EXAMINATION FINDINGS REGARDING CONTINENTAL ILLINOIS NATIONAL BANK'S LOAN MANAGEMENT AND CAPITAL

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STAFF REPORT

TO

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS SUPERVISION, REGULATION AND INSURANCE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

This report is the result of staff findings to date, and does not necessarily reflect the views of the Members of the Subcommittee.

EXAMINATION FINDINGS REGARDING

CONTINENTAL ILLINOIS NATIONAL BANK'S

LOAN MANAGEMENT AND CAPITAL

This report presents in summary form the findings of examinations of Continental Illinois National Bank (CINB) relating to its loan management and capital. CINB was examined by the Office of the Comptroller of the Currency once every year from 1976 through the present except 1978. The examiners-in-charge of the examinations discussed in this report were John Meade (1976), Richard Kovarik (1977 and 1982), and Allan McCarte (1979, 1980, and 1981).

Section I provides a brief review of CINB's financial history from 1976 to 1981. Section II discusses the findings of the OCC examiners regarding CINB's loan management and credit quality control systems. Section III reviews OCC examiner comments about CINB's capitalization. The boldface emphasis in some quotations has been added by staff.

SECTION I

1976 THROUGH 1981, A BRIEF REVIEW

In July 1976, Continental Bank's chief executive officer, Roger Anderson, announced his intention to make Continental one of the three top U.S. banks serving industry. This was a bold objective and Continental's starting point was not the strongest.

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, 63% in September 1974, and 109% in June 1975. (See attached tables of supervisory ratios.)

Three months before Anderson's July 1976 announcement, OCC examiners had rated the Bank's 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."**
> (Examiner's Comments on Matters Requiring Attention, Report of Examination, April 1976, Comptroller of the Currency, p. 2.)

In the confidential section of the report, the OCC examiner John Meade 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."
> (Confidential Memorandum to the Comptroller of the Currency, Report of Examination, April 1976, p. D-c.)

Meade, however, rated both Continental's management and future prospects as "Excellent". (Confidential Memorandum to the Comptroller of the Currency, Report of Examination, April 1976, pp. D-a and D-d.)

Despite its weak starting point, Continental's management started out aggressively and confidently on a path of remarkable growth and earnings increases. So taken were the financial markets with Continental's performance, Dun's Review, a widely read financial magazine, included Continental in its 1978 list of the five best-managed companies in America. Dun's Review said:

> "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.)

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 simply outgrew 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, and rose only slightly in 1981 to 67%.

The financial markets looking at published financial statements showing steadily increased earnings and apparent portfolio soundness, were greatly impressed with CINB and bid its stock up accordingly.

In 1981, five years after Anderson's announcement, Continental attained its goal of becoming 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 management objectives of CINB were clearly reflected in the 1980 corporate plan. 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

("Performance Relative to Corporate Goals", Internal Competitive and Performance Analysis, Continental Illinois Corporation, Annual 1980, p. 8)

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. Though the examiners remarked about CINB's corporate goals in examination reports, during staff interviews of them they acknowledged that they had never actually seen CINB's planning documents.

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 vunerable 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 by Richard Kovarik, author of the 1982 OCC examination report, this way:

> "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."
>
> (Letter to the Board of Directors, Report of Examination, November 1982, p. 2.)

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.

In hindsight, CINB required federal aid to remain in existence because (1) its loan management system was inadequate and permitted credit problems to grow undetected, and (2) its focus on earnings per share growth required keeping capital at a minimum. Both of these matters were commented upon repeatedly in examination reports but their significance was masked by the decline in the ratio of classified assets to capital. Understanding the relationship among loan management, capitalization, and classified loans is critical to understanding what happened to CINB.

SECTION II

DISCUSSION OF CINB

LOAN ADMINISTRATION AND CREDIT QUALITY SYSTEMS

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. The examiners' comments regarding loan management year-by-year are set out below.

Commenting in 1977, Examiner Kovarik 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."
> (Loan Portfolio Management, Report of Examination, August 1977, p. 7-1.)

Kovarik 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."
> (Loan Portfolio Management, Report of Examination, August 1979, p. 7-1.)

At the time, Kovarik 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, OCC's Deputy Comptroller for Multinational Banking, Billy Wood, 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."**
> (Transmittal Letter to the Board, Report of Examination, August 1979, p. 1.)

The examiner-in-charge of the 1979 examination, Allan McCarte, 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."**
> (Letter to the Board of Directors, Report of Examination, August 1979, p. 1.)

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, McCarte 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."
> (Letter to the Board of Directors, Report of Examination, October 1980, p. 1.)

Concerning the deficiencies he had cited the year before in the area of credit management, McCarte 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."**
> (Letter to the Board of Directors, Report of Examination, October 1980, p. 1.)

McCarte took his analysis a step further and warned Continental officials about an inherent weakness in its 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."**
> (Letter to the Board of Directors, Report of Examination, October 1980, p. 1.)

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, McCarte 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."
> (Letter to the Board of Directors, Report of Examination, August 1981, p. 1)

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, McCarte 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.**"
(Loan Portfolio Management, Report of Examination, August 1981, p. 16.)

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. Examiner McCarte 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."
(Letter to the Board of Directors, Report of Examination, August 1981, p. 1.)

Regarding the system overall, Examiner McCarte said:

"We found it to be functioning well and accurately reporting the more severely rated advances to the Board and senior management." (p.1)
(Letter to the Board of Directors, Report of Examination, August 1981, p. 1.)

When the staff interviewed the examiners, questions were posed to both Meade and Kovarik, regarding such situations. Both responded that absent detailed information concerning the loans not reviewed, a situation such as that described by McCarte sounded significant. McCarte, however, viewed it as significant in retrospect, but at the time in light of the Bank'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."
(Loan Portfolio Management, Report of Examination, August 1981, p. 13.)

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."
(Memorandum of Kathleen Kenefick, July 29, 1981, p. 1.)

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, Examiner-in-charge, Richard Kovarik, explained what happened to Continental and the relation 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."
(Memorandum from Richard Kovarik to William Martin, November 15, 1982, p. 1.)

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

"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.**"
(Loan Portfolio Management, Report of Examination, November 1982, p. 23.)

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 $2¼ 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."

...

"He indicated that 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 management information reports."

...

"He indicated that there were 38 cases involving $ 6 million or more which the Cont. attorneys indicated could be settled for about $175 million. He then indicated that not included in the $175 million figure were: a $50 million dispute with the IRS; the $60 million lawsuit regarding ------, Inc.; and another $100-$150 million in lawsuits with very questionable outcomes. He then stated that Continental had spent $19 million in 1983 to outside firms for litigation and the same in 1982. In comparison, ------ only spent $10 million in 1983 for all legal services. Continental has set up a reserve for litigation losses, but only $5 million in 1983 and only $8 million in 1984. ------ attorneys expressed concern about other legal action which may be taken by shareholders."

...

"------ 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."

...

"As a result of the above, a June 24, 1984 meeting between ------ and the FDIC closed with the comment that enthusiasm for the merger was dying at ------ with each passing day."

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.

SECTION III

REVIEW OF EXAMINATION COMMENTS ON CINB

CAPITALIZATION

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 Kovarik 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."
> (Analysis of Earnings and Capital, Report of Examination, August 1977, p.13-1.)

CINB's subsequent growth led Deputy Comptroller Wood 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."
> (Examination report transmital letter, from Billy Wood to Continental Board of Directors, October 25, 1979, p. 2).

In 1980, in his analysis of CINB's capital position McCarte 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."
> (Analysis of Earnings and Capital, Report of Examination, October 1980, p.27).

In the letter transmitting the 1980 examination report, Wood 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. "
(Transmittal Letter to Board of Directors, Report of Examination, October 1980, p.2.)

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."
(Transmittal Letter to the Board of Directors, Report of Examination, August 1981, p. 2.)

"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."
(Letter to the Board of Directors, Report of Examination, August 1981, p. 2.)

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, examiner Meade 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." (SIC)
> (Analytical Review of Earnings and Capital, Report of Examination, November 1982, p. 41.)

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."

Why and how the OCC's capital standards have changed over the years merit close study.

Attachment I

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

Category	Dates of Examinations							
	6/15/75	2/27/76	3/31/77	4/30/79	6/30/80	4/30/81	4/30/82	6/30/83
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, doubtul, 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.

Attachment II

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	1,025	1,193	1,410	1,651	1,848	2,144	2,157
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	156.27	150.85	97.23	92.33	81.50	99.08	262.19	351.72
Reserve for Possible Losses (RPLL)	166	151	144	175	208	235	287	363
Percent of RPLL to Total Loans	1.53	1.41	1.20	.96	.88	.89	.89	1.22
Standby Letters of Credit b/	38	513	545	1,198	2,272	2,937	5,060	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.