300	4,300	
Total interest income	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Interest on deposits	913,323	538,836	263,032	208,939	198,962
Int.on Fed.funds purch'd & secur. sold under agreements to repurchase	333,317	189,364	43,019	37,303	99,367
Interest on other borrowings	37,431	32,461	16,316	9,732	
Interest on long-term debt	9,133	6,632	5,337	--	--
Total interest expense	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Net interest income	297,848	219,916	211,393	194,380	188,382
Provision for credit losses	32,900	13,200	12,133	12,163	14,221
Net interest income after provision for credit losses	264,948	206,616	199,260	179,218	173,461
Trust income	31,463	31,404	29,773	27,328	22,732
Secur.trading profits & commissions	13,246	9,381	2,303	4,299	--
Foreign exchange profits (losses)	--	--	--	--	--
All other income	64,300	59,000	33,300	26,300	17,363
Total other operating income	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Net int.& other operating income	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Salaries and wages	103,924	89,618	77,378	64,764	
Pension, profit sharing, other employee benefits	24,099	20,401	17,649	13,936	76,361
Net occupancy expense	21,009	17,679	13,940	13,276	
Eqpt rentals, deprec.& maintenance	10,769	8,632	6,384	6,491	43,336
Other expenses	61,480	48,125	38,123	33,681	
Total other operating expenses	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Income before inc.taxes & securities gains or losses	130,394	119,936	107,426	99,291	93,739
Applicable income taxes (credit)	36,488	33,619	29,296	29,493	29,394
Inc.before security gains or losses	93,906	86,303	78,130	69,798	64,343
Secur.gains or (losses) less applicable income taxes	(226)	(833)	263	576	(6,813)
Extraordinary item, net of tax	--	--	--	--	--
Net income	93,680	85,470	78,393	70,374	57,530
Per common share					
Income before extraordinary item	$ 3.31	$ 4.94	$ 4.33	$ 4.11	$ 3.38
Extraordinary item	--	--	--	--	--
Net income	$ 3.31	$ 4.94	$ 4.33	$ 4.11	$ 3.38
Cash dividends declared	1.10	$ .97	$ .92	$ .88	$ .82
Average common shares outstanding (in thousands)	36,716	36,383	36,433	36,264	36,306

* Due to the availability of information, certain line items have been rounded or reasonably approximated. Also, inadequate information has prevented certain line items from being stated individually. In some cases, totals were used to maintain consistency for comparative purposes.

CONSOLIDATED STATEMENT OF CONDITION
Continental Illinois Corporation and Subsidiaries

December 31 ($ in thousands)*	1984[1]	1983	1982	1981	1980
Assets					
Cash and due from banks	2,039,281	2,369,566	2,179,386	2,313,080	4,361,304
Interest-bearing deposits	3,413,990	3,386,324	1,880,333	3,382,703	4,294,343
Fed. funds sold and securities purch'd under agrmts to resell	646,739	676,776	444,226	499,817	417,237
Trading account assets	761,666	361,389	833,463	169,164	123,363
Investment securities	1,814,336	1,762,394	2,364,764	2,169,303	2,303,826
Loans:					
Domestic	29,329,867	20,187,123	22,333,107	22,131,013	18,328,432
Foreign		10,203,246	10,817,216	10,344,482	8,381,366
Lease financing receivables	1,043,482	1,038,400	1,173,473	1,122,729	739,333
Total loans and lease receivables	30,373,332	31,428,769	34,343,799	33,299,226	27,429,731
Less: Unearned income	267,333	269,720	322,331	423,000	262,463
Reserve for credit losses	401,386	382,363	381,283	339,169	246,411
Net loans and lease receivables	29,704,613	30,776,686	33,339,163	32,387,037	27,120,623
Properties and equipment	323,399	337,363	362,261	298,713	276,479
Customers' liability on acceptances	870,013	839,318	690,442	2,469,917	1,398,371
Other assets	1,170,372	967,377	1,386,909	1,131,499	1,287,488
Total assets	41,430,809	42,097,371	42,899,626	46,971,733	42,089,408
Liabilities					
Deposits:					
Domestic offices	10,144,383	13,327,978	12,690,041	14,963,103	13,379,326
Foreign offices	18,133,706	15,903,490	15,486,980	14,630,902	13,736,361
Total deposits	28,278,787	29,231,468	28,177,021	29,594,005	27,115,687
Fed. funds purch'd & securities sold under agreemts to repurchase	3,193,733	4,830,443	3,920,332	7,998,482	7,361,300
Other borrowings	2,101,843	2,677,067	4,028,928	3,316,740	2,203,967
Acceptances outstanding	870,013	870,106	693,788	2,477,137	1,398,316
Other liabilities	1,231,387	1,210,378	1,100,169	1,316,402	1,110,719
Long-term debt	1,347,381	1,333,433	1,273,291	362,397	476,117
Total liabilities	39,622,636	40,275,797	41,189,323	45,261,083	40,364,446
Stockholders' Equity					
Preferred stock	39,400	89,400		--	--
Common stock	200,780	200,780	199,761	198,309	196,690
Capital surplus	326,906	326,893	323,323	322,812	317,826
Retained earnings	1,021,437	1,016,339	989,244	989,871	810,428
Accumulated translation adjustment	(10,326)	(9,933)	(6,433)	--	--
Total	1,828,283	1,821,639	1,713,097	1,710,692	1,324,942
Less - Treasury stock at cost	112	63	202	--	--
Total Stockholders' Equity	1,828,173	1,821,276	1,709,393	1,710,692	1,324,942
Total Liabilities & Stockholders' Equity	41,450,809	42,097,371	42,899,626	46,971,733	42,289,408

