Remarks by

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Good afternoon to you all. I hope that you are enjoying your visit to the United States and that your study schedule has not been so strict that you have not had a chance to meet some people who live here and to have some fun while you are discovering how Americans conduct the business of banking. We are very pleased to have you all with us and those of us who are your guests today are anxious to be helpful to you and your banks.

My assignment today is to discuss the reasons why some banks fail, what the consequences of failure may be, how failures can be limited by constructive supervision, and why a strong soundly managed banking system is critical to the successful operation of a market economy.

First, I will explain why banks are special among all business enterprises. Second, I will discuss very briefly two failures of American banks which failed for different reasons. Third, I will tell you what the consequences of those failures were and what they might have been. Finally, I will impress upon you the importance of maintaining a safe and sound banking system through a managed program of supervision, regulation and examination by a suitably chartered government agency, whether it be the central bank or an agency set up exclusively for supervision and regulation of the banks.

Well, then, what makes banks special? It is the unique role that they play in the economy. They are money managers in the sense that they match the needs of those who have excess funds with the need of those who require additional funds. Banks are intermediaries between borrowers and lenders. Depositors lend their money to banks in return for interest earned and services rendered by the bank. The bank, in turn, lends the depositors' money to borrowers who are in need of extra funds, whether the borrower is a government entity, a corporation, a partnership or an individual. The bank keeps the difference between what it earns from lending and what it pays for deposits in order to pay its own expenses and realize a return for those who have invested in the shares of the bank -- i.e., the stockholders. Depositors provide funds to the bank, the bank manages the investment of those funds in loans or securities. The bank manages the risk for the depositor. The shareholder provides capital to the bank to absorb losses if managers of the bank make a mistake by taking too much risk. If the capital supplied by the stockholders is not sufficient to cover the mistakes of management, then the bank fails and both stockholders and depositors lose all or part of what they had. If the bank is successful, the profits belong to the stockholders and the depositors' money is safe.

What makes banks special is that they are using other peoples' money. They use depositors' money to take risks and they use stockholders' money to absorb losses if they take too much risk. If the depositor and stockholder lose all or most of what they have because a bank fails, then they have less with which to buy goods and services and make investments in other enterprises. If many banks fail at the same time, the effect could be to damage the operation of the whole economy. That, in fact, is what happened in the United States between 1929 and 1933 and it had the effect of making the Great Depression much deeper and longer-lasting than it might otherwise have been.

The lesson of the failure of thousands of banks was not lost on the United States Congress. In the 1930's, the Congress made several laws strengthening the supervision and regulation of banks and, perhaps most important, creating the Federal Deposit Insurance Corporation to insure the deposits in banks. The purpose was to prevent runs on solvent banks by depositors who were alarmed by bad news about other banks and were trying to protect their money. No bank can survive a sustained run, because the assets, which are of essentially longer duration, cannot be liquidated fast enough to pay all of the depositors in a matter of hours or days.

With their deposits insured up to an amount which covered most individual depositors completely, consumers maintained their confidence that they would not be wiped out. From the mid-1930's until 1991, there were virtually no consumer runs on nationally insured depository institutions in the United States. And there were very few failures of nationally insured banks between 1935 and 1985. This system of deposit insurance is another thing which makes banks special.

I will now briefly describe the failures of two large United States banks. The banks were very different in structure and the methods for dealing with their failures by the United States authorities were very different. The consequences of their failures were also potentially very different. The two banks were the Continental Illinois National Bank in Chicago, Illinois which failed in 1984 and the Bank of New England Corporation in Boston, Massachusetts which failed in 1991.

Continental Illinois had assets in excess of 40 billion dollars in 1984. It operated in the financial district of Chicago under the laws of the State of Illinois which did not allow banks to have branches. As a result, Continental had very little consumer deposits. That is to say, insured deposits. In fact, consumer deposits were only about 10-12 percent of all liabilities. Continental was primarily a wholesale bank. That means it did most of its lending to large corporations. And it funded its lending with large uninsured corporate deposits and funds in the form of negotiable certificates of deposit, Eurodollars and subordinated debt.

