INQUIRY INTO CONTINENTAL ILLINOIS CORP. AND CONTINENTAL ILLINOIS NATIONAL BANK

HEARINGS

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS SUPERVISION, REGULATION AND INSURANCE

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS HOUSE OF REPRESENTATIVES

NINETY-EIGHTH CONGRESS

SECOND SESSION

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INQUIRY INTO CONTINENTAL ILLINOIS CORP. AND CONTINENTAL ILLINOIS NATIONAL BANK

TUESDAY, SEPTEMBER 18, 1984

HOUSE OF REPRESENTATIVES, SUBCOMMITTEE ON FINANCIAL INSTITUTIONS SUPERVISION, REGULATION AND INSURANCE, COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,

Washington, DC.

The subcommittee met, pursuant to call, at 10:08 a.m., in room 2128, Rayburn House Office Building, Hon. Fernand J. St Germain (chairman of the subcommittee) presiding.

Present: Representatives St Germain, Annunzio, Hubbard, Barnard, Oakar, Vento, Schumer, Patman, Carper, Wylie, Leach, McKinney, Shumway, McCollum, Wortley, and Dreier.

Also present: Representatives Mike Lowry and Thomas J. Ridge of the full committee.

Chairman ST GERMAIN. The subcommittee will come to order.

This morning we open hearings into the problems of Continental Illinois National Bank, an institution that failed to survive without massive, record breaking, infusions of Federal moneys and credit.

Deja vu.

For a decade and a half, this subcommittee, and the full committee, have probed bank and regulatory failures—U.S. National Bank in San Diego, the Texas Rent-a-Bank scandals, the Bert Lance playpen at Calhoun National Bank in Georgia, the Penn Square circus in Oklahoma City. We've monitored and gathered facts about dozens of lesser cases in all sections of the Nation.

In 1977 and 1978, we battled uphill against the combined bank and regulatory lobby to enact an entire set of new and improved supervisory powers—to make certain that no one in the Federal supervisory bureaucracy could claim they lacked the tools.

Yet, today, we return to this forum faced with what is, for all practical purposes, the granddaddy of bank failures, a $44 billion money center bank that rolled into the ditch uncontrolled by its $500,000-a-year chairman and the rest of the megabucks management team—or the Federal bank supervisory system.

Minus the excitement and the "anything your heart desires" approach to Federal assistance, 56 commercial banks have slipped quietly down the tubes this year—a failure pace rivaled only in the dark days of the Depression. In 1983, the bank tombstones numbered 48, and in 1982, 42. Hardly ringing testimony to the strength of the economy or the supervisory agencies.

No one on this committee is foolish enough to suggest that all bank failures could or should be prevented. But it is not unreasonable to expect the regulators to identify the problems early on and, most important, to force remedial steps with vigor and without the long period of handwringing agonizing that allow the problems to fester and become more expensive. When the remedial action isn't forthcoming and when the problems are terminal, it is incumbent on the regulators to concede the fact in a timely fashion and not allow the gap between knowledge and action to dupe and ensnare the public—as we saw so clearly in our Penn Square investigation.

The timidity factor in our Federal regulatory system is expensive for the investing public and the Federal Treasury. And it breeds contempt for a regulatory system that consults when it should condemn.

In the case of Continental, money managers and the foreign investors—about whom we have heard so much—obviously were knowledgeable and spotted problems at the bank. When the regulators failed to force meaningful change, when there was no public announcement or hint of vigorous action to assure the bank's improvement, the investors moved their money. A group clearly more devoted to definitive timely action than our Federal regulators.

In the world of the regulators, secrecy cures all. In my opinion, regulatory secrecy dupes the innocent, the unsophisticted, and doesn't fool, for long, the wise men of international finance.

For those of us who have ridden the failed bank circuit, the deja vu qualities of Continental are discouraging. It appears that the only thing the regulators have improved is their ability to make excuses.

The list of excuses will be long and varied. Some will tell us the economy did it. I was as concerned as anyone about the recession but it is far too simplistic to let the economic downturn be used to paper over the deficiencies at Continental. We must have a banking system and a regulatory system for all seasons—for good times and bad times.

Some will tell us that all would have been well—or at least undetected—had the Arabs just kept the price of oil going upward. True, the best bets about oil and gas supplies and prices missed the mark in the early 1980's. But prudent bankers hedge their bets and diversify the portfolios so that even if the most expert of the experts is wrong, the bank is protected. The proof of this is the fact that most banks, including those heavily committed institutions in the Southwest, did survive the downturns in their oil and gas portfolios without the kind of massive help required by Continental.

And if the problems of Continental were simply an unexpected downturn in prices of an otherwise solid oil and gas portfolio, one must again wonder the regulator. Regulators, like prudent bankers, presumably do watch the concentration of assets in a single industry and are in a position to demand the type of diversification that would enable the bank to ride out unforeseen storms.

The Office of the Comptroller of the Currency is skilled in is post-failure public relations. Officials of the agency have circulated among the Washington press corps, offering explanations and an occasional plea of mea culpa on some of the issues, reminiscent of the high school student who brings home the failing marks and quickly concedes he was tardy a few times in hopes that his angry parents will be diverted from asking about all those days he played hookey.

Before these hearings are completed, I am grateful that we will have been able to sift through these excuses, rationalizations, and wishful thinking. Some of the issues are, indeed, complex and some of the decisions, I will concede, are easier to second-guess than to make firsthand on the firing line.

We have an enormous amount of testimony scheduled to be presented to this committee, in coming weeks, but one central theme already stands out in the research.

In the late 1970's, the management of the bank made a conscious decision to become more aggressive and to move Continental up in the competition for the top rungs among money center banks. It was a big change for an institution that had a track record of moderate, if not conservative, banking. Little thought apparently went into the consideration of strengthening the bank's internal controls commensurate with the increased loan activity.

With the bank's growth shooting up past its peer groups among national banks, it is presumed that the alarm bells—if the system were working—would have sounded within the walls of OCC. It was time to move in, to demand a tough internal system of review, and to make certain that management at all levels could qualify for jet-age banking.

It is true that the examiners on the scene did spot troubles in the internal review process in the late 1970's and early 1980's. But, it is not apparent that OCC ever really did anything about the information—anything that might have forced the changes that might have negated the need for these hearings today.

In August 1981, the examiner reported the startling information that the internal review process was so badly in disarray that billions in loans had never even reached the review stage within the bank—finding $2.4 billion untouched 1 year, $1.6 billion in another year.

"* * * It is evident that no one is monitoring this situation to ensure that all credits are receiving timely review . . ." the examiner stated in his 1981 Examination Report.

Clearly, a dangerous situation in a bank now headed pell mell at top speed in the big time arenas of banking.

Strangely, this same examiner—after finding this mass of loan paper lying around unchecked—wrote the Continental board of directors this nicely perfumed note:

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

What kind of timid, tip toe through the tulips signal was this supposed to convey to the board of directors?

A little more than a year later, another examiner at Continental began to have second thoughts about the OCC's timidity.

Noting the aggressive growth policy of the bank and the lack of increased attention to controls, Richard Kovarik wrote in the 1982 examination report:

The loan review function at CINB has been the recipient of criticism from the OCC for at least three years. However as it was functioning fairly well, that criticism was not as strong as it now appears it should have been.

When we start passing out awards in the Continental case, I want to nominate Mr. Kovarik for the prize for understatement. Yes, Mr. Kovarik, you are right—it does indeed appear that OCC wasn't as strong as it might have been * * * much to the sorrow of this committee, the banking industry, and the American taxpayer.

As we proceed in these hearings it is essential that we keep in mind the critical importance of the internal review process in money center banks. The size of these institutions make it impossible for examiners to walk through all the loan documents—as might be possible in a smaller institution—and thus much of the regulatory process hinges on the integrity of internal audits, review and control processes. When internal review is faulty, the burden on the examiners increases dramatically.

In the case of Continental, the internal control machinery—the process by which the bank double checked its quality standards on loans—was manned frequently by inexperienced personnel or worse, by people who had made the loans in the first place. In either case, it was unworkable. It is not reasonable to expect a loan officer who has made the judgment to grant the loan to then turn around and conduct a harsh review and give himself or herself a bad mark. That just isn't human nature, and it isn't sound judgment on the part of bank management to allow the review process to be compromised in this fashion.

Overall, this case presents an unfortunate combination of aggressive, decentralized management and timid regulatory approaches. There is no more volatile mixture in banking than aggressive management and timid regulation.

When we have pursued these banking failures in the past, we have put a heavy emphasis on the safety and soundness of banks, the efficacy of the regulatory process, and the need to maintain banking services in local communities.

With Continental, we add a new ingredient—the safety and soundness of the U.S. Treasury. For it is the Federal Government, the American taxpayer and bank customers across the land who will bear much of the burden for the mistakes at Continental.

The bailout—the nationalization, assistance package, whatever name fits one's philosophical viewpoint—is enormous by any standard. Combining assistance from FDIC with the high point of the Federal Reserve's discount window operations and the package of loans from other banks, the bailout probably tops $15 billion.

FDIC's direct assistance includes the purchase of $4.5 billion of the bank's bad loans and a $1 billion infusion of new capital. In late August, the Federal Reserve's discount window had slipped $7.2 billion into the bank and the commercial banks, at the suggestion of the regulators, had moved more than $4 billion to Chicago.

In contrast, the entire package of loans to Lockheed, Chrysler and New York City voted by this committee did not exceed $6 billion combined.

More to the point, these instances of corporate assistance were possible only after extended debate, investigations and majority approval of both Houses of Congress, and the President of the United

States. Before the Lockheed-Chrysler-New York City packages were approved these recipients had to appear before the Banking Committees of both the House and Senate, to agree to stiff conditions and to subject themselves to ongoing reviews by specially established oversight oversight boards within the Federal Government.

In contrast, the bailout of Continental was put together behind closed doors by the three regulators. No public debate. No prior approval by the Congress and the President. Just an announcement of a fait accompli by the regulators. Not even the President of the United States, in the most dire of emergencies, can commit moneys in this magnitude without prior approval and knowledge.

Clearly, this kind of unchecked power—and the ability to commit the moneys and credit of the U.S. Government—cries out for the most thorough of reviews. We will explore every aspect of the statutes which the regulators claim gave them the authority to proceed with the Continental bailout. If, indeed, the authority is clear—as the regulators steadfastly contend—then we have a responsibility to review whether or not this power should remain in its unbridled form.

Obscured in the smokescreen about insurance premiums, funny money at the Federal Reserve and other suggestions that all this assistance is accomplished by mirrors, the hard cold fact is that it will have a substantial impact on the Federal budget deficit.

I have asked the Congressional Budget Office to review the transactions. CBO's final draft is not in hand, but I am sure it will be their approach to give us a range of possible impacts based on various economic conditions and interest rate projections. Using rose-colored glasses, it might be argued that the budget impact could dip to the vicinity of a half billion dollars. Removing those rosy hues, it appears a more realistic range would place the estimate between $2 and $3 billion with some worst case scenarios reaching well beyond.

And the estimates may well be only the tip of the iceberg if the FDIC and the Federal Reserve have created—without congressional approval—a brandnew entitlement program for money center banks. If Continental is a precedent, the big bank fail safe security program may, someday, rival defense outlays.

For the banking industry, the bailout presents some significant policy questions. If the bailout program is to proceed on the basis on bank size, there may be a substantial impact on the small and medium size institutions across the Nation that have not enjoyed the automatic bailout features incorporated in the Continental case. The fail-safe banks—with the Continental style 100 percent plus insurance of everything—will clearly have a big let up in the market in the competition for funds and investors.

Continental presents the greatest multitude of banking question ever to come before this committee. They are of critical importance to the Nation and are at the heart of this Committee's assigned jurisdiction and responsibility. I feel strongly that we must explore every aspect of this case. I deeply appreciate the support that this inquiry has received from the members of this committee on both sides of the aisle. I also want to commend the staff of both the majority and minority who have worked so well together in a tireless effort to compile the data for the Members. These issues which clearly transcend party and philosophical lines and judging from my conversations with Members, I know there is a determined effort to probe the Continental case with vigor and thoroughness.

[The staff reports and charts follow:]

THE FINANCIAL PERFORMANCE OF CONTINENTAL ILLINOIS NATIONAL BANK: A CHRONOLOGY AND PEER GROUP COMPARISON

September 17, 1984

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.

EXECUTIVE SUMMARY

This report presents information on the financial history of Continental Illinois National Bank and Trust Company of Chicago, discusses significant events which affected the Bank, and compares the performance of the Bank over time to other multinational banks and other Chicago regional banks. The report is divided into three sections. In the first section, we present (1) a chart which provides information on the increasing number of problem and failed banks, (2) a series of charts which highlight ratios related to Continental's performance in comparison with its peers, and (3) the consolidated statements of income and financial position of Continental for the period from 1970 through the first quarter of 1984. The second section presents a comparative financial analysis of the Bank in relation to its peers. The third section discusses the economic environment surrounding the Bank; changes in the Bank's organization and management; and the Bank's financial performance throughout the period from 1970 to date. The section also discusses significant events which contributed to the Bank's failure and subsequent rescue.

Continental Illinois Corporation, which commenced operations on April 1, 1969, is dependent primarily upon the financial condition of Continental Bank, accounting for approximately 95 percent of the holding company's consolidated assets. Through a network of subsidiaries, branches, and representative offices, the Bank provides a broad range of banking and related business services worldwide. At its peak in 1981 the Bank was sixth among other multinational banks and the largest domestic commercial and industrial lender, employing more than 12,000 employees.

The financial condition of the Corporation through 1981 was achieved primarily as a result of annual growth in assets and loans significantly in excess of its peers. However, by year-end 1982, the Corporation's ability to function as a viable entity was in extreme jeopardy. During 1982 and 1983, the Bank's financial condition deteriorated severely. The Bank's allowance for loan losses, net charge-offs, and nonperforming loans increased dramatically. Among the factors that lead to this situation were the failure of Penn Square Bank, the bankruptcy or depressed condition of Continental's once blue-chip customers, and Continental's dependency on short-term rate-sensitive funds.

Significant asset quality problems in the Bank's oil and gas lending department were highlighted by the Penn Square failure in July 1982. At year-end 1982, the provision for loan losses amounted to $492 million, which included a $220 million provision related to Penn Square. But, problems were not limited to just oil and gas lending alone. During 1983 and 1984, the Bank experienced significant credit quality and documentation deficiencies in all aspects of its loan operations. As a result, more and more loans were labeled as nonperforming. By June 30, 1984, nonperforming loans amounted to $2.7 billion.

After Penn Square failed, Continental's large uninsured depositors became increasingly concerned about the Bank's inordinately large amount of poor quality loans and its viability in general. By early 1984, cash flow problems had become critical. In May 1984, rumors of a possible failure or takeover circulated in the foreign money markets upon which the Bank had become so dependent. Soon after, major providers of overnight and term funds abandoned the Bank. Continental turned first to borrowing from the Federal Reserve and then from a consortium of other large banks, but it was unable to achieve stability. Consequently, on May 17, 1984, the Federal Deposit Insurance Corporation arranged an interim emergency assistance program and guaranteed all depositors of the Bank.

SECTION 1

Statistical Data on Problem and Failed Banks

Continental's Performance Ratios
in Comparison to its Peers

Continental's Consolidated Statements
of Income and Financial Position
for the Period 1970 Through
the First Quarter of 1984

SCHEDULE OF PROBLEM AND FAILED BANKS AND INSURED DEPOSITS

FROM 1974 TO 1984

Year	Number of Problem Banks	Failed Banks: Number Insured	Failed Banks: Insured Deposits (millions)
1974	183	4	$1,575.8
1975	349	13	339.6
1976	379	16	864.9
1977	368	6	205.2
1978	342	7	854.2
1979	287	10	110.7
1980	217	10	216.3
1981	223	10	3,826.0
1982	369	42	9,904.5
1983	642	48	5,541.4
1984	745 a/	55 a/	b/

a/ Information as of September, 1984

b/ Not available at time of printing

Performance Measures for Continental Illinois Corporation
As Compared to Other Multinational Banks From 1976 to 1983 1/

	1976	1977	1978	1979	1980	1981	1982	1983
Profitability/Earnings								
Return on Equity								
Continental	14.00	14.14	13.69	14.37	14.82	14.88	4.56	5.95
Peer Group	10.65	10.94	12.33	13.68	13.54	12.75	11.53	11.15
Return on Assets								
Continental	.58	.55	.54	.55	.54	.54	.18	.26
Peer Group	.46	.45	.50	.52	.52	.51	.49	.52
Asset Quality								
Net Charge-offs to Total Loans								
Continental	.62	.45	.32	.29	.28	.29	1.28	1.37
Peer Group	.77	.56	.46	.38	.46	.41	.55	.64
Allowance for Possible Loan Losses to Total Loans								
Continental	1.27	1.13	1.01	.91	.90	.89	1.15	1.24
Peer Group	1.04	.99	1.00	1.03	1.01	1.03	1.08	1.21
Non Performing Assets to Total Assets								
Continental	3.1	2.2	1.4	1.3	1.1	1.4	4.6	4.5
Peers	3.0	2.2	1.5	1.2	1.0	1.3	2.1	2.3
Capital Adequacy								
Equity Capital to Total Assets								
Continental	4.88	4.54	4.51	4.36	4.17	4.22	4.81	5.17
Peer Group	4.90	4.69	4.57	4.39	4.45	4.63	4.86	5.39
Equity Capital + Subordinated Notes and Debentures to Total Assets								
Continental	4.88	4.54	4.51	4.36	4.17	4.22	5.27	5.64
Peer Group	5.67	5.34	5.17	4.98	4.93	5.04	5.70	6.26
Equity Capital to Total Loans								
Continental	7.13	6.90	6.70	6.05	5.77	5.40	5.26	6.03
Peer Group	7.77	7.43	7.11	6.80	6.88	6.76	6.98	7.62

Performance Measures for Continental Illinois Corporation As Compared to Other Multinational Banks From 1976 to 1983 1/

	1976	1977	1978	1979	1980	1981	1982	1983
Liquidity								
Total Loans to Total Assets								
Continental	58.35	56.88	58.93	62.92	62.77	67.40	75.79	71.72
Peer Group	56.19	56.27	57.00	56.74	57.15	60.34	61.53	62.25
Liquid Assets - Volatile Liabilities to Total Assets								
Continental	-37.88	-38.18	-37.09	-45.70	-46.32	-51.85	-58.16	-52.61
Peer Group	-16.75	-17.75	-21.48	-22.30	-25.07	-31.55	-31.51	-30.88
Growth								
Growth in Loans								
Continental	N/A	14.44	24.73	23.03	17.32	19.84	2.70	-7.15
Peer Group	N/A	14.83	15.83	15.36	12.78	14.59	9.26	5.99
Growth in Assets								
Continental	N/A	17.41	20.38	15.23	17.60	11.60	-8.67	-1.87
Peer Group	N/A	14.75	14.19	16.09	11.85	8.48	7.56	4.59
Growth in Earnings								
Continental	N/A	11.80	17.25	16.68	15.39	12.69	-69.41	39.07
Peer Group	N/A	15.63	27.16	24.77	14.92	9.73	4.19	10.79

1/ More complete information on the composition of the ratios is contained in Section 2.

CONSOLIDATED STATEMENT OF INCOME
Continental Illinois Corporation and Subsidiaries

Year ended 12/31 ($ in thousands)	1984 (3/31)	1983	1982	1981	1980
Interest & fees on loans	803,734	3,453,274	4,683,350	4,796,322	3,448,973
Lease financing income	20,979	95,907	125,073	90,327	65,838
Interest on deposits with banks		214,107	499,437	747,149	658,355
Int.& dividends on investment securities:					
Taxable income	25,323	105,316	129,565	148,910	133,215
Income exempt from Fed.inc.taxes	10,702	49,759	59,667	64,194	70,951
Trading account interest	9,859	29,182	34,308	34,032	29,307
Int.on Fed.funds sold & securities purchased under agreemts to resell	90,149	29,499	47,876	83,281	65,874
Total interest income	960,746	3,977,044	5,579,276	5,964,215	4,472,513
Interest on deposits	572,309	2,191,239	3,100,409	3,316,677	2,397,443
Int.on Fed.funds purch'd & secur. sold under agreemts to repurchase	124,932	512,868	1,056,749	1,405,811	1,048,795
Interest on other borrowings	79,046	301,163	400,266	354,953	230,884
Interest on long-term debt	35,219	141,632	131,252	80,993	65,097
Total interest expense	811,506	3,146,902	4,688,676	5,158,434	3,742,219
Net interest income	149,240	830,142	890,600	805,781	730,294
Provision for credit losses	140,000	395,000	492,000	120,000	96,000
Net interest income after provision for credit losses	9,240	435,142	398,600	685,781	634,294
Trust income	15,857	62,369	60,428	53,600	44,809
Secur.trading profits & commissions	5,318	19,648	39,882	27,888	6,122
Foreign exchange profits (losses)	7,224	10,587	(1,428)	31,155	32,284
All other income	72,483	309,525	221,882	209,764	160,422
Total other operating income	100,882	402,129	320,764	322,407	243,637
Net int.& other operating income	110,122	837,271	719,364	1,008,188	877,931
Salaries and wages	80,702	309,639	293,575	265,614	227,758
Pension, profit sharing, other employee benefits	21,250	74,750	61,071	74,877	61,473
Net occupancy expense	20,134	87,410	72,726	65,747	53,314
Eqpt rentals,deprec.& maintenance	12,475	44,918	41,095	36,857	36,801
Other expense	83,357	204,462	204,727	180,759	178,874
Total other operating expense	217,918	721,179	673,194	623,854	558,220
Income before inc.taxes & securities gains or losses	(107,796)	116,092	46,170	384,334	319,711
Applicable income taxes (credits)	--	16,174	(38,206)	124,019	95,568
Inc.before security gains or losses	(107,796)	99,918	84,376	260,315	224,143
Secur.gains or (losses) less applicable income taxes 1	575	1,245	(6,489)	(5,692)	1,798
Extraordinary item, net of tax	136,628	7,156	--	--	--
Net income	29,407	108,319	77,887	254,623	225,941
Per common share:					
Income before extraordinary item		$ 2.46	$ 1.95	$ 6.44	$ 5.75
Extraordinary item		$ 0.17	$ --	--	--
Net income		$ 2.63	$ 1.95	$ 6.44	$ 5.75
Cash dividends declared		$ 2.00	$ 2.00	$ 1.90	$ 1.70
Average common shares outstanding (in thousands)		40,045	39,777	39,537	39,256

1 Gain on sale of charge card operations.

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

CONSOLIDATED STATEMENT OF INCOME
Continental Illinois Corporation and Subsidiaries

Year ended 12/31 ($ in thousands)	1979	1978	1977	1976	1975
Interest & fees on loans	2,437,870	1,496,957	1,022,987	918,572	1,017,596
Lease financing income	39,190	34,294	29,772	24,918	22,050
Interest on deposits with banks	455,931	307,933	224,991	217,617	152,619
Int.& dividends on investment securities:					
Taxable income	75,955	67,970	71,628	69,116	77,397
Income exempt from Fed.inc.taxes	77,568	75,789	70,903	63,607	46,107
Trading account interest	19,510	12,265	11,060	10,326	13,169
Int.on Fed.funds sold & securities purchased under agreemts to resell	62,103	39,000	12,000	8,000	7,000
Total interest income	3,168,127	2,034,208	1,443,341	1,312,156	1,335,938
Interest on deposits	1,739,743	1,049,519	696,809	661,192	668,449
Int.on Fed.funds purch'd & secur. sold under agreemts to repurchase			253,530	182,784	189,919
Interest on other borrowings	806,611	444,161	27,398	23,603	14,077
Interest on long-term debt	47,920	33,665	23,712	12,089	28,309
Total interest expense	2,594,274	1,527,345	1,001,449	879,668	900,754
Net interest income	573,853	506,863	441,892	432,488	435,184
Provision for credit losses	70,000	62,500	53,500	75,000	75,000
Net interest income after provision for credit losses	503,853	444,363	388,392	357,488	360,184
Trust income	37,434	34,521	34,082	33,618	31,845
Secur.trading profits & commissions	15,730	11,255	10,954	17,299	17,282
Foreign exchange profits (losses)	12,583	15,267	15,005	7,152	
All other income	141,983	105,713	79,395	66,953	56,175
Total other operating income	207,730	166,756	139,436	125,022	105,302
Net int.& other operating income	711,583	611,119	527,828	482,510	465,486
Salaries and wages	199,501	166,358	145,600	131,937	119,386
Pension, profit sharing, other employee benefits	51,187	44,456	37,180	32,048	29,606
Net occupancy expense	41,401	33,838	30,228	25,509	25,640
Eqpt rentals,deprec.& maintenance	27,549	20,889	18,658	18,888	15,347
Other expense	144,894	118,401	91,231	85,898	80,346
Total other operating expense	464,532	383,942	322,897	294,280	270,325
Income before inc.taxes & securities gains or losses	247,051	227,177	204,931	188,230	195,161
Applicable income taxes (credits)	52,925	58,453	60,727	57,468	76,164
Inc.before security gains or losses	194,126	168,724	144,204	130,762	118,997
Secur.gains or (losses) less applicable income taxes	1,681	(907)	(1,081)	(2,958)	(6,107)
Extraordinary item, net of tax	--	--	--	--	--
Net income	195,807	167,817	143,123	127,804	112,890
Per common share:					
Income before extraordinary item	$ 4.99	$ 4.49	$ 4.02	$ 3.63	$ 6.49
Extraordinary item	--	--	--	--	--
Net income	$ 4.99	$ 4.49	$ 4.02	$ 3.63	$ 6.49
Cash dividends declared	$ 1.52	$ 1.32	$ 1.26	$ 1.18	$ 2.23
Average common shares outstanding (in thousands)	39,195	37,336	35,537	35,130	34,758

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

CONSOLIDATED STATEMENT OF INCOME
Continental Illinois Corporation and Subsidiaries

Year ended 12/31 ($ in thousands)	1974	1973	1972	1971	1970
Interest & fees on loans	1,249,113	716,490	356,674	318,388	373,238
Lease financing income	19,000	8,000	5,000	3,000	--
Interest on deposits with banks	207,811	133,548	53,738	11,621	2,395
Int.& dividends on investment securities:					
Taxable income	73,816	50,515	45,295	63,059	41,837
Income exempt from Fed.inc.taxes	44,438	48,826	43,845	39,805	34,385
Trading account interest	25,076	14,546	6,983	10,733	34,236
Int.on Fed.funds sold & securities purchased under agreemts to resell	16,000	15,000	9,000	4,000	
Total interest income	1,635,254	986,925	520,535	450,606	486,091
Interest on deposits	915,323	538,834	243,052	208,939	198,962
Int.on Fed.funds purch'd & secur. sold under agreemts to repurchase	355,517	189,064	43,019	37,305	99,047
Interest on other borrowings	57,431	32,461	16,514	9,782	
Interest on long-term debt	9,135	6,652	6,357	--	--
Total interest expense	1,337,406	767,011	308,942	256,026	298,009
Net interest income	297,848	219,914	211,593	194,580	188,082
Provision for credit losses	32,900	15,300	12,353	15,262	14,221
Net interest income after provision for credit losses	**264,948**	**204,614**	**199,240**	**179,318**	**173,861**
Trust income	31,465	31,404	29,773	27,824	22,732
Secur.trading profits & commissions	13,246	9,381	2,303	4,299	--
Foreign exchange profits (losses)	--	--	--	--	--
All other income	64,000	59,000	33,000	26,000	17,563
Total other operating income	108,711	99,785	65,076	58,123	40,295
Net int.& other operating income	373,659	304,399	264,316	237,441	214,156
Salaries and wages	105,924	89,618	77,574	66,766	
Pension, profit sharing, other					74,861
employee benefits	24,099	20,401	17,669	15,936	
Net occupancy expense	21,009	17,679	15,940	13,276	
Eqpt rentals,deprec.& maintenance	10,749	8,652	6,886	6,491	45,556
Other expense	61,484	48,125	38,823	35,681	
Total other operating expense	223,265	184,475	156,892	138,150	120,417
Income before inc.taxes & securities gains or losses	150,394	119,924	107,424	99,291	93,739
Applicable income taxes (credits)	54,488	33,619	29,294	29,493	29,394
Inc.before security gains or losses	95,906	86,305	78,130	69,798	64,345
Secur.gains or (losses) less applicable income taxes	(226)	(835)	265	576	(6,815)
Extraordinary item, net of tax	--	--	--	--	--
Net income	95,680	85,470	78,395	70,374	57,530
Per common share:					
Income before extraordinary item	$ 5.51	$ 4.94	$ 4.55	$ 4.11	$ 3.38
Extraordinary item	--	--	--	--	--
Net income	$ 5.51	$ 4.94	$ 4.55	$ 4.11	$ 3.38
Cash dividends declared	1.10	$ .97	$ .92	$ .88	$ .82
Average common shares outstanding (in thousands)	34,716	34,583	34,453	34,264	34,584

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

CONSOLIDATED STATEMENT OF CONDITION

Continental Illinois Corporation and Subsidiaries

December 31 ($ in thousands)	1984[1]	1983	1982	1981	1980
Assets					
Cash and due from banks	2,039,281	2,569,866	2,199,386	2,513,080	4,361,504
Interest-bearing deposits	3,415,990	3,586,524	1,880,853	5,082,703	4,294,045
Fed.funds sold and securities purch'd under agrmts to resell	646,739	676,774	444,224	499,817	417,207
Trading account assets	761,664	561,589	853,460	169,164	128,065
Investment securities	1,814,334	1,762,394	2,064,744	2,169,303	2,505,924
Loans:					
Domestic		20,187,123	22,053,107	22,131,015	18,528,132
Foreign	29,329,847	10,203,246	10,817,214	10,044,482	8,381,566
Lease financing receivables	1,045,485	1,038,400	1,172,478	1,123,729	720,003
Total loans and lease receivables	30,375,332	31,428,769	34,042,799	33,299,226	27,629,701
Less: Unearned income	267,333	269,720	322,551	423,000	262,663
Reserve for credit losses	401,384	382,565	381,083	289,169	246,413
Net loans and lease receivables	29,706,615	30,776,484	33,339,165	32,587,057	27,120,625
Properties and equipment	325,599	337,045	342,241	298,715	276,479
Customers' liability on acceptances	870,015	859,318	690,442	2,469,917	1,898,071
Other assets	1,870,572	967,377	1,084,909	1,181,999	1,087,488
Total assets	41,450,809	42,097,371	42,899,424	46,971,755	42,089,408
Liabilities					
Deposits:					
Domestic offices	10,146,083	13,527,978	12,690,041	14,963,103	13,579,324
Foreign offices	18,132,704	15,903,490	15,484,980	14,630,902	13,734,343
Total deposits	28,278,787	29,431,468	28,175,021	29,594,005	27,313,667
Fed.funds purch'd & securities sold under agreemts to repurchase	5,192,723	4,830,645	5,920,332	7,998,482	7,361,000
Other borrowings	2,801,843	2,677,047	4,028,928	3,014,740	2,203,947
Acceptances outstanding	870,015	870,106	692,788	2,477,137	1,898,816
Other liabilities	1,231,387	1,210,578	1,100,169	1,314,402	1,110,719
Long-term debt	1,247,881	1,255,953	1,272,291	862,297	676,317
Total liabilities	39,622,636	40,275,797	41,189,529	45,261,063	40,564,466
Stockholders' Equity					
Preferred stock	89,400	89,400		--	--
Common stock	200,780	200,780	199,761	198,009	196,690
Capital surplus	526,904	526,895	525,525	522,812	517,824
Retained earnings	1,021,457	1,014,539	989,244	989,871	810,428
Accumulated translation adjustment	(10,256)	(9,975)	(4,433)	--	--
Total	1,828,285	1,821,639	1,710,097	1,710,692	1,524,942
Less - Treasury stock at cost	112	65	202	--	--
Total Stockholders' Equity	1,828,173	1,821,574	1,709,895	1,710,692	1,524,942
Total Liabilities & Stockholders' Equity	41,450,809	42,097,371	42,899,424	46,971,755	42,089,408

1 As of March 31, 1984.

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

CONSOLIDATED STATEMENT OF CONDITION
Continental Illinois Corporation and Subsidiaries

December 31 ($ in thousands)	1979	1978	1977	1976	1975
Assets					
Cash and due from banks	3,366,816	3,897,143	2,879,378	1,523,849	1,761,488
Interest-bearing deposits	4,035,140	3,926,679	3,932,661		
Fed.funds sold and securities purch'd under agrmts to resell	308,174	361,591	183,324	3,942,564	3,235,981
Trading account assets	189,101	114,349	299,792	383,432	205,925
Investment securities	2,226,340	2,174,380	2,501,082	2,364,019	2,281,344
Loans:					
Domestic	16,366,150	12,796,075	10,883,300	9,601,343	9,334,256
Foreign	6,815,562	5,650,035	3,980,117	3,357,468	2,756,076
Lease financing receivables	609,668	451,816	400,394	324,865	274,967
Total loans and lease receivables	23,791,380	18,897,926	15,263,811	13,283,676	12,365,299
Less: Unearned income	215,374	143,305	121,027	107,000	97,000
Reserve for credit losses	212,180	191,237	168,164	163,271	161,890
Net loans and lease receivables	23,363,826	18,563,384	14,974,620	13,013,405	12,106,409
Properties and equipment	226,842	195,579	164,966	120,850	87,596
Customers' liability on acceptances	1,092,622	900,405	255,893	125,515	176,736
Other assets	981,258	925,155	608,564	511,265	360,264
Total assets	35,790,119	31,058,665	25,800,280	21,984,899	20,215,743
Liabilities					
Deposits:					
Domestic offices	12,517,200	12,142,717	10,089,704	8,708,640	9,351,904
Foreign offices	11,490,000	9,017,533	8,664,081	7,108,487	5,938,481
Total deposits	24,007,200	21,160,250	18,753,785	15,817,127	15,290,385
Fed.funds purch'd & securities sold under agreemts to repurcha	5,865,470	5,143,594	4,383,055	3,981,529	2,934,426
Other borrowings	1,901,351	1,492,881	450,272	325,028	313,159
Acceptances outstanding	1,096,924	905,557	257,764	126,269	177,268
Other liabilities	1,026,740	680,202	586,259	557,280	494,900
Long-term debt	529,532	450,457	357,050	265,293	180,000
Total liabilities	34,427,217	29,832,941	24,788,185	21,072,526	19,390,138
Stockholders' Equity					
Preferred stock	--	--	--	--	136
Common stock	196,095	195,839	177,824	177,335	173,937
Capital surplus	510,349	508,646	428,148	427,243	428,737
Retained earnings	656,458	521,239	406,123	307,795	222,795
Accumulated translation adjustment	--	--	--	--	--
Total	1,362,902	1,225,724	1,012,095	912,373	825,605
Less - Treasury stock at cost	--	--	--	--	--
Total Stockholders' Equity	1,362,902	1,225,724	1,012,095	912,373	825,605
Total Liabilities & Stockholders' Equity	35,790,119	31,058,665	25,800,280	21,984,899	20,215,743

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

CONSOLIDATED STATEMENT OF CONDITION
Continental Illinois Corporation and Subsidiaries