1 As of March 31, 1984.

* Due to the availability of information, certain line items have been rounded or reasonably approximated. Also, inadequate information has prevented certain line items from being stated individually. In some cases, totals were used to maintain consistency for comparative purposes.

CONSOLIDATED STATEMENT OF CONDITION
Continental Illinois Corporation and Subsidiaries

December 31 ($ in thousands)	1979	1978	1977	1976	1975
Assets					
Cash and due from banks	3,366,816	3,397,143	2,379,378	1,323,849	1,761,448
Interest-bearing deposits	4,333,140	3,926,679	3,932,661		
Fed.funds sold and securities purch'd under agr'mts to resell	308,176	361,391	133,326	3,962,366	3,233,981
Trading account assets	189,101	116,369	299,792	383,432	203,323
Investment securities	2,226,340	2,174,380	2,301,382	2,366,319	2,281,366
Loans					
Domestic	16,366,130	12,796,073	10,383,300	9,601,363	9,336,236
Foreign	6,813,362	5,630,033	3,980,117	3,337,468	2,736,378
Lease financing receivables	609,888	431,116	430,396	326,362	276,067
Total loans and lease receivables	23,791,380	18,857,926	15,263,811	13,233,676	12,363,299
Less: Unearned income	213,376	163,303	121,327	107,300	97,300
Reserve for credit losses	232,180	191,237	168,166	112,271	161,190
Net loans and lease receivables	23,345,826	18,503,386	14,976,420	13,011,403	12,106,409
Properties and equipment	226,342	193,379	166,966	172,330	87,396
Customers' liability on acceptances	1,092,422	900,403	233,893	123,313	176,736
Other assets	981,231	772,123	608,364	311,262	360,266
Total assets	33,790,119	31,028,443	25,800,230	21,986,899	20,212,761
Liabilities					
Deposits					
Domestic offices	12,317,200	12,162,717	10,089,706	8,708,640	9,331,906
Foreign offices	11,690,300	9,017,533	8,666,281	7,108,487	5,838,481
Total deposits	24,007,500	21,180,250	18,755,785	15,817,127	15,290,385
Fed.funds purch'd & securities sold under agreements to repurch.	3,363,670	3,163,396	4,183,033	3,981,329	2,836,426
Other borrowings	1,901,331	1,492,881	630,272	333,328	313,139
Acceptances outstanding	1,096,936	903,337	237,766	126,269	177,268
Other liabilities	1,326,760	680,202	386,239	337,280	496,900
Long-term debt	329,332	430,437	337,330	263,293	130,200
Total liabilities	32,427,217	29,832,961	24,788,183	21,073,326	19,390,138
Stockholders' Equity					
Preferred stock	--	--	--	--	136
Common stock	196,093	193,839	177,826	178,333	173,937
Capital surplus	310,369	308,646	428,148	427,263	428,737
Retained earnings	636,438	321,239	406,123	307,793	222,793
Accumulated translation adjustment	--	--	--	--	--
Total	1,362,902	1,223,726	1,012,393	912,373	825,633
Less - Treasury stock at cost	--	--	--	--	--
Total Stockholders' Equity	1,362,902	1,222,726	1,012,093	912,373	825,603
Total Liabilities & Stockholders' Equity	33,790,119	31,028,663	25,800,230	21,986,899	20,212,761

* Due to the availability of information, certain line items have been rounded or reasonably approximated. Also, inadequate information has prevented certain line items from being stated individually. In some cases, totals were used to maintain consistency for comparative purposes.

