FRBSF Weekly Letter

August 31, 1984

Market Responses to Continental Illinois

The handling of troubled Continental Illinois Bank and Trust Co. by the federal regulators will be debated for some time. On the one hand, the assistance provided may have been the only way of ensuring that the bank's problems did not "spill over" to other banks and the economy in general. On the other, critics of the assistance packages argue that the aid to Continental diluted market discipline by sending a dramatic new message that large banks would not be allowed to fail. Particularly troublesome to the critics was the proposed arrangement for restructuring Continental to give some protection to the bank's stockholders.

This *Weekly Letter* provides some perspective on the problems experienced by Continental Illinois and the assistance packages provided the bank by the Federal Deposit Insurance Corporation (FDIC). In particular, this *Letter* takes a look at how the market reacted to the episode and examines some of the evidence on whether the treatment of Continental affected the market's perception of the status of depositors and stockholders of failed banks.

The problem

The seeds of Continental's troubles were sown some time ago. In the second half of the 1970s, when Continental Illinois expanded rapidly, the bank accumulated a large volume of energy-related loans through direct lending and loan purchases, including loans from Penn Square Bank. The exposure in energy-related lending proved to be an Achilles' heel when, in July 1982, Penn Square collapsed and many of Continental's holdings of Penn Square loans were subsequently found to be in trouble.

Following the Penn Square episode, Continental's experience with nonperforming loans only worsened. Perhaps the best indication of the dimensions of Continental's problems came out of the FDIC's announcement on July 26, 1984 concerning the provisions of the "permanent" assistance plan for the bank. Under the plan, the FDIC would commit to purchase up to $4½ billion in loans from Continental. This would include loans with a face value of $3 billion, for which the FDIC would pay $2 billion with Continental charging off the other $1 billion. As part of the permanent package, the FDIC also would commit to purchase another $1½ billion in loans at a later date.

Impact on Continental

The market's awareness of and concern over the financial difficulties of Continental appeared to intensify in the early part of 1984. Chart 1 shows the movement in Continental's stock price along with indexes for the stock prices of the bank holding companies of 12 other money center banks and the S&P 500. To facilitate comparison, all three series are indexed at 100 in October 1983 (index values are based on Friday closing prices). The chart indicates that, from the end of 1983 to the beginning of May—before the deposit run at Continental, the price of that bank's common stock fell by 36½ percent. In comparison, the S&P 500 index and the index for the other large bank holding companies dropped only about 3½ percent on balance over that same period.

Depositors reacted abruptly to the troubles at Continental in early May by withdrawing a substantial volume of uninsured deposits. The sources of funding used by Continental made it particularly vulnerable to such a liquidity squeeze. The bank's quarterly report showed that, at the end of March 1984, its worldwide deposits came to $28.3 billion, $20.7 billion of which were in time deposits in excess of $100,000. (Given Continental's sources of deposits, it seems clear that the deregulation of retail-type deposits had little if anything to do with the bank's problems.)

Responding to the withdrawal of deposits at Continental, the Federal Reserve began to lend to the bank. Continental also was helped by a line of credit arranged with a number of commercial banks. These measures did not quiet the concerns of the depositors, and, on May 17, the federal bank regulatory agencies made a joint announcement concerning financial assistance for Continental. To ease the liquidity pressures from deposit withdrawals, the FDIC agreed to guarantee all depositors regardless of denomination. (Continental's line of credit with the commercial banks eventually was raised to $5½ billion.) The capital position of

Continental was helped by injections of $1½ billion from the FDIC and $500 million from the group of commercial banks.

The assistance given Continental stabilized the situation for a while, but by no means did it completely reassure the financial markets. Despite the FDIC's guarantee (which prompted some analysts to suggest that a Continental CD was just another U.S. Treasury security), the market still required an interest rate premium on large-denomination CDs issued by Continental. There were reportedly doubts about the CDs' liquidity in terms of resale in the secondary market, as well as concerns that there would be a delay in the disbursement of funds if Continental failed.