December 31 ($ in thousands)	1974	1973	1972	1971	1970 [2]
Assets					
Cash and due from banks	1,905,849	1,556,970	1,779,892	1,340,999	1,803,907
Interest-bearing deposits					
Fed.funds sold and securities purch'd under agrmts to resell	2,151,719	2,237,921	1,593,554	902,863	918,870
Trading account assets	356,048	339,825	181,290	181,992	413,528
Investment securities	1,774,445	2,069,506	1,802,936	1,707,646	1,519,447
Loans:					
Domestic	10,047,666	8,216,269	5,946,998	4,016,679	3,476,186
Foreign	2,607,592	1,777,829	1,173,004	879,614	--
Lease financing receivables	102,819		--	--	--
Total loans and lease receivables	12,758,077	9,994,098	7,120,002	4,896,293	3,476,186
Less: Unearned income [3]	--	--	--	--	--
Reserve for credit losses	157,378	142,950	129,530	125,639	123,782
Net loans and lease receivables	12,600,699	9,851,148	6,990,472	4,770,654	3,352,404
Properties and equipment	58,672	49,293	46,173	40,627	32,759
Customers' liability on acceptances	271,245	84,930	111,098	247,597	202,746
Other assets	522,070	537,637	194,526	762,729	445,037
Total assets	19,640,747	16,727,230	12,699,941	9,955,107	8,688,698
Liabilities					
Deposits:					
Domestic offices	9,752,612	8,576,870	6,936,739	5,764,402	4,980,456
Foreign offices	5,715,562	4,021,333	3,064,436	2,691,736	2,173,969
Total deposits	15,468,174	12,598,203	10,001,175	8,456,138	7,154,425
Fed.funds purch'd & securities sold under agreemts to repurchase	1,967,516	2,245,659			484,807
Other borrowings	457,403	618,406	1,542,339	515,345	172,646
Acceptances outstanding	272,013	86,445	116,216	251,468	204,159
Other liabilities	544,029	386,557	301,758	147,717	137,771
Long-term debt	180,000	100,000	100,000	--	--
Total liabilities	18,889,135	16,035,270	12,061,488	9,370,668	8,153,808
Stockholders' Equity					
Preferred stock	186	186	186	186	--
Common stock	173,663	173,095	172,539	171,359	168,643
Capital surplus	425,291	421,170	393,800	317,227	314,357
Retained earnings	152,472	97,509	71,928	95,667	51,890
Accumulated translation adjustment	--	--	--	--	--
Total	751,612	691,960	638,453	584,439	534,890
Less - Treasury stock at cost	--	--	--	--	--
Total Stockholders' Equity	751,612	691,960	638,453	584,439	534,890
Total Liabilities & Stockholders' Equity	19,640,747	16,727,230	12,699,941	9,955,107	8,688,698

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

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

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

CONSOLIDATED STATEMENT OF CONDITION
Continental Illinois Corporation and Subsidiaries
(as percent of total assets)

December 31	1984[1]	1983	1982	1981	1980	1979	1978	1977
Assets								
Cash and due from banks	4.9	6.1	5.1	5.4	10.4	9.4	12.5	11.2
Interest-bearing deposits	8.2	8.5	4.4	10.8	10.2	11.3	12.6	15.2
Fed.funds sold and securities purch'd under agrmts to resell	1.6	1.6	1.0	1.1	1.0	.9	1.2	.7
Trading account assets	1.8	1.3	2.0	.4	.3	.5	.4	1.2
Investment securities	4.4	4.2	4.8	4.6	6.0	6.2	7.0	9.7
Loans:								
Domestic		48.0	51.4	47.1	44.0	45.7	41.2	42.2
Foreign	70.8	24.2	25.2	21.4	19.9	19.0	1.82	15.4
Lease financing receivables	2.5	2.5	2.7	2.4	1.7	1.7	1.5	1.6
Total loans and lease receivables	73.3	74.7	79.4	70.9	65.6	66.5	60.8	59.2
Less: Unearned income	.6	.6	.8	.9	.6	.6	.5	.5
Reserve for credit losses	1.0	.9	.9	.6	.6	.6	.6	.7
Net loans and lease receivables	71.7	73.1	77.7	69.4	64.4	65.3	59.8	58.0
Properties and equipment	.8	.8.	.8	.6	.7	.6	.6	.6
Customers' liability on acceptances	2.1	2.0	1.6	5.3	4.5	3.1	2.9	1.0
Other assets	4.5	2.3	2.5	2.5	2.6	2.7	3.0	2.4
Total assets	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Liabilities								
Deposits:								
Domestic offices	24.5	32.1	29.6	31.9	32.3	35.0	39.1	39.1
Foreign offices	43.7	37.8	36.1	31.1	32.6	32.1	29.0	33.6
Total deposits	68.2	69.9	65.7	63.0	64.9	67.1	68.1	72.7
Fed.funds purch'd & securities sold under agreemts to repurchase	12.5	11.5	13.8	17.0	17.5	16.4	16.6	17.0
Other borrowings	6.8	6.4	9.4	6.4	5.2	5.3	4.8	1.7
Acceptances outstanding	2.1	2.1	1.6	5.3	4.5	3.1	2.9	1.0
Other liabilities	3.0	2.9	2.6	2.8	2.6	2.9	2.2	2.3
Long-term debt	3.0	3.0	3.0	1.8	1.6	1.5	1.5	1.4
Total liabilities	95.6	95.7	96.9	96.4	96.4	96.2	96.1	96.1
Stockholders' Equity								
Preferred stock	.2	.2	-	-	-	-	-	-
Common stock	.5	.5	.5	.4	.5	.5	.6	.7
Capital surplus	1.3	1.3	1.2	1.1	1.2	1.4	1.6	1.7
Retained earnings	2.5	2.4	2.3	2.1	1.9	1.8	1.7	1.6
Accumulated translation adjustment	-	-	-	-	-	-	-	-
Total	4.4	4.3	4.0	3.6	3.6	3.8	3.9	3.9
Less - Treasury stock at cost	-	-	-	-	-	-	-	-
Total Stockholders' Equity	4.4	4.3	4.0	3.6	3.6	3.8	3.9	3.9
Total Liabilities & Stockholders' Equity	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

1 As of March 31, 1984.

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

CONSOLIDATED STATEMENT OF CONDITION
Continental Illinois Corporation and Subsidiaries
(as percent of total assets)

December 31	1976	1975	1974	1973	1972	1971	1970 [2]
Assets							
Cash and due from banks	6.9	8.7	9.7	9.3	14.0	13.5	20.8
Interest-bearing deposits							
Fed.funds sold and securities purch'd under agrmts to resell	17.9	16.0	11.0	13.4	12.5	9.1	10.6
Trading account assets	1.7	1.0	1.8	2.0	1.4	1.8	4.8
Investment securities	10.8	11.3	9.0	12.4	14.2	17.2	17.5
Loans:							
Domestic	43.7	46.2	51.2	49.1	46.8	40.3	40.0
Foreign	15.3	13.6	13.3	10.6	9.2	8.8	
Lease financing receivables	1.5	1.4	.5	-	-	-	-
Total loans and lease receivables	60.4	61.2	65.0	59.7	56.1	49.2	40.0
Less: Unearned income [3]	.5	.5	-	-	-	-	-
Reserve for credit losses	.7	.8	.8	.9	1.0	1.3	1.4
Net loans and lease receivables	59.2	59.9	64.2	58.9	55.0	47.9	38.6
Properties and equipment	.5	.4	.3	.3	.4	.4	.4
Customers' liability on acceptances	.6	.9	1.4	.5	.9	2.5	2.3
Other assets	2.3	1.8	2.7	3.2	1.5	7.7	5.1
Total assets	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Liabilities							
Deposits:							
Domestic offices	39.6	46.3	49.7	51.3	54.6	57.9	57.3
Foreign offices	32.3	29.4	29.1 *	24.0	24.1	27.0	25.0
Total deposits	71.9	75.6	78.8	75.3	78.7	84.9	82.3
Fed.funds purch'd & securities sold under agreemts to repurchase	18.1	14.5	10.0	13.4	12.1		5.6
Other borrowings	1.5	1.5	2.3	3.7		5.2	2.0
Acceptances outstanding	.6	.9	1.4	.5	.9	2.5	2.3
Other liabilities	2.5	2.4	2.8	2.3	2.4	1.5	1.6
Long-term debt	1.2	.9	.9	.6	.8	-	-
Total liabilities	95.9	95.9	96.2	95.9	95.0	94.1	93.8
Stockholders' Equity							
Preferred stock	-	-	-	-	-	-	-
Common stock	.8	.9	.9	1.0	1.4	1.7	1.9
Capital surplus	1.9	2.1	2.2	2.5	3.1	3.2	3.6
Retained earnings	1.4	1.1	.8	.6	.6	1.0	.6
Accumulated translation adjustment	-	-	-	-	-	-	-
Total	4.1	4.1	3.8	4.1	5.0	5.9	6.2
Less - Treasury stock at cost	-	-	-	-	-	-	-
Total Stockholders' Equity	4.1	4.1	3.8	4.1	5.0	5.9	6.2
Total Liabilities & Stockholders' Equity	100.0	100.0	100.0	100.0	100.0	100.0	100.0

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

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

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

SECTION 2

Analysis of the Financial Condition of Continental Illinois Corporation as Compared with Other Multinational Banks from 1976 to 1983

INTRODUCTION

In the last decade, the banking industry has been subjected to severe recessions, inflation market shifts, increased interest rate volatility, development of new types of assets and liabilities, and encroachment by other businesses. Furthermore, banking has become less protected by regulation and has become more competitive at home and abroad.

During this same period, the number of problem banks increased dramatically (from 183 at year end 1974 to 745 as of September, 1984). As described by the Federal Deposit Insurance Corporation (FDIC), a problem institution is one that has unsafe or unsound conditions and a relatively high possibility of failure. In most instances an increase in problem institutions is followed by an increase in failed institutions. Such was the case for this period. The number of failed institutions, those institutions receiving financial assistance from FDIC, increased dramatically from 4 at year end 1974 to 42, 48, and 55 in 1982, 1983, and 1984, respectively.

But what causes an institution such as Continental Illinois National Bank to become a problem or even a failed bank? The remaining sections of this report will attempt to answer this question by reviewing the objectives and components of the federal regulatory agencies' surveillance system and analyzing the financial condition/performance of Continental Illinois Corporation from 1976 to 1983. More specifically, these sections will focus on how well Continental has performed in comparison with other multinational banks and what factors led to its current situation.

OBJECTIVES AND COMPONENTS OF A SUREVEILLANCE SYSTEM

Each of the three bank regulators, the Office of the Comptroller of the Currency (OCC), Federal Reserve System (FRS), and FDIC maintain a surveillance system. A surveillance system is designed to identify financial institutions that have or are likely to have financial conditions that warrant special supervisory action. Prior to 1975, the regulators determined the financial condition of a financial institution solely through on-site examinations. However, in the mid to late 1970's, each regulator designed and implemented a surveillance screening system.

The surveillance screening systems are not intended as substitutes for bank examinations nor are they intended to replace the skills and judgements needed to monitor banks or resolve their problems. The primary objective of the systems is to aid the examination process by identifying changes in the financial condition of banks and bank holding companies between examinations. Detection of such changes enables the regulators to focus on a select number of banks as opposed to focusing on the total universe. In turn, the regulators can allocate examination resources efficiently by giving the most attention to those banks that warrant the closest scrutiny. Essentially, the early warning system is made up of three components: (1) a computer screening program to identify financial institutions that fail certain ratios, (2) a detailed financial performance analysis of the institution to its peers, and (3) a notification of corrective action and follow up of problems identified from components (1) and (2).

Although the regulators consider the present surveillance screening systems extremely useful, they do have several limitations. The results of a computer screen are only as good as the data and ratios used in the screen. A screen will not normally identify those banks subjected to fraud, embezzlement, or other theft nor will it readily identify understated amounts on the financial statements. Also, screens are based on predetermined ratios, thus they will not necessarily identify problems from an emerging industry trend, such as problems caused by bad energy loans, unless such information has been programmed into the computer. None of the systems are designed to predict bank failures nor will they identify all unsound banks. The systems simply tell the regulator that the financial condition of a financial institution has changed since the last bank examination.

FINANCIAL RATIOS

As mentioned in the previous section, the screening of specific ratios is basically the technique or tool used by the regulators to monitor/analyze the financial condition of an organization. The basic component of ratio analysis is a single ratio, constructed by dividing one balance-sheet and/or income-expense item by another. The denominator of such ratios may be conceived as a "base" or scale factor. For example, a profitability ratio would relate a firm's profits to its asset or equity-capital base to provide a return-on-assets or return-on-equity measure of a firm's overall performance.

It is important to recognize that ratios by themselves do not tell us much about the financial condition of the organization. To provide a meaningful basis for evaluating an organization's financial condition, comparisons with other organizations and/or with its own performance at other times are required. Also, ratio analysis focuses only on symptoms not on causes of financial difficulty. The driving force behind an organization's performance is its management: financial planning, policies, and internal controls ultimately determine an organization's performance.

FINANCIAL ANALYSIS

In our analysis of Continental's financial condition from 1976 to 1983, we have basically taken the approach used by the regulators and relied upon ratio analysis. We have selected 13 financial ratios under 5 major categories that are used to measure an institution's financial condition. For each ratio we have compared Continental's financial condition with two peer groups. The first peer group includes 16 multinational banking organizations, while the second peer group includes 4 of Chicago's largest banking organizations. The ratios used in the analysis were determined from financial information as filed by bank holding compnies with the Federal Reserve. The data obtained is based on year-end financial data which has not been adjusted for prior year restatements. To supplement the Federal Reserve data, we obtained comparative ratios from an outside consulting firm and reviewed data from the Office of the Comptroller of the Currency, including bank examination reports of Continental Bank from 1976 to date.

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

Profitability/Earnings

Ratio 1	Return on Equity
Ratio 2	Return on Assets

Asset Quality

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

Capital Adequacy

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

Liquidity

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

Growth

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

The remainder of this section analyzes each performance category and provides specific information about Continental's financial condition as it relates to other multinational organizations. Additional information related to the components of the above ratios and the multinational and regional peer group data discussed below may be obtained from the Committee upon request.

PROFITABILITY

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

Return on equity capital

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

In 1982 and 1983, Continental's return was 4.56 and 5.95 percent, respectively. This was 7 and 5 percentage points below the average of the multinational and 4 and 2 percentage points below the regional peer groups, respectively. In both analyses, Continental ranked last and next to last. The extremely low return was due primarily to a significant increase in the provision for loan loss expenses, a direct result of Penn Square's failure and the bankruptcy and near bankruptcy of several of the Bank's large midwest and manufacturing corporate borrowers.

Return on assets

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

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

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

ASSET QUALITY

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

During the period 1978 to 1981, the asset quality ratios of the multinational and regional peer groups revealed the following. Continental's ratio of allowance for possible loan losses to total loans was as much as .09 and .25 percentage points below the average for the peer groups. Continental's ratio of net charge-offs to total loans was consistently below its peers, averaging .29 percent as compared to the peer group's average of .43 and .46 percent. Finally, the Bank's ratio of nonperforming assets averaged 1.30, just slightly above the multinational peer group.

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

CAPITAL ADEQUACY

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

Equity capital to total assets

Equity capital to total assets (ratios 6 & 7) indicates the percentage decline in total assets that could be covered with equity capital and, where applicable, subordinated notes and debt. The ratios are inversely related to the size of the bank. This reflects the more conservative stance of small banks and the ability of larger banks to reduce their need for capital because it is believed they can reduce the adverse effects of the default risk and market risk through the law of large numbers. An analysis of the multinational peer group data reveals that Continental's equity capital to total assets ratios were relatively constant for the period 1976 to 1983, averaging 4.6 and 4.7 percent, approximately .15 and .69 percentage points below the peer average. On the other hand, an analysis of the regional data ranked Continental last, at least .67 and .90 percentage points below the peer averages.

Equity capital to total loans

Equity Capital to total loans (ratio 8) also indicates the percentage decline in assets that could be covered with equity capital. However, this ratio uses total loans in the denominator based on the belief that the majority of the risk in total assets is in the loan portfolio.

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

Our financial analysis and a review of the bank examination reports from 1976 to 1982 reveals that Continental's level of equity capital over the period did not keep pace in relation to the extremely high volume of loan and asset growth. As a result, the below average base that existed in 1976 continued to erode. Continental was able to assume the additional risk and maintain a strained capital base, whereas others with the same capital ratios could not, because of its continued increase in earnings performance. However, in 1982 and 1983, when the quality of Continental's assets was determined to be poor and the earnings on those assets were depressed, the risk of insolvency significantly increased.

LIQUIDITY

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

Loans to assets

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

Liquid assets minus volatile liabilities to total assets

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

An analysis of both the multinational and regional data reveals that Continental's ratio was extremely poor during 1976 to 1983, averaging -45.97 percent, or at least 21 percentage points below its peers. Not only did Continental rank last during the entire period, but its ratio also increased significantly (from an average of -37.7 percent for 1976 to 78 to -46 percent for 1979 to 1980 to -54.2 percent for 1981 to 1983).

Our analysis of the period from 1977 to 1983 revealed that Continental was increasing its assets with heavy loan volume and had to finance them with more volatile, more expensive money. Continental was not adjusting its maturities and asset and liability composition in order to achieve a relative balance between interest sensitive assets and liabilities. For example, to support its aggressive loan policy, Continental maintained a high degree of rate sensitivity through the heavy use of overnight funds and shortened CD and Eurodollar maturities. In addition, Continental began attracting deposits of other commercial banks, particularly foreign banks, by in some cases paying them more interest than domestic banks. At the same time, core deposits from individuals, partnerships, and corporations remained constant during the period, lagging behind the 8 percent growth rate reported by Continental's peer group.

GROWTH

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

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

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

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

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

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SECTION 3

Financial History of Continental Illinois Corporation from 1970-1984

INTRODUCTION

In an attempt to protect the safety and soundness of the banking industry, the Federal Deposit Insurance Corporation (FDIC), the Comptroller of the Currency (OCC), and the Federal Reserve (FRS) on May 17, 1984, arranged an interim emergency financial assistance program and guaranteed all depositors and creditors of Continental Illinois National Bank and Trust Company (the Bank). At the time, the Bank had more than $40 billion in assets and had huge amounts of funds either loaned to or borrowed from many U.S. banks. Regulators were concerned that if the Bank failed it could have had a domino effect on the banking industry resulting in many other bank failures. The assistance program was designed to alleviate the cash shortages facing the Bank so that it would have time to recover in an orderly and permanent manner.

After an evaluation of various alternatives, the regulatory agencies on July 26, 1984, provided the Bank a permanent financial assistance program intended to restore it, over time, to a profitable business entity. The major components of the plan, which is subject to stockholders' approval, include (1) installing a proven internationally recognized management team, (2) moving $4.5 billion in problem loans to FDIC, (3) infusing $1 billion in new capital from FDIC in exchange for preferred stock convertible to 80 percent of the equity of Continental Illinois Corporation (the Corporation) which is the holding company for the Bank, and (4) ensuring an ongoing line of credit from the regulators and participating banks.[1]

But what caused the financial condition of the Bank to deteriorate? This section of the report presents information on the Corporation's and Bank's organizational structure and financial history along with a discussion of relevant events from 1970 to 1984 to help understand how the problems developed.

CONTINENTAL ILLINOIS CORPORATION

Continental Illinois Corporation was incorporated in Delaware in November 1968 and commenced operations on April 1, 1969, after it acquired all of the outstanding stock, except for directors' qualifying shares, of Continental Illinois National Bank and Trust Company of Chicago. The Corporation directly or through wholly-owned subsidiaries engages in lease and debt financing, mortgage lending and banking, financing of energy development and exploration, asset-based financing, reinsurance of credit life and credit health insurance directly related to extensions of credit by the Bank, fiduciary and investment services, and merchant banking overseas. The Corporation also owns two banks in the suburbs of Chicago, Illinois, a small business investment company, and an equity investment company.

Through a worldwide network of branches, representative offices, subsidiaries, and affiliates staffed by more than 12,000 people, Continental provides commercial, personal, trust, and money market services to individuals, businesses, and governmental entities. Its business units are organized according to market areas.

SUBSIDIARY ACQUISITIONS

The Corporation's significant subsidiaries as of 1984 were as follows:

Name[2]	Jurisdiction of incorporation	Percent of voting securities owned
Continental Illinois National Bank & Trust Co. of Chicago	Illinois	100(2)
Continental Bank International	Illinois	100
Continental International Finance Corporation	Illinois	100
Continental Illinois Bank (Canada)	Canada	100
Republic Realty Mortgage Corporation	Delaware	100
Continental Illinois Leasing Corporation	Delaware	100
Continental Illinois (Delaware) Limited	Delaware	100
Continental Illinois Equity Corporation	Delaware	100
Continental Illinois Service Corporation	Delaware	100
Continental Illinois Venture Corporation	Delaware	100
Continental Illinois International Investment Corporation	Cayman Islands	100
Great Lakes Life Insurance Company	Arizona	100
Continental Illinois Overseas Finance Corporation, N.V.	Netherlands Antilles	100
Continental Illinois Trust Company of Florida, N.A.[3]	Florida	100
Continental Illinois Trust Company of Sarasota, N.A.[3]	Florida	100

Name	Jurisdiction of incorporation	Percent of voting securities owned
Continental Illinois Energy Development Corporation	Delaware	100
Continental Illinois Commercial Corp.	Delaware	100
Continental Bank of Buffalo Grove, N.A.[3]	Illinois	100
Continental Bank of Oakbrook Terrace[3]	Illinois	100
Continental Illinois Corporation Financial Futures	Delaware	100

CONTINENTAL ILLINOIS NATIONAL BANK

The Bank, which became a subsidiary of the Corporation, has been in business for more than 124 years. At the end of 1983, it was the largest bank in Chicago and was seventh in size in order of both assets and deposits among approximately 15,000 national and state banks in the United States. Operating a full service commercial banking and trust business, the Bank serves individuals, businesses and government in the metropolitan area of Chicago; other major metropolitan areas throughout the Nation; and overseas. It receives deposits; makes and services secured and unsecured loans; distributes U.S. government and municipal securities; and performs a wide variety of personal, corporate, and pension trust and investment advisory services.

Over the past two decades the Bank changed from a conservative institution whose principal functions were providing a safe place for people and businesses to keep their money and lending to good credit risks, to an institution striving for constant growth at home and abroad. During the 1960's, the Bank developed extensive international operations; established groups to render specialized services to the Bank's oil, utility, and finance company customers; established a unified Retail Banking Department to fully serve the consumer and small businessperson; developed a separate Real Estate Department to make commercial and home loans and to service the properties which the Bank holds in a fiduciary capacity; and established a division to provide counseling to companies wishing to relocate in the Chicago metropolitan area. The Bank has a large network of correspondent banking relationships in the United States and throughout the world and provides a wide variety of services for banks.

ORGANIZATION OF THE BANK

The organization of the Bank is built around markets it defines as groups of customers who have common needs for the services offered. The activities of each of the five customer-service units are summarized below.

General Banking Services

General Banking Services provides depository and financial services to corporations and correspondent banks wherever located and to governments and their agencies outside the United States. The responsibilities of the five units which comprise General Banking Services are as follows:

U.S. Banking Services is divided into two areas, that generally provide commercial deposit and loan facilities to corporations, banks, bank holding companies, other financial institutions, and other entities not classified as multinational.[4] The Metro-Midwest Groups, which are organized to provide specialized skills adapted to specific industries, serve customers in the greater Chicago metropolitan area, other parts of Illinois, as well as Indiana, Michigan and Wisconsin. The National Groups, organized on a geographical basis, serve domestic commercial customers not classified as multinational or served by Special Industries Services, including as many as 2,600 domestic correspondent banks[5] at one point.

Special Industries Services is organized to (1) supply specialized skills adapted to specific industries and (2) to provide credit and loan facilities to customers worldwide in the oil and gas, mining, construction and engineering, and shipping and marine industries. The Service also provides nationwide credit and loan facilities to public utilities, surface transportation, and equipment leasing industries.

International Banking Services is comprised of two Edge Act[6] Corporation subsidiaries and specialized geographic groups. It is headquartered in Chicago and has overseas branches, representative offices, and subsidiaries in 29 foreign countries. It assists foreign correspondent banks, government entities, and corporations not classified as multinational by providing them with international financial services that include short- and medium-term loans, letters of credit, acceptances, collections, remittances, deposit accounts, and foreign exchange services.

Under the Edge Act, the Bank currently operates an Edge Act Corporation subsidiary headquartered in Chicago named Continental Bank International, which has branches in New York, Miami, Houston, and Los Angeles. The branches provide international banking and financial services to corporations and correspondent banks in their respective markets. Another Edge Act Corporation subsidiary, Continental International Finance Corporation, also headquartered in Chicago, has investments (ranging from 100 percent ownership to minority interests) in various foreign financial institutions that serve to supplement the Bank's international services.

Multinational Banking Services provides the special expertise and worldwide capabilities required by major corporate customers that have extensive worldwide operations and are classified as multinational. In addition to Chicago, MultinationalBanking Services has personnel located in New York, London, Tokyo, Brussels, Frankfurt, and other cities where multinational corporations are located.

Financial Services provides the other units of General Banking Services with worldwide capability to serve clients by offering a comprehensive variety of trade financing, global cash management, and investment banking functions, including private placements, mergers and acquisitions, and corporate financial advisory services.

Trust and Investment Services

Trust and Investment Services provides a variety of services to a large number of individuals, associations, businesses, government entities, and institutions. Through it, the Bank acts as trustee, executor, administrator, guardian, conservator, depository, transfer agent, and registrar. In addition to the separate investment of trust assets, it maintains collective funds for trust investment, including Continental Illinois Investment Trust for employee benefit plans. It also offers custodian and investment counseling services, as well as portfolio management, and financial planning and advisory services for both domestic and international clients.

Real Estate Services

Real Estate Services makes a wide variety of residential, industrial, and commercial real estate loans, including secured and unsecured credits, to the real estate industry. The Bank's activities include extensions of credit to home builders and developers, mortgage bankers, and real estate investment trusts, and the origination, sales, and servicing of residential mortgages as well as other activities.

Bond and Treasury Services

Through Bond and Treasury Services, the Bank is a primary dealer in government and federal agency securities as one of approximately 35 primary government bond dealers authorized to deal directly with the Federal Reserve trading desk. It underwrites and distributes state and local government and public housing securities, provides short-term investment facilities to many corporations, supplies correspondent banks with services ranging from periodic pricing of portfolios to complete portfolio management, serves the primary banking needs of public bodies, funds the Corporation and its subsidiaries, manages the Corporation's interest rate sensitivity program and capital account, and controls the non-credit risk of the Corporation.

Personal Banking Services

The banking needs of individuals and households are the responsibility of Personal Banking Services. It administers savings accounts, time deposits, checking accounts, and a broad spectrum of consumer lending activities which includes personal loans, real estate loans, and the MasterCard/Visa bank card programs until their sale in 1984. The Executive Financial Center has been established in an effort to meet the complete banking, borrowing, and short-term investment counseling needs of a select group of Bank customers.

SUBSIDIARY ACQUISITIONS

The Bank has established a number of subsidiaries since 1970. Under the Edge Act, it owns and operates Continental Bank International and Continental International Finance Corporation. Headquartered in New York, Continental Bank International is an international banking organization, receiving deposits, making loans, and handling all forms of international banking transactions. It maintains direct correspondent banking relationships in most major countries, and its services are available to domestic and foreign banks, corporations, and individuals. The Continental International Finance Corporation, headquartered in Chicago, provides long-term equity and debt financing for businesses operating abroad. The Bank also has equity interests (ranging from 100 percent ownership to minority interests) in various foreign financial institutions located in various countries worldwide.[7] These institutions supplement the Bank's international operations. The statute limits Edge Act subsidiaries to serving foreign trade-related and other international banking needs as opposed to U.S. banking needs.

CHRONOLOGY OF EVENTS AND FINANCIAL HISTORY

The purpose of this section is to recount the events that took place and financial performance of the bank during the period from 1970 to the present. It is not intended to explain why these events occurred. Early events and financial information is grouped into two time periods --1970-74 and 1975-79. More recent events and financial information related to the period from 1980 to 1984 is presented on a year by year basis.

1970-1974

INDUSTRY ECONOMIC CONDITIONS

During the period 1970-74, the U.S. economy was in the midst of the most prolonged recession since 1933. Spending cutbacks by business, which reduced inventories and shifted borrowings into the bond and commercial paper markets, caused a decline in the volume of bank loans. In addition, the banking system was also affected by impending industrywide problems throughout 1974 resulting from the unusual failures of two large banks and the relatively high level of uncollectible loans.

BUSINESS SERVICES

In spite of the economic conditions during this period, the Bank emerged in a position of strength and stability by expanding in many areas. As of December 31, 1974, the Corporation and its subsidiaries had approximately 9,880 officers and employees, an increase of 1,600, or 19 percent, from 1970. All but 220 of the officers and employees were employed by the Bank.

The commercial banking department, which provided commercial deposit and loan facilities to individuals and corporations, was reorganized in 1973 around industry, customer size, and geographic markets in order to develop new markets. Represented among the approximately 33,000 accounts in the commercial banking department were 94 of the 100 largest American corporations and 318 of the Fortune 500 list.

The international and overseas operations grew rapidly and placed greater emphasis on regionalizing business development efforts and penetrating growth markets in each of the countries where the Bank operated. By the end of 1974, the Bank's international network included 122 facilities in 37 nations on six continents, making it the largest of such networks operated by a U.S. financial institution.

Several other Bank operations grew rapidly during this period. The real estate function expanded particularly as to lines-of-credit to home builders and developers, mortgage bankers, real estate investment trusts, and interim construction lending; bond operations enlarged its services to include underwriting and distributing state and local government and public housing securities, providing short-term investment facilities to many corporations and portfolio advisory services for correspondent banks, managing the Bank's investment portfolios, and procuring a large share of the funds required by the Bank; and Personal banking increased consumer credit services by implementing the Master Charge International Charge Credit system.

SUBSIDIARY ACTIVITY

The early 1970s was a period of rapid growth in the Corporation's subsidiary operations as evidenced by its activities. The Corporation

-- participated in organizing a venture capital firm which operated under the name of Continental Illinois Venture Corporation, in which the Corporation held 29 percent of the voting stock.

-- acquired the business and properties of Republic Realty Mortgage Corporation in June 1970 and continued to operate it as a mortgage banking firm doing business in Illinois, Missouri, Wisconsin, and Georgia.

-- acquired Group Counselors, Inc. by merger into Continental Illinois Realty Advisors, Inc. in March 1971.

-- entered into a joint venture with The Royal Trust Company in October 1971. The Corporation and The Royal Trust Company then organized Builders Financial Co. Limited and its wholly-owned subsidiaries, Builders Capital Limited and Western Builders Capital Limited, to engage in construction and development lending and other interim financing of Canadian real estate. The Corporation held 50 percent of the common stock and 49.9 percent of the preferred stock (voting) of Builders Financial Co. Limited. The balance of the Builders Financial Co. Limited stock was held by the Royal Trust Company.

-- formed Continental Illinois Leasing Corporation to engage in lease and debt financing in March 1972.

-- formed Continental Illinois (Delaware) Limited in July 1972 to engage in merchant banking overseas through subsidiaries chartered under the laws of Hong Kong and the United Kingdom.

-- formed Continental Illinois Leasing and Financial Ltd. in April 1974, a Canadian corporation, to engage in medium-term lease and debt financing in Canada.

MANAGEMENT

On March 26, 1973, Roger E. Anderson and John H. Perkins were elected by the Board of Directors to succeed Donald M. Graham and Tilden Cummings as Chairman of the Board and President, respectively. No other major changes occurred.

FINANCES

The financial position of the Corporation continued to improve for the fifth consecutive year since the bank holding company was formed. The increasing demand for loans over the previous 5 years was satisfied largely through an increased reliance on time deposits and interest-sensitive funds of all kinds. Total deposits had increased from $8.1 billion in 1972 to $15.5 billion in 1974. Particularly noticeable was the growth in overseas branches and subsidiaries where time deposits increased $2.5 billion from 1972 to $5.7 billion in 1974.

Dividends on common stock continued to increase in accordance with the Corporation's policy to increase dividends as earnings increased. Dividends declared in 1974 were $2.20 per share, as compared to $1.93 per share in 1973.

Earnings

Earnings for 1974 increased 11 percent from 1973 to $95.9 million, with a 5-year annual growth rate reaching 11.7 percent. The Bank's return on shareholders' equity in 1974 was 13.5 percent and had exceeded 12 percent annually for the fifth consecutive year. These accomplishments for 1974 were due in part to a 33 percent increase in net interest income, resulting from a sharp decline in interest rates during the fourth quarter.

Total operating income increased dramatically in 1974 to $1.7 billion, as compared with $1.1 billion in 1973 and $478 million in 1972. The 1974 increase was due primarily to interest fees on loans of $1.3 billion (representing 72 percent of total operating income) which nearly doubled the $720 million recorded in 1973 and quadrupled the $369 million in 1972.

The growth in income was offset somewhat by the growth in expenses. Total operating expenses also increased dramatically in 1974 to $1.6 billion, as compared with $967 million in 1973 and $422 million in 1972. The 1974 increase was due primarily to interest expenses of $1.3 billion (representing 83 percent of total operating expenses) which nearly doubled the $767 million and quadrupled the $346 million in 1972. Other expenses such as salaries, wages, and compensation increased from $110 million in 1973 to $130 million in 1974.

Assets

Total assets grew at a record rate from $10.7 billion at the end of 1972 to $19.8 billion in 1974, with a 5-year annual growth rate of 20 percent. This growth in assets was due largely to an increased demand for loans. At year-end 1973, loans were $9.9 billion, an increase of 40.4 percent over 1972. By year-end 1974, loans increased another $2.8 billion to $12.7 billion, representing 64 percent of total assets. Domestic loans in 1974 rose to $10.1 billion, an increase of $1.9 billion from 1973, while overseas loans reached $2.6 billion, an increase of $.8 billion.

Nonperforming Loans and Losses

The loan loss reserve for 1974 was increased to $213 million, or 23 percent, from 1973 in recognition of possible future losses in a number of areas, including the real estate field. This increase represented 1.2 percent of gross year-end loans.

1975-1979

INDUSTRY ECONOMIC CONDITIONS

The severe recession during the prior period which created financial difficulties for a number of companies began to recede in early 1976. The improvement in the banking industry occurred largely as a result of an increase in business borrowing, which was fueled primarily by a sharp rise in inflation, but also by increases in corporate spending for new plant and equipment and a continuing downturn in corporate liquidity.

As noted above, the economy during this period experienced a sharp rise in inflation. The consumer price index increased 13.3 percent between the beginning and end of 1979, or 11.2 percent on the average during the year, as compared with a 9.1 percent increase on the average for 1978. Also, world oil prices more than doubled in 1979 and were still rising, outracing the rate of inflation and fueling still more inflation.

BUSINESS SERVICES

During this period, as in the prior period, the Corporation experienced continued growth despite the economic conditions. General Banking Services, which includes commercial, multinational, and international activities, experienced profitable gains in volume and market position. New business development and increased market penetration, together with efforts at more effective comprehensive service for multinational customers worldwide further enhanced the Corporation's position. Results in all markets reflected an announcement made on July 7, 1976, by Continental's Chairman, Roger E. Anderson, that the Bank would embark on a strategy to make it one of the three biggest lenders to industrial and commercial companies by 1981.

Commercial Banking exhibited continued growth, especially in domestic commercial and industrial loans. In addition to competing aggressively for large loans, the Bank opened offices in the Midwest to enhance its position among small to mid-sized companies. International Banking increased its services during the period by opening five new branch and representative offices and three new bank subsidiaries. Also, a correspondent banking relationship was established with the Bank of China to conduct business both with its Peking headquarters and its branches.

Real Estate Services' loan portfolio continued to grow, aided primarily by the strength in the commercial construction market. Also, asset swap and repayment programs further improved the Bank's position and accelerated the repayment of real estate credits.

SUBSIDIARY ACTIVITY

The Corporation, through Continental Illinois Leasing and Financial Corporation, formed Continental Illinois Capital (Canada) Ltd. in 1975, a Canadian subsidiary, to engage in mortgage lending in Canada, acquired all outstanding common stock of Continental Illinois Venture Corporation in 1976; formed Great Lakes Life Insurance Company in 1977 which acts as a reinsurance underwriter of credit, life, accident, and health insurance; and formed Continental Illinois Equity Corporation in 1979 which makes equity type investments in unaffiliated companies.

MANAGEMENT

Executive management remained unchanged, with the exception of George R. Baker, who was placed in charge of the Commercial and International Banking Services consolidated under General Banking Services.

FINANCES

Continental's financial position continued developing during this period at a rate consistent with that of the previous 4 years. Stockholders' equity increased by $137 million or 11 percent to $1.4 billion at December 31, 1979. The rate of return on stockholders' equity has held steady over the period at 15 percent. In addition, the capital base has provided a steadily rising dividend to stockholders. The 1979 dividend was increased 11 percent to a new annual rate of $1.60 per share. This rate reflects a two-for-one common stock split which became effective in May, 1977.