CONSOLIDATED STATEMENT OF CONDITION
Continental Illinois Corporation and Subsidiaries

December 31 ($ in thousands)	1974	1973	1972	1971	1970 [1]
Assets					
Cash and due from banks	1,903,869	1,336,970	1,779,592	1,360,999	1,803,907
Interest-bearing deposits					
Fed. funds sold and securities purch'd under agrmts to resell	2,131,719	2,237,921	1,393,336	902,863	913,170
Trading account assets	336,348	339,123	181,290	181,392	413,325
Investment securities	1,776,443	2,369,306	1,802,936	1,707,646	1,319,447
Loans					
Domestic	10,047,666	8,216,269	5,946,998	4,016,679	3,476,136
Foreign	2,607,392	1,777,829	1,173,306	379,614	--
Lease financing receivables	102,119		--	--	--
Total loans and lease receivables	12,758,077	9,994,098	7,120,302	4,396,293	3,476,136
Less: Unearned income [3]	--	--	--	--	--
Reserve for credit losses	137,378	162,930	129,330	125,619	[illegible]
Net loans and lease receivables	12,600,699	9,831,168	6,990,972	4,770,634	3,332,436
Properties and equipment	58,472	49,293	46,173	43,627	32,739
Customers' liability on acceptances	271,363	86,930	111,098	267,397	232,746
Other assets	322,070	337,437	196,126	762,729	441,337
Total assets	19,640,767	16,777,230	12,679,361	9,333,107	8,488,498
Liabilities					
Deposits					
Domestic offices	9,732,612	8,376,870	6,936,739	5,766,402	4,880,436
Foreign offices	5,713,567	4,021,333	3,266,436	2,691,736	[illegible]
Total deposits	15,446,179	12,398,203	10,203,175	8,458,138	7,156,625
Fed. funds purch'd & securities sold under agreements to repurchase	1,967,316	2,203,639			486,307
Other borrowings	457,403	618,406	1,342,339	313,363	172,446
Acceptances outstanding	272,313	86,443	116,216	251,468	204,139
Other liabilities	344,329	386,337	301,758	147,717	137,771
Long-term debt	150,000	100,000	100,000	--	--
Total liabilities	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Stockholders' Equity					
Preferred stock	136	136	186	136	--
Common stock	173,463	173,393	172,339	171,339	168,441
Capital surplus	425,291	421,170	393,300	317,227	316,337
Retained earnings	132,472	97,309	71,928	93,467	31,390
Accumulated translation adjustment	--	--	--	--	--
Total	731,612	691,960	638,433	584,439	516,190
Less - Treasury stock at cost	--	--	--	--	
Total Stockholders' Equity	731,612	691,960	638,433	584,439	516,190
Total Liabilities & Stockholders' Equity	19,640,767	16,777,230	12,679,361	9,333,107	8,488,498

1 For Continental Illinois National Bank and Trust Company of Chicago and Subsidiaries only.

3 Due to lack of information in years 1974 to 1970, the unearned income line item was netted against the Loans (Domestic & Foreign) and Lease receivables line items. Lack of available information prevented a further breakdown of Lease receivables for the periods 1973 through 1970.

\-- Due to the availability of information, certain line items have been rounded or reasonably approximated. Also, inadequate information has prevented certain line items from being stated individually. In some cases, totals were used to maintain consistency for comparative purposes.