Other banks

A prime motivation behind providing assistance to Continental was to prevent its problems from spilling over to other banks and the economy more generally. (For a discussion of the arguments relating to the economic consequences of instability in banking, see F. Furlong, *Economic Review*, FRBSF, Spring 1984.) The market's evaluation of banks, the equity market at least, did not appear to change much *on balance* between the end of 1983 and the beginning of May 1984. Following the run on Continental, however, there was a distinct market reaction, at least as far as large banks were concerned. From early May through mid-June, stock prices at the money center banks (excluding Continental) fell about 18 percent while the S&P 500 fell only 6 percent (see Chart 1). The fall in stock price was more pronounced for some of the large banks than for others.

The drop in the stock prices of the large bank holding companies, of course, does not necessarily indicate spill-over effects from Continental *per se*. The market could very well have been reacting to some exogenous factor(s) that was perceived to affect large banks in general. One candidate for such an exogenous shock would be a change in the market's perception of the debt problem of less developed countries (LDC). It would explain why the stock prices for the largest bank holding companies apparently reacted more than those of other bank holding companies. For example, a randomly selected sample of smaller bank holding companies (assets of $1 billion to $10 billion), which generally would be expected to have less (if any at all) LDC debt exposure, experienced a smaller decline in stock prices than even the market in general between May 4 and mid-June (not shown in the chart).

Along with the equity market, the bank CD market reacted apparently by raising risk premiums on bank CDs. Chart 2 shows that the spread between the yield on three-month bank CDs in the secondary market and the three-month Treasury bill rate (bank discount basis) widened noticeably in mid-May, after edging up some in late April. The spread narrowed by mid-August but remained somewhat above the level observed at the end of April.

The higher risk premiums apparently demanded by the market would imply a greater amount of uncertainty about the safety of large-denomination deposits. The movement in CD yields relative to Treasury security yields suggests that CD holders did not have complete confidence that the FDIC's guarantee to large depositors at Continental would be extended to large-denomination deposit holders at other big banks. However, this does not mean that the FDIC guarantee to Continental depositors did not tend to lower the risk premiums below what would otherwise have been dictated by the market.

Message to stockholders

After weeks of futile searching for a take-over candidate for Continental Illinois, the FDIC finally announced on July 26 that it would commit the resources needed to ensure the survival of that bank. (The FDIC's plan still must be accepted by the stockholders of Continental.) A major part of the proposed package is the purchase of loans from Continental mentioned above. The plan also would provide a $1 billion cash infusion that would make the FDIC the major stockholder of Continental.

Even before the announcement of the assistance package in July, the fate of large depositors, of course, already had been determined. What was in question between May and late July was the future of the Continental Illinois stockholders. This period of uncertainty for the stockholders is indicated by the shaded area in Chart 1, and is marked by a 75 percent drop in the price of Continental stock. The bank's stock, however, did retain some value, indicating the belief that there was some chance the stockholders would not be totally wiped out in the final arrangements.

CHART 1

WEEKLY STOCK PRICE INDEX
OCTOBER 28, 1983 — AUGUST 24, 1984

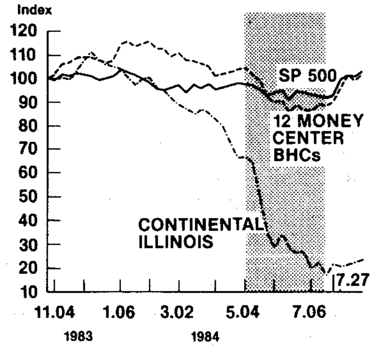
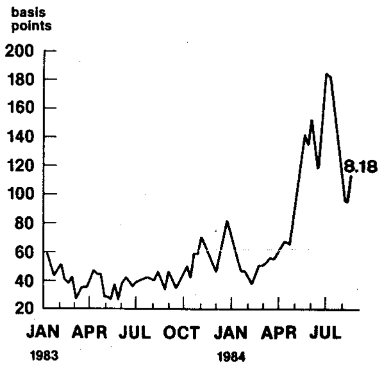


CHART 2

DIFFERENTIAL BETWEEN 3-MONTH CD AND 3-MONTH T-BILL RATES (weekly)



As it turned out, under the FDIC's proposal, current stockholders would not necessarily lose everything, although they would remain at substantial risk of bearing heavy losses in the future. The market reacted to the plan by bidding up the price of Continental stock about 29 percent in the week that the FDIC announced the permanent plan for assisting the bank (the week ending July 27). This suggests that the market thought the chances that Continental stockholders would not be wiped out had improved. Even so, the price of Continental common stock was close to 70 percent lower than its level just before the deposit run.