Earnings

Income before security transactions increased 15 percent to a record $194.1 million, for a 5-year compound growth rate of 14.2 percent, the same as in 1978. Net interest income increased by $80 million, or 13.3 percent, to $677.3 million. Other operating income increased by $41 million, or 24.5 percent, to $207.7 million, reflecting emphasis on noninterest income. Against the $121 million gain from these two principal income sources, other operating expenses were up $80.5 million, or 20.9 percent, to $464.5 million, reflecting business growth and the impact of inflation.

Assets

Loans and other earning assets averaged 20 percent above the 1978 level, and total assets increased by $4.7 billion, or 15.2 percent, to $35.7 billion.

Nonperforming Loans and Losses

The 1979 provision for credit losses and net charge-offs, which are applicable to both loans and lease financing receivables, were $70 and $49.1 million, respectively, as compared to $62.5 and $41.4 million, espectively in 1978. In each of the prior two years the provision had exceeded the charge-offs by approximately $21 million, thus slightly increasing the reserve to $212.1 million at December 31, 1979. Although the reserve increased during the period, the reserve as a percent of total loans and leased receivables decreased from 1.27 at year end 1976, to .91 at year end 1979.

1980

INDUSTRY ECONOMIC CONDITIONS

During 1980, the banking industry's attention was directed towards the continued concern over accelerating inflation, volatile financial markets and uncertain economic growth. The level of economic activity for 1980 was similar to the prior year. Unlike 1979, however, when the acceleration of prices was heavily concentrated in the energy sector, no single factor accounted for 1980's rise. The inflation rate remained high due to a deterioration in the price situation. For example, labor costs increased due to an acceleration of compensation per hour and a poor performance in productivity. Food prices surged under the influence of rebounding farm prices and rising costs of marketing. Conditions in the mortgage and housing markets deteriorated sharply. Also, inflation produced serious problems for the nonbank thrift institution and other entities that concentrate their holdings in longer-term instruments bearing fixed interest rates.

BUSINESS SERVICES

The Bank continued to work toward its goal of becoming one of the three top institutions serving American and foreign-based multinational customers by further developing its business services. General Banking Services, building on national presence of 25 offices, opened new offices in the South and West. Four Edge Act subsidiaries based in major cities were reorganized as branches of a single Edge corporation based in Chicago. Selective expansion of the international network continued with the opening of three new branches. In addition, a minority interest was purchased in a Nigerian firm, and service to correspondent banks in Europe was enhanced through a newly formed European Banking section headquartered in London.

In other areas, commercial finance activity was augmented by a new Commercial Services unit that specialized in helping businesses, such as smaller oil and gas producers that might not qualify for traditional bank financing, with loans secured by the value of equipment or merchandise.

SUBSIDIARY ACTIVITY

In February 1980, the Corporation established Continental Illinois Energy Development Corporation to make loans to energy development and exploration companies and to service such loans; formed Continental Illinois of Florida, Inc., to engage primarily in the marketing of trust and investment services provided by the Bank; and funded Continental Illinois Overseas Finance Corporation N.V. in the Netherlands Antilles.

MANAGEMENT

Donald C. Miller was permanently assigned as Vice Chairman of the Board of Directors; Edwin J. Hlavka was designated as the Vice President and Auditor of the Corporate Financial Services; and Edward S. Bottum was assigned as the Vice President of Trust and Investment Services, replacing Charles R. Hall.

FINANCES

The Corporation's financial growth continued amid 1980's high rate of inflation and unprecedented interest rate swings. The Multinational Lending Department placed heavy emphasis upon extending commitments to carefully identified targets and increasing these commitments to the full lending limit. International Banking Services and the Financial Institution Division stressed expansion of wholesale banking both nationally and internationally.

Equity capital increased by 11.8 percent to 3.62 percent of total assets. Retained earnings increased by $162 million, bringing the year-end total to $1.5 billion, thus building the capital base for further growth.

Earnings

Earnings reflected continued, steady earnings on the part of major profit contributors, General Banking Services and the Special Industries Group. The Oil and Gas Division was the Special Industries Group's single largest source of profit for the year. Net income was up $30.1 million, or 76 cents a share, to $225.9 million. The overall return on assets declined by two-hundredths of 1 percent.

Assets

Loan volume averaged $4.2 billion and other earning assets $1.3 billion above the 1979 level, increasing net interest income on a taxable equivalent basis from this source by $140 million, or 20.6 percent. Except for April and May, the Corporation recorded increases in average total loans each month. Growth in loans was heavier in the second half of the year and more pronounced in domestic loans, in contrast with the first half, in which foreign loan growth predominated. Average total assets grew by about $6.3 billion. The growth in assets was financed largely through higher balances of interest-bearing liabilities.

Nonperforming loans and losses

Nonperforming credits were $444 million. Mortgage and real estate loans on a renegotiated basis were up $21 million from the prior year. The reserve for credit losses increased 13.9 percent from 1979. Relatively lower growth of loans in 1980, coupled with a higher net addition (provision for credit losses minus net credit losses) to the reserve, maintained the percentage relationship of the reserve to total credits at the 1979 year-end level.

Net credit losses on consumer installment loans were the highest single loss category in 1980. These losses were 45.9 percent of total net charge-offs in 1980 as opposed to 64 percent in 1979. Net losses on commercial and industrial loans were up $15.2 million in 1980 and represented 39.3 percent of total net losses, compared with 16.5 percent in 1979.

1981

INDUSTRY ECONOMIC CONDITIONS

The year 1981 was a year of extremes for banks in a number of key areas. There were general domestic and worldwide economic weaknesses and wide fluctuations in interest rate levels. Furthermore, the banking industry's capitalization base was eroding causing concern to the bank regulators.

The overall level of economic activity during 1981 accelerated and the rate of price increases slowed, but the burden of high interest rates placed some sectors of the economy under heavy pressure. The housing industry was devastated, many auto dealers closed because of declining sales and the extremely high cost of financing inventories, and many other small firms in other lines went out of business. The thrift industry experienced a severe squeeze on earnings and high interest rates impeded the formation of business capital needed for improving productivity performance.

BUSINESS SERVICES

The Corporation's performance in 1981 was strong and compared well with the previous strong year, 1980. The Bank moved up in the order of banks ranked by asset size, taking over the sixth position from Chemical Bank. The Corporation's performance stemmed from its concentrating in a number of areas, including significant non-interest expense restrain and substantial expansion in the size of its loan portfolio. In 1981 the Bank became the largest domestic corporate and industrial lender in the Nation.

One of the primary growth areas within the Bank was in the Oil and Gas Division of the Special Industries Group. By mid-year, domestic oil and gas loans totaled $2.9 billion and represented more than 10 percent of the Bank's total loan portfolio. The Bank had developed a presence in most of the active areas in the industry by establishing regional offices in Texas; Colorado; and Alberta, Canada. As with the oil and gas loans, commercial real estate loans also made up about 10 percent of the Bank's total loan portfolio.

SUBSIDIARY ACTIVITY

New regional offices in Atlanta; Detroit; Minneapolis; and White Plains, New York, further expanded the Corporation's U.S. network to 13 locations. Agreements were reached to acquire two small Chicago banks.

The Corporation continued to enhance its position in the international financial marketplace through selective foreign branch office expansion. Growth overseas was principally related to the Multinational Banking Department and the Special Industries Group. Branch offices were opened in Canada, Barcelona, and Puerto Rico, while satellite facilities were closed in Dusseldorf, Edinburgh, Munich, Rotterdam, and Vienna.

FINANCES

As a concrete step toward further enhancing the attractiveness of stock as an investment, long-range targets for two key performance measures were raised in 1981, and new higher goals were set. The return on equity goal was raised from 15 percent to 18 percent, and return on total assets was raised to 0.65 percent, or 6 basis points[8] above the average return of the previous 5 years. The commercial and industrial loan portfolio grew to $12.8 billion at year-end.

Stockholders equity averaged $1.6 billion in 1981, a 12.0 percent increase from 1980, and was 3.6 percent of total assets at year-end. Stockholders received 28.8 percent of 1981 income before security transactions in the form of dividends, while in 1980 the dividend payout ratio was 29.78 percent.

Earnings

Attention to resource allocation, expense control, funding, and liquidity management made an important contribution to record earnings. Income before security transactions of $260.3 million increased 16.1 percent from the $224.1 million recorded in 1980. Net income rose 12.7 percent from the previous year to $254.6 million. Return on total assets increased 3 basis points over 1980. Net interest income was up 8.8 percent over the 1980 level. The increase was made possible by a 17.7 percent increase in average loans and a 27.3 percent increase in average leases.

Assets

Average total loans increased each month, except for February, with heavier growth occurring in the second half of the year. The commercial and industrial loan portfolio grew to $12.8 billion from about $9.8 billion in 1980 and real estate loans increased by 12 percent to a total of $3.9 billion. The Bank continued to be the leading lender to domestic energy producers. Although only sixth in assets among American banks, it loaned more money to domestic commercial and industrial companies than any other bank in the Nation.

During the year, Continental moved toward higher yielding earning assets with shorter maturities. This move was in line with the Bank's interest rate sensitivity management policy which involved lengthening and shortening maturity schedules of assets and liabilities in anticipation of interest rate cycles. Foreign operations accounted for 40.7 percent of total assets at year-end and produced 29 percent of total net income for the Corporation.

Average earning assets increased 12.8 percent, due primarily to growth in loans and lease financing. The increase in average earning assets was financed primarily through interest-bearing liabilities. These sources increased 13 percent in 1981 over the 1980 average, while interest-free funds increased 8.7 percent over the same period. The 15.2-percent rate on average foreign time deposits tied the overall rate of average savings and time deposits, and together these deposits increased 13.3 percent in 1981 over the 1980 average. The more expensive money-market liability, short-term borrowed funds, also increased 11.8 percent over the same period.

Nonperforming Loans and Losses

As a result of high interest rate levels and an economic slowdown in 1981, the Bank had nonperforming credits of $653 million; representing 1.9 percent of total loans and lease receivables outstanding at year end, compared wiht $444 million, or 1.6 percent at year end 1980. Before this rise, nonperforming credits had declined steadily from $705 million, or 5.7 percent of the total loan and lease portfolio reported at year end 1975.

Net credit losses increased 15.8 percent from 1980 to $71.1 million. Increased domestic and industrial loans and overseas loan charge-offs contributed to the entire increase amid sluggish economic conditions.

1982

INDUSTRY ECONOMIC CONDITIONS

Persistent weakness in business activity and employment, along with high interest rates, exerted pressure on commercial banks. Profits edged down and returns on assets and on equity reached lows last observed in the recovery from the 1973-75 recession. Potential losses became worrisome as the financial difficulties of some major borrowing countries impaired their ability to maintain payments on debt owed to U.S. banks. Most commercial banks recorded substantial profits, but the proportion of banks with operating losses rose to nearly 8 percent, about equal to the mid-1970's peak and more than double the recent low in 1979.

BUSINESS SERVICES

The Corporation experienced serious difficulties because of an inordinately high level of problem assets. Significant publicity of its relationship with the defunct Penn Square Bank caused Continental's image in the financial community to fall precipitately. This in turn, caused a significant change in its funding profile. Because domestic investors were reluctant to purchase long-term instruments, the Euromarkets were heavily used in order to maintain a relatively stable mix between long- and short-term funding.

Problems were evident in all lending departments with oil and gas and real estate accounting for a large portion of the problem loans. Between 1981 and 1982, outstanding loans in the Oil and Gas Division increased from \$2.8 billion to \$5.2 billion, more than 15 percent of the Bank's total loan portfolio.

Under market pressure, the Bank removed its name in late July from the list of banks where CDs were eligible for delivery to fill Chicago Board of Trade and Chicago Mercantile Exchange futures contracts. In early September, Standard and Poor's reduced the Bank's credit rating for the second time.

SUBSIDIARY ACTIVITY

Growth through establishment or acquisition of subsidiaries slowed to almost a standstill. The Corporation completed the acquisition of two smaller banks in Chicago which it initiated in 1981 and established a subsidiary to deal in the financial futures market.

MANAGEMENT

As a result of Penn Square problem loans, a group of the Bank's senior officers conducted a comprehensive management review of its operation and recommended a number of management changes. A new auditor and Executive Vice President for General Banking Services were appointed, and a new credit risk evaluation division was created. A special litigation committee was also appointed to assess the Bank's officers' and directors' responsibility for the Bank's actions in connection with derivative and class action lawsuits.

In 1983, the Bank entered into a written agreement with OCC agreeing to address certain problems noted in OCC's 1982 examination of the Bank. Under the agreement, the Bank was required to continue implementation and maintenance of new and strengthened plans, policies, and procedures designed to improve overall performance in accordance with the Bank's revised corporate objectives and to report periodically on such matters to OCC. These actions cover such areas as asset and liability management and the Bank's credit approval, evaluation, and collection activities. By May 1984 the Bank was experiencing severe cash flow problems requiring assistance from the FDIC and a consortium of United States banks.

FINANCES

The Bank began to lose its position as a top money center bank. Total assets of the Corporation declined by 8.5 percent from \$46.9 billion in 1981 to \$42.9 billion in 1982. Stock prices fell from \$36.90 per share to as low as \$15 per share. Sources of funds declined in all major categories except other borrowing, foreign deposits, and long-term debt, which increased from the previous year by \$1 billion, \$800 million, and \$400 million, respectively. The greatest decline in source of funds was in domestic demand and time deposits which decreased by \$634 million and \$1.6 billion, respectively, from 1981.

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Severe market resistance curtailed the issuance of domestic CDs and commercial paper to such a degree that the Bank was able to rollover only about 60 percent of its commercial paper. When sizeable amounts of term money were obtained, the Bank had to pay substantial premiums. By September 1982, the Bank's primary incremental funding sources were overnight Eurodollars and brokered Federal funds.

Total stockholders' equity declined by $797,000 at year-end 1982, over year-end 1981. As a result of reduced 1982 earnings and maintenance of the $0.50 a share quarterly dividend, stockholders received 94.34 percent of income before security transactions as dividends in 1982 compared with 28.88 percent in 1981. Retained earnings were down by $627,000 from 1981's total.

Earnings

Net interest and other operating income was a record $1.2 billion before provision for credit losses. But net income was the lowest in 5 years, primarily due to a sharply increased provision for loan losses of $492 million, compared to $120 million the year before. Both the earnings decline and the increased provision reflected a steep rise in problem credits. Income before security transactions totaled $84.3 million, down substantially from $260.3 million in 1981. Net income for the year was $77.8 million, down from $254.6 million a year earlier. Net interest income accounted for 73.5 percent of total operating revenues before provisions for credit losses, compared with 71.4 percent a year earlier.

Assets

Average total loans increased from 1981 levels in 8 of the first 9 months of 1982 but declined in 2 of the final 3 months for a 15.8 percent overall increase over 1981. Commercial and industrial loans averaged $13.7 billion in 1982 and remained the largest domestic loan category, increasing by 28 percent in 1982. Mortgage and real estate loans rose 9.6 percent, compared with 12.9 percent growth in 1981, while loans to financial institutions were up 11.6 percent in 1982. Average interest earning assets, reflecting higher loan and lease receivable balances, were up 15.8 percent to $33 billion.

Nonperforming Loans and Losses

At the close of 1982, nonperforming loans totaled $1.9 billion or 5.6 percent of total loans and leases receivables, up substantially from $653 million or 1.9 percent of 1981 loan and lease receivables. The provision for loan losses totaled $492 million, which included a $220 million increase in the provision for loan losses during the second quarter due to problem credits as a result of Penn Square loans. Net credit losses were $393.2 million, up substantially from $71.1 million in 1981. Net losses of $191 million on participations purchased from the Penn Square Bank were a major factor in the increase.

1983

INDUSTRY AND ECONOMIC CONDITIONS

The economy in the aggregate proved strong but banks experienced fewer demands for business loans, which in the past had been among the highest yielding assets in banks' portfolios. Credit problems intensified in energy and energy related businesses as the recession lingered in that area. Housing and consumer spending provided the main thrust for the economy. Business spending for autos, trucks, and high technology goods accelerated, but investment in structures and heavy machinery remained weak. Federal government spending was stimulative, but part of this effect was offset by declines in state and local government spending. Exports remained weak and the trade deficit ballooned as imports responded to rising domestic demand.

BUSINESS SERVICES

The Corporation continued to experience losses especially in the oil and gas area which accounted for a high percentage of problem loans. Between nonperforming loans and loss provisions, the Bank was carrying close to $590 million pretax drag on earnings. Although funding had reasosnably stabilized, resistance to the Bank was still apparent, especially in the domestic markets. Reduced premiums on term funds and asset reductions allowed overnight funds to decrease by about $4.6 billion. A shift to offshore funding began in mid-1982, and in mid-1983 over one-half of term funds were obtained in the Euromarkets.

SUBSIDIARY ACTIVITY

Subsidiaries of the Corporation, excluding the Bank, represented 5 percent of total consolidated assets at December 31, 1983, down slightly from 5.1 percent a year earlier. For the year the subsidiaries contributed $33 million to net income, compared with $43 million for 1982. No new acquisitions were reported by the Corporation.

MANAGEMENT

The Board and management responded to serious credit problems uncovered in 1982 by conducting an in-depth management review of operations. As a result, management made major changes in lending policies and restructured senior management to better define lines of authority and responsibility and provide for orderly management succession. The "corporate office"[9] concept was dissolved, with most department heads reporting to the Chairman. In August, the Board elected Executive Vice Presidents Taylor and Bottum to the Board. Mr. Taylor became Vice Chairman and retained his position as head of Bond and Treasury Services, with Mr. Bottum shifting duties to become the head of General Banking Services. In November, the Bank realigned the investment responsibilities and restructured the credit review function. A Credit Evaluation Department was created to replace the old rating committee.

FINANCES

The Corporation turned its attention to overcoming the problem of large amounts of nonperforming loans causing depressed earnings far below that experienced during the past few years. During 1983, the Corporation continued to pay a premium for certain of its liabilities. Funding sources were shifted substantially to offshore markets. Foreign deposits accounted for 38 percent of the Bank's funds, followed by 16 percent from time deposits, and 16 percent from purchased federal funds. Subsequent to year-end 1983, one of the major rating agencies reduced the Corporation's rating on nonredeemable preferred stock and further reduced its rating of the Corporation's long-term debt.

Earnings

Earnings continued to be depressed because of heavy loan loss provisions, income reductions due to nonperforming assets, and increased funding costs. In addition, interest expense continued to be higher than normal due to funding premiums of 25 to 50 basis points paid on a portion of the Bank's liabilities.

Net income was $108.3 million in 1983, $30 million greater than 1982 but only about one-third of 1981 net income. The return on average total assets for 1983 was 0.26 percent, compared with 0.17 percent in 1982 and 0.57 percent in 1981. Net interest income on a taxable equivalent basis declined 8.4 percent from 1982 but increased slightly from 1981.

Assets

Earning assets averaged $36.1 billion in 1983 reflecting a decline of $4.1 billion or 9 percent from 1982. Of the total earning assets, $23.4 billion was domestic and the balance, $12.7 billion, foreign. Domestic and foreign loans made up $30.8 billion of total earning assets and of these loans $20.5 billion was domestic and $10.3 billion was foreign.

Nonperforming Loans and Losses

Loan quality continued to decline as more loans entered the nonperforming category. Nonperforming loans totaled $1.9 billion, or 6.2 percent, of total loans and lease receivables. This compared with 1.9 percent at year-end 1981. Nonperforming loans included $456 million in participations purchased from Penn Square, down from $595 million at year-end 1982. Loans purchased from Penn Square in the amount of $135 million were written off during the year. The provision for credit losses was $382.5 million or 1.21 percent of total loans compared with 1.11 percent at the end of 1982. Net loan losses for the year totaled $386.5 million compared with $393.2 million in 1982 and $71.1 million in 1981.

1984

INDUSTRY ECONOMIC OUTLOOK

Continuing economic expansion set the stage for improved banking industry performance in 1984. The cash flow of corporations was much improved over earlier periods and business borrowing from banks was increasing because of low current inventory levels. Corporations did some restocking, a process normally financed with bank borrowings. Rising levels of industry capacity utilization and the expressed intention of corporate executives to boost capital spending indicated an increasing demand for funds.

Foreign loans increased in 1984, but banks shifted their emphasis from foreign to domestic consumers. The rate of growth in consumer lending, in the form of personal loans and mortgages, was expected to surpass all other lending categories in 1984, according to Standard and Poor's. Personal income was up, unemployment down, consumer confidence high, and the demand for durables and housing brisk.

BUSINESS SERVICES

Beginning in May 1984, the Bank experienced a serious liquidity crisis resulting from the loss of a major portion of its funding base domestically and abroad. Major providers of overnight and term funds failed to renew their holdings and the Bank was forced to prepay time deposits in the Eurodollar and domestic markets and to arrange for the replacement of CD's in the domestic market. Because no other adequate funding sources were available, the Bank resorted to Federal Reserve Bank borrowings which rose to an average daily level of $2.6 billion.

SUBSIDIARY ACTIVITY

During March 1984, the Bank sold its charge card operations, and during July 1984 the Corporation sold Continental Illinois Limited, its London-based merchant bank. The Corporation announced plans to sell its leasing company and real estate mortgage company.

MANAGEMENT

In early 1984, Chairman Anderson was replaced by David Taylor. Edward S. Bottum was made President. In August, Messrs. Taylor and Bottum were replaced by John E. Swearingen (Chairman of the Board of Directors and Chief Executive Officer of the Corporation) and William S. Ogden (Chairman of the Board of Directors and Chief Executive Officer of the Bank).

FINANCES

The Corporation's financial position eroded rapidly in early 1984, resulting primarily from a run-off of deposits and other funding sources starting in May 1984. Business was sluggish because of sharply narrowed margins and the effects of a large amount of Latin American loans classified as nonperforming. At June 30, 1984, interest bearing deposits totaled $14.5 billion, down from $24.9 billion at December 31, 1983.

Earnings

Earnings were offset by lower net interest income, reflecting the impact of interest earnings reversals from nonperforming credits and increases in the general level of interest rates which raised the cost of funding and narrowed margins. Higher other operating income during the quarter more than offset the declines in net interest income. Net income was $29 million for the first quarter; however, it was dependent upon a nonrecurring revenue item totaling $188 million from the sale of the Bank's credit card operations. The Corporation would have experienced a pretax loss of $140 million without the nonrecurring income. The second quarter net loss was $1.2 billion. Net interest income on a taxable equivalent basis was $166 million for the first quarter of 1984, down from $241.5 million in the prior year's quarter. The net interest margin was 1.83 percent, compared with 2.63 percent during the same period last year.

Assets

Earning assets averaged $34.5 billion during the second quarter -- $21.9 billion domestic and $12.6 billion foreign -- down from $36.6 billion a year earlier. A significant portion of this decline was in reduced domestic loan volume including the sale of the charge card portfolio. At period end, earning assets totaled $32.3 billion, including loan balances of $29.6 billion.

Nonperforming Loans and Losses

Nonperforming loans and lease financing receivables amounted to $2.7 billion at June 30, 1984 and represented 9.2 percent of the loan and lease portfolio. Loans and lease financing receivables to borrowers in the oil and gas industry totaled approximately $4.7 billion of which $1.1 billion were nonperforming. The provision for credit losses was $705 million. Net credit losses totaled $748 million.

FOOTNOTES

1 Participants include 28 major American banks.

2 Certain subsidiaries of Continental Illinois National Bank and Trust Company of Chicago and certain subsidiaries of Continental Illinois Corporation are omitted because such subsidiaries, considered in the aggregate, would not constitute a significant subsidiary.

3 Except for directors' qualifying shares.

4 A multinational business is one that serves customers in the U.S. and other countries.

5 U.S. banks that provide service to other domestic banks.

6 A Federal statute which authorizes national banks to form subsidiary corporations for development of overseas business.

7 These countries are Argentina, Australia, Austria, Belgium, Brazil, Canada, the Cayman Islands, Colombia, Ecuador, France, Indonesia, Iran, Jamaica, Japan, Lebanon, Luxembourg, Malaysia, Morocco, Pakistan, Peru, the Philippines, Singapore, Spain, Switzerland, Taiwan, Thailand, and the United Kingdom.

8 100 basis points equals 1 percent.

9 The corporate office included the Chairman, Vice Chairman, and the President. The concept provided for most department heads to report to the corporate office rather than to specific individuals.

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

SEPTEMBER 18, 1984

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."**
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> ...
>
> **"Gross capital funds amount to 5.5% of total resources, down from 6.1% last examination."**
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> ...
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> **"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."**
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> ...
>
> **"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	6/15/75	2/27/76	3/31/77	4/30/79	6/30/80	4/30/81	4/30/82	6/30/83
	Dates of Examinations							
Substandard a/	760	848	806	1,045	921	1,025	2,908	4,113
Doubtful b/	357	381	197	72	81	180	548	485
Loss c/	14	11	28	12	4	29	230	135
Total Classified Assets d/	1,131	1,240	1,031	1,129	1,006	1,234	3,686	4,733
OAEM e/	491	306	429	173	340	597	1,934	2,853
Total Criticized Assets f/	1,622	1,546	1,460	1,302	1,346	1,831	5,620	7,586

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

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

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

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

e/ Other Assets Especially Mentioned are assets, not including those identified as substandard, 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.

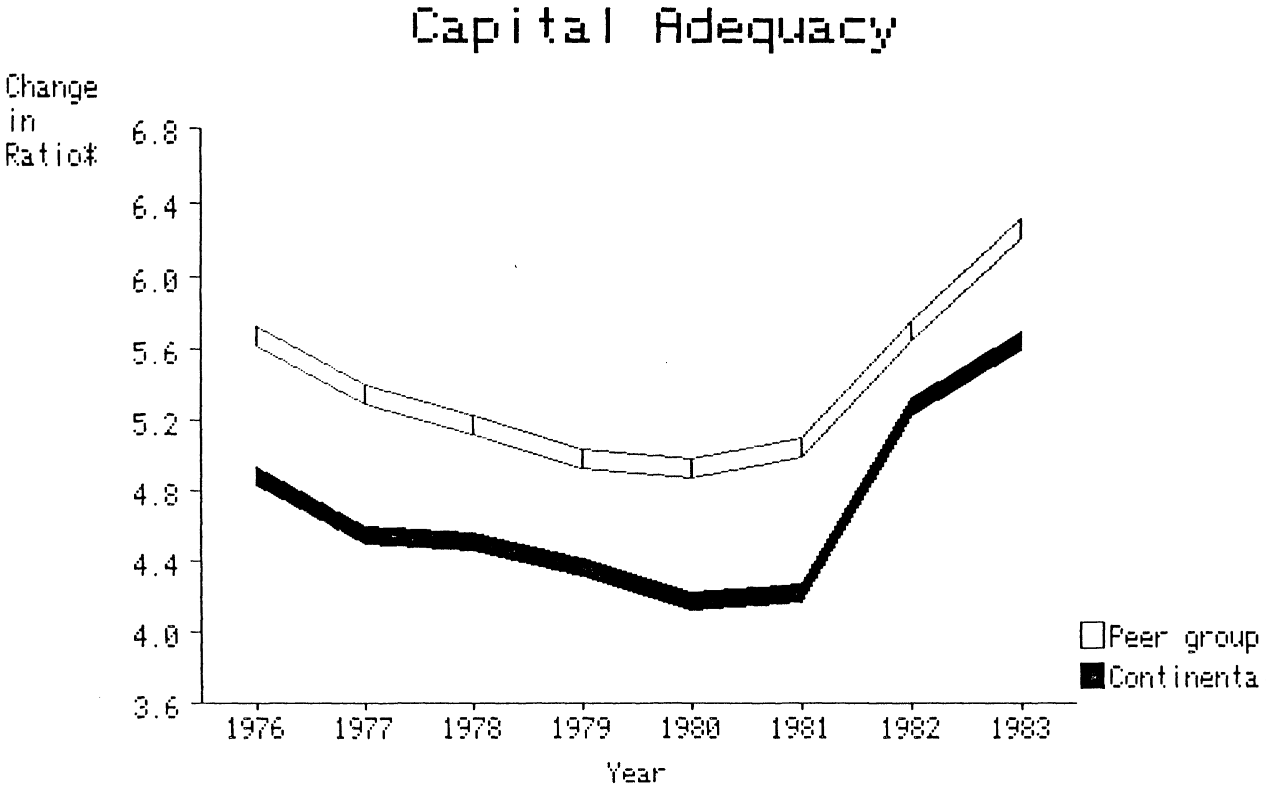
Attachment II

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

	Dates of Examinations							
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
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.

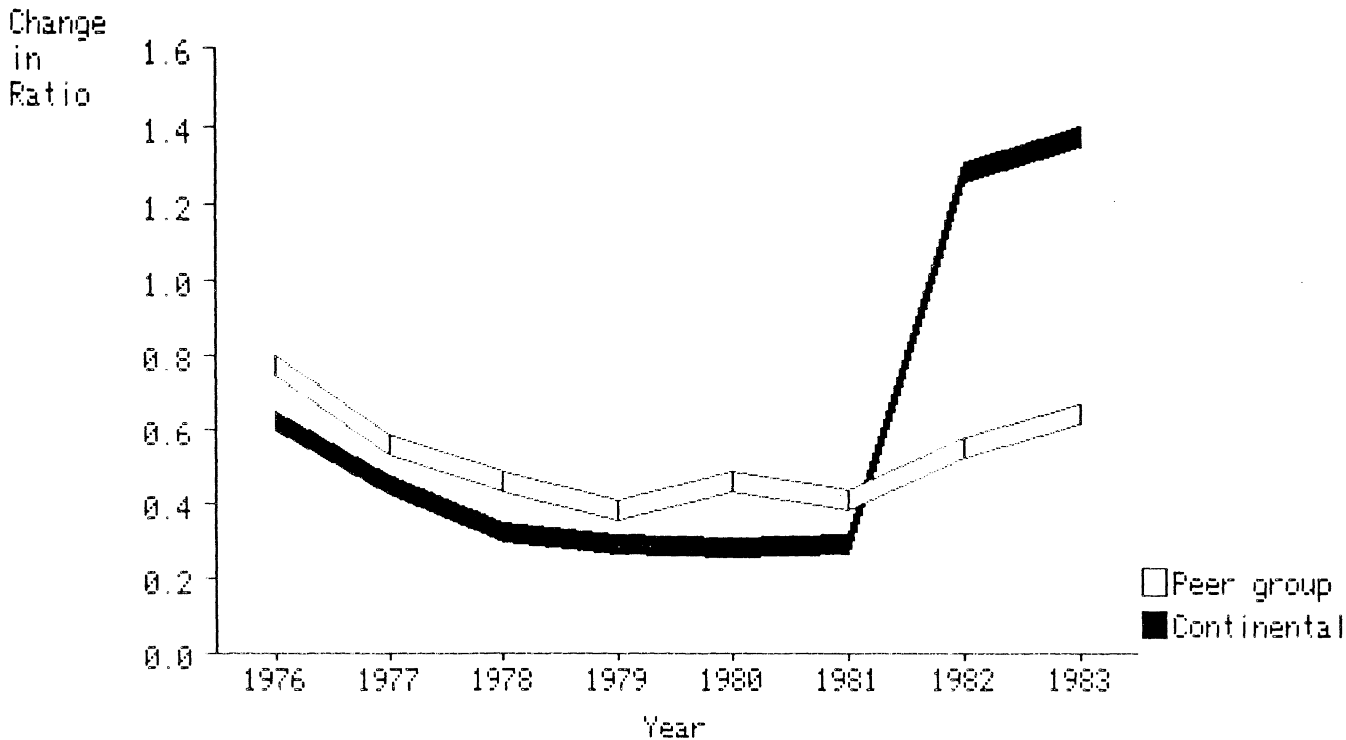


*Equity Capital and Subordinated Notes to Total Assets.

71

Growth in Loans
Percent Change
30
25
20
15
10
5
0
-5
-10
1977
1978
1979
1980
1981
1982
1983
Year
Peer group
Continental

Net Charge-offs to Total Loans



Chairman St Germain. At this point, I call on the very distinguished ranking minority Member, Mr. Wylie, for a statement.

Mr. Wylie. Thank you very much, Mr. Chairman. That was a very far-reaching and thought-provoking opening statement, and certainly sets the stage for this hearing this morning.

There is indeed a desire, at least on this Member's part, to proceed with vigor and thoroughness to probe the Continental case. We do not want it to be laced with acrimony or politics, but rather to stress the many positive aspects of this inquiry, that this subcommittee is conducting into the case of Continental Illinois to ascertain if there are indeed some things that we need to learn for the future.

I would associate myself with your compliment of our staff. They have done an enormous amount of good, hard preliminary work through a bipartisan effort, and with assistance of the General Accounting Office have come up with some general ground rules which the chairman and I have discussed.

I think the delicate nature of the information in some of the documents with which we must deal has required careful coordination between the majority and minority with respect to certain investigatory tools of the regulatory agencies; and despite some differences along the way, most of the problems have been resolved with reference to the ascertainment of the information which will be developed before this committee in a very cooperative relationship.

I believe we all agree that the purpose of this hearing is not to engage in any political debate but to learn what factors contributed to the deterioration of Continental Illinois to the place where Federal assistance was required, and to consider what measures might be taken to prevent this situation from occurring again. We should make certain that we do not create the expectation that as long as an institution is big enough, there is no limit to the amount of risk the Federal Government is willing to go to accommodate.

As we begin these hearings, I want to stress several points that should be borne in mind throughout the long hours we will spend on this case. This is a unique inquiry because it is being conducted on an open bank, one that we all want very much to succeed in its efforts to restructure itself with Federal assistance. Therefore, our inquiry is historical in nature in that respect.

We should refrain as much as humanly possible from speculation as to the current condition or future prospects of the bank, I think.

Major banks operate in an environment drastically different from that which prevailed 50 years ago when the regulatory and deposit systems were designed by Congress. Large banks now fund themselves twice a day. Electronic communications make it possible for institutions to raise or lose funds practically instantaneously.

This inquiry should prod the next Congress to give urgent consideration to the forthcoming recommendations for reform of the regulation of depository to institutions be made by the Vice President's task force, as well as to the deposit insurance reforms already submitted by the regulatory agencies.

We are all aware of the need to maintain the stability of our monetary system. Despite deposit insurance and the part it has played as a central part of this effort, we do need to do other things to maintain that stability. But stability should not imply that no bank should fail. Rather than that, the banks which fail should not threaten the system as a whole. To provide absolute protection against failure would imply a degree of regulation and supervision that would stifle innovation and reduce the efficiency of the entire economy.

With respect to the particular situation involving Continental, I think it is remarkable that a small group of regulators were able to develop a $4.5-billion rescue package without guidance or consultation with Congress. This rescue package was necessary to maintain the stability of the domestic and international financial markets, in my judgment.

It is unfortunate that these solutions have had to be fashioned on an ad hoc basis whenever a failure or crisis has occurred. Too often in the past, hearings have focused on the manner in which the regulatory process functioned in a particular case without giving adequate consideration to the larger policy issue of the most appropriate needs of maintaining reasonable stability in financial markets and who should be responsible for this and what price should be paid.

In your statement on Continental, Mr. Chairman, you have suggested that perhaps this rescue should have been debated by Congress, as was the case with Lockheed and Chrysler. But would that have been practical? Legislation to assist Lockheed was introduced in May 1971, but was not enacted until August 1971. The Chrysler legislation was introduced in October 1979 but was not enacted until January 1980.

Continental's problem was basically a liquidity crisis prompted by a run on the bank. In a day when funds can be transferred internationally almost instantaneously, the bank's deposit base would have been eliminated before we got a bill out of this committee. I think prompt action was essential. And rather than attempt to inject ourselves into the process, which I do not believe we really want to do, we should concentrate on providing guidance to the regulators as to how they should proceed in the future.

Mr. Chairman, I look forward to working with you toward that end. Thank you very much.

[The opening statement of Congressman Wylie follows:]

STATEMENT OF
REP. CHALMERS P. WYLIE, OHIO
SEPTEMBER 18, 1984
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
HEARINGS ON CONTINENTAL ILLINOIS

MR. CHAIRMAN:

THAT WAS A VERY FAR REACHING, THOUGHT PROVOKING STATEMENT, MR. CHAIRMAN, - - AND CERTAINLY SETS THE STAGE.