CONSOLIDATED STATEMENT OF CONDITION
Continental Illinois Corporation and Subsidiaries
(as percent of total assets)

December 31	1984(1)	1983	1982	1981	1980	1979	1978	1977
Assets								
Cash and due from banks	4.9	6.1	5.1	5.4	10.4	9.4	12.3	11.2
Interest-bearing deposits	5.2	8.3	4.4	10.8	10.2	11.3	12.6	13.2
Fed funds sold and securities purch'd under agrmts to resell	1.6	1.4	1.0	1.1	1.3	.9	1.2	.7
Trading account assets	1.8	1.3	2.0	.4	.3	.3	.4	1.2
Investment securities	4.6	4.2	4.8	4.6	6.3	6.2	7.0	8.7
Loans								
Domestic	70.4	48.0	51.4	47.1	44.3	43.7	41.2	42.2
Foreign		26.2	25.2	21.4	19.9	19.0	1.82	15.4
Lease financing receivables	2.3	2.2	1.7	2.4	1.7	1.7	1.3	1.5
Total loans and lease receivables	73.3	76.7	79.4	70.9	65.6	64.3	60.2	59.2
Less: Unearned income	.6	.6	.8	.9	.6	.6	.3	.5
Reserve for credit losses	1.3	.9	.9	.6	.6	.8	.6	.7
Net loans and lease receivables	71.7	75.1	77.7	69.4	64.4	63.3	59.8	58.0
Properties and equipment	.5	.8	.8	.6	.7	.6	.6	.6
Customers' liability on acceptances	2.1	2.0	1.6	5.3	4.3	3.1	2.9	1.3
Other assets	4.3	3.1	3.3	3.2	3.6	3.7	3.0	3.4
Total assets	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Liabilities								
Deposits								
Domestic offices	26.5	32.1	29.6	31.9	32.3	35.0	39.1	39.1
Foreign offices	41.7	37.1	36.1	31.1	32.6	32.1	29.0	33.6
Total deposits	68.2	69.3	65.7	63.0	64.9	67.1	68.1	72.7
Fed funds purch'd & securities sold under agreemts to repurchase	12.9	11.5	13.8	17.0	17.3	16.4	16.6	17.3
Other borrowings	6.3	6.4	9.4	6.4	5.2	5.3	4.8	1.7
Acceptances outstanding	2.1	2.1	1.6	5.3	4.3	3.1	2.9	1.0
Other liabilities	3.0	2.9	2.6	2.8	2.6	2.9	2.2	2.1
Long-term debt	3.0	3.0	3.0	1.8	1.6	1.3	1.2	1.4
Total liabilities	95.6	95.7	96.3	96.4	96.4	96.2	96.1	96.1
Stockholders' Equity								
Preferred stock	.2	.2	-	-	-	-	-	
Common stock	.3	.3	.3	.4	.3	.3	.6	.7
Capital surplus	1.3	1.3	1.2	1.1	1.2	1.4	1.6	1.7
Retained earnings	2.5	2.4	2.3	2.1	1.9	1.8	1.7	1.6
Accumulated translation adjustment	-	-	-	-	-	-	-	-
Total	4.4	4.3	4.0	3.6	3.6	3.5	3.9	3.9
Less - Treasury stock at cost	-	-	-	-	-	-	-	-
Total Stockholders' Equity	4.4	4.3	4.0	3.6	3.6	3.8	3.9	3.9
Total Liabilities & Stockholders' Equity	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

1 As of March 31, 1984.

* Due to the availability of information, certain line items have been rounded or reasonably approximated. Also, inadequate information has prevented certain line items from being stated individually. In some cases, totals were used to maintain consistency for comparative purposes.

CONSOLIDATED STATEMENT OF CONDITION
Continental Illinois Corporation and Subsidiaries
(as percent of total assets)