One of the major concerns with the assistance package proposed by the FDIC is that it sent a message to stockholders of other banks, particularly large banks, that they too stood a better chance of being protected if their bank should get into trouble. Some indication of how the aid to Continental affected the market's view of the riskiness of bank equity might be gleaned from the reaction of bank stock prices. An examination of Chart 1 indicates that the stock price index for the 12 money center bank holding companies rose only slightly in the week ending July 27—a 2 percent increase compared with a 1 percent rise in the S&P 500 index. In subsequent weeks, the index for the stock price of the 12 money center bank holding companies did rise more noticeably, a move that might be taken to confirm the view that the market reacted with some lag to an unexpectedly favorable treatment of Continental stockholders. However, even this rise in the stock price index for the largest bank holding companies may have had little or nothing to do with the decision on Continental Illinois since the increase was about in line with the overall rise in market prices indicated by the S&P 500. Moreover, the stock prices of other bank holding companies—the sample of smaller bank holding companies mentioned above—did not react much in the week of July 27, and in subsequent weeks the prices of the stocks for this sample rose even less than the market as a whole.

Conclusion

Part of the initial assistance the FDIC provided Continental Illinois was a guarantee to cover all deposits at the bank. Contrary to speculation by some, the market does appear to have interpreted this guarantee as foretelling blanket protection of uninsured deposits at all large banks.

Following the July announcement by the FDIC on the permanent assistance for Continental, the movement in the bank's stock price suggests that the proposed plan did improve the prospects for Continental stockholders compared to their situation just prior to the announcement. Nevertheless, Continental's stockholders have not been "let off the hook," as they have sustained heavy losses and still face considerable uncertainty. The issue of whether even minimal protection to stockholders is warranted, of course, will continue to be debated. On the question of whether a *new* message was sent to stockholders of other bank holding companies, it is possible that the treatment of Continental did not alter to any great extent the market's view of how other banks would be handled if they were in the same situation.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 8/15/84	Change from 8/8/84	Change from 12/28/83 Dollar	Change from 12/28/83 Percent Annualized
Loans, Leases and Investments[1] [2]	182,111	808	6,086	5.4
Loans and Leases[1] [6]	163,063	801	7,708	7.8
Commercial and Industrial	48,689	– 316	2,726	9.3
Real estate	60,640	102	1,741	4.6
Loans to Individuals	29,227	186	2,576	15.2
Leases	5,024	– 6	– 39	– 1.2
U.S. Treasury and Agency Securities[2]	11,864	– 7	– 643	– 8.1
Other Securities[2]	7,183	13	– 980	– 18.9
Total Deposits	189,747	1,307	– 1,250	– 1.0
Demand Deposits	45,153	1,559	– 4,084	– 13.0
Demand Deposits Adjusted[3]	29,290	– 513	– 2,041	– 10.2
Other Transaction Balances[4]	12,294	– 197	– 481	– 5.9
Total Non-Transaction Balances[6]	132,299	– 55	3,314	4.0
Money Market Deposit Accounts—Total	37,674	– 150	– 1,923	– 7.6
Time Deposits in Amounts of $100,000 or more	40,812	– 41	2,647	10.9
Other Liabilities for Borrowed Money[5]	19,877	966	– 3,130	– 21.4

Weekly Averages of Daily Figures	Period ended 8/13/84	Period ended 7/30/84
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (–)	43	61
Borrowings	24	111
Net free reserves (+)/Net borrowed(–)	19	– 50

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately