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BANK ASSISTANCE: HANDOUT OR SENSIBLE SOLUTION?

An Address By

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Before The

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Just over two years ago, the Federal Deposit Insurance Corporation assisted Continental Illinois National Bank, thus averting the failure of the bank -- then the nation's eighth largest. The FDIC provided assistance totaling $4.5 billion and effectively took over ownership of the bank. In the words of former FDIC director Irvine Sprague's new book on the FDIC, that was the biggest government "bailout" of a bank in U.S. history.

Speaking of Irv's book, I found it to be an informative, first-hand account of FDIC-engineered bank rescues. But I couldn't help but recall the words of Winston Churchill, "History shall be kind to me - because I intend to write it."

The Continental Illinois transaction and the events that led up to it received a lot of press coverage, much of it reflecting criticism of the FDIC. The FDIC was accused of undermining our capitalistic system by removing the loss potential from the free enterprise equation. Many assumed the FDIC had bailed out shareholders and management.

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Some argued the system had been denied the therapeutic benefits that would have arisen from liquidating Continental, benefits in the form of visiting large losses on uninsured depositors and creditors. The FDIC was accused of starting to nationalize the banking system and of squandering deposit insurance funds. We were accused of favoring large banks over small banks.

Of course, there were some others who felt that the transaction was a timely reaction to a potential international financial panic and that any other response would have been irresponsible.

I intend to review some of the issues that were raised in the Continental assistance transaction. What can we learn from the Continental experience that is useful for dealing with problems in the U.S. banking system today?

This is a particularly appropriate time for a review of the issues raised in the Continental assistance package. I have an announcement to make regarding the final chapter in this story, a chapter entitled "The Reprivatization of Continental." The FDIC from the outset said it would return the ownership of Continental to the private sector as soon as practicable. I'm pleased to report to you that we are now ready to begin the process of reducing our ownership in Continental Illinois.

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The FDIC Board has decided to sell to the public a portion of its holdings in Continental. The sale will be equivalent to 50 million shares of common stock. This would bring the number of publicly owned shares to about 65 million and reduce our ownership in the company by approximately 30%. We expect the registration statement to be filed with the SEC shortly and the sale to be accomplished before year-end.

My lawyers advise me to say no more than that. I almost forgot! I am further advised by counsel to inform you that this speech is neither an offer to sell, nor a solicitation of an offer to buy any of these securities. That can be done only by means of a prospectus in a registration statement.

The FDIC will continue to have a significant stake in Continental through its ownership of preferred stock convertible into 110 million common shares. The FDIC also has potential ownership of an additional 40 million common shares. Over time, we expect these holdings will also be returned to the private sector.

We recognize that the size of the proposed public offering is relatively modest. But, we are attempting to balance two possibly competing goals -- a quick privatization of Continental and maximum recovery of deposit insurance fund outlays.

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Now, just a bit of history for those not familiar with how the FDIC found itself involved with Continental. For some time, the bank had been facing serious financial problems. Its earnings and capital were threatened by losses on loans, many of which were bought from the much smaller and now infamous Oklahoma institution -- Penn Square Bank. Uninsured depositors were nervous about the bank's problems and, in May of 1984, a massive run on the bank began.

No bank can survive a loss of depositor confidence and Continental was no exception. Its access to cash quickly ran out and it had to borrow, increasingly, from the Federal Reserve. America's eighth largest bank was failing! Rumors began to affect deposits at other large U.S. banks.

Various solutions were considered. One solution was to allow the bank to fail and then arrange for another bank to take over the remains with FDIC assistance. This is the way most bank failures are handled. A merger with another bank or various shared ownership options were also considered. But no reasonably priced alternative was available, and time was short. Continental was just too big and its condition too uncertain.

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The FDIC, the Federal Reserve, and the Comptroller of the Currency all agreed that paying off insured depositors and liquidating the bank's assets was not feasible. The system simply would not be able to handle a shutdown of a bank this size without chancing potentially disastrous results.

While I was not involved, no regulator is likely to take that much risk. "Not on my watch," as we used to say in the Navy. So, the FDIC decided the least costly and least risky option was direct assistance to keep the bank open.

In total, the FDIC committed $4.5 billion to the purchase of Continental preferred stocks and the takeover of poor loans.

At the time the assistance transaction was put in place there were approximately 40 million Continental shares outstanding. The ultimate ownership of these shares will be determined in three years. If the FDIC loses more than $800 million on the loans it acquires, the 40 million shares will be transferred to the FDIC. Since this appears likely, the old shareholders will have been virtually wiped out.

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Thus, the transaction that was put in place was fashioned so that little equity would remain for the old shareholders. The old senior management was removed and a new management team was selected. The board of directors has largely been replaced.

During the past two years, Continental has worked its way out of a heavily borrowed position and strengthened its liquidity. Continental now has one of the highest capital ratios of any large bank in the country. The management, under the leadership of John Swearingen and Bill Ogden, as well as the board, deserve the credit for this improvement. While the FDIC can remove Board members and must approve such things as acquisitions, major capital outlays and dividend payments, the FDIC does not interfere with operating decisions. We do not, and have not, "run the bank."

It is still too early to determine what the final cost of the Continental assistance transaction will be for the FDIC. That will depend on losses on loans transferred to the FDIC and the proceeds of the disposition from our Continental stock. Overall, I would guess our losses will be about $1 billion or less than three percent of the assets Continental had when failure was threatened. This compares favorably to our overall experience where costs have been exceeding 10 percent. In Continental's case, 10% would have meant a loss of about $4 billion.

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Let me summarize some of what we did and didn't do with respect to Continental, keeping in mind some of the criticism I mentioned earlier. We did not bail out shareholders or senior management. We treated uninsured depositors the same way they are treated in most bank failures -- that is, they were fully protected. Some holding company creditors and preferred shareholders fared better than they would have had the bank failed, because it was not feasible to do anything else.

And when the transaction has been completed, we will have saved a substantial amount of money for the deposit insurance fund -- probably $3 billion. To give meaning to that number, remember our total reserves are $18 billion.

If the Continental "bailout," (I prefer "rescue") can be considered a success in containing the cost of bank failure, how does it fare in terms of some of the systemic issues raised by its critics?

Have we effectively removed discipline from the marketplace, particularly depositor discipline? We think not. Discipline clearly remains in full force for shareholders, directors and managements. Further, the fact that banks still must pay different rates for their deposits suggests depositors still evaluate banks. What the rescue did do was to help prevent "depositor panic," then and now - and that has to be good for the financial system.

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Another concern was the effect of temporary government ownership of the bank on the private sector. We can all agree that nationalization is a detriment per se, but the question is, "how much of a problem has it turned out to be in the Continental case?" My answer would be, not much so far. But it will become increasingly more of an issue the longer the bank is in the FDIC's hands. That is why today's announcement of sale is an important step. It shows that we can reprivatize and will do so as soon as feasible.

During the balance of my remarks I would like to explore what the future of direct assistance by the FDIC may be.

Philosophically, the FDIC has been opposed to giving assistance to keep banks open. We thought (and still do) that it is best if unprofitable institutions are allowed to exit the marketplace. So, in the past we provided assistance only in those cases where the bank was just too big to handle with a sale of a closed bank's assets and where we were convinced a payoff would have major consequences for the community.

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Since Continental Illinois, the FDIC has approved open bank assistance to two banks: The Talmage State Bank, a $10 million bank in Kansas, and the $600 million Bank of Oklahoma. Significantly, for the first time, cost, not essentiality, was the basis for approving these two cases. The increase in troubled banks in this country has brought with it a significant increase in applications for FDIC assistance. Currently, we have more than a dozen requests covering banks of various sizes at some stage of consideration.

We are in a buyers market for failed banks, with an expected 150 failures this year. Constructing lower-cost alternatives for the insurance fund is an increasingly important challenge. Our fund is sound and profitable, even at today's level of failures. But it will stay that way only if we continue to develop more cost-effective ways to handle failures. We see assistance as a potentially cost-effective answer for some situations. It is not only lower cost, but it is less disruptive to the local community. It keeps banks alive so that borrowers will be dealing with bankers, not government liquidators.

So, where are we headed? The FDIC has no intention of becoming the saviour of every troubled bank in the country. We prefer the marketplace working its will.

But we will use assistance where necessary. Our guidelines will provide high hurdles to any assistance transaction.

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They include:

One, there must be convincing evidence that the transaction will be significantly less costly -- both in the short and long run -- than other available alternatives.

Two, we must be reasonably assured that the revived bank will be able to survive and prosper.

Three, shareholders must give up much of their interest in the institution -- and perhaps all their interest -- if the case warrants it.

Four, the FDIC must not be the only party bringing new capital to the bank. Shareholders, creditors, even outside investors, must be prepared to make a significant contribution toward saving the bank.

Five, active management and directors must not escape legal and financial accountability for their actions. We still cling to the belief that management is the deciding difference. In business as in life, we usually have a lot to do with our own undoing.

Let me conclude by saying that the banking system is sound. Effective safety supervision and handling of bank failures by regulators will be essential to keeping it that way.

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In the case of Continental, with today's announcement of sale of stock, I believe we have an example of effective work by regulators that should be judged a success. Since I was not responsible for this adventure, the credit belongs to those involved at the time.

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