December 31	1978	1977	1976	1973	1972	1971	1970 [2]
Assets							
Cash and due from banks	6.9	8.7	9.7	9.3	14.0	13.3	10.8
Interest-bearing deposits / Fed. funds sold and securities purch'd under agrmts to resell	17.9	16.0	11.0	13.4	12.3	9.1	10.6
Trading account assets	1.7	1.0	1.8	2.0	1.4	1.8	4.8
Investment securities	10.8	11.3	9.0	12.4	14.2	17.2	17.3
Loans							
Domestic	43.7	46.2	51.2	49.1	46.8	40.3	40.0
Foreign	15.3	13.6	13.3	10.6	9.2	8.8	
Lease financing receivables	1.3	1.4	.2	-	-	-	-
Total loans and lease receivables	60.4	61.2	65.0	59.7	56.1	49.2	40.3
Less: Unearned income [3]	.3	.3	-	-	-	-	-
Reserve for credit losses	.7	.8	.8	.9	1.0	1.3	.6
Net loans and lease receivables	59.2	59.9	64.2	58.9	55.0	47.9	38.6
Properties and equipment	.5	.4	.3	.3	.4	.4	.4
Customers' liability on acceptances	.6	.9	1.4	.3	.9	2.3	2.3
Other assets	1.3	1.8	1.7	3.2	1.3	7.7	3.1
Total assets	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Liabilities							
Deposits							
Domestic offices	39.6	44.3	49.7	51.3	54.6	57.9	57.3
Foreign offices	32.3	29.4	29.1	26.0	24.1	27.0	23.0
Total deposits	71.9	73.8	78.8	77.3	78.7	84.9	80.3
Fed. funds purch'd & securities sold under agreemts to repurchase	18.1	14.3	10.0	13.4	12.1		3.6
Other borrowings	1.3	1.3	2.3	3.7		3.2	2.0
Acceptances outstanding	.6	.9	1.4	.3	.9	2.3	2.3
Other liabilities	2.3	2.4	2.8	2.1	2.4	1.3	1.6
Long-term debt	1.1	.9	.9	.4	.8	-	-
Total liabilities	95.9	95.9	96.2	95.9	95.0	94.1	93.8
Stockholders' Equity							
Preferred stock	-	-	-	-	-	-	
Common stock	.8	.9	.9	1.0	1.4	1.7	1.9
Capital surplus	1.9	2.1	2.2	2.3	3.1	3.2	3.4
Retained earnings	1.4	1.1	.8	.6	.6	1.3	.4
Accumulated translation adjustment	-	-	-	-			
Total	4.1	4.1	3.8	4.1	5.0	5.9	6.2
Less - Treasury stock at cost	-		-	-	-	-	
Total Stockholders' Equity	4.1	4.1	3.8	4.1	5.0	5.9	6.2
Total Liabilities & Stockholders' Equity	100.0	100.0	100.0	100.0	100.0	100.0	100.0

2 For Continental Illinois National Bank and Trust Company of Chicago and Subsidiaries only.

3 Due to lack of information in years 1976 to 1970, the unearned income line item was netted against the Loans (Domestic & Foreign) and Lease receivables line items. Lack of available information prevented a further breakdown of Lease receivables for the periods 1973 through 1970.

* Due to the availability of information, certain line items have been rounded or reasonably approximated. Also, inadequate information has prevented certain line items from being stated individually. In some cases, totals were used to maintain consistency for comparative purposes.

For the inspection As of MARCH 31, 1979, completed May 11, 1979

FEDERAL RESERVE BANK OF CHICAGO
230 SOUTH LA SALLE STREET
CHICAGO, ILLINOIS 60690
(312) 322-5322

August 10, 1979

Mr. Roger E. Anderson
Chairman of the Board
Continental Illinois Corporation
231 South La Salle
Chicago, Illinois 60693

Dear Mr. Anderson:

Enclosed is a Report of Inspection of Operations and Condition of Continental Illinois Corporation, Chicago, Illinois, prepared by [redacted] administrative bank holding company examiner. The inspection is as of March 31, 1979, commenced on April [illegible], 1979, and was completed on May 11, 1979. It is requested that the report be reviewed by the Board of Directors at its next meeting, and such review be noted in the minutes.

Continental Illinois Corporation continues to rely heavily on volatile funds to sustain growth in assets and earnings. The success of such a policy is dependent on the quality of underlying assets. In this connection, it is noted that asset quality appears to be improving, although results of the recent examination of Continental Illinois Corporation's subsidiary bank are not yet fully available. While asset quality control systems appear adequate, we urge continued close attention to this vital area, especially during prolonged periods of high interest rates and retarded capital formation.

Please respond to the examiner's comments concerning violations of statutes and regulations within thirty days of receipt of this report.

Please acknowledge receipt of the report by signing the attached form and returning it to this office.

Very truly yours,

9.12.79 - via telephone, extension until 10-15

dt

cc - Board of Governors
Regional Administrator of National Banks

COPY

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FEDERAL RESERVE BANK OF CHICAGO
230 SOUTH LA SALLE STREET
CHICAGO ILLINOIS 60690
(312) 322 5322

February 20, 1981

Mr. Donald C. Miller
Vice Chairman
Continental Illinois Corporation
231 S. LaSalle
Chicago, Illinois 60693

Dear Mr. Miller:

Enclosed is a Report of Inspection of Operations and Condition of Continental Illinois Corporation, Chicago, Illinois ("CIC"), prepared b[redacted], administrative bank holding company examiner. The inspection as of June 30, 1980, commenced on August 11, 1980, and was completed on September 26, 1980. It is requested that the report be reviewed by the Board of Directors at its next meeting and such review be noted in the minutes.

Attached are copies of Federal Reserve correspondence related to matters discussed on page 1, examiner's comments.

Upon receipt of this report, please sign the attached form and return it to this office.

Very truly yours,

Enclosures

ARB:cja
cc - Board of Governors
Regional Administrator of National Banks

COPY

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FEDERAL RESERVE BANK OF CHICAGO
230 SOUTH LA SALLE STREET
CHICAGO, ILLINOIS 60690
(312) 322-5322

October 13, 1981

Mr. John H. Perkins
President
Continental Illinois Corporation
231 South LaSalle
Chicago, Illinois 60693

Dear Mr. Perkins:

Enclosed is a Report of Inspection of Operations and Condition of Continental Illinois Corporation, Chicago, Illinois, prepared by [redacted], bank holding company examiner. The inspection as of April 30, 1981, commenced on July 6, 1981, and was completed on August 21, 1981. It is requested that the report be reviewed by the Board of Directors at its next meeting and such review be noted in the minutes.

Upon receipt of this report, please sign the attached form and return it to this office.

Very truly yours,

RJB:dap
cc - Board of Governors
Regional Administrator of National Banks

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BB 103

FEDERAL RESERVE BANK OF CHICAGO
230 SOUTH LA SALLE STREET
CHICAGO, ILLINOIS 60690
(312) 322 5322

December 10, 1982

Board of Directors
c/o Roger E. Anderson
Chairman of the Board
Continental Illinois Corporation
231 S. LaSalle Street
Chicago, Illinois 60693

Gentlemen:

Enclosed is a Report of Inspection of Operations and Condition of Continental Illinois Corporation, Chicago, Illinois, prepared by [redacted] examiner. The inspection, as of April 30, 1982, commenced on August 2, 1982, and was completed on October 6, 1982. It is requested that the report be reviewed by the Board of Directors at a meeting within the next sixty days and that such review be noted in the minutes.

It is recognized that management has taken steps to address various internal control deficiencies as well as to arrest expansion. However, the ramifications associated with the unusually high level of problem loans and the related cost of procuring funds from market sources raise concerns. We request the opportunity to discuss these concerns and other matters with senior management and members of the audit committee. Please contact the undersigned at 322-5889 to arrange for a mutually agreeable time.

Upon receipt of this report, please sign the attached form and return it to this office.

Very truly yours,

cc - Clearing Unit (2 copies)
OCC
FDIC
Field copy

COPY

FEDERAL RESERVE BANK OF CHICAGO

230 SOUTH LA SALLE STREET
CHICAGO, ILLINOIS
(312) 322-5322

February 10, 1984

Mr. Roger E. Anderson,
Chairman of the Board
and Chief Executive Officer
Continental Illinois Corporation
231 S. LaSalle
Chicago, Illinois 60693

Dear Mr. Anderson:

Enclosed is a Report of Inspection of Operations and Condition of Continental Illinois Corporation, Chicago, Illinois, prepared by [redacted] examiner. The inspection as of September 30, 1983, commenced on October 31, 1983, and was completed on December 30, 1983. It is requested that the report be reviewed by the Board of Directors and such review be noted in the minutes.

As detailed in the accompanying report, the holding company's financial condition is regarded as unsatisfactory. This assessment is reflective of the problems presently confronting its principal bank subsidiary which constitutes the vast majority of its assets. These problems are set forth in the examination report covering the lead bank prepared as of June 30, 1983, and have been further covered with you in your meetings with representatives of the Office of the Comptroller of the Currency. Your attention is directed to pages 1 and 5 of the enclosed report for a discussion of the overall condition of the Corporation and certain policy matters which we believe should be considered. We will be in contact with you with regard to a possible meeting with the Audit Committee or other appropriate body.

As you know, we have had the opportunity to review your 1984 operating plan with your staff. While we are not in position to make a judgment concerning the achievability of this plan, we would comment that it does not appear to provide for much flexibility. Clearly, the performance of the Corporation over the next several months is critical. Consequently, we will closely follow its progress in meeting its plan objectives and maintain our dialogue with your staff.

Very truly yours

cc: Board of Governors (2 copies)
Comptroller of the Currency
State Banking Department
Federal Deposit Insurance Corporation