THERE IS INDEED A DESIRE ON THIS MEMBER'S PART TO PROCEED WITH VIGOR AND THOROUGHNESS TO PROBE THE CONTINENTAL CASE. WE DO NOT WANT IT TO BE LACED WITH ACRIMONY OR POLITICS BUT, RATHER TO STRESS THE MANY POSITIVE ASPECTS OF THE INQUIRY THIS SUBCOMMITTEE IS CONDUCTING INTO THE CASE OF CONTINENTAL ILLINOIS.

THE PRELIMINARY WORK HAS BEEN CONDUCTED THROUGH A BIPARTISAN STAFF EFFORT WITH THE ASSISTANCE OF STAFF FROM THE GENERAL ACCOUNTING OFFICE, UNDER GROUND RULES AGREED TO BY THE CHAIRMAN AND MYSELF. THE DELICATE NATURE OF THE INFORMATION IN THE DOCUMENTS WITH WHICH WE MUST DEAL HAS REQUIRED CAREFUL COORDINATION BETWEEN THE MAJORITY AND MINORITY AND WITH THE RESPECTIVE REGULATORY AGENCIES. DESPITE SOME DIFFERENCES ALONG THE WAY, MOST OF THE PROBLEMS HAVE BEEN RESOLVED, AND THERE IS EVERY REASON TO BELIEVE THAT WE CAN CONTINUE TO ENJOY A COOPERATIVE RELATIONSHIP. I BELIEVE WE ALL AGREE THAT THE PURPOSE OF THIS HEARING IS NOT TO ENGAGE IN A POLITICAL DEBATE, BUT TO LEARN WHAT FACTORS CONTRIBUTED TO THE DETERIORATION OF CONTINENTAL ILLINOIS TO THE POINT WHERE FEDERAL ASSISTANCE WAS REQUIRED AND TO CONSIDER WHAT MEASURES MIGHT BE TAKEN TO PREVENT THIS SITUATION FROM OCCURRING AGAIN. WE SHOULD MAKE CERTAIN THAT

WE DO NOT CREATE THE EXPECTATION THAT AS LONG AS AN INSTITUTION IS BIG ENOUGH, THERE IS NO LIMIT TO THE AMOUNT OF RISK THE FEDERAL GOVERNMENT WILL BE WILLING TO ACCOMMODATE.

AS WE BEGIN THESE HEARINGS I WANT TO STRESS SEVERAL POINTS THAT SHOULD BE BORNE IN MIND THROUGHOUT THE LONG HOURS WE WILL SPEND ON THIS CASE. THIS IS A UNIQUE INQUIRY, BECAUSE IT IS BEING CONDUCTED ON AN OPEN BANK, ONE THAT WE ALL WANT VERY MUCH TO SUCCEED IN ITS EFFORT TO RESTRUCTURE ITSELF WITH FEDERAL ASSISTANCE. THEREFORE, OUR INQUIRY IS HISTORICAL IN NATURE. WE SHOULD REFRAIN AS MUCH AS IS HUMANLY POSSIBLE FROM SPECULATION AS TO THE CURRENT CONDITION OR FUTURE PROSPECTS OF THE BANK.

MAJOR BANKS OPERATE IN AN ENVIRONMENT DRASTICALLY DIFFERENT FROM THAT WHICH PREVAILED FIFTY YEARS AGO, WHEN THE REGULATORY AND DEPOSIT INSURANCE SYSTEMS WERE DESIGNED BY CONGRESS. LARGE BANKS NOW FUND THEMSELVES TWICE A DAY. ELECTRONIC COMMUNICATIONS MAKE IT POSSIBLE FOR INSTITUTIONS TO RAISE OR LOSE FUNDS PRACTICALLY INSTANTANEOUSLY. THIS INQUIRY SHOULD PROD THE NEXT CONGRESS TO GIVE URGENT CONSIDERATION TO THE FORTHCOMING RECOMMENDATIONS FOR REFORM OF THE REGULATION OF DEPOSITORY INSTITUTIONS TO BE MADE BY THE VICE PRESIDENT'S TASK GROUP. AS WELL AS TO THE DEPOSIT INSURANCE REFORMS ALREADY SUBMITTED BY THE AGENCIES.

WE ARE ALL AWARE OF THE NEED TO MAINTAIN THE STABILITY OF OUR MONETARY SYSTEM. DEPOSIT INSURANCE HAS PLAYED A CENTRAL PART IN THIS EFFORT. BUT STABILITY SHOULD NOT IMPLY THAT NO BANK SHOULD FAIL. RATHER, THE CONCERN SHOULD BE THAT THOSE FAILURES THAT DO OCCUR SHOULD NOT

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THREATEN THE SYSTEM AS A WHOLE. TO PROVIDE ABSOLUTE PROTECTION AGAINST FAILURE WOULD IMPLY A DEGREE OF REGULATION AND SUPERVISION THAT WOULD STIFLE INNOVATION AND REDUCE THE EFFICIENCY OF THE ENTIRE ECONOMY.

WITH RESPECT TO THE PARTICULAR SITUATION INVOLVING CONTINENTAL, I THINK IT IS REMARKABLE THAT A SMALL GROUP OF REGULATORS WERE ABLE TO DEVELOP A $4.5 BILLION RESCUE PACKAGE WITHOUT GUIDANCE OR CONSULTATION WITH CONGRESS. THIS RESCUE PACKAGE WAS NECESSARY TO MAINTAIN THE STABILITY OF DOMESTIC AND INTERNATIONAL FINANCIAL MARKETS. IT IS UNFORTUNATE, THOUGH, THAT THESE SOLUTIONS HAVE HAD TO BE FASHIONED ON AN AD HOC BASIS WHENEVER A FAILURE OR A CRISIS HAS OCCURRED. TOO OFTEN IN THE PAST, HEARINGS HAVE FOCUSED ON THE MANNER IN WHICH THE REGULATORY PROCESS FUNCTIONED IN A PARTICULAR CASE, WITHOUT GIVING ADEQUATE CONSIDERATION TO THE LARGER POLICY ISSUE OF THE MOST APPROPRIATE MEANS OF MAINTAINING REASONABLE STABILITY IN FINANCIAL MARKETS, WHO SHOULD BE RESPONSIBLE FOR THIS, WHAT PRICE SHOULD BE PAID, AND BY WHOM.

IN YOUR STATEMENTS ON CONTINENTAL, MR. CHAIRMAN, YOU HAVE SUGGESTED THAT PERHAPS THIS RESCUE SHOULD HAVE BEEN DEBATED BY CONGRESS, AS WAS THE CASE WITH LOCKHEED AND CHRYSLER, BUT WOULD THAT HAVE BEEN PRACTICAL? LEGISLATION TO ASSIST LOCKHEED WAS INTRODUCED IN MAY 1971 BUT WAS NOT ENACTED UNTIL AUGUST 1971. THE CHRYSLER LEGISLATION WAS INTRODUCED IN OCTOBER 1979 BUT NOT ENACTED UNTIL JANUARY 198Ø. CONTINENTAL'S PROBLEM WAS A LIQUIDITY CRISIS PROMPTED BY A RUN ON THE BANK. IN A DAY WHEN FUNDS CAN BE TRANSFERRED INTERNATIONAL ALMOST INSTANTANEOUSLY, THE BANK'S DEPOSIT BASE WOULD HAVE BEEN ELIMINATED BEFORE WE GOT A BILL OUT OF COMMITTEE. I THINK PROMPT ACTION WAS ESSENTIAL.

RATHER THAN ATTEMPT TO INJECT OURSELVES INTO WHAT THE FUTURE HOLDS FOR THE RESCUE PROCESS, WHICH I DO NOT BELIEVE WE REALLY WANT TO DO, WE SHOULD CONCENTRATE ON PROVIDING GUIDANCE TO THE REGULATORS AS TO HOW THEY SHOULD PROCEED IN THE FUTURE. I LOOK FORWARD TO WORKING WITH THE CHAIRMAN TOWARD THAT END.

Chairman St Germain. I thank the gentleman for his excellent statement. However, I would like to make a point in response to what he said.

In my delineation of the Lockheed, New York City and Chrysler situations, what I was illustrating was the enormity of this bailout with no discussion whatsoever as compared to those three combined. And as we know, they hit every financial publication in the world for months and months, as you outlined.

What I am pointing out is that in this instance we discovered that the regulators have taken unto themselves powers that the President of the United States does not have, and we have to determine whether or not this is to continue in the future. I think that is the purpose of these hearings.

Mr. Wylie. I do think there is another dimension in the Lockheed and Chrysler case. There was obviously an instance where there might have been some exposure on the part of the Federal Government.

I happen to have a disagreement in that respect. I think that this went through the insurance process. The FDIC does have a fund, and perhaps this is what it is to be used for. But, in that case, we did have to have legislation because the Federal Government was indeed involved in the bailout. And I am pleased to say that in both cases they worked out. I supported the chairman in the case of Lockheed and the Chrysler matter—one of the few Republicans who did. But, in both cases, that proved to be a good investment.

I thought there was a little different dimension in this case in that we do not need legislation. But, of course, that is the subject of these hearings this morning.

Chairman St Germain. And as the case evolves, we will get more information.

At this point, I will call on the distinguished gentleman from Chicago, the Honorable Frank Annunzio.

Mr. Annunzio. Thank you, Mr. Chairman.

Mr. Chairman, I support you in the holding of these hearings on the subject matter under consideration. However, I have serious reservations about the timing of the hearings. Whether or not the Continental situation was handled properly by the banking agencies and the management of Continental is important and a subject that must be addressed. Of greater concern is whether Continental will survive or fail. I feel certain that given the new management at the bank, the recapitalization and increased attention by the regulatory agencies, Continental will survive. But the bank is not completely out of the woods. I hope these hearings will not cause damage to the bank's future.

The rescue plan for Continental, the promise of insurance guarantees, regardless of the amount of deposits, are precedent setting. But these hearings mark the first time in history that a hearing has been held dealing with a federally insured financial institution while that institution was open and operating.

The Congress has carefully guarded the need not to cause public panic. Yesterday a member of this committee pointed out that these hearings are really not about Continental but rather about the regulation of banks, and we must bear this in mind.

That may be the case, but in practice, it is like the father preparing to give his son a spanking who announces to the child, "Son, this spanking is going to hurt me more than it does you."

It may be the regulators who are spanked during these hearings, but it is Continental that will feel the pain. If Continental, its depositors, its employees, its stockholders, and the U.S. taxpayers are injured by these hearings, then this committee must be prepared to take the blame.

I fail to see why the timeframe under which we are holding these hearings is so critical. And if the timeframe is indeed critical, why these hearings could not be held in executive session the way other hearings have been held dealing with an open institution.

Let me turn now to the question of the Continental bailout which seems to hold most of the public interest. Twenty years I have been a member of this committee. In that time, we have bailed out Lockheed Corp., the city of New York on two different occasions, the Chrysler Corporation, and the International Monetary Fund. This committee has had more bailouts than the 82d Airborne Division.

Too much attention has been given to the negative side of the bailout of Continental, but not enough to the positive side. Continental prior to the bailout had correspondent banking relationships with some 2,200 banks. That is, banks who had deposits with Continental.

Of that figure, 976 banks had deposits in excess of the federally insured ceiling. Breaking that figure down further, 66 banks had deposits which were more than 100 percent of their equity capital, and 113 banks had deposits in the amount of between 50 and 100 percent of their equity capital. Had there not been a bailout plan, not only would Continental have failed, but at least 66 other banks in the Midwest would have failed because their capital would have been wiped out. And, a large number of additional banks would have gone under because much of their capital was tied up with Continental.

On the people side of the ledger—which I have always advocated in this committee—between 10,000 and 12,000 Continental employees would have lost their jobs, as well as the employees of the other banks who had large uninsured deposits in Continental.

Top-level management is not out of work long in a situation such as Continental, but it is the lower, the middle-level groups, the tellers, the clerks, the janitors, the messengers, the cleaning force, and other administrative personnel who have the tough times. While we cannot get too upset about losses to large and wealthy stockholders, we should be concerned about the losses to the small stockholders of the banks and the stocks held by pension plans and other similar groups.

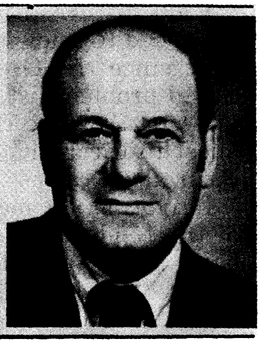
There is concern, and rightfully so, that Continental was given a 100-percent guarantee of insurance for losses suffered by depositors while other troubled or failed banks received no such guarantees. While I commend the regulatory agencies for saving Continental, I am concerned about the dual standard. On June 6, 1984, I wrote to FDIC Chairman Isaac asking him to clarify the FDIC policy in the future.

I am disturbed that even today no such hard line policy exists. The need to know the FDIC policy is more critical now than at any time since the Great Depression. There are 750 banks on the so-called problem list, 3 years ago that figure was only 250. Bank failures for 1984 are running at record rates. Today I reiterate my request to the FDIC to give the American people a policy on deposit insurance.

In closing, let me make it clear that I am not carrying the water of the top-level management of Continental who failed to run the bank properly. But I make no apology or excuses for carrying the water of those 12,000 Continental employees and those thousands of small shareholders, many of whom are widows and pensioners and many, many of the pension funds involving hundreds and thousands of workers that are on the books of the Continental Bank.

[The following news release containing a copy of the letter sent to FDIC Chairman Isaac on June 6, 1984 by Congressman Annunzio referred to above was submitted for inclusion in the record:]

NEWS RELEASE
from
Congressman
FRANK ANNUNZIO
11th Congressional District — Illinois



FOR IMMEDIATE RELEASE

CONTACT: Curtis A. Prins
Subcommittee on Cosumer Affairs and Coinage
(202) 226-3280
Wednesday, June 6, 1984

ANNUNZIO ASKS FDIC FOR GAME PLAN

The following is the text of a letter sent today by Chairman Frank Annunzio (D-Ill.) of the House Consumer Affairs and Coinage Subcommittee to Chairman William Isaac of the Federal Deposit Insurance Corporation:

June 6, 1984

Honorable William M. Isaac
Chairman
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Dear Mr. Chairman:

While I applaud your decision to guarantee all deposits and general creditors of the Continental Illinois bank, I am at the same time concerned about the overall procedures used by your agency in dealing with bank failures.

My observations lead me to the conclusion that the Federal Deposit Insurance Corporation operates by a "seat of the pants" technique in dealing with bank failures. Instead of presenting a well thought out game plan on bank failures, your team looks as if it is drawing the plays in the sand after each bank failure. This approach has caused anger, resentment and frustration on the part of many bank depositors, bank officers and bank customers.

Many of my constituents have contacted me concerning the failure of the United of America bank, and the government assistance and guarantees provided the Continental bank. In the United failure, your agency used the so-called "market discipline" approach, under which depositors have received 60 percent of their uninsured deposits. Please tell me how I can explain to my constituents that deposits in one bank are not insured the same way they are in another bank.

As I stated in the beginning of this letter, I applaud your action on Continental, but what position will your agency take when the next bank is in trouble or fails? Will your decision be based on size alone?

I urge you, Mr. Chairman, to develop a publicly stated position on bank failures and troubled banks. While there may be disagreement on what that position may be, at least bankers and their customers will know in advance what the rules of the game are. If the market discipline approach is to be used, then use it. If guarantees such as those used in the Continental case are to be employed, then let everyone know that fact, but there must be a stated policy. Without such a policy, I foresee massive lawsuits, charges of favoritism and insurance by size rather than equity.

I urge you to adopt such a policy with the utmost speed. By the time this letter reaches you another bank may well have failed, and the question of the treatment of those depositors and creditors will be raised anew.

I hope you will give this your urgent and immediate attention, and that you will favor me with a reply as quickly as possible.

Sincerely,

Frank Annunzio

Frank Annunzio
Chairman

Chairman ST GERMAIN. I thank the gentleman. I am sure he has that same feeling for the widows and the unfortunates who were hurt by the failure of Penn Square Bank.

Now, I call on Mr. Leach for an opening statement.

Mr. ANNUNZIO. Mr. Chairman, I would like to respond to that. I was one of those that went to Oklahoma City. I reiterated my feelings. I expressed myself to the gentleman who had lost his son in a plane crash and received $1 million and put that money in Penn Square and thereby losing over $900,000. There is no question——

Chairman ST GERMAIN. He should have put it in Continental.

Mr. ANNUNZIO. Well, he put it in Penn Square. He came close. But I do want to point out here, Mr. Chairman, that when the Federal Deposit Insurance Corporation acted and the other regulatories, they acted under what they feel is the authority given them by the Garn-St Germain bill that was passed and signed by the President.

So what needs clarification is the legislation that you sponsored with Mr. Garn, that I voted for and the members of this committee voted for, because we had faith in your leadership and in Mr. Garn's leadership, and if that legislation needs fixing, you will bring it back before this committee, and we will fix it.

Chairman ST GERMAIN. Well, I will say to the gentleman, since I indeed was responsible for writing that legislation and contend that that did not give them this authority, we will have you testify at one of the hearings.

Mr. ANNUNZIO. I am not a lawyer, so I don't know.

Chairman ST GERMAIN. Mr. Leach, you are recognized for your statement.

Mr. LEACH. Thank you, Mr. Chairman.

I have a lengthy statement that I would ask be submitted for the record.

Chairman ST GERMAIN. Without objection, so ordered.

Mr. LEACH. I would just like to make a few remarks.

One, it is hard not to decide that in a free enterprise society, any institution, no matter how large, should be allowed to fail. What we have here is a regulatory, as well as banking scandal. The problems of this bank were largely undetected by the regulators and loose banking practices were allowed to continue. The biggest regulatory problem of all is that standard rules for large bank failures didn't and don't now exist.

Therefore, instead of simply pointing fingers of blame at the regulators and Continental, I would hope the committee and the regulators would explore ways to prevent this from occurring again.

One approach might well be to consider guaranteeing a hefty percentage—perhaps as much as 80—of all deposits above $100,000 in insolvent institutions, so that insolvent institutions can be liquidated with a minimum disruption of the financial system.

It is quite clear that the issues we face in American banking today are question about quality of money center bank loans, the adequacy of the capital of our larger banks and lack of uniformity in regulation. I think it is time that "get tough" policy of national bank regulation is instituted and greater attention is given at the larger banks to the capital adequacy problem. The big should be regulated as firmly as the small and if circumstances warrant, they should be allowed to fail.

Finally, one comment about the distinguished gentleman from Illinois' reference to the timing of this hearing. I think it is important and fair to note that what we have here are potential taxpayer liabilities. I would stress the regulators refused earlier this summer to come before this committee to talk about this issue. So we have postponed consideration for a number of months.

I would also stress that I don't think survival of Continental is very much in question. The Chairman of the FDIC has announced publicly that he is prepared to infuse new funds into Continental and what we really have in Continental is a situation where miracle workers are not needed as they were needed at Chrysler, just glad-handers. What we have here is a newly organized bank with a fair capital base, few nonperforming loans—thanks to the Government—and an open-ended commitment from the FDIC to provide more funds.

That is unlike any other bank in this country today, and I think that what we really have here is a question of whether we embarrass the regulators, not whether we have a bank that is going to exist. This bank has got it made.

Thank you.

Chairman ST GERMAIN. I thank the gentleman. I now would like to put your entire statement in the record, without objection.

[The opening statement of Congressman Leach follows:]

JIM LEACH
IOWA'S CONGRESSMAN
FOR THE FIRST DISTRICT

Statement by
REPRESENTATIVE JIM LEACH
before the
Subcommittee on Financial Institutions,
Supervision, Regulation and Insurance

September 18, 1984

I am sure that I speak for the committee in stressing that the purpose of these hearings is not to diminish confidence in the newly created Continental Bank nor to unravel the FDIC rescue package, but to explore ways to prevent the need for this type of unprecedented government intervention from recurring.

But I must confess at the outset that I have grave doubts about the wisdom of the course of action the regulators took. In a free enterprise society, all institutions, no matter how large, should have the right to fail.

Fifty-six banks have been declared insolvent this year and either closed or merged. Yet Continential, the nation's eighth largest bank, has received a massive aid package that will allow it to continue to compete as a quasi-nationalized entity. This action has serious implications both for market discipline and for large bank-small bank competition.

The Continental precedent would appear to imply that large banks have a better brand of deposit insurance. Thus, large depositors are given an incentive to place their funds in money center banks, no matter how imprudently managed, rather than in small banks, which may well be on a percentage basis better capitalized. I am hopeful that one of the results of these hearings will be that Congress redress this inequity.

One approach to this dilemma might be for the federal bank regulators to develop uniform rules and procedures for handling bank liquidations. In order to assure broad confidence in the U.S. banking system, but not go to the brink of protecting high-flying banks and high-risk depositors, they might consider announcing a policy of guaranteeing that a hefty percent (perhaps 80) of all deposits above $100,000 will be immediately returned to depositors in banks that become insolvent, with assurances of the return of any additional recoverable assets after liquidation. Such an approach would have the advantage of assuring standard rules and orderliness, without dulling market discipline.

The bailouts of Lockheed, Chrysler and New York City stand as controversial acts of government, but at least they were widely debated and received the specific statutory support of Congress and the President. The bailout of Continental is based on broad stand-by authority transferred to regulators by previous Congresses. What makes it particularly unseemly is that the regulators who decided on the nationalization approach are the very ones who failed to stop the banking practices that caused the problem in the first place.

The ultimate irony may be that the only approval required for the regulator's approach had to come from a formal vote of stockholders who were to be saved, not from taxpayers or their representatives in Congress who potentially have to foot the bill.

Chosen to head the newly reorganized bank are two distinguished businessmen -- John Swearingen, formerly Chairman of Standard Oil of Indiana and William Ogden, formerly vice-chairman of Chase Manhattan. But the public need not hold its breath in doubt, as it did with Chrysler, whether Continental will make it. Unlike Chrysler and Lockheed before it, actual cash -- not just a leveraged loan guarantee -- has been infused into the bank and the most dubious portion of Continental's liabilities assumed by the government. William Isaac, the chairman of the FDIC, even pledged at a news conference that if things do not go well in the months ahead, his agency is prepared to give more. Survival is not in question. Continental does not need miracle workers, just glad handers. Swearingen and Ogden have taken the helm of a financier's utopia: a newly organized bank with a solid capital base, few non-performing loans, and an open-ended commitment of the FDIC for more funds. Can there be any doubt that Continental represents as much a regulatory as a banking scandal?

A wiser approach, it would seem, would simply have been to liquidate the bank, selling off at a discounted value its loan portfolio. The regulators argued this would have taken years, sparked a loss of confidence in America's banking system, and caused in a domino fashion the collapse of numerous smaller banks. I doubt it. Give or take a few billion, what Continental represented when the regulators stepped in was a bank with no capital base, approximately $35 billion in responsible loans and perhaps as much as $5 billion in uncollectables. Instead of moving to insure all depositors on May 18 and eventually making what appears to be a $4.5 billion mistake, the FDIC could have closed the bank, sold its loan portfolio, paid off fully the $3 billion in insured deposits, and 86¢ on a dollar of uninsured deposits. The shareholders and bondholders would have lost all, and the uninsured depositors been burned to the tune of 14 cents on the dollar -- not an unrealistic penalty for poor risk management of funds, nor one likely to have caused the failure of other banks or a collapse in confidence in America's banking system. Instead of rewarding risk-prone banking practices, the precedent established would be one of providing a firm but not panicked warning to stockholders and depositors to watch management more carefully. All growth is not good growth. Smaller can be more beautiful.

Rather than reinforcing the safety and soundness of the nation's banking system, the approach federal regulators took emboldens improvidential banking practices. The consequences for taxpayers are grave. But far graver are the consequences for management of the money supply and, in effect, the economy itself. If banks do not face the discipline of the marketplace and keep prudent loan portfolios, the money supply will grow disproportionately in industries or geographic regions where growth-at-all-costs banking takes place.

While Continental's problems are unlike those of other money center banks in that they largely relate to inadequately supervised domestic as opposed to foreign loans, the Continental bailout carries with it implications for the international lending practices of other larger banks. When lending is unrestrained by either the enforcement of an adequate capital base or, as in the case of foreign reserve requirements, financial institutions have a tendency to create excessive capital through the multiplier effect of making loans. The inflation of the late 1970s as well as the overextension in foreign lending can be traced in no small measure to the 25 percent per year growth regulators allowed to occur in Eurocurrency financing. Since any bank can grow simply by taking on more loans as long as depositors can be attracted and protected, it is imperative that incentives be established for depositors to be wary of institutions like Continental. Management's decision to expand the bank's loan base at twice the national average -- over 20 percent per year from 1977 to 1981 and to rely excessively on high cost, short term money should have been warning enough to depositors as well as shareholders.

Perhaps the most important reform that occurred in banking as a result of the bank failures of the Depression was the establishment of deposit insurance, which today covers accounts up to $100,000. But the FDIC announcement May 18 that it intended to insure all deposits of any size at Continental signalled for the world that bankers need give little heed to risk management. Uncle Sam would provide a safety net for the big and powerful even at a time government agencies were given a mandate to prune programs for the weak and defenseless. The Continental bailout could not more graphically illustrate that deregulation is a matter of rhetoric rather than substance in Washington. If the most free enterprise biased administration in recent history blinks in the face of political embarrassment involved in the potential folding of our eighth largest bank, what can be said about the future of our market economy?

Ironically for smaller banks that have stronger capital requirements than larger ones, the ramifications of the Continental bailout are likely to be similar to those that occured after the Bert Lance episode. The regulation will be toughened. For larger banks, boardrooms can breathe easier. The precedent will be comforting. Pressure to put our biggest banking houses in order will be reduced. Attention will be focused on broadening FDIC insurance coverage rather than on the real problem, which is capital adequacy.

The scatter-gun decisionmaking that hallmarked the regulators' handling of the Continental issue underlines the appropriateness of Congress' rethinking the entire federal bank regulatory structure. Three separate federal agencies were responsible for overseeing Continental, and this diffusion of responsibility may be partially responsible for the negligence that appears to have characterized the oversight of the bank. A single federal banking agency might have some advantages in eliminating the problems of overlapping jurisdiction and vague responsibility which plague the system. The burden of proof, generally speaking, rests with those who advocate institutional change and while it may be premature for Congress to take a definitive position, the case for a thorough review of the regulatory system is powerful.

One footnote speaks for itself. Congress, as the elected body of the American people empowered to make spending decisions for taxpayers, was not only not fully consulted in advance on the policies that were applied to Continental, but regulators refused this summer to come before the appropriate oversight committee except on the agreed upon premise that they would not respond to questions about Continental. It is alway easy to suggest that confidence in the banking system might have been jeopardized if the issue received a thorough review, but this Representative is hard pressed not to wonder whether confidence in the judgment of the regulators is not the real issue.

The bailout that is needed for our large banks is a private- rather than public-sector one -- a recapitalization based on the selling of equity. Large banks don't want to sell stock because it implies dilution at a time when the vast majority of bank stocks sell for less than book value. But raising money the old-fashioned way makes a lot more sense than relying on the government for newfangled bailouts.

* * * *

Chairman St Germain. Mr. Schumer has an opening statement.

Mr. Schumer. I have an opening statement I won't read, but I ask unanimous consent that it be read into the record.

Chairman St Germain. Without objection.

Mr. Barnard.

Mr. Barnard. Thank you, Mr. Chairman.

Mr. Chairman, I would just like to make a couple of observations as we proceed with this very important hearing today.

Perhaps I am emphasizing something that Mr. Wylie mentioned in his opening statement, but I can see that the hearings beginning today will serve a very beneficial purpose. We have had on the menu for several years issues that I think will give us further light and edification as we begin to consider them.

One is regulatory reform. That has been a consideration and even the vice president formed a task force. We haven't heard anything final from that task force's recommendations, but I think these hearings will show further that regulatory reform should be a consideration of this committee in the next session.

Second, insurance reform; I think we already see that the FDIC and FSLIC can't be the sole support of risk that banks take and that this is another subject that needs some very definite consideration.

Three, I think possibly we need to rethink the Garn-St Germain bill. As beneficial as that was in solving the crisis of the savings and loan industry when it was passed, perhaps these hearings show that this is a consideration that we ought to also anticipate in the next session, as to what guidelines we need to set up that the regulators should follow instead of following their own desires in solving these problems.

Four, I think that this also should give us an opportunity to further examine the issue of deregulation and how far deregulation really should go and whether or not deregulation had any really significant effect on the condition of this institution or the other institutions that have failed.

So, I summarize by saying that I think these can be beneficial as to setting us on a course of action that this committee, the Financial Institutions Subcommittee of Banking, should take in the ensuing months and years to come.

Chairman St Germain. I thank the gentleman.

Mr. McKinney is recognized.

Mr. McKinney. Thank you, Mr. Chairman.

As disagreeable a topic as Continental Illinois bailout is for us, I am glad that the subcommittee is finally moving ahead with this oversight investigation. I find myself increasingly annoyed at what I am reading and hearing about the way this bank conducted its business and the role played by the regulators responsible for examining the financial condition of that institution.

My curiosity is heightened, Mr. Chairman, by the appearance in the last few days of an interview with a senior official of the Comptroller's Office published by the Washington Post 4 days ago and a report in the New York Times of a memorandum circulated to the media by the Comptroller's Office. It appears to me the motivation behind this sudden outburst is to seize the offensive before this subcommittee can ask any embarrassing questions. Why that office might be embarrassed eludes me since the questions have all been asked before.

Approximately 2 years ago, in fact, we conducted hearings into the failure of the Penn Square Bank, I would expect that Mr. Conover could come before us with boiler plate testimony today, changing only the names of the bank.

Mr. Chairman, in addition to learning how this bank fell to such a state, I hope we focus some attention on future hearings and how to prevent similar occurrence. I think that will demonstrate there is a relationship between poor bank management practices and potential risks involved in other business lines.Why should we trust a banker who can't manage a loan portfolio to be able to successfully engage in insurance, securities, or real estate?

There are several other points which need to be made during the course of these hearings. There is a great distinction between a congressionally approved bailout of New York City or Chrysler and an administratively approved Continental bailout. I don't want to abuse the kindness of the chairman and the subcommittee to elaborate, but the difference is valid and I hope, it will be made very clear to the public as time goes on.

I would also like to find out what the regulators feel they have done, No. 1, by creating a new class of bank in the United States of America, a TBTF—too big to fail. What have they done to the soundness of the funding of the Federal Deposit Insurance Corporation and its future; what have they done to the myth of the wall of separation between the holding company and the banks since they have really in fact saved the holding company rather than the bank, and what have they done to determine what is a safe level of assets in short-term foreign deposits.

If I sound as though my mind is made up on this issue, it is only because we have been there before. No city followed New York to ask Congress for help, no corporation came asking for the treatment we gave Chrysler. That was because no one in charge of a city or industrial company wanted to be laced with the stringent oversight conditions we—the Congress of the United States, acting for the people of this country—imposed on that city and on that corporation as a precondition for Federal assistance. Why do the regulators treat banks differently?

It seems to me that regulators have decided that, in fact, a bailout may be conducted without the consent of those who are going to pay the bill and without stringent requirements and regulations that we put on those other Federal assistance bills, Mr. Chairman. In fact, it is with great interest I note that the regulators have decided that the very people who issued those rotten loans will now manage them.

Chairman St Germain. The Chair recognizes Mr. Shumway for a unanimous consent request, I believe.

Mr. Shumway. Thank you, Mr. Chairman.

While I believe this to be largely an exercise of Monday morning quarterbacking, I do recognize the high state of emotions on this issue, indeed on both sides of the aisle. I share the concern regarding the timing of these hearings expressed by the gentleman from Illinois, Mr. Annunzio.

Without taking further of the committee's time so that we can get to the witnesses, Mr. Chairman, I request unanimous consent that my full statement be included in the record.

[The opening statement of Congressman Shumway follows:]

STATEMENT OF THE HONORABLE NORMAN D. SHUMWAY

September 18 1984

Mr. Chairman, I commend you for calling these hearings which, hopefully, will provide the Committee Members with a fuller understanding of the backdrop of events occurring at Continental which led to its recent crisis and subsequent federal intervention, as well as the implications of these actions for the banking industry. I am, however, concerned that the focus of these hearings may shift away from their original goals and delve into the possible relationship between Continental's woes and proposals now before the House and Senate to deregulate further the banking industry.

I am all too aware that opponents of product deregulation for banks will try to cite the Continental experience as still one more piece of evidence that bankers are so inept at handling their own business that it would be folly to trust them with additional powers. What is even more disturbing to me is that these opponents are inflaming the general -- and largely unsophisticated -- public into assuming that Continental's problems were even attributable to the limited deregulation that has already occurred...I would suggest that not only are these notions fallacious but also are submitted by those competitors of banks seeking to protect their respective turfs.

Let's examine some of the fallacies. First, I would note that deregulation did not cause the problems of Continental when its troubles first became apparent. Rather, Continental's operations were conducted in one of the most regulated states in the country, which prohibits even branch banking. Because Continental was more geographically limited in its deposit taking function than other banks, it was forced to seek and to rely on high-cost -- not to mention volatile -- international deposits to fund its lending program. Further, the bank's problems appear to have been the result of unusually poor management of a quite traditional banking function of taking in deposits and lending them out, and not from the new activities sought such as securities trading or investment banking. The bank's reliance on international purchased funds, together with non-performing loans purchased from the now-failed Penn Square Bank, created a real drain on earnings and increased its exposure to speculation as to the future viability of the institution.

This speculation reached a crisis level in mid-May of this year when Continental was hit by the classic run on deposits, something, from which, I might add, no financial depository institution is immune. I am convinced that had the Federal regulators not stepped in when they did, the effect on public confidence in and the stability of our nation's financial system would have been devastating.

Just why the panic run developed when it did, the extent of federal involvement in and the favorable treatment of Continental will be the subject of great debate. Suffice it to say that I, too, am anxious to have the cards put out on the table. However, I am afraid that when all is said and done, the true culprit in the Continental debacle will not be forced into the open. Who is the culprit? The current system is. The laws that were designed to regulate and restore confidence in the nation's banking system bear a large share of the responsibility for the problems facing the financial services industry today. This is particularly true of federal deposit insurance, which eliminates market discipline in the banking industry and encourages insured depository institutions to take additional risks. I am convinced that until we change our perspective of providing blanket guarantees where the institution is too large to fail and applying uniform insurance premiums -- rather than assessing premiums based upon institutional risk of exposure -- we will be faced with many more "Continentals". We cannot let this happen to the American depositor or to the American banking system.

Chairman St Germain. Do any other members of the subcommittee seek recognition?

Ms. Oakar. Mr. Chairman. Just a brief comment.

Chairman St Germain. Mary Rose.

Ms. Oakar. Mr. Chairman, I want to commend you for these hearings on Continental Illinois. Hopefully, the thrust of the hearings will not be what Continental is today, because I share the gentleman from Illinois' concern about a run on the bank. Consumers ought to know that they are probably dealing with a bank that is very well protected and assured that their investments with the bank are fine.

However, I have some concerns about the Comptroller, the primary regulator of Continental Illinois, and I think we ought to use this hearing not so much in terms of identifying the bank but as a point of departure, as a benchmark for how we don't want to see banks operate. I really want to know why the Comptroller issued a statement on May 10, 1984, that he was not aware of any problems when, 7 days later, a massive rescue program was announced.

I can understand my friend from Chicago's concern, and I hope that the focus will be on the regulators and their oversight and what we do in the future to assure that this kind of catastrophe doesn't happen again. Consumers should know that they are protected, which is important, for managing the situation in Chicago.

Thank you.

Chairman St Germain. Mr. Dreier.

Mr. Dreier. Thank you very much, Mr. Chairman.

Like everybody here, I am extremely concerned about the two-tiered handling of the Federal insurance system, but although it is becoming more and more difficult after having listened to my senior colleagues on this subcommittee, I am going to try to keep an open mind as we face the issue.

Thank you, Mr. Chairman.

Chairman St Germain. Mr. Vento.

Mr. Vento. Thank you, Mr. Chairman.

I want to commend you for holding these hearings.

I frankly felt that we should have moved as quickly as possible to evaluate this because I think there is a debate whether or not the regulators actually had the power to do what they have done.

I think all of us recognize the volatility of this problem, the types of concerns that affect our colleague from Illinois, which in fact affected our entire international economy with the demise of Continental Illinois.

Nevertheless, these meetings and our role as a part of representative democracy are such that we should exercise it with care and responsibility and trust that our constituents have in us.

Mr. Chairman, I am concerned about the issue that arises with almost 800 banks in trouble this year, many of them have been treated far differently than this large financial institution. The challenge to this committee fundamentally relates to these large money center banks, megabanks, if you would, and whether or not we are able to supervise them adequately, whether, for instance, the FDIC action to protect consumers here has been used for a far different purpose in essence, to reinforce and deal with a different problem.

After all, the $4.5 billion that we put in at the discount window that is open to all banks with the special charters that banks have, those types of loans and responsibilities and decisions to make those loans basically on an international basis throughout our country are decisions which we end up underwriting as a National Government.

So we are, in essence, opening the economic book to be used in the private sector to write a whole host of loans which are then bought by the public sector through insurance and chartering functions we have. It is as if these private entities, the private banking system in this country and financial institutions are absorbed and nationalized.

And yet we have an inadequate control over the economic writing and loan capacity of these particular institutions. This is the fundamental question that we, as a committee in terms of our charter and in terms of our relation, have to come to deal with.

I might remind the committee they are all not losers, the bondholders, those with the golden parachutes, many others that benefited from these types of actions.

So I commend the chairman and look forward to working with him and the other members of the committee as we try to resolve these and many other questions being raised.

Chairman ST GERMAIN. Thank you.

Mr. Patman.

Mr. PATMAN. Thank you, Mr. Chairman.

I am grateful for the opportunity to attend this hearing and listen to what I hope will be somber good testimony.

I do urge this committee press forward immediately to clarify the rules on insurance companies for the largest banks as compared to the insurance coverage available to the depositors in the smaller banks.

Where is the dividing line? What are the questions? What are the guidelines that enter into the minds of those regulators who are undertaking to determine whether or not the bank in Seminole, TX, for example, that went broke a few weeks ago apparently, has only 55 cents on the dollar for its depositors above $100,000? What are we going to do about Financial Corp. of America out on the west coast and these many, many other large institutions that appear to be very fragile in their financial stability?

I am hoping that we can develop the guidelines, the information needed, for the depositors and the investors all over this Nation and come out with legislation that may be necessary in order to strengthen the regulatory process, grant greater authority if necessary to the regulatory agencies, but do give more safety and soundness to our system of financial institutions.

Mr. SCHUMER. Mr. Chairman.

Chairman ST GERMAIN. Mr. Schumer.

Mr. SCHUMER. I can't resist making it a straight flush on the top row by saying a few words.

I think the question we must address concerns not just the regulators, Mr. Chairman. I think the question is how many more large money center banks will run into the same problems that Continental has run into? We are in a new world of go-go banking. We are in a world where banks are under tremendous pressure to maximize the return they get from loans. We have seen not just too much money pushed into oil and gas loans, we have seen money pushed into Third World countries and now into leveraged buyouts.

Will we be sitting here 3 years from now having another hearing about 1 or another of the 10 largest banks that put too much into leveraged buyouts? One thing is clear, if a penny candy store was run the way Continental was run, it would be bankrupt in 6 months. The issue is how many more banks are in this problem?

And it is our responsibility to look at that because, one, banks are not an unregulated industry, the Federal Government gives them all sorts of advantages; but, two, they are too important to the lifeblood of this country to be left simply to the bankers themselves.

Chairman St Germain. The Chair would observe that after my many years on this committee, this is probably one of the most stimulating and participatory openings of any set of hearings. It would appear to me that there is a slight bit of interest on the part of the members of this subcommittee in these proceedings. Certainly, I have been listening attentively to my colleagues, each and every one of them, and I appreciate the fact that they see challenges in this set of hearings and have questions about what occurred.

So all I can say is that it bodes well for the work of the committee that we have so many members who are so intensely interested.

Now, we will begin the actual proceedings. I would ask Mr. Meade, Mr. Kovarik, Mr. McCarte and Ms. Kenefick if they would be kind enough to stand and raise their right hands.

Do you swear that the testimony you are about to give will be the truth, the whole truth and nothing but the truth?

[Witnesses sworn.]

Chairman St Germain. Please be seated.

I would ask that when Mr. Meade, Mr. Kovarik, Mr. McCarte are called upon to answer their initial questions that they provide for the subcommittee the information on the sheet that I have provided to you, to wit, your OCC employment background and current employment, which examinations you served as examiner in charge, which examinations you participated in, and whether or not you had the opportunity to reacquaint yourselves with the examination reports, and if so, which ones?

When you are called upon for your initial answer to a question, we would ask you to address those points for the benefit of the members of the subcommittee and for the record.

I would like to address my first question to Ms. Kenefick.

But before I do, I would ask unanimous consent to place in the record at the conclusion of my questioning the September 17 staff report on Continental Bank's financial history, the September 18 staff report on examiner findings, the November 15, 1982 memorandum from Richard Kovarik to William Martin, and the July 1982 Kathleen Kenefick memorandum which will be the subject of my questioning with Ms. Kenefick.

There being no objection, so ordered.

Ms. Kenefick, I am going to ask you to outline for us your employment history at Continental and the staff has made copies of your July 1982 memorandum on oil and gas lending available to all the members. We will ask you to describe the circumstances that led up to your writing, of this memo, we will ask you to summarize the memo; and we will ask you to explain the following excerpts from it: what you meant by the status of the Oklahoma accounts—particularly Penn Square Bank—as a cause for concern; next, management of credit relationships has not taken place; next, in some cases the initial credit writeup had customer information missing, out-of-date or incorrect, and in other cases there has not been a credit writeup.

Furthermore please comment on: followup of accountability having been rare; next, housekeeping problems, missing note sheets on approvals, documentation errors and omissions, past due principal and interest compounding the situation. Do you consider these housekeeping? They sound like fundamental documentation problems. Then, the Oklahoma calling personnel continuing to fight to keep their heads above water with time spent putting out fires and, therefore, falling further behind.

At the conclusion of her outline or explanation of her memorandum, I would ask the examiners to reply as to whether or not they feel the conditions Ms. Kenefick described would have been viewed as serious by OCC examiners. In other words, please comment on the seriousness of the conditions described in the Kenefick memorandum.

Ms. Kenefick, I would like you to address one last thing in your reply. I would like to know if you feel—this is important to a lot of my staff members on this side—that perhaps the memorandum you wrote—that to many of us seemed very penetrating and well done—perhaps due consideration was not given to this memorandum because despite the fact that a lot of people tout that they have females in high positions in their organizations, unfortunately often times it is more lip service than anything else, and I would like to know whether you feel that that had any bearing on the fact that your memorandum was not given due consideration by upper management in Continental Illinois.

That is the conclusion of my question. You are now recognized to reply, Ms. Kenefick.

TESTIMONY OF KATHLEEN KENEFICK, FORMER EMPLOYEE, CONTINENTAL ILLINOIS NATIONAL BANK

Ms. KENEFICK. Thank you, Mr. Chairman.

You asked me to outline my employment history at Continental Bank. I started in the bank in January 1975 as a management trainee in the commercial lending department of the bank, and I was in that training program until late summer or early fall of that year.

I then received my first assignment in one of the commercial lending departments as a member of the surface transportation division. My title at that time was commercial banking associate, and I worked in the section which was responsible for the area west of the Mississippi River.

During that time period I received two promotions from—to comercial banking officer and again in late summer or early fall of 1976, and then secondly—should I continue?

Chairman St Germain. Yes, please.

Ms. Kenefick. Then to second vice president, again in late summer or early fall of 1978. My responsibilities during that time grew as I had more experience. I originally worked assisting others with their customers and eventually came to handle independently my own customers and territories. I was responsible for marketing bank products to the various customers and prospects, doing financial analysis and negotiating on behalf of the bank.

In the late fall of 1979, I was asked to take a new assignment as a supervisor in the management training program. In that responsibility I managed various associates with backgrounds from BA's to MBA's. This is, in effect, the same training program that I had started in at the bank. I supervised, evaluated, reviewed, I also had various administrative functions and worked on recruiting and interviewing for the bank.

In the spring of 1981, I had completed my assignment as supervisor in the training program, and I was assigned to the midcontinent division of the oil and gas group.

I left the bank in September of 1981.

Chairman St Germain. Now, would you continue to address the other portions of the question? The circumstances that led to your writing the memorandum that we have inserted in the record.

Ms. Kenefick. During the time I was in the division, before writing the memo, approximately 4 months, I was trying to learn about the oil and gas industry, and the division and the customers. I became more uncomfortable with the decision process that was being followed in order to make the credit decisions.

I was also becoming less and less comfortable with our relationship with Penn Square Bank. I had had several conversations with Mr. Lytle of specific instances or questions or concerns, and I felt that I wasn't——

Chairman St Germain. Mr. Lytle, what was his capacity in this area?

Ms. Kenefick. Mr. Lytle was division manager of the midcontinent division of the oil and gas group.

Chairman St Germain. Was he the principal contact with Penn Square?

Ms. Kenefick. Yes, he was, Mr. Chairman.

Chairman St Germain. Is he the individual who borrowed rather substantial sums of money from Penn Square during this period of time, he was also pursuing participation loans from Penn Square on behalf of Continental Illinois?

Ms. Kenefick. Mr. Chairman, I don't have any personal knowledge of his loans.

Mr. Barnard. Mr. Chairman, could you ask her to speak up? I can't hear her.

Ms. Kenefick. I am sorry.

Mr. Wylie. If the chairman will yield so I might edify the memorandum we are talking about.

Chairman St Germain. We have placed it in the record.

Mr. Wylie. Is this it here? There are no names on it, and it doesn't indicate who prepared the memorandum or to whom it was sent.

Chairman St Germain. The memorandum is the one we have before us; unfortunately, the Xerox is not as good as it might be, but it is on stationery of Continental Bank, and it says, "Oklahoma" in big letters and the first lines read "Status of the Oklahoma accounts, particularly Penn Square Bank, is a cause for concern." That is the memorandum.

Mr. Wylie. I want to be sure we were referring to the same memo. It doesn't have any identifying names on it.

Chairman St Germain. Except with the initials of Ms. Kenefick at the end—CK.

Mr. Wylie. Did you prepare the memorandum on your own initiative, or was that at the request of someone else?

Ms. Kenefick. Congressman——

Chairman St Germain. That she is right now describing—she is describing the circumstances that led to her preparation of the memorandum.

Mr. Wylie. That is a good question then. OK; thank you.

Ms. Kenefick. As I was saying, I felt that I wasn't making much progress in various conversations I was having with Mr. Lytle regarding some areas of discomfort and concern that I had, and I felt perhaps that the best way to approach it would be to put some thoughts in writing, so Mr. Lytle and I could discuss them. Basically, that is the circumstances.

Chairman St Germain. Would you just summarize the memo for us?

Ms. Kenefick. All right. The memo is basically five pages long; it is a memo that I wrote in July 1981 addressed to Mr. Lytle, titled "Oklahoma." The purpose of the memo was to summarize what I felt were various problems and the reasons for those problems that were occurring in the midcontinent division, but the primary reason of the memo was to propose what I felt were solutions to the issues that I raised.

Chairman St Germain. Now, if you would explain specifically the items I have listed under (3).

Ms. Kenefick. The first sentence, status of——

Chairman St Germain. These are excerpts from your memo.

Ms. Kenefick. The first sentence in my memo in here is what I am saying is that the Oklahoma accounts, and particularly those accounts where we have participated with Penn Square Bank, were in my opinion a cause for concern.

This really just summarizes my feelings at the time.

Chairman St Germain. Next, management of credit relationships has not been consistently taking place.

Ms. Kenefick. Again, this summarizes some of the feelings that I had at the time where I felt that we were not consistently on top of our accounts, we were not able to anticipate future requirements or future actions that——

Chairman St Germain. What do you mean by "on top of your accounts"?

Ms. Kenefick. Well, to the extent that we would be managing the credit relationship of the account, we would be monitoring the situation, watching for certain things, anticipating the next step.

Chairman St Germain. Could you be a little more specific, because what you are saying is, they had not taken place. So what we would like to know is, what was it that didn't take place?

Ms. Kenefick. Perhaps, Mr. Chairman, I can answer it this way, that the environment of the division at the time I was there was a very reactionary type of environment due to the growth in the division, as well as what I felt were shortages of people in the division, and, therefore——

Chairman St Germain. People or qualified people?

Ms. Kenefick. People. People in the section, I should say, not division. And, therefore, we were not able to really take charge of the relationship as best perhaps we could have.

Chairman St Germain. Next, in some cases, the initial credit writeup had customer information, et cetera.

Ms. Kenefick. This is just another one of the problems I felt were present in the division at the time. I can't recall numerous specific instances. I just say that at the time my thoughts were, after having reviewed various different credit writeups and things and doing some questioning of the people that had written them, that perhaps there was additional information that should have been included, some information that was out of date.

In a couple occasions with further digging, we found information that was provided to us that was not correct. In other cases, I say there has not been a credit writeup, there were again—again, this is a hazy memory, but I do recall that many of the credits were approved with just a commercial reporting form which is a computer input form without a detailed note sheet in many occasions explaining the purpose of the credit.

Chairman St Germain. What size loans are we talking about here, roughly?

Ms. Kenefick. Most of these loans were small loans, $5 million or under.

Chairman St Germain. Five million or under?

Ms. Kenefick. Yes.

Chairman St Germain. To a lot of us, that is a lot of money.

Mr. Barnard said it turned out to be housekeeping problems, that is, missing note sheets, approvals documentation, errors and omissions, and past due principal and interest compounding the situation.

Were those really housekeeping problems and or do you think that missing note sheets, document errors—never existed?

Ms. Kenefick. Mr. Chairman, I don't know if they never existed or if they were missing.

Chairman St Germain. In other words, you never saw them? They were not available?

Ms. Kenefick. Correct.

Chairman St Germain. So it could be that they never existed.

Ms. Kenefick. That is possible.

Chairman St Germain. And then, one more after this, the Oklahoma calling personnel continue the fight to keep their heads above water with time spent putting out fliers and, therefore, falling further behind. Would you elaborate on that?

Ms. Kenefick. In this sentence I was basically trying to summarize what I felt at the time the environment in the division was. I felt we were short people, I felt that we were continually expected to react in a very short timeframe. The demands for turnaround were very quick.

Chairman ST GERMAIN. What do you mean by "turnaround?"

Ms. KENEFICK. To make a decision on a credit request. And because we seemed to be suffering from some catchup work, we were never able really to both catch up and go forward at the same time with growth in the division.

Chairman ST GERMAIN. Are you essentially saying that within that division one of the big problems that you found was that you were always appeared to be behind rather than acting currently, to something that had already happened, No. 1.

Second, I asked you, you said you were short of people, and I said "qualified people" and you said "people". But is it not a fact you need scientific personnel as well, engineers, et cetera, to go out and look at these properties and properly evaluate them, and did they have that type of personnel available to them in sufficient numbers to do the work that had to be done in reviewing these loan applications and loan approvals?

Ms. KENEFICK. Well, Mr. Chairman, during the time period that I was in the division, there were initially two petroleum engineers and one chemical engineer and an additional chemical engineer was added to the division, and I do believe that Mr. Lytle was looking for an additional petroleum engineer. I am not sure I am qualified to say whether that was adequate staff or not, but they were extremely busy.

Chairman ST GERMAIN. But you did say there were not enough people.

Ms. KENEFICK. The engineers were extremely busy individuals. My comment about enough people was primarily relating to the account managers, people calling directly on the customers.

Chairman ST GERMAIN. Thank you, Ms. Kenefick.

[Copies of the memorandum by Ms. Kenefick to Mr. Lytle of July 1981 and the bank examination report of Mr. Kovarik dated Nov. 15, 1982, follow:]

MEMORANDUM

CONTINENTAL BANK

TO	BLDG	FLOOR NO	DIVISION	NAME	DATE
FROM					TEL NO.

OKLAHOMA

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. Customer dissatisfaction is a possible next occurence.

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

Suggested actions address both the immediacy needed to handle the current situation and procedures to follow in the future which try to prevent the same problems. It should be recognized that this redirection and reprioritizing of efforts involves tradeoffs, primarily affecting the rate of growth of new business at least in the short term. The long run positive effects of knowing where we are and where we should be going should outweigh this. In addition it should facilitate a smoother transition of account relationships (customer benefit) and potentially improve people development while hopefully using them more effectively.

Short Term Proposal

Using a team of people made up of calling personnel and administrative support, the following steps should be taken:

1) Organize accounts by "family" exposure and prioritize by available credit; make assignments of responsibility to calling persons.

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CONTINENTAL BANK

2) Totally re-examine the relationship, i.e.:

   a) verify customer information, filling in any missing information or updating it as needed

   b) critically evaluate the situation, emphasizing strengths and weaknesses of the credit

   c) recommend future action, both what we and the customer should be doing to improve the relationship

   d) examine documentation, comparing what we think we have and what we actually possess; determine what we need

   e) present the above material in written form.

3) Lytle and Kenefick "reapprove" each exposure and the steps to be taken.

4) Work with Penn Square Bank, Loan Division, Collateral Vault, Credit Files, etc. to complete our requirements.

5) Start new procedures (outlined in Long Term Proposal) on any new transactions that arise.

Timing of completion is impacted by the number of people and other resources dedicated to the project, as well as the number of accounts to be examined. The first step may take a week to ten days. It is estimated it will take one calling officer on average 2 to 3 full days to handle the second step per "family" of accounts, with (2A) being potentially very time consuming. With respect to (2d), the calling officer should work with a senior counterman to determine what we need while the administrative people can handle the other requirements. Step 4 may drag on for quite some time, potentially months.

It is suggested that a minimum of six calling personnel and three administrative support people be assigned to the team. At least one calling person would handle current business, though possibly two may be needed on some days. The remaining members would devote their time to their responsibilities connected with this team. Travel during this phase should be limited to obtaining any information needed, by either meeting with Penn Square Bank and/or the customer as necessary. Other resources such as a work area away from other distractions, storage space to accumulate materials and a designated typist or two would speed results.

MEMORANDUM

CONTINENTAL BANK

CONTINENTAL ILLINOIS NATIONAL BANK AND TRUST COMPANY OF CHICAGO

TO | DATE

FROM | TEL. NO

Suggested Members:

Kenefick, Lucas, Liddell, Sullivan, Cavallo, two banking associates, Donis, Malley, two operating trainees.

NOTE: Winget and Bainbridge would be especially valuable in the early stages so addressing this course of action early on would be important. Their help would facilitate the organization of accounts and assist the development of the new banking associates.

Long Term Proposal:

Probable causes of the situation at hand should be addressed in order to attempt to keep the same situation from happening again.

1) Rapid Growth in the number of relationships

This in itself is a benefit and a cause we don't want to change. We should however recognize its side effects when we and Penn Square Bank are not able to keep pace with it. We should also recognize some of the time requirements for turnaround may be lengthened by what is proposed here.

2) People Shortages

It is my understanding that close to half of the available credit and approximately two-thirds to three quarters of the borrowing accounts are located in the Oklahoma territory. Having four people handling this volume in the past was not adequate. The ideal would be to have two calling personnel handling Tulsa and four handling the rest of the state. They would report to a Section Head who would be able to devote full time to their direction.

3) Organizational Structure

The account relationships should be divided among the calling personnel. Accountability and follow thru should be more consistent as a result. Duplication of effort and inefficient use of time may diminish. Some of the more active and/or complex accounts should utilize a backup arrangement. Management of the relationship, both the credit risks and the profitability of the account, should be stressed. All credit requests should initially be examined by the calling officer whose responsibility it is to decide whether to proceed. They will also have the responsibility to monitor the situation. All necessary

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materials to aid them (i.e., past due notices, Customer Balance Reports, Loan Review writeups, etc.) should be directed to them. Account assignments should come after the short-term proposal is at least assigned. We should also utilize the engineers properly without confusing the function of the account officers, i.e., loans based on reserve quality should be reviewed by the engineers whose responsibility it is to set loan values.

4) Transaction Philosophy

As mentioned previously, the philosophy of keeping our customers on a "short string" (30-90 day transaction loans) with either a strategy or more information to follow adds to our problems. Besides requiring us to look at the same transaction at least twice, our options are potentially limited when the money is out the door. We should strive to match the length of the transaction to repayment source. Strategy and necessary information should be known up front before a decision to lend occurs. Short term credits may make sense in situations when a specific event is supposed to occur.

5) Standards of Acceptability

Hopefully with additional personnel we will have the ability to improve our output while keeping pace with new business and handling the old effectively. Our credit proposals would be enhanced if in addition to the purpose of the loan and possible repayment, qualitative discussion occurred which examined both the strengths and weaknesses of the deal before reaching a conclusion. Minimal information should include current financial information (audited or unaudited); Other debt especially in the event secured (and by what) should be noted. Basis used for assets (book/market) should be included and any significant investments should be examined. Besides a balance sheet and income statement contingent liabilities should be included (especially in the case of individual statements). All these comments apply to both corporate and individual statements. We should also require the statements be signed by either the individual or an officer of the company (if unaudited).

We should stress internally with our people and externally with Penn Square Bank and other banks, the importance of putting the loan on properly the first time. Funding should occur not only after we have the proper approvals but after we have the proper documents on hand, documents which have been approved to form by the account officer, counterman and legal counsel. We must particularly remember to have

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CONTINENTAL ILLINOIS NATIONAL BANK AND TRUST COMPANY OF CHICAGO

TO	BLDG.	FL./RM. NO.	DIVISION	NAME	DATE
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counsel approve any documents we did not draft internally. We have to better train ourselves first and then others as to what is expected; they won't change unless we do.

6) Lack of Control

It is not clear whether the participation agreements are currently drafted in a way which allows Penn Square Bank to "change" the deal after the fact and merely inform us (rather than consult us) or that they just do it anyway. It is thus not clear whether using a multibank agreement would be an advantage over a participation certificate (or even then if they would recognize the different requirements) but it is potentially something to consider.

In any event we should consider taking on more responsibility ourselves, whether directly (both in terms of decision making and in terms of adminstrative functions) or indirectly (keeping copies of everything, "auditing" their material, etc.). We should recognize that the problems we have had keeping pace with the growth have been even greater at Penn Square. We should also make sure that in the event any set-off would take place, the banks would share pro-rata based on exposure.

Conclusion

Again the importance of recognizing tradeoffs comes to mind, both in terms of timing and scope of actions taken and not taken. Both short term and long term solutions should be sought. We need to get our own house in order first while at the same time potentially changing our procedures. Only then can we get others to change. Positive steps taken today may minimize future losses and alleviate problems. Making sure we explore the credit request thoughtfully, putting the loan on right the first time and then monitoring the results afterward should be re-emphasized. Having an adequate number of people to handle the volume is also important for success. The desired results from these steps would be to have a good understanding of what shape the current Oklahoma portfolio is in (at the same time allowing us to catch up on all of our exceptions), a plan of action to be taken if necessary in the future, a smoother transition of account managers, and a reduced likelihood that the current situation would occur again.

MJH:CK

17-66

TO: William E. Martin, Deputy Comptroller for Multinational Banking

From: Richard M. Kovarik, Senior National Bank Examiner

Date: November 15, 1982

Subject: Continental Illinois National Bank and Trust Co., Chicago, Il.

SUMMARY OF PROBLEMS

Problems are centered in heavy volumes of problem loans which have received wide exposure in the press, and their affect on earnings which resulted in a second quarter loss of $61 milllion after a special provision to the RPLL of $220 million on loans purchased from the Penn Square Bank, N. A. The increasing levels of non-performing loans and the second quarter loss resulted in a severe blow to CIC's position and reputation, with domestic investors shunning many of CIC's liability instruments.

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.

The Loan Review function at CINB has been the recipient of criticism from the OCC for at least three years. However, as it was functioning fairly well, that criticism was not as strong as it now appears it should have been.

The decentralized management philosophy works well in many areas of the bank which is truly the result of having good managers overall. In the Special Industries Group, the chain of command from John Lytle through Gerald Bergman was deficient in attending to matters such as collateral documentation and following bank policy with respect to reporting credits. The big problem here, was that there was no system in place to uniformly assure that managers at various levels were taking the responsibility along with their authority. As long as everything appeared to be going along smoothly, no one bothered to check. In fact, when there were signs of trouble, (bad press about Penn Square Bank and CINB's relationship - audit and operations memos discussing various operational problems with Penn Square) no one took the steps to independently look at the situation. They merely went to those in charge of the area and were reassured that things would be/were OK.

The bank now faces the job of rebuilding its image. In the present environment this will prove to be a difficult task. Third quarter earnings will be respectable but not overly encouraging. Non-performing loans will hit the $2 billion mark and the acme may still not have been reached, although any rise in the fourth quarter is not expected to be steep at this time.

SUBSEQUENT EVENTS

After becoming aware of the problems related to Penn Square, Chairman Roger Anderson asked the Board to form a Special Review Committee consisting of Directors Robert Malott (CEO, FMC Corporation), Blaine J. Yarrington (EVP, Standard Oil Co. Indiana) and Chairman William B. Johnson (CEO, IC Industires, Inc.) to oversee reviews to be made by management. Management is being aided in their reviews by accountants and attorneys from Ernst & Whinney ~~and~~ Mayer, Brown & Platt, both firms connected to CIC, however, those "outside" individuals have not been directly involved with CIC in the past. Additionally, the Directors Review Committee is advised by independent legal counsel (a retired judge) and accounting counsel (partner from Price Waterhouse & Co.).

The first phase of management's review is completed and has received Board approval. This resulted in numerous personnel changes and a redistribution of responsibilities among the senior staff. Phase two is in process with preliminary results encouraging. Loan review will be completely revamped and numerous other internal control changes will be instituted.

RECOMMENDED CORRECTIVE ACTION

The situation is severe, but not believed critical. Although management is surely to blame for the shortcomings in the systems that allowed the present problems, they have recognized them and are taking steps to deal with them. Many of the loan problems need an improved economic environment to turn around and until that happens, significant reductions in problem assets cannot be expected. The funding problem will only go away with improved earnings and asset quality, although presently it must be considered stable.

Some enforcement action to relate our concerns is appropriate. It should, however, be in line with, and take note of, what they have already done or have instituted. Further, I have made a strong bid toward getting the bank to be much more open with us. We should take this opportunity to get the flow of information we need started.

Chairman St Germain. I now ask Mr. Meade and Mr. Kovarik and Mr. McCarte to introduce themselves as provided for in the outline I gave them and then to tell us whether or not Ms. Kenefick's memorandum was an accurate one from their experience.

Mr. Meade.

TESTIMONY OF JOHN MEADE, SENIOR NATIONAL BANK EXAMINER, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. Meade. Mr. Chairman, and members of the committee, my name is John Meade, and I am from Northfield, IL. I am senior national bank examiner with the Office of the Comptroller of the Currency. The Office of the Comptroller of the Currency supervises the national banking system. To perform its task, the Comptroller's Office through its examination force, examines each of the more than 4,500 national banks located throughout the United States.

An examination may include, among other things, a review of the bank's asset quality, liquidity, earnings, and any other areas deemed necessary or appropriate. The end result of the examination is detailed in a report of examination.

I joined the Comptroller's Office in 1964 as an assistant national bank examiner, and I was commissioned a national bank examiner in 1968. From 1966 to 1969, I primarily examined the foreign branches of national banks and the international departments of multinational banks.

From 1970 to 1976, I examined banks of all sizes and complexity in the Chicago area. In 1977, I was——

Chairman St Germain. Excuse me, Mr. Meade. Staff will try to get that microphone a little better placed for you.

Now, Ms. Kenefick realizes she is not the only one who has problems with the mike. Thank you.

Mr. Meade. In 1977, I was appointed Deputy Regional Administrator in Cleveland. In that position—which I held for 6 years—I was responsible for surveillance and supervision of national banks in Ohio, Indiana and Kentucky.

My duties included scheduling examination, monitoring and reviewing reports of examination, and initiating appropriate action to address problems in national banks. I have been in my current position as a senior national bank examiner in Chicago since August 1983, currently serving as examiner in charge of multinational banks in Chicago.

Chairman St Germain. Would you tell the subcommittee what you mean by the term "multinational banks"?

Mr. MEADE. Multinational banks are those generally defined in the Comptroller's Office as the 10 or 11 largest national banks throughout the country.

Chairman ST GERMAIN. And in Chicago there would be how many of those?

Mr. MEADE. There would be two.

In early 1973, I was first selected to be the examiner in charge of the examination of Continental Illinois National Bank. As examiner in charge, I was responsible for planning, organizing, directing, and controlling the examination function.

I also supervised the examining personnel assigned to me, prepared the report of examination, and reviewed the results of the examination with executive management. Between 1973 and mid-1976, I examined the bank five times. Since that time, I have participated in the summer of 1983 examination of the bank, and I also participated in the May 1984, examination of the bank, assisting Examiner Kovarik.

I have had the opportunity to review the five reports of examination that I conducted from 1973 to 1976. At this point, I would be happy to answer any questions you may have concerning Continental Illinois or the examination process.

Chairman ST GERMAIN. Would you just briefly tell us, when the Comptroller's Office goes into a bank, specifically Continental Illinois, which, as you say, is one of the 10 largest banks in the country, a multinational, how many personnel do you usually have with you and for how long a period of time does an examination ordinarily take place? What is the average time span?

Mr. MEADE. I think, Mr. Chairman, I will speak for the period prior to 1977, because in 1977, we changed our examination procedures, and the approach was somewhat different. So for exams prior to 1977, an examination would take approximately 2 months; we would have a number of people assigned to us that would peak at 50 or maybe 55 people and toward the end of the examination, the numbers would diminish, so that at the conclusion there were 3 or 4 people assigned there.

Chairman ST GERMAIN. And the frequency of examination?

Mr. MEADE. At that time, we were examining the bank three times every 2 years.

Chairman ST GERMAIN. So actually, the exams were about 6 months out of every 36 months?

Mr. MEADE. Approximately 6 to 8 months.

Chairman ST GERMAIN. Every 6 months, thank you.

Mr. MEADE. Every 8 months.

Chairman ST GERMAIN. Mr. Kovarik.

TESTIMONY OF RICHARD KOVARIK, SENIOR NATIONAL BANK EXAMINER, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. KOVARIK. Thank you, Mr. Chairman.

My name is Richard Kovarik, I am senior national bank examiner with the Office of the Comptroller of the Currency from Naperville, IL.

I have been employed by the Comptroller since 1966 with my first employment being as an assistant national bank examiner. In

1970, I was commissioned a national bank examiner and in 1979, I was appointed a senior national bank examiner.

Chairman St Germain. Have you always been in the Chicago area?

Mr. Kovarik. Yes, sir. I have.

During my 18 years with the Comptroller's Office, I have examined a number of banks, primarily in Illinois and Michigan. I have participated in all areas of the commercial examination process and most recently I have been functioning as the examiner in charge or concentrating on asset quality evaluations.

Since 1977, my primary duties have involved examining Continental Illinois National Bank and the First National Bank of Chicago.

As examiner in charge of those banks, it has been my responsibility to coordinate the examination team, ensure timely completion of those examinations, and, of course, write the resulting report of examination.

I was first involved in the examination of Continental Illinois in the late 1960's, and, at one time or another, I have been involved in numerous facets of the commercial examination at Continental Illinois.

I conducted the examination as examiner in charge of Continental in 1977, 1982, 1983, and 1984. While the principal focus of these examinations concerned asset quality, other areas such as liquidity, earnings, capital, policy and procedure, systems and internal controls, were also reviewed.

Examination timeframes at the examinations I was in charge of varied from 4 to 6 months, consumed as many as 2,200 work days, and involved as many as 60 assisting examiners.

I have had an opportunity to review my 1977, 1982, and 1983 reports of examination.

Chairman St Germain. Now, you were examining during the period of time Ms. Kenefick wrote her memorandum. Had you been aware of that memorandum?

Mr. Kovarik. I was not examiner in charge.

Chairman St Germain. You were examining at that point?

Mr. Kovarik. I examined in 1982, yes.

Chairman St Germain. Did you have an opportunity to review her memorandum?

Mr. Kovarik. I read her memorandum, I believe it was in either July—no, it was August or September of 1982.

Chairman St Germain. And what was your reaction to her memorandum at that time, as to its value and its accuracy?

Mr. Kovarik. I think I said to myself I wish I would have known this 3 months ago.

Chairman St Germain. Thank you.

Mr. McCarte.

TESTIMONY OF ALLAN McCARTE, FORMER NATIONAL BANK EXAMINER, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. McCarte. Mr. Chairman, I am Allan McCarte, former member of the Office of the Comptroller of the Currency. I welcome this opportunity to visit with you and I would like to give you some of my background when I was employed by the OCC.

I joined the Comptroller's Office in 1963 as an assistant national bank examiner, and was promoted to the level of commissioned national bank examiner in 1967. From approximately 1966 through June 1981, I was involved in and responsible for a variety of assignments which included the following. I served as regional coordinator for college relations which primarily was recruitment efforts in the States of Illinois and Michigan.

I also functioned as an administrative assistant in the regional office and became involved in the budgeting and monitoring of human resources as they were involved in the examination process for Chicago and the various subregions.

Additionally, as part of my assignment as administrative assistant I was responsible for reviewing reports of examination at the regional level. I have also been involved in the investigative process as it relates to new bank charters as well as to branch sites of existing banks.

I was one of 3 Chicago area crew chiefs with personnel responsibility for approximately 24 assisting examiners as well as the scheduling and examination responsibilities for approximately 50 banks, one of which was the Continental Illinois.

During the years of 1979, 1980, and 1981, I served as examiner in charge of the Continental. The 1981 examination was commensed in early June of that year and employed financial data with an "as of" date of April 30, 1981. The examination was concluded in early to mid-August 1981. I was scheduled to perform the 1982 examination of the bank and had gone so far as to schedule personnel and arrange for working space and request list data when the bank approached me with an employment opportunity on June 10, 1982.

Chairman ST GERMAIN. The bank approached you with an employment opportunity?

Mr. MCCARTE. Opportunity, yes, on June 10, 1982. Once this overture was made, I removed myself from the examination to avoid a conflict of interest situation.

I would mention at this juncture that at the time the Continental Bank approached me I was entertaining another employment opportunity with another sizeable bank holding company outside of the seventh region.

I was immediately assigned to the Chicago Office and I made the decision to join Continental in late June 1982. I have had the opportunity of reviewing the 1981 examination report in some detail but have had lesser time to spend on the 1979 and 1980 reports.

Chairman ST GERMAIN. Thank you.

Mr. Annunzio.

Mr. ANNUNZIO. I would like to ask one question. You know, we heard after Oklahoma City about the administration of the bank, and the mismanagement and all the ills that led to the problems that Continental is facing.

Are any of you—Ms. Kenefick, are you in a position to tell us now that all the ills are out in the open? What kind of position, in your opinion, is the bank in now?

Ms. KENEFICK. Mr. Congressman, the only information I have to reach an opinion, of course, is what I have read in the press. I am quite hopeful for Continental Bank based on the steps that have been taken. I believe they are a strong bank and they still have a strong management team in place.

Mr. ANNUNZIO. Thank you.

Mr. Meade, you have heard my question, and you have been examining the bank. When was your last examination?

Mr. MEADE. It was in 1976, sir.

Mr. ANNUNZIO. The last time you were there?

Mr. MEADE. 1976 was the last time I was examiner-in-charge. I assisted Examiner Kovarik in 1983, and 1984.

Mr. ANNUNZIO. Can you add an answer to the question that I have asked? In your opinion, what kind of situation is the bank in today?

Mr. MEADE. I believe that in light of some of the concerns raised by members of the committee, it wouldn't be appropriate for me to comment on this point.

Mr. ANNUNZIO. Mr. Kovarik?

Mr. KOVARIK. I would also submit that it would not be appropriate for me to comment on the present circumstance of Continental.

Mr. ANNUNZIO. Mr. McCarte?

Mr. MCCARTE. Well, of course, I would be hard pressed to have an unbiased observation, but I am personally encouraged by the condition of the bank right now.

Mr. ANNUNZIO. Well, Mr. McCarte, when was the last time you were in the bank to examine?

Mr. MCCARTE. As I stated, I was there for the 1981 examination.

Mr. ANNUNZIO. And, Mr. Kovarik?

Mr. KOVARIK. I performed the examinations in 1982, after having done one in 1977, and also in 1983 and 1984.

Mr. ANNUNZIO. And your last examination, Mr. Meade?

Mr. MEADE. Was 1976.

When I was in charge, yes.

Mr. ANNUNZIO. When you go into these banks you have examining teams. When was the last time you were in there, Mr. Kovarik, as a member of a team?

Mr. KOVARIK. We performed an examination starting in June 1984.

Mr. ANNUNZIO. All right, that is getting close. In what condition did you find the bank in June 1984?

Mr. KOVARIK. Sir, I really would rather not answer that question as far as the current status of the bank. I think the bank's circumstances have been highly publicized with the assistance package, the number of loans being bought by the FDIC.

Mr. ANNUNZIO. We all know that the bank has been reduced from a $40 billion bank to a $25 billion institution. I thought by having you gentlemen here you could give us some authentic information. But all the mistakes and the ills and the situations that led to the downfall of Continental have been scrutinized closely by the regulators and certain corrections have been made and it looks like Continental will probably come out of it, and instead of being one of the large banks of $40 billion, it is going to be a good $25 billion bank.

Mr. WYLIE. Would the gentleman yield on that question?

Mr. ANNUNZIO. Yes.

Mr. WYLIE. I think maybe that is a question that more appropriately ought to be addressed to the Comptroller of the Currency. I have visited with him about that and I think he is prepared to discuss that, Mr. Annunzio.

Mr. ANNUNZIO. Well, I do wish that when the regulators get here they will be able to shed some light. That is one of the reasons I felt that maybe we needed more time as far as the hearings are concerned. Mr. Chairman, you can recall in Oklahoma City when we had the members of the board of that bank there and the regulators, the people in Oklahoma City felt that Penn Square was not an institution that should be closed. And if they were given enough time they would be able to have the necessary capitalization to keep the bank open.

There was a great deal of disagreement at that point as to whether the capital raised by the members of the board in Oklahoma City would be able to save the bank, and they accused the regulators of acting too hasty. I am not accusing anybody of acting hasty, but I do think the committee needs a lot more information before we can really make a judgment as to the necessary legislation and procedures we are going to follow in order to correct the situation.

This committee, as I see it, is not interested in correcting anything at Continental, but we are interested in tightening up the authority of the regulators to do what they did with Continental and with other multinational corporations. My time has expired.

Chairman ST GERMAIN. I assure the gentleman that you will have the opportunity to ask Mr. Conover those questions and Paul Volcker. Paul wants to see you about that, too.

Mr. ANNUNZIO. He called me, in fact.

Chairman ST GERMAIN. I am sure he did.

Mr. Wylie.

Mr. WYLIE. Thank you very much.

Mr. Kovarik, I was interested in your comment to the chairman a little while ago when he asked you if you had seen this Continental memorandum from Ms. Kenefick and you said that you had and you made the observation that you wished you had seen it 3 months ago.

Chairman ST GERMAIN. Had seen it 3 months earlier.

Mr. WYLIE. Three months earlier.

At the time you read it you said to yourself I wish I had seen it 3 months ago.

Chairman ST GERMAIN. Earlier. He said in 1982.

Mr. WYLIE. I understand that, but earlier than the time you saw it. What would have been your reaction if you had seen it 3 months earlier?

Mr. KOVARIK. Sir, I think after reading the memo it confirmed a lot of our observations and the findings we came to as conclusions in our examination and it would have helped us to focus initially on those instead of having to start on something else and eventually getting to those conclusions.

It basically recapped a number of problems that we found in the midcontinent division and especially in the Penn Square loans.

Mr. WYLIE. What did you do about it after you read the memorandum? Did they continue the same procedure for making loans?

Would you describe—maybe I should ask that of Ms. Kenefick first. Would you descirbe the procedure for making the loans?

Ms. KENEFICK. Mr. Congressman, the procedure for making the loans wasn't necessarily the same for every loan. Primarily, the loan requests would come from a variety of sources, either directly from the customer or from Penn Square Bank which would make a request either by phone or by in-person visit to the bank where they would bring representatives from Penn Square Bank, and they would bring with them packages of material relating to various loans that they wanted Continental Bank to participate in. The majority of these conversations involved at some point or another Mr. Lytle, and after some discussion, a decision was made whether or not to partake in the particular credit request.

The normal practice in the bank was to write up the credit request in a note sheet form and then circulate it to the appropriate people to get approval signatures on it and if those were not objective, then the loan was, in effect, approved and then input into the loan division operations system and the funds were advanced.

Mr. WYLIE. What did it take to get a million dollar loan approved?

Ms. KENEFICK. To get any loan approved the way the bank system ran it took a minimum of two signatures to agree to lend the money to the customer. It was a dual authority system as opposed to a credit committee system in other banks.

The individuals themselves, the necessary individuals were defined by memorandum—I can't remember the exact title, I refer to it as sort of an authorization memo, which would specify what level of credit authority was required for a $1 million loan. It may, for instance, vary not only on the amount but also on the length of the loan.

Mr. WYLIE. Did anyone keep track of those loans?

Ms. KENEFICK. I am sorry. I didn't understand.

Mr. WYLIE. Did any one keep track of those loans once they were made? I understand now that one person could authorize a loan, the second person had to approve it if it was a million or more. Did anyone keep track cumulatively, of the number of loans made?

I think in your memorandum you suggest there might have been some internal control function that was not there.

Ms. KENEFICK. Well, the loans themselves in order to be funded had to, to my understanding, during my time at the bank, had to be entered onto the bank's internal computer system so that the loans themselves were part of the bank's record.

Mr. WYLIE. There was some suggestion earlier by one of the witnesses, I thought it was you, that maybe the internal computer system was not all that good, that there was, in fact, some problem with keeping track of the loans, the cumulative impact or effect of the loans and was it possible for somebody to go to that computer and say there are so many loans being made to Penn Square or so many loans being made in this particular area, and then maybe make an evaluation of the impact that that loan may have?

Are you in a position to answer that?

Ms. KENEFICK. No, I am not.

Mr. WYLIE. Mr. Kovarik, when you read the memorandum what did you do about it? Did you change your procedure for examining these loans?

Mr. KOVARIK. If I can clarify, Congressman, I saw the memorandum in August or September 1982 which was a full year after it was written and after Penn Square had failed. Penn Square loans had by that time basically been stopped by the bank so far as any granting of credit to Penn Square borrowers.

Mr. WYLIE. How about foreign country loans?

Ms. OAKAR. Will the gentleman yield on that point just for clarity's sake? I thought the memorandum said 7-29-81: Am I correct Mr. Chairman?

Chairman ST GERMAIN. You are correct.

Ms. OAKAR. Are we talking about two different memos?

Mr. KOVARIK. Perhaps I can clarify. The memo did not come to my attention until August or September 1982 during my 1982 examination.

Chairman ST GERMAIN. You said you wished you had seen it 3 months earlier.

Mr. KOVARIK. At the beginning of the examination, it would have helped me focus the examination.

Chairman ST GERMAIN. You said it reached the same conclusions.

Mr. KOVARIK. Yes, we did, but I think if I would have seen it earlier, it would have cut down the amount of work we had to do to reach those same conclusions.

Chairman ST GERMAIN. What did you do about it?

Mr. WYLIE. That is what I asked him.

Mr. KOVARIK. There was not much I could do——

Chairman ST GERMAIN. You say the memo was a good one, right?

Mr. KOVARIK. Yes, sir.

Chairman ST GERMAIN. You say you reached the same conclusions, but it took you longer because it took a while for you to focus.

Mr. KOVARIK. That is right, sir.

Chairman ST GERMAIN. Then what did you do about it?

Mr. KOVARIK. That was the conclusions we reached concerning the Penn Square loans, and the midcontinent division were detailed in the report of examination showing the condition of that portfolio.

Chairman ST GERMAIN. Do you feel you wrote a strong enough critique at that time? Did you suggest to your superiors that they bring it to the attention of the board of directors and have a decision as to lack of internal controls, and sloppiness of recordkeeping?

Mr. KOVARIK. That was brought out in the examination report, sir.

Chairman ST GERMAIN. Did you recommend to your superiors that they bring that to the attention of the board of directors and the chairman of the bank?

Mr. KOVARIK. Yes, it was.

Mr. WYLIE. Thank you very much, Mr. Chairman. That is exactly the direction I was headed.

How did you feel about what happened as a result of your recommendation? You had a strong recommendation. Were you happy with it or disappointed or did you go back at it or what?

Mr. KOVARIK. I believe that the bank at the time implemented almost every one of our recommendations—all that I can remember. In fact, they were taking steps during the examination starting in August of 1982 to institute certain changes including the formation of a new credit risk evaluation division, they had done an internal—were working on internal review of their policies and procedures at the same time we were conducting the examination, and to my recollection every recommendation that we made to them in that report or with contact with the board of directors was included and was implemented.

Mr. WYLIE. Mr. McCarte, did you see the memorandum Ms. Kenefick referred to?

Mr. MCCARTE. No, sir. I did not. I can perhaps help on the timing of this. The July memorandum would have been written or typed, I think, as Ms. Kenefick said, towards the end of the examination that we were conducting in 1981.

At that time we had identified or recognized the bank had a relationship with the Penn Square Bank and the credits that we looked at during the examination of 1981 were credits that were primarily secured by standby letters of credit. This memorandum was something that we had just not known about during the 1981 examination.

Mr. WYLIE. Do you have an opinion as to the internal control mechanism of the bank, whether there were adequate internal controls as far as ending practices were concerned; do you have an opinion?

Mr. MCCARTE. As to adequacy of the bank's internal controls?

Mr. WYLIE. Yes.

Mr. MCCARTE. I would say on balance that we were generally reasonably satisfied with internal controls. The internal control deficiencies that we highlighted in the report in the loan area, I think, were well founded and significant and were reported as such.

The other internal controls with respect to the authorization of credits as Ms. Kenefick pointed out, the bank did not have a preapproval committee, as some banks will have. They had a process where officers, depending on their grade level, would approve credits.

Mr. WYLIE. What did you mean when you say we need to get our own house in order while at the same time potentially changing our procedures, Ms. Kenefick?

Mr. Kovarik and Mr. McCarte think they were adequate, internal controls, functioned properly, that there was a way to evaluate the loans.

Ms. KENEFICK. I am trying to recall exactly where this was.

Mr. WYLIE. It is on page 5, in the conclusion, it says, we need to get our own house in order first while at the same time potentially changing our procedures. This is back in 1981.

Ms. KENEFICK. Yes.

Congressman, this was just a summary sentence of what I felt. I was describing what were basically changes that I was suggesting in the way that the division, the midcontinent division had been run. I felt if we were to make these changes that would help us better understand where we were with respect to some of our customers.

When I say, in order first, I think I was also referencing the fact that we needed to also look to Penn Square Bank to improve the information flow to us.

Mr. WYLIE. All right. My time is up, Mr. Chairman.

Chairman ST GERMAIN. Mr. Barnard.

Mr. BARNARD. Thank you very much.

Ms. Kenefick, are you presently employed with the bank?

Ms. KENEFICK. No, I am not.

Mr. BARNARD. Good. After having worked in such an important phase of the bank operations at Continental, what is your general impression of a bank exmination? Is it good? Is it thorough? Or is it just a hit-and-miss operation? Do you find that it really did uncover anything that was unusual? Did you all learn anything from bank examinations?

Ms. KENEFICK. I am afraid, Congressman, that I never was directly involved with any bank examination or read any bank examination reports. So I don't know; I don't have an opinion.

Mr. BARNARD. You were in loan review capacity at Continental?

Ms. KENEFICK. No, I wasn't.

Mr. BARNARD. Didn't you review this particular credit and write a memorandum?

Ms. KENEFICK. I was a vice president, commercial lending officer, in the midcontinent division for a period of under 6 months time and I worked for John Lytle. I was not in a loan review capacity. I was in a commercial lending capacity.

Mr. BARNARD. A bank examiner never talked with you about credits?

Ms. KENEFICK. No, sir.

Mr. BARNARD. Not one time?

Ms. KENEFICK. No, sir.

Mr. BARNARD. And yet you were in a very critical place in this bank where you could appraise credits.

Ms. KENEFICK. Yes.

Mr. BARNARD. You were. Now, this memorandum——

Chairman ST GERMAIN. He is our banker in residence.

Mr. BARNARD. No—I really am not.

Chairman ST GERMAIN. Excuse me. What I want to point out is that Mr. Barnard does have a good deal of experience in banking.

Mr. BARNARD. I had some. I am about to lose it.

How far did this memorandum go? Did it just go to Mr. Lytle and then reach file 13?

What happened to this memorandum? Did it go into file 13, or did it go into the file of the Penn Square Bank?

Ms. KENEFICK. Congressman, I can only testify to what I know with respect to the memo. I had given a copy to Mr. Lytle and I had given a copy to Mr. Rudnick.

Mr. BARNARD. Who?

Ms. KENEFICK. Mr. Rudnick.

Mr. BARNARD. Who is he?

Ms. KENEFICK. Mr. Rudnick was at one time my manager in the bank, and at the time I gave him the memo, he was assistant to Mr. Baker.

Mr. BARNARD. Mr. Kovarik, where did you find the memorandum?

Mr. KOVARIK. Sir, it was included in some work papers that the phase I committee for the bank had pulled together during their review in August 1982.

Mr. BARNARD. So it did get into the file?

Mr. KOVARIK. It was in the file of that committee's work papers. Where they got it from, I have no knowledge.

Mr. BARNARD. What committee?

Mr. KOVARIK. The phase I review committee of the bank.

Mr. BARNARD. Was that under the jurisdiction of Mr. Lytle?

Mr. KOVARIK. That committee, no, sir. That was set up by the board to investigate the occurrences that brought about the Penn Square situation.

Mr. BARNARD. So this was after the fact, 1 year later.

Mr. KOVARIK. Yes, sir, it was.

Mr. BARNARD. Mr. Meade, I believe you were in on the examination in 1977.

Mr. MEADE. Yes, sir—1976, sir.

Mr. BARNARD. 1976?

Mr. MEADE. Right.

Mr. BARNARD. Did you have any inkling at that time of the emerging problems of Penn Square?

Mr. MEADE. I never heard of Penn Square until July 1982.

Mr. BARNARD. Who was in the bank now in 1978, 1979, 1980, and 1981?

Mr. MCCARTE. I was there in the years 1979, 1980, and 1981.

Mr. BARNARD. Mr. McCarte, were you alerted to the problems of Penn Square in those years?

Mr. MCCARTE. I had received no communication from Washington with respect to the situation.

Mr. BARNARD. The office in Dallas never alerted the regional office in Chicago that they were having problems with Penn Square?

Mr. MCCARTE. Not to my knowledge.

Mr. BARNARD. In other words, what happened here is, here we have a situation in Oklahoma where the regional Comptroller of the Currency was having meetings with the board of directors of Penn Square threatening cease and desist, and yet at no time did you know about that?

Mr. MCCARTE. That is correct.

Mr. BARNARD. OK.

In those years, didn't you find it highly unusual that a $400 million bank in a shopping center in Oklahoma City was selling upward of $1 billion worth of loans to Continental Illinois?

Mr. MCCARTE. I can speak for the period of time I was at the Continental, and when I left the bank in 1981. In completing the examination at that time, I had been advised that there were approximately $320 million to $330 million of Penn Square-related credits, and a great number of those credits were secured by standby letters of credit.

Furthermore, of course, standby letters of credit, in terms of a collateral position, is a rather handsome one; it is nice collateral to have. Notwithstanding the fact that to a $40 billion bank, $300 million of credit is relatively small, we sent people back to look for any kind of concentrations on the banks that may have issued the standby LC's and the message came back that in fact there were no significant—no concentrations. And that is the extent of my knowledge with the Penn Square Bank.

Chairman St Germain. He didn't answer your question.

Mr. McCarte. Excuse me. The growth of the portfolio occurred subsequent to my departure from Continental.

Mr. Barnard. In other words, what you are saying is, between the time that you left in 1981-82 is when it moved from $300 million to $1 billion?

Mr. McCarte. Yes, sir.

Mr. Barnard. Who was from the Comptroller's Office in the bank in between that time?

Mr. McCarte. There was no general examination conducted during that time period. What the Comptroller's staff did was to have a series of visitations, and the visitations would focus on movements of the criticized or classified total and just looked for major type of adversity.

Mr. Barnard. No bank examination from 1981 to after Penn Square?

Mr. McCarte. That is correct.

Mr. Barnard. And at which time they built up a portfolio of over $700 million in loans?

Mr. McCarte. Yes, sir.

Chairman St Germain. Would you yield to me?

Mr. Barnard. Yes, sir.

Chairman St Germain. That should be followed up on.

Mr. Kovarik, did the Dallas office ever inform you—because Mr. McCarte wouldn't know this; he left the Comptroller's Office—of the problems at Penn Square?

Mr. Kovarik. No, sir, they did not. I did not hear of Penn Square until, I believe, prior to the week of June 21, 1982, when I was notified by some of our people in Washington that, first of all, I was going to take over the Continental examination, and then additionally that there were problems with Penn Square. That was the first time I had ever heard that name before.

Chairman St Germain. Mr. McCarte, one more question. You are no longer with the Comptroller's Office, so maybe you can answer this objectively.

Would it have helped you if the Dallas office had informed the Chicago Office of the Comptroller of the problems of Penn Square to not react from hindsight but rather have forward vision?

Mr. McCarte. I would say yes, in retrospect.

Chairman St Germain. Don't you think that should have been done, because they knew that these participations were being sold mainly to three or four large banks and that they were becoming substantial? Don't you think they should have notified the Chicago Comptroller's office rather than keep it a secret from them?

Mr. McCarte. I would suppose so.

Chairman St Germain. Thank you.

I thank the gentleman.

Mr. BARNARD. Mr. Kovarik, I believe the staff has given you a copy of the Continental Bank examination findings. On page 11, beginning with the phrase "Our review of credits criticized * * *"—I would like to ask several questions on that.

What do you mean by a "B" rated credit? And what is the problem if that credit is criticized by the OCC?

Mr. KOVARIK. The phrase "B" credit?

Mr. BARNARD. Yes.

Mr. KOVARIK. That was in Continental's rating system. They had a credit rating system that ranged from A to D, A being prime quality and D being the worst quality—four gradations in their system.

I am sorry; I didn't catch the rest of your question.

Mr. BARNARD. That is primarily what it is. It is a rating system that the bank had, and the A is the top rated, and B is second grade.

Is that it?

Mr. KOVARIK. Yes, sir.

Mr. BARNARD. And on down to D, E?

Mr. KOVARIK. D.

Mr. BARNARD. OK.

What is a WLR, a watch loan report?

Mr. KOVARIK. That is a report prepared by the account officer on a loan either rated—in Continental's situation—either rated D, where the watch loan reports were required on all loans rated D; and they were required also on some "C" rated credits. So it would be a quarterly report of the problem credit.

Mr. BARNARD. In that examination, there are 119 criticized credits that are not on the WLRL, watch loan report list. Why was that?

Mr. KOVARIK. They were not recognized as being problems.

Mr. BARNARD. By whom?

Mr. KOVARIK. By the bank.

Mr. BARNARD. Even though the Comptroller of the Currency had brought them to their attention?

Mr. KOVARIK. They eventually would have been placed on the watch loan report, but they were not on the watch loan report as of our examination date. In trying to determine whether the bank's loan review function is operating correctly, it doesn't really give them—you can't give them credit for putting something on after you have told them it is a problem. You would hope they get it there before you came in.

Mr. BARNARD. Well, 8 months later, how do you review as to whether or not that credit has improved or whether it has gotten on the watch loan report?

Mr. KOVARIK. Sir, you say 8 months later, how——

Mr. BARNARD. Yes. Don't you all keep a record of the loans that you turned?

Mr. KOVARIK. Yes, sir. We keep records of the loans we review at each examination.

Mr. BARNARD. So if you had a loan that is criticized and you go back in at the next examination, do you make note of the fact that the criticized loan that you had in there has either improved or asked the bank why it was not on the watch loan report?

Mr. KOVARIK. I can't remember any circumstances where we criticized a loan and then came back the next time and criticized it again when it was not on the watch loan report.

Mr. BARNARD. Thank you.

Chairman ST GERMAIN. Ms. Oakar.

Ms. OAKAR. Thank you, Mr. Chairman.

As a followup, I would like to ask Mr. McCarte a few questions. If you turn to page 7 of the staff examination findings report and review the two quotes in the middle of that page—"Our review of the credit administration * * *" and "Several credits which were rated 'B' * * *"—do you have the area I am speaking to?

Mr. MCCARTE. Yes, ma'am.

Ms. OAKAR. On the third quotation, what is the significance of what is said in the first and second sentences?

Mr. MCCARTE. Where we said, "While it is recognized * * *"—bottom of the page there?

Ms. OAKAR. Right.

Mr. MCCARTE. I think that the paragraph at the bottom deals with the fact that the level of classified or criticized assets in the corporation was above what we consider to be acceptable or traditional standards; in other words, that there was greater dollar amount of credits that we were listing as special mention, substandard doubtful, et cetera.

Ms. OAKAR. In relationship to that quote, a third quote, what did you expect and want the board of directors to do in response to your statement that, "A reappraisal of the credit rating process and system is appropriate"?

Mr. MCCARTE. As Mr. Kovarik pointed out, the B credit was normally a credit we would pass, and expect to pass, that credit.

The observation I believe that we are making at this time was one that we did pick up and classify or criticize several credits that were rated a "B" that were not on the watch loan reports. That is somewhat subjective in any evaluation of any credit concerned. But what we simply said was that we have traditionally recognized these as sound credits from an examination and evaluation standpoint status. However, we criticized them. And the point of it is that perhaps they deserve watch loan priority.

That date—looks like that was 1979, to my recollection—the volume of credits we were picking up as nonwatch loan credits and that we would criticize was not what we would consider to be significant.

Part of the thing I think we should recognize is the fact that in a $40 billion bank, with 800 account officers worldwide, there will be differences due to timing differences and other matters. I think what we try to do is put this in perspective as to just how significant is the number of credits and dollar amount we are focusing on in terms of credits that we are criticizing that perhaps have not had watch loan recognition yet.

So what we simply said was that we have observed that we had some of these—what we were basically doing is monitoring how the watch loan system worked, how the bank's internal rating system worked. And we were simply going to monitor, during my stay as examiner in charge, what was occurring, what exceptions were we picking up, and that was an exception we picked up.

Ms. OAKAR. Let's look at the second quote on that page. What was meant by the last sentence: "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."

Is this an example of a firm warning, or what kind of warning would you say you were trying to give them?

Mr. MCCARTE. I think we all recognized, of course, the bank was going to engage in some significant growth. They had stated such in press. And we knew from the internal review that we had——

Ms. OAKAR. I can't hear you. Sorry.

Mr. MCCARTE. I am sorry.

We recognized and knew that the bank was embarking upon a growth scenario. And one of the most important things in any kind of growth environment is that the bank be fully aware and appraised of the condition of the portfolio; and since the corporate accounts were targeted for increased loan growth, we simply were reminding the bank that if you are going to engage in this type of activity, it is very important that you identify problems when they become problems.

Ms. OAKAR. Right.

So to followup this point—was the situation you found in 1979 regarding the loan ratings—rating errors, less serious than the situation you found in 1981 regarding not rating $2.4 billion worth of loans; and, if so, why were the comments to the board more firm in 1979 than in 1981?

Mr. MCCARTE. The comments in the 1979 report deals with credits that we rated as criticized or worse—special mention, or more adverse classification—that were not on the watch loan reports.

The 1981 report focused not only on the fact that there was an increase in credits that the examiners were criticizing as special mention, substandard, doubtful and loss that were not on the watch loan report—that was part of the 1981 report. Also—and this is an area separate and distinct from the fact there were not watch loans attached to some of these. The $2.4 billion of——

Ms. OAKAR. $2.4 billion?

Mr. MCCARTE. Billion; that is correct, right—of credit that was stale rated meant that perhaps it may have been rated by the bank's internal loan review system, but the timing of such was not within what was prescribed or what was wished by the corporate office and board of directors.

Ms. OAKAR. Let me tell you my observation, based on what you said and what Mr. Kovarik said.

I don't think you attempted to have any idea of the soundness of what was going on. I want to refer again to Ms. Kenefick's memo, which Mr. Kovarik says if he had received it 3 months before he wrote his report—and according to your testimony, you got it 3 months before you mentioned you received it, in August of 1982, and your report is dated November 15, 1982. Ms. Kenefick report is, if somebody listened to her, pretty devastating, and apparently the bank sat on it.

Is that what happened, Ms. Kenefick? Nobody really did anything about your report. Is that pretty much accurate?

You talked to Mr. Rudnick, I think you mentioned.

Ms. KENEFICK. I said earlier I really can't testify to what happened with the report after I left the bank.

Ms. OAKAR. To your knowledge, nobody did a thing about it; they sat on it?

Ms. KENEFICK. I don't have any knowledge.

Ms. OAKAR. Mr. Kovarik, how do you reconcile the differences in dates here? She wrote it a year, year and a half, before; you claim you got it almost a year to the day later, in August of 1982. You wrote your report in November. You wish you had had it 3 months before? You had it 3 months before.

Mr. KOVARIK. If I could clarify that.

Our examinations started, I believe, on May 24, 1984—1982, excuse me.

Ms. OAKAR. Yes.

Mr. KOVARIK. So we had people in the bank since May of that year. I arrived at the bank in late June of 1982. My comment of 3 months earlier was, if I would have had it from the time I got into the bank, as I said before, I could have targeted our review and avoided some of the work we did that may have come to a dead end. As I say, eventually we got to the same conclusion. But if I had known what——

Ms. OAKAR. Your language is not devastating at all. I have read your report and I read Ms. Kenefick's language, and she talks about getting on with it quickly and the accountability. However, your report is mild; essentially it says it is still a great management team even though there are problems. That is what I read into your report.

I have, Mr. Chairman, one question for Mr. McCarte.

When you were preparing or reviewing the report, or any other report regarding Continental Illinois is that when Continental Illinois approached you about employment?

Mr. MCCARTE. No, they did not. The timing, I think, was rather explicit. What happened was, we had left the bank in August of 1981 and the bank did not come to me until June 10, 1982.

Ms. OAKAR. What part of 1981 did you say?

Mr. MCCARTE. As I said, August 1981—approximately 10 months earlier.

Ms. OAKAR. Did they ever approach you before that?

Mr. MCCARTE. No, they did not.

Ms. OAKAR. Did you have any idea they were interested in you as an employee?

Mr. MCCARTE. No, ma'am.

Chairman ST GERMAIN. Would the gentlelady yield?

Ms. OAKAR. I would be happy to yield.

Chairman ST GERMAIN. You said you were considering another employment opportunity outside the areas covered by the Comptroller's Office in Chicago.

Mr. MCCARTE. Yes, sir.

Chairman ST GERMAIN. Had you been seeking employment elsewhere?

Mr. MCCARTE. No, sir, I had not.

Chairman ST GERMAIN. They just came to you out of the blue?

Mr. MCCARTE. Yes, sir. It is not uncommon, I think, that that may occur.

Chairman ST GERMAIN. I know.

Ms. OAKAR. I want to yield to my friend from Georgia, Mr. Chairman.

Mr. BARNARD. I want to ask Mr. Kovarik a question.

You say you began the examination in May 1982?

Mr. KOVARIK. The examination was begun in May 1982, yes.

Mr. BARNARD. And Penn Square failed in February 1982; is that correct?

Mr. KOVARIK. July of 1982, I believe.

Ms. OAKAR. July.

Mr. BARNARD. We had our hearings——

Ms. OAKAR. July 5, 1982.

Mr. BARNARD. But this was right in the middle of your examination, you know, that all the Penn Square thing came out. You didn't take note of that?

Mr. KOVARIK. Yes, sir. From the time I entered the bank, as I say at the end of June—the week of the 21st or so was the first time I entered Continental, in 1982—I was informed by our staff in Washington, first of all, that I was to do the examination; second, that there were problems with Penn Square. From the time I entered the bank, I was in contact with people in Washington on a very frequent basis, two to three times a day, either gathering information at Continental to help them with the Penn Square examination or with them giving me information to check out at Continental.

The period from, say, June 21 to probably July 20 or 30 was a very hectic period at Continental in our examination, and it was constantly during that period, I would say, I was involved almost 100 percent with Penn Square as it related to Continental.

Mr. BARNARD. I know my time is expired.

Chairman ST GERMAIN. Go ahead. I am being a little more liberal here, and I will use a little more of the chairman's discretion so that we will have a situation where we don't drop a trend or a line of questioning, as too often happens. So I hope the Members will bear with me because they will all be the beneficiaries of it, I assure you.

Mr. BARNARD. Mr. Kovarik, in your report on page 4, it says, and I will read:

> 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 lost. Of these, $1.2 billion were oil and gas loans with Penn Square-related classified loans.

So evidently you did pick up the Penn Square situation.

Now, the next is what I want you to explain to me. The causes of Continental's problems were explained by Richard Kovarik, author of the 1982 OCC Examiner's Report, in 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 deci-

sions regarding growth and the system of decentralized authority and responsibility/accountability.

Chairman St Germain. What is the date of that one again?

Mr. Barnard. This is on page 4.

Chairman St Germain. The date of it?

Mr. Barnard. The date is September 18, 1984. That is somewhat after the horse is gone.

Ms. Oakar. If the gentleman would yield back——

Mr. Barnard. A whole herd. It is the 1982 report.

Ms. Oakar. Excuse me.

Mr. Barnard. What you are saying, Mr. Kovarik, is as early as 1982—and this is 1984 that the Comptroller's Office was alerted to the deficiencies or to some real criticisms in bank management——

Mr. Kovarik. Yes, sir. That is from my 1982 report, which covered the period from May to November of that year. It was my findings that, although a number of the credits that were problems at the time were related to the economy, there were still—there were also credits that were related to the systems that had been in place, specifically in relation to the Penn Square loans.

Mr. Barnard. Did this generate any new activity or discussion between the Comptroller's Office and the management of Continental Illinois?

Mr. Kovarik. Yes, sir, it did.

Mr. Barnard. And what kind of discussions?

Mr. Kovarik. There were numerous discussions between myself and the board, between other—from my understanding, staff in Washington. It resulted in actions taken and recommendations made to the bank and actions taken against the bank.

Mr. Barnard. What kind of follow-through did the bank make in regards to those?

Mr. Kovarik. As I said before, to my recollection they implemented every recommendation we made, including the establishment of a new credit evaluation division; beefing up controls; changing the approval system on loans. A number of items were covered.

Chairman St Germain. That is interesting because I think we are going to have somebody in here. As you know, there were banks that went in and evaluated Continental to determine whether they would like to merge with Continental, and they were not too impressed with some of the things you said were being improved upon. So we better be very cautious there.

Ms. Kenefick, let me ask you this: You gave a copy of your memo to Mr. Rudnick and Mr. Lytle?

Ms. Kenefick. Yes, sir.

Chairman St Germain. Anyone else?

Ms. Kenefick. I left a copy for Mr. Goy, who replaced me in my position. But he was out of town at the time, and I don't know whether he actually received it.

Chairman St Germain. You say that—in answer to Ms. Oakar—you don't know what, if anything, was ever done as a result of your memo?

Ms. Kenefick. Well, I——

Chairman St Germain. Because you left shortly thereafter.

Ms. KENEFICK. I interpreted her question as a general, "What did the management of the bank do?"

Chairman ST GERMAIN. Correct.

Ms. KENEFICK. In that regard, I don't know.

Chairman ST GERMAIN. Let me ask you: Once you issued the memo, you gave it to Mr. Lytle and Mr. Rudnick, and subsequently you left it for your successor. How many times did Mr. Lytle or Mr. Rudnick call you to discuss the memo that you wrote and addressed to them?

Ms. KENEFICK. Well, I had one meeting with Mr. Lytle regarding the memo.

Chairman ST GERMAIN. Did he indicate to you what he thought he would do as a result of the memo? What changes he would implement?

Ms. KENEFICK. I don't believe at that initial meeting, but subsequent to my resignation, he did mention that he was looking to add more people to the division. Also, one of my assignments was to work on organizing the accounts to the extent I could, as suggested in the memo, by family of accounts and make recommendations of people in the division to handle those accounts. So I was aware of those two steps being followed.

But my general impression from Mr. Lytle was that he didn't share the same view that I did with respect to that.

Chairman ST GERMAIN. Let me put the question to you this way: Did you feel that many people got motivated, excited, what-have-you, as a result of your memorandum? Or do you think that the publisher turned it down?

Ms. KENEFICK. Mr. Chairman, I don't believe Mr. Lytle shared the same concerns I did.

Chairman ST GERMAIN. OK. Last, you left Continental shortly thereafter.

Ms. KENEFICK. Yes.

Chairman ST GERMAIN. How long after writing the memo?

Ms. KENEFICK. I left there in late September.

Chairman ST GERMAIN. And the memo was dated August?

Ms. KENEFICK. The memo was dated July.

Chairman ST GERMAIN. July.

Could you tell us what the reasons were for leaving Continental? Are you at liberty to tell us that?

Ms. KENEFICK. Well, I was not seeking outside employment, but an opportunity presented itself to me which I felt was a good one and provided different challenges and greater financial rewards. And I was not happy in the division that I was in. I had some difficulty working with Mr. Lytle.

Chairman ST GERMAIN. As expressed in your memorandum?

Ms. KENEFICK. Yes, sir.

Chairman ST GERMAIN. Thank you.

Mr. Leach.

Mr. LEACH. Thank you, Mr. Chairman.

Ms. Kenefick, you are the most reluctant martyr this committee has ever heard. Whistleblowers in Government are substantially less modest, from our experience on this committee. I would like to go to one question of procedures. You testified a minute ago that two signatures—unlike in other banks that often have committees—are enough to authorize a loan. In the Penn Square hearings, we were also informed that Continental had a unique system of offering bonuses to employees to bring in business; that is, you get a bonus if you made a loan.

Is that your understanding?

Ms. KENEFICK. I don't have that understanding.

Mr. LEACH. Second, let me just comment for those of us that follow Chicago banking, from the Midwest, there was kind of a feeling a few years back that the bad guy of Chicago banking was Robert Abboud of First Chicago.

As I have listened to this testimony, it appears to me he is talking on almost heroic dimensions as the tough guy who says, "We don't want to follow the procedures of our main competitor." I stress this because, as I review the examination reports, as put together by our staff, there are a lot of comments about peer bank pressures and peer bank analogies. Here, let me just make a couple analogies.

First of all, in the securities industry, many firms have many long names to them because they were forced to merge because they didn't get their backrooms in order. It appears that Continental never got its backroom in order. There wasn't even proper accounting after fairly loose standards were used in making a loan.

But let me come back to the regulators, because I think this is more regulatory than a banking issue. One of the recommendations that was not made in 1982, because—I stress this because, Mr. Kovarik, you mentioned that the bank met most of the regulations that were made—one of the recommendations that was not made was to increase the capital ratio of the bank.

Here, let me stress for the committee that on pages 14 through 16 of the committee staff report, and the two tables that follow, is an excellent summary of the capitalization problem at Continental Bank. I would just like to briefly review one paragraph in summary of the committee report, and that reads:

> In 1976, Continental's ratio of classified loans to gross capital funds had reached 121 percent. Its ratio of total assets to total capital was 21 percent.

Then further on, it says:

> In the staff interview, Examiner Meade estimated that Continental was between 60 and 70 percent dependent on purchased funds. In comparison, in 1982, the classified loan to gross capital ratio had risen to 172 percent, the degree of asset to capital leverage had risen to 25 percent, and dependence on purchased money was up to 80 percent.

But,

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

In 1982, the examiners concluded that the capital base of Continental

> Is presently considered adequate.

However, the examiners also noted that an inordinate level of classified assets and loss of confidence by the financial community lent definite reservations to this assessment.

The point I would stress is if one is looking for a public rather than private sector bailout of institutions in difficulty, the easy way is to force the institutions to raise more private sector capital.

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One of the questions I would just ask is—first of Mr. Meade—Why did you determine in 1976 that the bank's capital was inadequate; what happened after that assessment; and why in 1982, in a much deteriorated bank situation was the capital base rated as adequate? Do you think that, first, your report in 1976 made any difference at all? Second, that the 1982 assessment of adequacy was valid?

Mr. MEADE. I will speak to the 1976 examination, and I will let one of my colleagues speak to the subsequent examinations.

In 1976, the classified assets—that is, those assets which were rated substandard, doubtful, and loss—aggregated 121 percent of the bank's gross capital funds. Looking beyond those numbers, I believe there was about $375 million in the doubtful category; that is, those assets which collection in full is highly problematical, $375 million amounted to roughly 35 percent of the bank's capital funds. The 121 percent of capital—the classified assets of 121 percent of capital was the highest I had ever seen up until that time.

I will have to point out that the bulk of those classified were centered in real estate credits, and this was during the period of high interest rates. The problems in the real estate sector were widely known and experienced by most of the multinational banks.

Chairman ST GERMAIN. Are you talking about the realty income trusts?

Mr. MEADE. Right; the REIT's.

Chairman ST GERMAIN. Weren't those part of the holding company rather than of the bank?

Mr. MEADE. There were loans in the bank—the holding company had sponsored a REIT, but that was not the problem. It was loans to REIT's not related to Continental.

Chairman ST GERMAIN. Could the gentleman yield for half a second?

Mr. LEACH. Of course, of course.

Chairman ST GERMAIN. The fact is, the bank had lent to the holding company REIT. The subsidiary or affiliate—there was a subsidy of the holding company that was an REIT; correct?

Mr. MEADE. Right.

Chairman ST GERMAIN. And Continental Bank had lent substantial sums to that REIT?

Mr. MEADE. That was not the problem, as I understand it.

Chairman ST GERMAIN. Had that occurred?

Mr. MEADE. It may have occurred, but the primary problem was that it lent—REIT's which had no affiliation with Continental Bank whatsoever.

Chairman ST GERMAIN. OK.

Mr. MEADE. They were located in New York, Florida, and California.

Chairman ST GERMAIN. Thank you.

I thank the gentleman for yielding.

Mr. LEACH. Mr. Kovarik——

Mr. MEADE. Did I respond to your question?

Mr. LEACH. You did, to my satisfaction.

Why did you conclude that the capital was adequate? Wasn't it in better shape than in 1976, Mr. Kovarik?

Mr. KOVARIK. The capital increased through retention of earnings, primarily.

Mr. LEACH. But not on percentage basis?

Mr. KOVARIK. I believe in 1982 the primary capital was well above what it had been in the past. I believe at the time it was in excess of its peer group. The classified assets were very heavy, as I pointed out.

Chairman ST GERMAIN. Excuse me. I have to interrupt again.

You say in excess of its peer group. If you say that, you will have to discuss the peer group and how adequate that was. Because the Comptroller's Office insisted they improved; right?

Mr. KOVARIK. Yes, sir.

When I speak of peer group, I speak of multinational banks that we supervise.

The classified assets, as I pointed out, were extremely high at that time. But the majority of the doubtful and loss classifications were related to the Penn Square. It was at that point in time Penn Square was, to me, a very isolated portion of the bank. We had criticized, I believe, 80 percent of the loans that they had purchased from Penn Square, in one way or another.

Mr. LEACH. Let me just ask another question in that light.

How many banks that you have ever examined had 80 percent of their assets dependent upon basically short term large sums of money from other banks or other large institutions?

Mr. KOVARIK. I think this is the only one that was 80 percent.

Mr. LEACH. The reason I stress that is because it is a warning sign. As anyone who studied economics 101 or beginning theories of banking knows the money supply can grow as banks make loans; and, at the same time, banks can grow if they can find someone to lend to. So that if you have a situation in which banks willy-nilly take on a lot of loans, they will grow a lot. In the 5 years prior to your examination, Continental had grown at almost double the rate of all other banks in the country on the average; and at the same time, Continental had come to be very dependent on short-term funds.

Isn't this situation a warning sign to look at the bank capital adequacy?

Mr. KOVARIK. We look at the liquidity of the bank or its ability to fund itself through these short-term markets. First of all, you have to look at it historically. Have they been able to do it? Have they met resistance in the markets?

Up to July 1982, with the failure of Penn Square, they had not met resistance in those markets. During the examination, the stability of that funding had come back to a certain extent from what it was immediately after the failure of Penn Square. During July and August, the funding situation was much more critical than it was in September and October and November by the time we had completed our examination, which I think showed to me that the bank had taken steps, gone out into the markets, told their story, and gotten back some of that confidence that they had lost immediately after the failure of Penn Square.

Mr. WYLIE. Would the gentleman yield?

Mr. LEACH. Yes; of course I will yield.

Mr. WYLIE. How much confidence do you put in internal controls when you make your examinations?

Mr. KOVARIK. How much confidence?

Mr. WYLIE. Yes.

Mr. KOVARIK. Quite a bit.

Mr. WYLIE. Quite a bit. Yes; OK.

So if the internal controls were bad enough, then you really don't know where you stand.

Mr. KOVARIK. If they are that bad, yes, you wouldn't know where you stood. However, if during an examination or before an examination when we plan it the internal controls are not sufficient, we expand our examination procedures to cover areas where we felt that internal controls were not adequate.

Mr. WYLIE. What kind of red flag do you have that internal controls might not be up to standard so that you could place confidence in them?

I am not trying to put you on the spot here, but I go back again to my question a little while ago when Ms. Kenefick thought maybe internal controls weren't as good as they should be. And you say, "I wish I had known that 3 months before," and so forth. You really didn't answer my question as to what you might have done about that. Maybe you can answer it.

But I am trying to find out now how you can go about ascertaining whether the internal controls are adequate, whether the loans and functions the bank is engaging in are properly evaluated by someone.

Mr. KOVARIK. Initially in an examination we would review the internal controls to see what controls were said to be in place. And then during the examination we will check to make sure that they were in fact working. And depending on the area of the bank, we would use audit reports made by internal or external auditors; we would do our own checking as far as testing transactions.

The internal control exceptions that Ms. Kenefick brought up, and the ones we were most concerned with at the conclusion of our examination, were the controls that—if I can say—were misutilized in identifying problem loans.

Mr. WYLIE. Misutilized by whom?

Mr. KOVARIK. By the lending officers who were there to review certain information that, if it would have been reviewed and acted upon, would have said there is a problem in the midcontinent oil division. There were reports of collateral exceptions, reports of nonrated loans, loans that had not even come to the committee for rating over a period of months, which to my recollection at least 50 percent—and I think at times in excess of 65 percent—of all exceptions for the whole bank related to the midcontinent division.

Mr. WYLIE. So the bottom line of all that is that it was just bad judgment on the part of some of the lending officers and some officers of the bank that caused the problem.

Mr. KOVARIK. As far as the exceptions I think it is the people who were responsible for reviewing and ensuring that those exceptions were cleared or that if they couldn't be cleared, find out why and put a stop to it. That wasn't being done.

Mr. WYLIE. Thank you. Thank you, Mr. Leach, for yielding.

Mr. LEACH. Let me ask one other thing in terms of warning flags. Continental was unique in comparison with other money center banks in that it didn't put as high percentage of its lending abroad but it did put a very high percentage of lending in areas outside its normal areas of jurisdiction, whether they be in Oklahoma for one type of oil lending or Florida for other types of real estate.

Was this unusual to you and was this something that was cause for alarm?

Mr. KOVARIK. Obviously the Oklahoma section caused me alarm.

Mr. LEACH. Surely.

Mr. KOVARIK. As far as the others, I didn't view it as being out of the ordinary to have lending relationships throughout the country. Most banks that I am familiar with—and I include banks that I have either read about or talked about with other examiners from different parts of the country—have offices throughout the country such as Continental did.

Mr. LEACH. Let me just conclude, Mr. Chairman, with the observation that while the examiners are largely responsible for the financial well-being of the bank and protecting depositors' money in terms of mandate, but they also have indirect responsibility for money supply growth and the allocation of credit. You are going to have more economic growth in areas where loans are made than not.

When you have one type of bank get out front with one type of lending and then be, in effect, protected implicitly by the U.S. Government, we have a serious problem on our hands. One way to approach this problem is to stress capital adequacy as a means of providing evenness in the system.

As I look at Continental's capital adequacy, first in comparison with its peer group it comes out less well than otherwise; but secondly, when you compare capital adequacy to problems with the loan portfolio it seems that in 1982, there was reason for a redder flag to be hoisted than was the case.

I don't want to criticize one particular examination of the bank in comparison with all others, but I would stress that I think the examiners of all national banks are going to have to apply a little more rigid standards than has been the case.

Thank you, Mr. Chairman.

Chairman ST GERMAIN. Mr. Kovarik, what did you say about the capital adequacy of Continental in response to Mr. Leach's earlier question relating to its peer group?

Mr. KOVARIK. I believe it was comparable and at times exceeded its peer group during that time from 1976 or 1977 through 1982.

Chairman ST GERMAIN. I would direct your attention to the chart on the board over there, to your left. You see that first chart, "Capital Adequacy?"

Mr. KOVARIK. Yes, sir.

Chairman ST GERMAIN. You see the red line?

Mr. KOVARIK. Yes, sir.

Chairman ST GERMAIN. That red line is Continental Illinois.

Mr. KOVARIK. Yes, sir.

Chairman ST GERMAIN. The white line, you know, the up above part that starts between 5.6 and 6, that is 1976, that is the peer group. So where did you see it exceeding the peer group?

Mr. KOVARIK. I am sorry, sir; I do not know. Is your peer group the multinational banks?

Chairman ST GERMAIN. Yes. That chart was prepared by GAO.

Mr. KOVARIK. That chart is not similar to the ones I have seen comparing continental with its peers.

Chairman ST GERMAIN. The Comptroller's Office has to get new chart preparers, is that it?

Mr. KOVARIK. I am not sure, sir.

Chairman ST GERMAIN. Now, one more and I will go to Mr. Vento.

It was noted that the bank was troubled by an outmoded computer system and the bank had commenced a system of design review in 1977. Did you ever criticize the bank's computer system for being inadequate, Mr. Meade, Mr. Kovarik, Mr. McCarte? Now, we are talking about the computer system with respect to loan operations as being inadequate. Lytle was not alone in his perception that the loan operations exceptions reports contained errors. The bank's management generally recognized that loan operations were troubled by an outmoded computer system.

Did any of you in your reports ever criticize their computer system for being outmoded?

Mr. MEADE. Mr. Chairman, in some of the examinations that I conducted, it was commented on that reports generated by the system were generally not accepted by the people on the line.

Chairman ST GERMAIN. Did you point out the fact that the system was outmoded and therefore just couldn't do the job?

Mr. MEADE. I am not aware that it was outmoded.

Chairman ST GERMAIN. What I am quoting from now is the report of the loan—report of the special litigation committee of the board of directors of Continental Illinois Corp., dated January 7–February 8, 1983. But they did a total review and found that back then the computer system was outmoded and just couldn't keep up on installment loans. If it was over, what, 9,999,999.99, they had to split it down because the system couldn't take it.

Mr. Kovarik, did you ever criticize the computer system as being outmoded?

Mr. KOVARIK. No, sir.

Chairman ST GERMAIN. Mr. McCarte?

Mr. MCCARTE. No, sir.

Chairman ST GERMAIN. Thank you.

Mr. Vento.

Mr. VENTO. Thank you, Mr. Chairman.

Let me just ask a general question to the examiners, those chief examiners that are here. When you have a bank that is in an obviously aggressive growth mode as Continental Illinois National Bank pursued, that is knowledge on the part of the examiners, you recognize that particular type of strategy, I assume. Does that type of institution receive any additional attention because of the tremendous number of decisions that are being condensed within any given time? Can any of you comment on that?

Mr. McCarte?

Mr. McCarte. The field examiner as a result of that, I think if you read the reports that we prepared during 1979, 1980, and 1981, observed that that was in fact about to occur. We thought it would occur. As a result, we spent additional time in the actual reviewing of specific credit.

Mr. Vento. So in other words, you make an analysis of their ability to make credit judgments and the loans they are taking and placing and the type of analogies of the type of deposits they are securing?

Mr. McCarte. That is correct.

Mr. Vento. In other words, you did give this extra attention. Is that accurate?

Mr. McCarte. We spent a lot of time during those examinations concentrating on determining the quality of the portfolios and what type of credits were being booked during this growth period.

Mr. Vento. Mr. Kovarik, you agree with that, that a fast-growing institution of this size that is trying to grow is receiving more attention?

Mr. Kovarik. Yes, sir.

Mr. Vento. I assume, Mr. Meade, you agree with that as well?

Mr. Meade. Yes.

Mr. Vento. Is the size of this bank, did that represent special problems, Mr. McCarte?

Mr. McCarte. Well——

Mr. Vento. The size of this financial institution?

Mr. McCarte. Everything is relative, of course, but I would say that a larger bank requires a greater staffing consideration on our part, but also just putting an entire report together on a larger bank is more difficult than a smaller bank. But in terms of that bank in relation to other banks that I am familiar with it was not any more difficult than other banks.

Mr. Vento. One of the criteria—and I refer you to page 9 of the staff examiner's findings, Mr. McCarte—I would like you to review the first quotation on page 10 of the staff examiner's finding report. It begins, "Review of those internal reports." The first comment is what is the significance of the increase in volume of old credits to $2.4 billion in 1981 from $1.6 billion in 1980?

Mr. McCarte. What is the significance of that?

Mr. Vento. Yes.

Mr. McCarte. The significance of that is that the amount of credit exceptions which is, of course, different than a credit problem, has increased. The loan review function had not been able to keep up with the volume of work or, as it was stated earlier in the report or elsewhere in this report, that the line managers had not submitted the appropriate information to loan review to allow them the rating process. The combination of reasons I am sure.

Mr. Vento. It is pretty significant. The bank had not grown by that much. In other words, you have an increase here of almost 50 percent.

Mr. McCarte. That is correct.

Mr. Vento. You know, of the exceptions, in just a single year.

Mr. McCarte. Yes. I would hasten to point out, of course, that in banking terms and in how examiners view credits there is a significant difference in a credit problem, for example a substandard, doubtful or special mention or loss. But what we pointed out is the amount of exceptions increased dramatically and we were concerned about it and this was part of the rationale——

Mr. VENTO. One of the statements following is itself evidence no one is monitoring the situation to assure that all credits are receiving timely reviewed as required by the corporate office. So they have this requirement and nobody is doing anything about it. Then you go on, you have the statement in your letter to Continental's board of directors, we find it, the internal rating system, to be functioning well and accurately reporting the more severely rated advances to the board and senior management.

In one case you are saying one thing, Mr. McCarte, in the other case it seems to me that there is a problem, you know. It seems you are pursuing serious problems, but you write to the board of directors and you seem to have backed off.

What is the reluctance on the part of an examiner to share the unvarnished truth with the board?

Mr. MCCARTE. I am glad you bring that up. Let me take a few minutes and expand on that. The $2.4 billion credit exceptions were, in fact, credits that deserved to be rated and it was the wishes of the corporate office that in fact it be done on a timely basis, but it was not being accomplished. As a testing against whether these in fact were credit problems versus credit exceptions, we, in fact, had reviewed approximately 60 to 70 percent of the volume of credit outstanding at the Continental Bank which in terms of what most examiners would do is significantly above what you might expect in a money center bank.

And as a result of the testing that we did, the sampling we had done as well as looking at the large credits and scope of the review we had performed in the last several exams, which was to look at credits of $10 million and over, all C and D rated credits, past dues and nonperforming, we also did the sample, sampled credits above the $500,000 threshold where the bank internally rates credits and those below $500,000 looking for exceptions. The results of our sampling reveal that the quality of the assets had not deteriorated other than the credits we had listed in the report and as you will find in that 1981 report we stated that the total criticized had risen to approximately 99 percent of the bank's gross capital funds, a reversal of what had occurred in the past.

That statistic, that number was generated from the review by examiners in the various divisions, so in fact while we are talking about a credit exception problem, we are also going through the exercise of testing that and in terms of the comment we made about the internal rating system as functioning, that deals specifically with was the bank being apprised of credits that were troublesome; that is, credit problems. We did not find enough instances other than the ones cited earlier in the report.

Mr. VENTO. The point is that these exceptions, you say you are doing testing. I don't know what that means. You are not testing all of the exceptions? In other words, when you say you are testing that, almost by definition that says I am sampling some of these to see what the quality is. But you are not doing all $2.4 billion worth, is that accurate?

Mr. McCarte. We did not do—I would have to have the work papers, but I am sure we did not look at all the $2.4 billion. But I am confident that a number of the credits came up in the sample.

Mr. Vento. You are saying they were selected randomly and you were doing a sample.

Mr. McCarte. A statistical sample was performed, done in accordance with the guidelines.

Mr. Vento. You know, the thing is that that—if that were all by itself and you said the exceptions and that, but if you look at it in relation to some other things like liquidity position of the bank, then I think that problems began to arise. Total loans, income to total assets, is a measure of an institution's liquidity. An analysis of the multinational and regional data reveals that the Continental loans continued to increase and became far and away its major source of assets.

During the period of 1976 to 1983, the bank's ratio rose significantly from an average of 58 percent in 1976 to 62 percent in 1979 to 71.6 percent in 1981 to 1983, placing it really in a very poor liquidity position with all these exceptions with regards to its loan portfolio and, of course, forced it very often then into a volatile market to raise these funds.

Wasn't that a further warning sign, even compared with its peer group? Its peer group, analysis of both the multinational regional data revealed that the Continental ratio was extremely poor during 1976 to 1983 averaging a minus 45.97 percent, or at least 21 percentage points below its peers in terms of that status. Didn't you point these problems out to the bank? Didn't you address that in any way, especially in light of the fact that you have all this undocumented loans coming in with this weak liquidity position represented by it?

Mr. McCarte. You were reading from some areas I am afraid I couldn't follow you on, where you were coming from. But in terms did we criticize the bank's liquidity, if that is your question——

Mr. Vento. Yes.

Mr. McCarte [continuing]. I think the answer is we did not criticize it. We recognized the fact that the bank had a greater dependence on purchase funds but by the same token so did a number of the peer groups, as was pointed out. With respect to anything beyond that I am afraid I would have to——

Mr. Vento. Well, if the peer groups are at some value of 20-some points difference in terms of percentages in terms of what they are raising, an analysis of both the multinational regional data reveals that Continental's ratio was extremely poor during 1976 to 1983 averaging a minus 46 percent or 21 percent below its peers in terms of liquid assets, minus volatile liabilities to total assets. In other words, you are familiar with that term, aren't you? That particular definition is one that I don't work with day in and day out, but it is one, Mr. McCarte, that the examiner must. I guess not.

Mr. McCarte. I think we understand what liquidity means, yes, sir.

Mr. Vento. Can you share with us, during your period of examination, the amount of foreign bank deposits versus domestic correspondent bank activity? Can you tell us what the volume of correspondent or foreign bank deposits were at that time in 1981 when you last did the examination, Mr. McCarte?

Mr. McCARTE. I don't have those statistics with me. I would have to defer on that question.

Mr. VENTO. Can you provide us with insights into the amount of foreign bank/correspondent deposits with this institution, Mr. Kovarik, during the period that you provided examination work?

Mr. KOVARIK. I don't have anything specific on correspondent/foreign bank deposits. Their relationships to foreign funds did increase after July of 1982, I believe at one point it reached about 50 percent of their total purchased funds.

Mr. VENTO. Fifty percent. And of course we all are aware of the fact that they were raising money on a daily basis, but that of course—I am asking about the deposits that were present there and about the correspondent banking relationship. When you began to examine this, how do you treat this as the holding company? Are you just looking at the bank side or at all the other assets, Mr. Kovarik, and all activities in terms of the holding company? How is that relationship worked to the bank examination that you provided?

Mr. KOVARIK. We examine the bank, the Federal Reserve Board examines the holding company and holding company subsidiaries. We do work together during the examination and would share our information as far as the quality of the bank, our view to the Federal Reserve, and they supply us with information as far as the quality of the assets and the operations of the holding company and its holding company subsidiaries.

Mr. VENTO. What type of communication during the periods that you are doing the examination with the holding company did you receive from the Federal Reserve Board with regards to the holding company?

Mr. KOVARIK. The Federal Reserve examiners were in Continental during our examinations. The examinations were conducted as of the same dates although the Federal Reserve examiners in Continental's case were not there as long as we were. Because my recollection is that the holding company and its subsidiaries accounted for 5 or so percent of the total assets of the corporation whereas the bank was 95 or 96 percent of the total assets.

Mr. VENTO. Mr. Kovarik, you heard my question of Mr. McCarte, with respect to the liqudity of the bank. Do you have any comments with respect to the significant difference between the liquidity of Continental Illinois and its peers? The ratios, the assets?

Mr. KOVARIK. I believe that they historically had been higher than their peers. One of the reasons was that they were—they are located in Illinois whereas a number of their peers are located in States that have the ability to branch and to garner retail deposits throughout a greater location than Continental did. I think if you look at the two multinationals that we have in Chicago their percentage of purchased funds is higher than those banks in California of relatively the same size.

Mr. VENTO. You think that is the major reason, is the inability to branch that causes their funding——

Mr. KOVARIK. Yes, and the fact that Continental is a wholesale bank, not concentrating on consumer relationships. If I was a consumer, I wouldn't put my deposit—you know, if it wasn't convenient for me and if I wasn't assured of getting a loan from that bank when I needed it.

Mr. VENTO. In your statement in terms of the record, I forget the date, but you point out that less than 20 percent of the deposits of Continental Illinois were in Penn Square. I guess that was what you were saying. What was the exact percentage?

Mr. KOVARIK. I don't understand the question. I don't recall saying anything about deposits in Penn Square.

Mr. VENTO. Let us see then, the statement—it says although the Penn Square relationship accounts for a relatively small proportion of the problem loans, less than 30 percent, the publicity surrounding its closing is surely the one event that has done the most damage.

In other words, in that case you are talking about what? You are talking about Continental Illinois National Bank having a small portion of the problem loans, or who are you talking about?

Mr. KOVARIK. No, sir. I believe that is talking about the total criticized assets at Continental in my 1982 examination, and that the Penn Square participations accounted for 20 percent of criticized assets.

Mr. VENTO. Were they 20 percent or less than 20 percent?

Mr. KOVARIK. They were approximately $820 million.

Mr. VENTO. In other words, $820 million—in multiplying that out, that indicates there are $4 billion worth of problem loans in 1982. Is that right?

Mr. KOVARIK. There were $5.6 billion—according to your page 17, there were $5.6 billion of criticized assets at that examination, so the $820 million would have been less than 20 percent—16 or 17 percent.

Mr. VENTO. It shows there were a lot of problems here. It was just not an isolated situation.

Mr. KOVARIK. That is right. As I pointed out earlier, though, at that point Penn Square did account for the majority of those doubtful assets and the losses at that examination. Those two categories are the most severe.

Mr. VENTO. There is a reluctance on the part of the bank, any bank, to write off any type of bad loan at any time, isn't there? In other words, it is your job to begin to ferret our whether or not some of these loans are collectible. Ultimately, if you go back and look at those loans, the question arises in my mind that it seems like today, after not putting out any more loans, they ended up with 4.5 billion dollars' worth. So these loans looked to me like they are the ones that resulted in the bulk of the $4.5 billion in loans that have been declared as bad loans right now. Is that accurate or not?

Mr. KOVARIK. I don't know which $4.5 billion you are referrng to.

Mr. VENTO. I mean that there are some assets in the bank right now, today, trying to make a relationship now between what occurs today and what you discovered at that time. They had $5 billion worth of problem loans at that time.

Mr. KOVARIK. Yes, sir.

Mr. VENTO. Thank you, Mr. Chairman.

Chairman ST GERMAIN. Mr. Kovarik and Mr. McCarte, you were scheduled to do the 1982 examination, is that correct?

Mr. MCCARTE. That is correct.

Chairman ST GERMAIN. Then on what date did you state that you would not do it because you were under consideration by Continental?

Mr. MCCARTE. I believe I said I was approached on June 10 and it was a Thursday, and on Friday was a day off for the examiners, I was not in the bank. Just to clear this up, we discussed it with my wife over the weekend and on Monday, the first thing I called Washington to advise them that I had been approached, and at that time I left the bank and joined the regional office.

Chairman ST GERMAIN. Mr. Kovarik, you then were given the responsibility for that particular examination, is that right?

Mr. KOVARIK. Yes, sir.

Chairman ST GERMAIN. On what date did you receive that responsibility?

Mr. KOVARIK. I entered the bank on June 21 and I think I was notified either Thursday or Friday the week before.

Chairman ST GERMAIN. When were you told by the Washington office of the problems at Penn Square?

Mr. KOVARIK. I think the name Penn Square came up when I received a call to tell me I was to go to the bank. But it was just—we have got some problems with Penn Square—is my first recollection. It was the following week, the week of June 21, before I got any information about Penn Square.

Chairman ST GERMAIN. What type of information did you get?

Mr. KOVARIK. What was going on during the examination down there as far as losses at Penn Square, the amount of loans that Continental had purchased from Penn Square, information like that. It had expanded over the next 2 weeks I would say, 3 weeks.

Chairman ST GERMAIN. Mr. McCarte, prior to your decision not to conduct that examination were you advised by the Comptroller's Office as to what was occurring at Penn Square?

Mr. MCCARTE. No, sir.

Chairman ST GERMAIN. Mr. Schumer.

Mr. SCHUMER. Thank you, Mr. Chairman.

And my first question is directed at Mr. McCarte. If you would, turn to page 10 of the examination findings. The last couple of sentences in the first paragraph you state that no significant problems are evident as noted by the fact that only two oil and gas credits were classified herein. What do you mean by the phrase "no significant"—what you are saying is no significant problems are evident in oil and gas loans. What do you mean by that?

Mr. MCCARTE. Well, it means that if we had found a large number of credits that were—that we were reading as special mention or substandard, doubtful and loss, and it was large in relation to the portfolio, we would have considered it to be perhaps a problem. And the observation was that only two credits were cited. One of them was a significant doubtful credit, I believe.

Mr. SCHUMER. The basic question is this: You with your team of auditors, probably very experienced auditors, crack auditors, are here in the bank examining the oil and gas loans at the very same time that Ms. Kenefick is issuing her report, and her report is a devastating document and at the same time you are stating no significant problems are evident as noted in the oil and gas area.

How did that happen?

Mr. McCARTE. I can't speak to—we obviously did not have Ms. Kenefick's memo during the examination.

Mr. SCHUMER. I am not asking did you have her memo. You had her oil and gas loans. That was one of your jurisdictions.

Mr. McCARTE. That is right. The amount of credit that Oklahoma City had generated at that time was in the neighborhood of $300 million, which in a $40 billion bank is relatively insignificant. However, as I said before, we did send examiners back to establish what type of credits they were. The answer came back was they were primarily credits secured by standby letters of credit and that type of collateral is rather good.

Mr. SCHUMER. All the things she catalogs in her report, all the many things, do those just completely escape the eyes of auditors?

Mr. McCARTE. I have not read Ms. Kenefick's memo in its entirety. I have not read it at all as a matter of fact. It came to me this morning.

Mr. SCHUMER. What she is basically saying is there are hardly even documents for any of the loans. If you are going to take a sample of loans you are not going to find undocumented loans as part of the sample.

Mr. McCARTE. Perhaps we can explain the methodology of how we examine a bank. What happens is during the examination, as Dick Kovarik points out, the examiners will test the internal controls. The examination procedures employed in the large banks allow for the review of the external auditor's report, we try and determine their adequacy and competency. We do the same with the bank's internal audit report. The rationalization is that examiners will not redo good work that has already been done.

As a result of the internal control questionnaires that we were using at the front end of the examination, we established that the bank through its internal devices, the bank's internal auditing department, the operation of the bank, had tested and found no significant problems. What we do is review the reports of the auditors and from that basis we make a determination as to how far we are going to go.

During the sampling technique that we would employ once we have established up front that the internal controls seem to be adequate.

Mr. SCHUMER. Excuse me——

Mr. McCARTE. And from——

Mr. SCHUMER. You are past the point I want to be and I don't want to take up the committee's time on that.

Mr. McCARTE. OK.

Mr. SCHUMER. Her report makes obvious that the internal auditing mechanism in the bank was atrocious.

Mr. McCARTE. Her report seems to be also dealing with 300 million dollars' worth of credit. And I can't explain anything beyond that, sir.

Mr. SCHUMER. I don't understand. You are saying if it was $3 billion you would have caught it?

Mr. McCARTE. If it was $3 billion, I would presume it to be——

Mr. SCHUMER. Most of the bad loans are undocumented is what she said. A lot of them were not there. Would you catch them?

Mr. MCCARTE. Yes, I think so.

Mr. SCHUMER. Why? You couldn't pick them from the sample?

Mr. MCCARTE. The sample did not. Neither the condition of the banks internal controls nor the documentation of the credits would have any bearing on whether they were selected in a sample. The OCC sampled from outstandings and if the loans were booked on the loan system they had the potential of beings selected. Additionally it should be noted that both the number and dollar amount of Penn Square credits was small at April 30, 1981, thus reducing even the potential for selection.

Mr. SCHUMER. You approved the internal auditing?

Mr. MCCARTE. That is right.

Mr. SCHUMER. And it is clear it was junky?

Mr. MCCARTE. If I can be allowed to finish, I think what we established is the bank's internal devices had done some testing in these specific areas and if they are coming up relatively clean and if we can't challenge the independence and competency of a bank's internal audit department as well as external auditors in the bank, the guidelines require us to go no further, state we should go no further.

At the beginning of an examination we visit with the bank's internal audit department and attempt to gauge their independence and competency. If the scope and frequency of their work is acceptable we would shift our emphasis from operational and audit concerns to credit quality matters. Also during the early stages of an examination the competency and independence of the external auditors is also evaluated. It is my recollection that during the 1981 examinaiton there was no grounds for concern from either of these sectors. As such our guidelines would not require us to delve deeply into operational matters.

Mr. SCHUMER. Then that leads to my next question. But before I get to that next question which I would like to ask you, Mr. McCarte, I want to say, and I can't speak for the committee, that I think Ms. Kenefick is the good guy in this operation. She is the good gal—excuse me, Ms. Kenefick—and she is here, but I imagine she has to pay a lawyer and all the expenses. It is not going to do you much good, but my apologies. I sympathize with your situation. You did the right thing and you are still in the soup somehow or other.

Ms. KENEFICK. Thank you.

Mr. SCHUMER. What went wrong, Mr. McCarte? If you were sitting in my chair, what the heck went wrong? Something very badly went wrong. What went wrong? Well, did nothing go wrong?

Mr. MCCARTE. Obviously the results of the examinations and what was published——

Mr. SCHUMER. What went wrong?

Mr. MCCARTE. I am afraid I can't give you a very thorough or complete an explanation.

Mr. SCHUMER. I am asking you, you have had 22 years' experience both as an officer of Continental Illinois and before that as an auditor. You have to give me some answer—I am asking for your help.

Mr. McCarte. I would suggest that perhaps it is a combination of factors. In 1981 the Continental Bank seemed to embark upon an agreement with or a relationship with the Penn Square National Bank. The credits that were purchased from that institution I think translated to approximately $1.1 billion. In retrospect, those credits were not very good with very sizable losses and doubtful classifications eventually being rendered on those credits. Also, at that time in late 1981, early 1982, the energy sector began——

Mr. Schumer. Excuse me, Mr. McCarte, I wasn't clear in my question. I don't want to know what went wrong in the energy sector, I want to know what went wrong with the auditing procedures other than that what Ms. Kenefick was able to find out was oblivious to everybody contemporaneously and later?

Mr. McCarte. I am afraid I can't answer that question.

Mr. Schumer. You can't answer?

Mr. McCarte. I think what we did was totally appropriate, given the circumstances, and I think we followed the guidelines as prescribed to the letter.

Mr. Schumer. What you are saying to me is that you can be going through these same guidelines right now with other banks and 2 months from now, we could be hearing about another problem.

If there is nothing that went wrong here, and this was the typical procedure, appropriate procedure, for doing bank auditing—right—then it could be that your colleagues, maybe Mr. Kovarik, Mr. Meade, or thousands or hundreds of other auditors around, are not catching the same kinds of problems, maybe not oil and gas, maybe not Penn Square—isn't that an accurate statement?

Mr. McCarte. It sounds like you are asking me to guess as to what could occur. It is only conjecture and I have been away from the office 2 years now, and I am not thoroughly versed in what they do.

Mr. Schumer. Well, from what you used to do.

Mr. McCarte. What we have is a situation where we have a bank who has had sizable problems, and they are a combination of not only——

Mr. Schumer. Those problems are not detected by the auditors. That is my point to you. You know, obviously, the bank has real problems and the banking system has even more serious problems, but all we have is you folks.

Mr. McCarte. The only observation I would offer is that a lot of the problems that we are discussing are not operational problems, they are problems related to the economy.

Mr. Schumer. I would ask you the same question. Mr. Kovarik, first comparing Mr. McCarte's memo and Ms. Kenefick's memo. What went wrong? What went wrong with the auditing procedures?

Mr. Kovarik. From——

Mr. Schumer. Why wasn't this problem caught earlier?

Mr. Kovarik. As I said earlier, the mechanisms that the bank had in place including the collateral reports and rating reports which clearly in my examination of 1982 pointed out that there was a problem in the midcontinent division, and Ms. Kenefick's memo speaks of the Oklahoma portion of that midcontinent division—those exceptions were in my opinion clearly isolated to that one section, that midcontinent division.

As I said, my recollection is that during the first 6 months of 1982, those exceptions accounted for more than 50 percent of the total exceptions within the bank and as many as 65 percent of the exceptions within the total bank.

So, in my opinion, there was a clearly isolated problem with the Oklahoma portfolio or midcontinent portfolio.

Mr. SCHUMER. That was a pretty big portfolio.

Mr. KOVARIK. $1.1 billion.

Mr. SCHUMER. Yes.

Mr. KOVARIK. Again——

Mr. SCHUMER. What was the capital of the bank at that time?

Mr. KOVARIK. Approximately $2.2 billion.

Mr. SCHUMER. So it was 50 percent of the total capital of the bank?

Mr. KOVARIK. Yes, sir. But if you——

Mr. SCHUMER. That is the book value of those loans, not the market value.

Mr. KOVARIK. Yes, sir, but if I can go one step further, I think Mr. McCarte said earlier that when he did his examination, those loans amounted to $330 million, and they grew substantially, especially during the last half of 1981, and first half of 1982, a time we were not in the bank examining it.

Mr. SCHUMER. You wrote in——

Chairman ST GERMAIN. Chuck, excuse me, do you have perhaps the date of the last participation that was purchased from Penn Square by Continental?

Mr. KOVARIK. No, I don't, sir.

Chairman ST GERMAIN. Would you make that available to us?

Mr. KOVARIK. We can get it for you.

Chairman ST GERMAIN. Everybody knows Penn Square failed, so we don't have a secrecy problem there.

Mr. KOVARIK. Yes, sir.

Chairman ST GERMAIN. Thank you.

Mr. SCHUMER. I am afraid maybe some of the people who audited the banks didn't know it failed, even after it failed. But in any case, Mr. Kovarik, in your November 15 memo to William Martin, Deputy Comptroller, you said that quality control problems were endemic throughout the bank.

I am trying to find the sentences here. Quality control—it can be said that quality control is useful for the bank.

Now, when you see such problems in one area, as you called it the midcontinent area, and you see the quality control problems throughout in the bank, doesn't it lead you to think that problems can occur in the rest of the parts of the bank that you may not be detecting?

Mr. KOVARIK. Yes, sir, but we were talking specifically about internal controls and those internal controls which would have pointed out the Oklahoma portfolio is what I was referring to before.

Mr. SCHUMER. But they didn't exist for the receipt, did they?

Mr. KOVARIK. Yes, sir, they were there, and being observed by other division heads. The fact that——

Mr. SCHUMER. It says here that quality control is useful for the bank. Internal control and quality control are different?

Mr. KOVARIK. Yes, sir.