In the late 1970's and early 1980's, the management of Continental adopted a corporate strategy which we now believe led to its later failure. Management announced that it was Continental's goal to become the largest lender to commerce and industry in the United States. That meant it was setting out to take a share of business held by others like Bank of America, Citibank, Morgan, Chase, Chemical and its nearby rival First National Bank of Chicago.

In order to take loan business from another bank or to get new loan business which might otherwise go to a competitor, a bank must offer the borrower more favorable terms. These may be in the form of lower interest rates or easier repayment terms. But there also may be lower credit standards which increase the risk in the loan. In Continental's case, there was also a delegation of loan approval authority to less experienced officers. These officers also interpreted their opportunities for promotion and higher pay as depending more on the quantity of new loans they could produce than on the quality of the loans.

This is an almost perfect formula for disaster: Relaxed standards in order to win business; management emphasis on quantity rather than quality; and delegation of lending authority to inexperienced loan officers.

The energy business was booming in the early 1980's and there was a tremendous demand for oil exploration and production loans. Some Continental officers established a close working relationship with a small bank in the oil-producing section of Oklahoma called the Penn Square Bank. Continental assumed Penn Square knew all there was to know about oil loans and agreed to buy from Penn Square loans they could not keep on their own books. Continental also took participation in Penn Square loans in excess of Penn Square's legal limit.

Continental took Penn Square loans without any significant credit analysis of its own and little attention to checking documentation. Again, I must emphasize that one of the key errors of management in the case of Continental was to abandon good lending procedures and credit standards in a reckless pursuit of new loans.

Continental's troubles began to show up when the Penn Square bank failed due to losses on bad loans. Some of those loans were also believed to have been fraudulently made. Obviously, many of the loans sold or participated to Continental were also bad. And Continental was not the only victim of Penn Square's bad practices. There were several banks in other cities which also participated in loans made by Penn Square or bought loans outright. Examiners found hundreds of millions of such tainted loans on Continental's books. In addition, there were many tens of millions of dollars of other bad loans. Energy loans and more conventional commercial and industrial loans made under the same system of inadequate credit policies, poor procedures and unwisely delegated lending authority.

With the failure of Penn Square it became widely known and reported in the press that a lot of Penn Square's bad loans had gone to Continental. The insured depositors at Continental were unconcerned because the United States government fully guaranteed the insurance which protected their deposits. But the uninsured depositors, general creditors and Eurodollar deposit holders began to withdraw their support. When term deposits came due, they were not renewed. Eurodollar contracts were closed out and the bank found difficulty in raising federal funds in the interbank market.

Continental not only had a potential capital deficiency due to bad loans, but also a very real liquidity crisis due to a corporate run on the bank by uninsured depositors and general creditors. Continental borrowed heavily from the Federal Reserve, as the central bank and lender of last resort, to meet the liquidity crisis, but it soon became evident that the bank could not meet the demands of its creditors and capital was seriously impaired by realized and anticipated losses on bad loans.

It might have been possible to close the bank and liquidate it in an orderly fashion. That would mean paying off insured depositors and then selling or collecting the remaining assets of the bank with the uninsured depositors and other creditors sharing whatever losses were realized on liquidation. But another serious problem arose. Continental was one of the nation's leading correspondent banks with deposit accounts from hundreds of banks all over the country, particularly from banks in the states in the Middle Western United States near Chicago. Many of these were small banks which maintained large accounts at Continental to facilitate check settlements, securities transactions, wire transfers and other routine business transactions. For several hundred of these correspondent banks the amount of their deposits with Continental exceeded their capital. If Continental were closed, they would be insolvent. The prospect of the failure of so many banks at one time was alarming. The result would have been serious losses to the depositors and stockholders of the smaller banks and disruption of commerce in the communities they served. Furthermore, if the bank had been closed by the authorities, many of the large companies and banks both in the United States and in foreign countries would have lost large amounts as their CDs, federal funds loans, Eurodollar contracts and other claims were not honored. This might well have created a crisis of confidence which would have caused them to close out claims on other U.S. banks linked to the Penn Square Bank. That would have seriously destabilized the entire banking system.

The Federal Deposit Insurance Corporation, the Comptroller of the Currency and the Federal Reserve Board determined that the threat to the stability of the banking system was serious enough to declare the Continental too big to fail. Consequently the Federal Reserve loaned several billion dollars to Continental to meet its liquidity requirements and the Federal Deposit Insurance Corporation injected several billion dollars of capital into the bank, in effect replacing the private shareholders who were virtually wiped out. With the FDIC as the principal stockholder, the bank was owned by a government agency which tended to restore confidence. The FDIC then moved to replace the management and the situation was stabilized.

Under new management, the loan problems were addressed, the bank was significantly reduced in size and gradually returned to profitability. It also paid off its loans to the Federal Reserve. New capital was brought in and the FDIC eventually sold off its interest in a secondary offering, returning the bank to private ownership. In the process, a banking crisis was narrowly averted and many depositors and institutions tied to Continental through the interbank market were spared very large losses.

This history of Continental's troubles illustrates the interdependence of banks and the importance of sound banks to the proper functioning of the payments system and the economy as a whole. The failure of Penn Square was a direct cause of the failure of the much larger Continental and, had Continental been closed by the authorities instead of taken over as a going concern, hundreds of other institutions might also have failed with very serious consequences for the entire economy.

The other failure I want to describe to you is the Bank of New England. It was a large regional bank holding company with about $24 billion in assets. The head office was in Boston, Massachusetts, but it also had a large bank in Hartford, Connecticut and subsidiary banks and branches over much of New England. The bank had a proud tradition going back 150 years or more and was the result of the consolidation by merger and acquisition of many banks in the major cities of the region.

Bank of New England also was a case of mismanagement and careless, perhaps even negligent, loan administration. In the 1980's, New England, and California, were the nation's most prosperous regions. The computer industry, defense contractors, health care providers, insurance companies, banks and universities which were the core of the New England economy were all booming. To support these prosperous industries, real estate development blossomed. The demand for first class office space, hotels, laboratories, manufacturing plants and multi-family residential facilities seemed to be insatiable. Several thousand hotel rooms were added in Boston alone in the early 1980's and as soon as a new office building was completed it was filled. Rents for first-class office space in Boston went from $15 per square foot per year in 1978 to $35 per square foot by the mid-1980's. And prices for single family houses quadrupled in ten years time.

To finance this real estate boom, banks entered into a highly competitive bidding war to obtain the developers' business. Banks were convinced that prices for real estate could only go up and that a new building would be worth more than the cost to build it by the time it was completed. We have seen construction loans made for 100 percent of the cost of completion. Therefore, the developer or builder had none of his own money in the project. In addition, banks would build into a loan a contingency reserve of 5 to 10 percent to cover cost overruns and finally they would lend the full interest to be paid on the loan up to the time of completion.

Historically, banks would not finance speculative building projects. Instead they would require either a commitment for permanent financing at the completion of the building or the acquisition of the building on completion by an individual or corporation of high credit standing. These basic principles of sound construction lending were abandoned or compromised by many banks in the 1980's and the Bank of New England, fighting to obtain a dominant market share in real estate finance in the region, was one of the most aggressive banks to offer favorable terms like those I have described in order to get the business. And they succeeded. Too well. Their loan portfolio became overloaded with real estate loans, bad ones as it turned out, and when the New England economy went into rapid decline in 1989 and 1990, real estate prices declined even faster. There was an oversupply of available space. House prices declined as much as 15 or 20 percent and first-class office space rent went from $35 per square foot back to $20 per square foot.

As a result, the buildings on which banks had loans were unsold or unrented. Developers were bankrupt and the loans on the buildings were now far in excess of their market value. The loans could not be serviced from income. They could not be sold except at deep discounts which would result in heavy losses to the bank holding the loan.

Perhaps hardest hit of all New England banks by these circumstances was Bank of New England. With its heavy concentration in real estate loans and real estate related loans it was particularly vulnerable to the turn of events. An inappropriate management strategy, bad credit policies and a failure to make an accurate judgment of market conditions and the risks in the marketplace all combined to put the bank in deep trouble. Loan loss provisions to bring the loan portfolio into some relation to actual value consumed earnings and invaded capital.

Early in the crisis the directors of the bank assumed the lead in trying to save it. They organized several special committees to oversee various parts of the bank. They fired the chairman and some other members of the senior management and brought in a new chief executive officer to try to work the bank out of trouble. He did a remarkable job. He sold assets, worked down the problem loans and tried to improve the capital position by negotiating with debt holders to convert their debt to equity. He did reduce staff and shrink the bank to improve the capital ratios and he stabilized the operation enough to pay off loans from the Federal Reserve where the bank had been borrowing steadily for six months due to the loss of corporate deposits.

But, in the end, the wounds were too deep, the losses too great for the bank to survive. The end came in January 1991. In spite of management's valiant efforts to keep the bank going, events conspired to bring it down. The New England economy continued to decline and as a result the weakness in Bank of New England's loan portfolio spread from real estate to other loan categories. As losses mounted, capital was further depleted. Negotiations with debt holders collapsed. The final blow was the failure of the state deposit insurance system for credit unions in the adjoining state of Rhode Island. The press reports of small depositors losing their money created a panic among Bank of New England depositors. Press reports of the bank's problems combined with the Rhode Island mess resulted in the first consumer run on a bank in more than fifty years.

Between opening on a Friday and closing at noon on Saturday, consumers withdrew nearly $1.5 billion even though their accounts were fully insured. Under the circumstances, the authorities decided the bank was no longer viable. The Federal Deposit insurance Corporation seized the bank and requested bids from other banks who wished to take over the franchise of Bank of New England subject to the FDIC assuming responsibility for bad loans. The successful bidder was Fleet -- a Rhode Island bank holding company -- which assumed responsibility for all deposits and acquired some of the loans which its analysts judged to be sound.

Again the device of government takeover rather than liquidation was chosen by the authorities because in their judgment the shut down of Bank of New England in an already seriously crippled New England economy would have been seriously destabilizing and might have impaired the ability of other banks in the region to fund their own operations.

The consequences of bank failures are serious no matter how small or how large the bank and no matter how the failure is resolved -- whether by liquidation or purchase of assets and assumption of deposit liabilities. In a small rural community where the failed bank may be the only bank, the failure may virtually bring commerce to a halt. Any failure imposes personal hardships on individuals as well as corporations. Inevitably people lose employment. Some depositors lose money. Stockholders lose their investment -- usually all of it. Those who supplied goods and services to the bank lose a customer. Those who used the bank as a source of financial support must now establish sources of that support with another institution.

When one thinks of the consequences of the failure of a major money center bank in New York, or London or Frankfurt or Tokyo, it is not difficult to understand that there could be worldwide repercussions with the real possibility of widespread financial panic.

The whole rationale for supervision and regulation of the banks is to avoid such consequences -- whether they be the localized effects of a small bank failure or the earth-shaking reverberations from the fall of one of the giants.

All through history, the most important reason for bank failure has been bad loans or bad investments -- usually bad loans. Therefore, it is imperative that bankers exert their best energies and judgment in managing the acquisition and administration of loans. Analysis of the borrower's ability to repay must be thorough and accurate. The loan must be constructed so that the borrower can service it as to interest and principal without impairing his normal pace and scope of activity. The risk inherent in the loan must be accurately reflected in the interest and fees which the bank earns on the loan during its life. The bank should be paid for the level of risk it is assuming. And, since the best bankers sometimes make mistakes, there must be sufficient capital to absorb losses and yet sustain the bank's viability. While all capital is always available to absorb losses, it is prudent in good times to set aside reserves over and above operating capital to absorb expected losses.

Since governments, businesses and individuals are all dependent on banks to facilitate payments and obtain credit, the safety and soundness of the banking system is critical to the proper operation of a nation's economy.

In order to assure that banks are operating in a safe and sound manner, government must devise ways to monitor the banks and create regulations for their operation which help them avoid difficulties. In the united States, we have both national and state regulatory authorities and at both levels of government we have established a monitoring system which is based on periodic uniform reporting by the banks and on-site examination of the banks by the regulatory agencies. Some would argue that we have overdone it. That our banks are over-regulated to the point of being smothered. Indeed, some moderation of regulation is probably due here. But by and large our system has worked well and you would do well to consider how it might be adapted to your own situation.

In closing, my wish for all of you is that you will grow to be full of the wisdom and judgment to guide your banks in safe and sound operations for your own benefit and for the benefit of your community and your nation.

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