Mr. SCHUMER. In what way?

Mr. KOVARIK. Internal control can have an effect on quality, but it is not the only—put it this way, you can make a loan that is very good at the outset, but if you don't document it properly and your internal controls don't catch that, it can turn into a problem.

You can also make a very good loan at the beginning, document it perfectly and do everything and it can turn into a problem loan.

The quality control detection is after the loan is booked, are people looking at it to make sure that it is meeting the requirements and if it is not, are steps being taken——

Mr. SCHUMER. You say both are necessary, and neither is sufficient?

Mr. KOVARIK. That is true.

Mr. WYLIE. Would the gentleman yield on that point?

Mr. SCHUMER. Yes, sir.

Mr. WYLIE. I think the testimony that you have elicited here is very revealing. From what you have said, it is possible to have as many deficiencies in a loan approval, approval and documentation functions as were later found in the case of Continental Illinois, and still have a sound system of internal controls.

Is that a fair observation?

Mr. KOVARIK. No, sir.

Mr. MCCARTE. No.

Mr. KOVARIK. No, I am saying that the unsoundness of their controls was isolated to a certain segment or portfolio.

Mr. SCHUMER. Internal, not quality controls?

Mr. KOVARIK. Not quality controls, yes, sir.

Mr. SCHUMER. Just to clarify.

Mr. WYLIE. You based a lot of your determination on what was going on in the bank on the internal controls within the bank, and what you ascertained from those internal controls.

Mr. KOVARIK. Yes, sir. And if I can go one step further?

Mr. WYLIE. You must have thought those were at the time sound.

Mr. KOVARIK. Except as they related to the midcontinent division, strictly internal controls were sound. If I could take just one example of the collateral exceptions. The operations division of the bank that was charged with gathering all the documentation for a loan and making sure it was all there, they would submit reports on a monthly basis to the division heads and their superiors.

And it was the division heads' responsibility to clear those exceptions.

In the case of divisions outside of the midcontinent those were taken care of on a very timely basis. It was rare to see more than one or two exceptions per month in a division and the next month that exceptions would be cleared and another one, more due to timing than anything else, would appear.

However, in the midcontinent division, the exceptions grow over a period of time with the first ones not being corrected, a group of other ones coming on, and then the next month those also not being corrected, so they grew.

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The fact that the division head of that midcontinent division was not responding to his responsibility as I stated in my letter to the board, he did not take his responsibility along with the authority he had been granted to make sure these corrections were made.

The other breakdown, as I saw it, was that his superiors also did not take their responsibility in overseeing his job. And the other divisions of the bank where we did not find exceptions of any magnitude at all, those division heads and their superiors were taking that responsibility, so that internal control system of reporting an exception to the officer was working in those because those other officers were doing their job and saying here, I have an exception, I have to do something about it and they would correct it.

Mr. WYLIE. But it wasn't working in the case of midcontinent. Did you consider doing any additional test or examinations or establishing any different standards so that the internal control system in the case of midcontinent would be adequate? Or is that not your function?

Mr. KOVARIK. Yes, sir. Our recommendations to improve the controls started off with, somebody had to be on top of those items to be sure those offices were taking their responsibility along with their authority.

Mr. SCHUMER. My colleague, Mr. Barnard, has pointed out something to me. I would like to read two sentences into the record, one from the 1981 report, done by Mr. McCarte, and one for the 1982 report done by Mr. Kovarik.

The 1981 report stated that CINB, "Continental Illinois National Bank is adequately staffed with both sound lending officers and scientific engineers, geologists, personnel—scientific personnel to handle current relationships and meet strong continued growth anticipations." 1981. 1982: "It can be said that the lack of quality control is universal for the bank."

One has to look at those sentences and say something is rotten in the state of the Comptroller of the Currency's Office and the way they function. I am sure there was not a total revamping from 1981 to 1982.

And yet, you are saying complete contradictory things.

I would like to ask two more questions.

First, have any of the three auditors here been in a situation where you saw a bank in the same kind of shape you saw Continental, where you made your audit and then as a result of your audit, which you quietly and internally passed along to the bank, the situation was corrected so that the bank didn't go bad, although Continental did?

Any of the three of you think of an instance of that? The banks will be in good shape now, so you are not revealing any confidences that would lead to problems.

Because that is the premise of the question. Can you think of an example, not where each of you were personally involved, but where this happened?

Mr. MEADE. Can you repeat the question?

Mr. SCHUMER. The question is whether you or another auditor that you know from the Comptroller's Office have ever been involved going to a bank, auditing, discovering real internal problems, such as have been touched on in some, though not all, of the reports that we have issued here, you brought that to the attention of the bank's management, and that situation was corrected, so that a Continental did not occur.

Mr. KOVARIK. As for myself, I have been invovled in the examination, as examiner in charge or as assistant or assisting examiner in a number of problem banks during my career, and the vast majority of those are still around today.

Mr. SCHUMER. That wasn't my question. I know that the vast majority of the banks are still around today. My question was did you examine one of those banks, any one, and find a significant and serious problem, issue a report so, said that, and then management took corrective action?

If so, please cite to me the bank and the instance. We want to get an example of when this system ever works.

Mr. MEADE. I am not prepared to give you an example. But that is the whole objective of our work, is to identify the problem——

Mr. SCHUMER. I am aware of that.

Mr. MEADE [continuing]. And to prompt management to take corrective action. We have very limited resources to accomplish the job in the 4,500 national banks. We do identify the problems and it is management's responsibility to correct them.

Mr. BARNARD. Would the gentleman yield?

Let me phrase it a different way. How responsive was the Continental in making the necessary corrections that you recommended over the period of years? I can't ask Mr. McCarte, because he is with the bank.

Mr. MCCARTE. I can respond for the period of time I was there, if you like. I can respond for the period of time I was with the Comptroller's Office, if you like. I found the bank to be receptive to the comments and had in the past demonstrated a commitment to make change.

Mr. BARNARD. How can you respond, then, when there was such a difference in the two reports, where the one you reported shows the bank was adequately staffed, had sound lending, and so forth and so on, and then in the next examination Mr. Kovarik found it in disarray.

Mr. MCCARTE. I cannot speak for Mr. Kovarik.

Mr. BARNARD. What is your opinion, Mr. Kovarik? Do you feel like the Continental responded aggressively enough to the recommendations for corrections?

Mr. KOVARIK. Yes, sir; I think they did. As I said before, I cannot think of any of the recommendations that we made in 1982 that were not responded to positively.

If I can get into the other question about the two comments, I think they are related to two different things. Mr. McCarte's comment is specifically to the oil and gas portfolio in 1981, and I am talking about a breakdown in the quality, loan quality control system that not only included Penn Square loans, but other loans on the books at the time in 1982.

Mr. SCHUMER. If I might reclaim my time—your comment applies to oil and gas, too.

Mr. KOVARIK. Yes, sir.

Chairman ST GERMAIN. You don't have any to reclaim.

Mr. SCHUMER. Sorry, Mr. Chairman. I would just like the record to state, and I will ask this tomorrow as well, instances where we have a real dilemma, to say the least, here.

First, three points I would just like to make that I derive from the testimony. As Mr. Barnard elicited, Continental followed all your recommendations. That is No. 1. That means that the procedures set up by the Comptroller can't avoid Continentals, and to me, it implies if other Continentals are blooming, the Comptroller doesn't have any power to stop them.

Chairman ST GERMAIN. He has the power.

Mr. SCHUMER. Sorry. Any ability under the present way he is working to stop them.

The second thing which makes me think that is that nobody can seem to point out an instance where their work was able to discover problems and lead to corrective or prophylactic action so that a debacle didn't occur.

And third, which is a separate point, but I think an important one, the contradictions between the various statements made in 1981, 1982, just alone by employees of the Comptroller of the Currency, make me feel that their standards at the very least are flimsy, if not nonexistent.

I yield back.

Mr. MEADE. May I comment on the period from 1973 to 1976? The classified assets, as you recall, in 1976 were at approximately 120 percent, and I was very impressed with management in terms of the responsive action they took to address those problems.

Chairman ST GERMAIN. In 1978, they embarked on their new venture, is that right?

Mr. MEADE. I think the study on the high growth scenario, I believe that was undertaken in 1976. But I was very impressed the way management jumped in and recognized problems and effected correction.

Chairman ST GERMAIN. Well, gentlemen, Mr. Schumer made a great point. If management did everything the Comptroller's Office told them to do, all along the line, from 1976 to 1983, 1984, and Continental still failed, then maybe the Comptroller's Handbook has to be revisied to determine what it is that is not in the handbook, or whether you should be given more power and more discretion than you have been given to date.

Let me ask you this: Mr. McCarte, you were informed about problems at Penn Square when? You resigned June 21, 22, right, from the Comptroller's Office. What did they tell you about Penn Square?

Mr. MCCARTE. When I had resigned?

Chairman ST GERMAIN. Before you left, when you were still scheduled to be the chief examiner of Continental for the June examination.

Mr. MCCARTE. I had no insights on the Penn Square, the condition of the Penn Square portfolio. The conversations that I would have had with the Comptroller of the Currency's Office in Washington was as part of the budgeting process.

When we finished the 1981 examination, we had targeted three areas as part of the normal budget to do next time around—which areas, what type of people you want, and the like. We had targeted at that point in time three broad categories.

One was real estate, we were in an environment of high interest rates, the bank had problems in the past they had corrected, we wanted to see if they continued as such.

The bank had a profit center which was primarily steel scrap dealers, automotive suppliers, related to the Midwest type of economy, which of course we had suspicions might be under some stress, given the recession. And we also had high classified coming out of that particular area. So we concentrated on that one. The third one was the energy area.

As part of the scope of the next examination for 1982, we decided that the best way to approach that was to perhaps get some expertise from an area outside of Chicago to help and assist the examiners in the Chicago district.

And what we had done——

Chairman St Germain. That was in the energy area in general.

Mr. McCarte. I am sorry.

Chairman St Germain. You are talking about the energy area in general, and not Penn Square specifically?

Mr. McCarte. That is correct. As I said before, we had done a limited amount of testing, tested some of the collateral pieces on the Penn Square related credit, and as we proceeded between August of 1981 and June of 1982, we would have a series of conversations in Washington between myself and the Washington staff, basically fine-tuning the budget, and as part of the program we had decided we were going to ask an examiner to come from the Southwest to assist us.

And he was going to go through the Penn Square bank and report back to us.

Chairman St Germain. You did that of your own volition and motivation as a result of your 1981 exam?

Mr. McCarte. Correct.

Chairman St Germain. You did not do that because Washington told you to do it?

Mr. McCarte. No, sir.

Chairman St Germain. OK.

Mr. Kovarik, you took over as the chief examiner for the 1982 exam on June——

Mr. Kovarik. June 21, I believe it was.

Chairman St Germain. June 21. All three of you still were in the Chicago office in June of 1982, right?

Mr. Meade. No. I was in Cleveland at that time.

Chairman St Germain. So you had departed.

Mr. Meade. Right.

Chairman St Germain. OK.

Mr. Kovarik, it is now June 21, 1982. You are now told you are going to be the chief examiner. When did you first receive a call from Washington—obviously, Mr. McCarte, since he did not receive any call from the Comptroller's Office in Washington saying Penn Square is in trouble or might be in trouble. When did you receive that call, Mr. Kovarik? Was it a separate call or what?

Mr. Kovarik. When I was called, the week prior to the 21st, I believe it was either Thursday or Friday of that week, I was called and informed that I would be taking over the examination and the comment was made, we have got some problems with Penn Square, we will talk to you about it next week.

I happened to be on vacation at that time, and I think they delayed so I wouldn't get my vacation ruined.

Chairman St Germain. OK. Now, do you know if anyone else in your Chicago office was called and told to do an examination for Penn Square?

Mr. Kovarik. No, I do not.

Chairman St Germain. Would your colleagues in the Chicago office have informed you? Was there a memorandum that came into the Chicago office saying there were problems at Penn Square, or was it merely on the telephone?

Mr. Kovarik. I know of no memorandum. Continental at the time, and still today, is under the Comptroller's supervision—of the Multinational Division here in Washington. So, the region itself, the seventh, the old region, now the central district, does not have responsibility for Continental.

Chairman St Germain. If the Washington Office of the Comptroller were to say they had informed the Chicago office of the Comptroller that there were problems at Penn Square because of the fact they knew that Continental was involved, your division would have been informed also?

Mr. Kovarik. I would assume so.

Chairman St Germain. The multinational, right? There is a reason for this questioning, ladies and gentlemen? I know I have interceded. We heard what Mr. Kovarik said earlier and Mr. McCarte.

May 11, 1982. This is from Mr. Conover's testimony on July 15, 1982. April 1982, Penn Square Examination commenced. On May 11, 1982, Regional Administrator notified Washington office of problems being uncovered.

May 11, 1982. OK?

Now, I asked Mr. Conover on July 15, 1982: "Now, I ask you, was the information that was gleaned from the examination of Penn Square forwarded to your Chicago offices so that the examiners at Continental would have knowledge of the fact that some of these participations in some of those loans which they urged to Penn Square were as you described it in your statement, not too well-collateralized?"

He said, "I think I would like to answer the second part first. And then I would ask Mr. Homan if he would deal with the first part involving the transmittal of information to Chicago."

All right. We go to Mr. Homan. And I quote him. "During the course of the examination—" that commenced April 19—"as soon as the losses and poor quality loans both in the bank and that portion that was participated with other banks became apparent, we did notify all of our offices effected and particularly our larger regional office that directly supervised the Continental, Chase, and Seattle First and a number of other participants.

"We also sent an energy examiner, one of the experts from Oklahoma, to Continental to aid our examiner in the assessment of that portfolio."

Now, we hear that Mr. McCarte asked for the examiner to come in from Oklahoma. It is not that the Comptroller's Office decided to do that because of what they were finding in Penn Square. And we find May 11, the Comptroller's Office knew about and had been told, and they told us that on May 11, 12, 13, and 14, they informed the Chicago office of the problems that were occurring in Penn Square.

And lo and behold, the reality is that it wasn't until June 17, 18, 21, that Mr. Kovarik was told there might be problems at Penn Square. I think this puts in question some of the testimony we received on July 15, 1982, relative to Penn Square. That is why I wondered when Continental purchased its last participation from Penn Square.

Wouldn't it be rather sad if we were to find that they purchased one on the 30th of May, Memorial Day, or 2 days before it, 2 days over? Wouldn't it? That would be, wouldn't it, Mr. Kovarik?

Since they had knowledge on May 11 in the Washington Office of the problem, the severity of the situation in Penn Square. You can answer that question, can't you, as an examiner?

Mr. Kovarik. I guess it would.

Chairman St Germain. Wouldn't it be sad to find that out? I know we are supposed to have a veil of secrecy. But my goodness gracious, if there are problems in the audit department discovered by Mr. McCarte, certainly Continental should have been told about the Penn Square situation as soon as possible, because that is in the energy field.

Mr. Wortley?

Mr. Wortley. Thank you, Mr. Chairman.

I wonder if we could talk a little bit through the procedure that is followed once you put together a report. Here is 50 to 60 pages in which you have examined the earnings and the capital, reviewed the profit centers, loan portfolio management, liquidity, and assets.

I am looking at the December 6, 1982, report, some very damaging language in here. Second paragraph, the letter to the board of directors, says,

> The examination results show the condition of the institution to be seriously deteriorated.

Another sentence in the next paragraph starts out,

> Current problems can be largely attributed to decentralization of authority without adequate policies, procedures and quality control systems, combined with a management direction that encouraged aggressive growth, but failed to hold managers accountable.

It goes on and on with some very critical things. But once this is completed, who do you deliver this report to in the bank? Do you drop it off to a secretary or take it to the president of the bank, or sit down with the board of directors or just what happens to this report?

Mr. Kovarik. The report, after we complete it, is, in this case, submitted to the multinational division in Washington. A transmittal letter is prepared by the Deputy Comptroller for multinational. It is sent to the bank and it is presented to them formally at a board meeting held with the board of directors sometime after they had received that report.

Mr. WORTLEY. Do you or anybody from the Office of the Comptroller actually sit down in that board meeting and go through this report with them, or is this something that the officers are supposed to relay to the board of directors and it is part of their big meeting agenda, and it gets 1½ minutes of comment?

Mr. KOVARIK. No, sir. We present the report of examination to them covering the high points or the areas that we want to stress. It includes, I think, in the case of the 1982 report, was probably a 30- to 45-minute formal presentation, and then another half an hour or so, maybe even longer than that, of discussion after that formal presentation.

Mr. WORTLEY. So you spent a good couple of hours with the directors, officers and directors of the bank, is that correct?

Mr. KOVARIK. Yes, sir. And that is just at that meeting.

Mr. WORTLEY. In all cases, do you do that, or just when you have a very critical report?

Mr. KOVARIK. No. That would be in all cases of course, the length of time would vary. But all reports are presented to the board of directors.

Mr. WORTLEY. In person.

Mr. KOVARIK. In person.

Mr. WORTLEY. Did you present this one to the board yourself?

Mr. KOVARIK. Yes, sir, I did.

Mr. WORTLEY. Did they have a lot of questions?

Mr. KOVARIK. Yes, sir. I might also say that prior to that meeting, I had held, I believe, two and possibly three meetings with the audit committee of the board, starting in September 1982, September, October.

Mr. WORTLEY. Now, once you have made that report to the board, to the officers, is there any sort of a followup procedure that ensues, like in 60 days or 90 days, do you go back and ask them, what have you done to correct this situation, or that situation?

Mr. KOVARIK. We do a quarterly visitation at all of our multinational banks, any of them. In this case, there was very frequent conversations between our Washington office, myself, and officers of the bank, even after the examination was presented to them.

Mr. WORTLEY. What was their response along the way? Did they say they were pulling up their sox and taking care of this?

Mr. KOVARIK. As I said, to my recollection they instituted every recommendation that we put into the report.

Mr. WORTLEY. They instituted all of the recommendations you put into the report.

Mr. KOVARIK. Yes, sir.

Mr. WORTLEY. And when you went back in 1983, did you find all those situations corrected, or had the ship sprung a leak in another spot?

Mr. KOVARIK. A number of the recommendations were, of course, geared toward improvement in the operations and especially the credit review division—the credit quality section of the bank. Those recommendations were implemented. They were reviewing loans more frequently, concentrating on the much more critical problem of the problem loans.

In 1983, the condition continued to deteriorate.

Mr. WORTLEY. But the condition was still deteriorating. Was this the condition of the old loans that was deteriorating or the new loans.

Mr. KOVARIK. No, sir, it was old loans that were on the books, and were feeling the further effects of the downturn in the economy.

Mr. WORTLEY. But most of the problem that existed in 1983 and in 1984 you are saying were based upon old loans and not on the current or new loans that had come into the portfolio?

Mr. KOVARIK. Yes, sir.

Mr. WORTLEY. Now, do you exchange information in this report with either the Federal Reserve Board or the FDIC? Do you pass on this report of the FDIC—if there is a problem?

Mr. KOVARIK. It is my understanding that those reports do go both to the FDIC and to the Federal Reserve Board. As I said before, during the examinations we conducted on Continental, the Federal Reserve was there, and I had at times daily contact with their examiners while they were in the bank.

I am sure that they are—the report in its entirety is sent to those two agencies.

Mr. WORTLEY. I hope they exchange it more expeditiously than you do within the Office of the Comptroller of Currency, when you don't share information back and forth very well. In your report, you noted that although the lack of quality control is universal for Continental Illinois, this deficiency was most notable within the special industries and real estate groups.

In your opinion, what factors contribute to this and why were they not detected sooner?

Mr. KOVARIK. Well, in the case of the special industries group, a large majority of those credits were the Penn Square credits in the midcontinent division. The system employed at Continental and in most banks that have loan review systems relies to varying degrees on the account officers initiating any information up through senior management with regard to deterioration in individual credits.

I believe in both of those areas, it was a fact that the loan officers were not as fast in putting loans on the bank's watch loan report or bringing them up to management as problems.

Mr. WORTLEY. Was this a management problem or a personality problem, would you say? Was the style of management adequate to cope with this or were they just plain inept individuals not paying attention to their business or trying to cover up their tracks, they were hoping for something better to come along.

Mr. KOVARIK. I think the answer is all of those, depending on which area you are looking at in Continental.

Mr. WORTLEY. But this was essentially in the special industries area, where this problem existed.

Mr. KOVARIK. A great deal of those were in the special industries area.

Mr. WORTLEY. What about the real estate group?

Mr. KOVARIK. I think my recollection is that was the second largest, but it was much lower than the special industries.

Mr. WORTLEY. You noted the earnings were depressed and would remain so until at least 1985. You also mentioned Continental's heavy loan loss provision, income reductions due to nonperformance as either an increased funding cost all adversely affected the ability of Continental to return to normal profitability.

Given these projections, did you recommend any critical supervisory actions be taken at that particular time?

Mr. KOVARIK. I recommended that we institute enforcement action against the bank at that time, yes, sir.

Mr. WORTLEY. You could foresee the events of 1984 taking place?

Mr. KOVARIK. No, sir, I did not foresee those, but as spelled out in the report, there were a number of areas that needed improvement and it was my recommendation that that be reduced to a formal agreement between the bank and our office.

Mr. WORTLEY. Did the bank respond?

Mr. KOVARIK. I am sorry.

Mr. WORTLEY. Was the bank responsive? You made those recommendations. And did the bank take the next action that you had recommended?

Mr. KOVARIK. As I said, they instituted those recommendations; yes, sir.

Mr. WORTLEY. To your satisfaction?

Mr. KOVARIK. When we again examined the bank in 1983, yes, they had complied with every aspect of our agreements with them and all of the recommendations that we had made.

Mr. WORTLEY. Thank you, Mr. Chairman.

Chairman ST GERMAIN. You say that you share your reports with the FDIC and the Fed?

Mr. KOVARIK. Yes, sir.

Chairman ST GERMAIN. Does the Fed share their reports with you of the holding company?

Mr. KOVARIK. Yes.

Chairman ST GERMAIN. You have seen them?

Mr. KOVARIK. I have, yes.

Chairman ST GERMAIN. Do you know when the practice of sharing these reports started?

Mr. KOVARIK. No, I don't.

Chairman ST GERMAIN. Do you share them with the FDIC as well?

Mr. KOVARIK. Our reports, yes. Yes, sir.

Chairman ST GERMAIN. Mr. Patman.

Mr. PATMAN. Thank you, Mr. Chairman.

Miss Kenefick, were you employed by the Continental Illinois National Bank or the Continental holding company?

Ms. KENEFICK. I was, I guess, an employee of the bank directly.

Mr. PATMAN. You were what?

Ms. KENEFICK. I was an employee of the bank.

Mr. PATMAN. You say you guess?

Ms. KENEFICK. I never really thought of it in that distinction. I was an officer of the bank itself, which was a subsidiary of the holding company.

Mr. PATMAN. Mr. Kovarik, did you examine all of these other—do you consider this as an entity with many of its other subsidiaries, or do you simply investigate the bank itself, the Continental Illinois National Bank?

Mr. KOVARIK. We examined the bank and its operating subsidiaries. The Federal Reserve examines the holding company and its subsidiaries.

Mr. PATMAN. Is it your understanding that the extensions of credit that have been made will be guaranteed by the assets of all these other entities that are parts of the holding company?

Ms. KENEFICK. That is my understanding.

Mr. PATMAN. You don't examine at all the holding company itself, the parent company; is that true?

Mr. KOVARIK. That is true.

Mr. PATMAN. Well, does its financial solvency or prosperity enter into your judgment about the bank itself or do you simply examine it based on its own merits?

Mr. KOVARIK. As I said, we do joint examinations with the Federal Reserve, and the Federal Reserve examines the holding company and its subsidiaries. They pass along their information to us. We examine the bank and its subsidiaries and we pass along that information to them.

Mr. PATMAN. In sort of a formal hearing or get together periodically or how often?

Mr. KOVARIK. It is between the examiners in charge or other examiners on the teams. We have—I am trying to remember—I think we have been working with the Federal Reserve in Chicago on our two multinationals back into 1977 or 1978, sometime in that period. But I am not sure exactly when it was.

Mr. PATMAN. And you have apprised the Federal Reserve of all the problems that have been found in the bank?

Mr. KOVARIK. Yes.

Mr. PATMAN. From the beginning. Apparently they go back to 1976, if not earlier; is that not true? Is that your recollection in your examination of the bank, your knowledge of its background?

Mr. KOVARIK. My knowledge of its background showed that it had problems in the 1975–76 period that were decreasing during my 1977 examination.

Mr. PATMAN. Ms. Kenefick, did you ever write any memorandum about the Third World loans; did those ever concern you?

Ms. KENEFICK. No, sir.

Mr. PATMAN. Did you examine them? Were those a part of your responsibility, or did you have knowledge about their previous nature at all?

Ms. KENEFICK. They were not part of my responsibility.

Mr. PATMAN. Did you understand that the bank was concerned about those?

Ms. KENEFICK. I am trying to recall. During the time I was there, I don't recall that a major topic.

Mr. PATMAN. Tell me, did any bank employees, officers or others have an arrangement about which they could take a proprietary interest or an equity interest in any of these businesses to which credit was extended?

Ms. KENEFICK. Let me answer the question perhaps a slightly different way. I believe it was either a policy of the bank or a Federal regulation that the employees were—well—the policy of the bank was that you were not to do as you suggest. To the extent that you wanted a waiver, so to speak, you had to in effect get it approved. So it was not practice then to invest in your customers.

Mr. PATMAN. But to your knowledge were waivers ever granted?

Ms. KENEFICK. I don't have any knowledge.

Mr. PATMAN. Well, you have no knowledge of any instances that were called to your attention or about which you heard reports?

Ms. KENEFICK. No, with respect to Continental employees, no.

Mr. PATMAN. How about Continental Bank itself, did it have the option and did it take advantage of its option to acquire equity interests in businesses to which it extended credit?

Ms. KENEFICK. I cannot think of an instance that I was directly involved with Continental.

Mr. PATMAN. Do you have knowledge of any instances?

Ms. KENEFICK. I have just a general knowledge that in some situations with a problem loan, the bank had occasionally taken warrants, I believe, of stock as part of compensation for reducing interest terms or principal amortization. It was part of the negotiations.

Mr. PATMAN. With prospective borrowers?

Ms. KENEFICK. In the example that I am thinking of, not specific, but in the general context, it was with loans that were problem accounts and as they were trying to work out of the situation there was a negotiation and give and take.

Mr. PATMAN. Were they in business to extend credit in circumstances where it would otherwise be regarded as risky or too risky?

Ms. KENEFICK. What I am referring to was credit was already extended and they were trying to work out of the credit.

Mr. PATMAN. And as a consideration for continuing the extension of credit or not foreclosing, then these inducements were given, these rewards, as you might say, were given? Were they given to the bank or to the employees?

Ms. KENEFICK. It was part of the bank, in effect a collateral, so to speak, security for the loan. It was not directly to the employees of the bank.

Mr. PATMAN. Did those occur in any of the loans that were made to Penn Square?

Ms. KENEFICK. I am not aware of any.

Mr. PATMAN. To Penn Square credits. Let me ask the other gentleman.

You have heard my questions of Ms. Kenefick. Are you familiar with any of those instances during your examinations of the affairs of Continental Bank or any of its subsidiaries?

Mr. McCARTE. I think what Ms. Kenefick is referring to was, if I can try to clarify it a little bit, is a situation where the borrower perhaps is unable to pay the principal and interest owing. It is perhaps an occasion where the borrower will offer shares of stock in lieu of cash or repayment.

Quite often, however, those instances were on credits that actually had been charged of and perhaps it was in terms of book value less than what was originally advanced.

Mr. PATMAN. Were those standard practices? Were those wholesome practices for the banking industry?

Mr. McCARTE. It is just a matter of trying to recoup moneys that are already out to the borrower. The cases that I would be familiar with are instances where the loan had already been made. Now it is an attempt to recover, the company cannot pay through normal cash flow. It is a matter of how do we recover on our original advances. And at times the corporations will offer stock or warrants in lieu of that.

But the examiners would traditionally charge those loans down to the appropriate carrying values.

Mr. PATMAN. Let me ask you three gentlemen who have been examiners or have had occasion to examine these affairs at the bank, and its parent holding company—I suppose not the parent holding company. Are you aware of any employee at the Comptroller's Office that has lost his job or been promoted because of inadequacies in his performance, in this instance of the bank's obviously becoming insolvent or reaching the stage of near insolvency and there being some oversights, if not negligence, on the part of the employees of the Comptroller's Office who examined its affairs and failed in some way in their obligations?

Mr. McCARTE. Personally I am not aware of oversights nor people losing their jobs.

Mr. PATMAN. You are not aware of any oversights or negligence on the part of any of the employees of the Comptroller's Office in their work with respect to Continental Bank. Is that what your statement is?

Mr. McCARTE. It is a very restricted view I could offer, sir. I could not speak for the entire office. I can just speak for——

Mr. PATMAN. To your knowledge there were not.

Mr. McCARTE. The answer is no.

Mr. PATMAN. Is that what you think, Mr. Kovarik?

Mr. KOVARIK. I have no knowledge of anyone.

Mr. MEADE. I don't either.

Mr. PATMAN. In other words, everything that was done by the Comptroller's Office and its employees was in perfect order and fully adequate to the needs of the instance and the job that they had in this case and in all cases regarding the Continental Bank. Is that what you are saying?

Mr. KOVARIK. I don't know of any one.

Mr. PATMAN. All three of you? All right.

Are you aware of any person or persons in the employ of any person who has been or is currently in political office who contacted the Comptroller's Office or any of its employees with the idea, with the purpose of attempting to get you to modify your approach or your judgment with respect to any matter involving the Continental Bank or its parent company or subsidiaries?

Mr. KOVARIK. I am not.

Mr. McCARTE. Nor am I.

Mr. MEADE. I am not aware either.

Mr. PATMAN. May I continue with one thing. Do we need any statutory changes in your judgment in order to handle matters of this nature, in order to protect the public and insure the public's confidence in the safety and security of our financial institutions? Let's take you in order from the left, Mr. Meade. Yes or no?

Mr. MEADE. No.

Mr. PATMAN. If you are aware of any, please provide them. How about you, Mr. Kovarik?

Mr. KOVARIK. I am not aware of any and I cannot suggest any at this time.

Mr. PATMAN. Mr. McCarte?

Mr. McCARTE. The same.

Mr. PATMAN. Where do we draw the line on when you decide whether or not we are going to bail out these depositors with credits above $100,000 or regular deposits with over $100,000? What status, what bank, what status must be achieved by a bank in order to receive that gold-plated assurance from the Federal Government or any branch of the Federal Government, that the depositors will indeed be protected to the full extent of their deposits, whether they are foreign investors, whether they are other banks, whether they are knowledgeable people apparently taking certain risks or what. What is the status, what is the point in the financial status that an institution has to reach in order to provide that guarantee to its depositors?

What about it, Mr. Meade?

Mr. MEADE. I am really not prepared to comment on that. It seems like the bank lost the confidence of those that were providing it with funds and I am not aware of anything that could have been done to instill confidence.

Mr. KOVARIK. I would have to respond almost in the same words. I don't feel qualified to answer a question as to what level that should be.

Mr. PATMAN. Were you frankly surprised the Federal Government did intercede in this case, the Fed, and other parts of the Federal Government, and provide that protection for depositors who had in excess of $100,000 on deposit through the FDIC?

Mr. KOVARIK. No, I wasn't surprised. I don't think—at the point where it took place, I could see, in my opinion any other course.

Mr. PATMAN. It was a decision of historic proportions, wasn't it?

Mr. KOVARIK. Yes, sir.

Mr. PATMAN. Thank you very much, Mr. Chairman, for your indulgence.

Chairman ST GERMAIN. Mr. Hubbard. Wait a minute, Mr. Kovarik—you don't want to be Comptroller?

Mr. KOVARIK. Not tomorrow, please.

Chairman ST GERMAIN. Mr. Hubbard.

Mr. HUBBARD. Thank you, Mr. Chairman.

As this hearing nears to a close, let me express my appreciation to the witnesses—Ms. Kenefick, Mr. McCarte, Mr. Kovarik, Mr. Meade, for your testimony and also for your indulgence.

We have been here more than 4 hours now. We are grateful to you.

This committee referred to Mr. Kovarik's memo which I read with interest—your November 15, 1982, memo to William Martin concerning Continental's condition.

In the third paragraph of that memorandum you say, "It is my opinion that there are two interrelated causes of the present situation." Then I read your following sentences. Would you for the record give those two interrelated causes of the problem.

Mr. KOVARIK. In my opinion they were the aggressive growth philosophy, that was not tempered by the increased safeguards that obviously were needed, and second, the management style which gave a great deal of authority to officers and did not hold them accountable or ensure that they were taking that—the responsibility along with that authority.

Mr. HUBBARD. Again, to Mr. Kovarik, in your last paragraph of your two-page memo to William E. Martin, you say,

Some enforcement action to relate our concerns is appropriate. It should, however, be in line with and take note of what they have already done or have instituted. Further, I have made a strong bid towards getting the bank to be much more open with us. We should take this opportunity to get the flow of information we need started.

Let me just ask you a few questions. Please share with us some information and please be open with us.

How do you require a bank to be open? Do you use the law, for example? Do you take advantage of the law, the cease and desist powers, or, as in this situation, are you saying "please".

Mr. KOVARIK. Yes—the cease and desist powers can be used in that instance. My comments here relate to the fact that my prior experiences with the bank had been that although we always did get the information we required, it was not always on a timely basis and at times was after having to go through various levels of management, many people in the bank, especially at the lower levels.

What I mean by lower levels is maybe assistant vice presidents type level—would at times when we would ask for certain information defer to their boss who would defer to his boss. During the 1982 examination that changed completely and we were given almost everything and anything we asked for immediately.

Mr. HUBBARD. But prior to 1982——

Mr. KOVARIK. It was my experience that we got the information, but at times it was slow.

Mr. HUBBARD. Is that unique as to Continental Bank? Or is this something you experience in other banks?

Mr. KOVARIK. No; each bank is a little unique. It has been my experience that how the bank treats—that is not the right word—but looks at an examiner and how cooperative outwardly they are is usually a reflection on the people at the top of that bank.

In a bank where the chief executive is pleased to see the examiner come in, cooperation is usually full and very timely. At the other extreme is a bank where the president or the chief executive officer does not want the examiners there, they are a bother to him.

Continental fell between those two extremes, if I can put it in that vein. I felt, though, when I wrote this that we had made some great strides during 1982. I had tremendous personal contact with a number of officers in getting information, in getting replies to our requests—much more quickly than we had in the past.

And I wanted to see that continue because of the situation in the bank, and I didn't think we could afford not to have complete access to them at the time.

Mr. HUBBARD. I represent a rural area of Kentucky. If you came to a bank, in, say, Farmington, KY, the Bank of Farmington, your requests of them were not timely taken care of and they continued to pass the buck there at that little bank, wouldn't this give you suspicions that something was wrong there? Or does that just take——

Mr. KOVARIK. It depends on how it was. As I said, each bank is unique. Some just are very proprietary in all their information.

Another thing is in a smaller bank a lot of things that we would ask for in a bank such as Continental, or even banks smaller than that, but still large—in a very small bank we would get ourselves, because the information would be there, it would be very easy to gather ourselves.

When we are talking about an institution with 10,000 employees, at times it is just difficult to figure out or to get to which one employee or which two employees you have to see to get that information.

Mr. HUBBARD. How many employees does Continental Bank have?

Mr. KOVARIK. Today I am not sure. At one time it was as high as 12,000.

Mr. HUBBARD. As high as 12,000?

Mr. KOVARIK. That is my recollection.

Mr. HUBBARD. Quickly, and not wanting to take too much more time, let's talk together about watch loan reports. Who was responsible for putting a loan on the watch loan report?

Mr. KOVARIK. The account officer has the responsibility. His superior would have that responsibility if he felt it should be there. The rating committee of the bank, if they rated it a "D" or if it was a "C" rated credit, it could also ask it be placed on a watch loan.

Any loan criticized by an examiner during his examination was required to be placed on a watch loan.

Mr. HUBBARD. Does it make any sense to have this loan officer who originated the loan responsible for reporting it to senior management if the loan develops a problem?

Mr. KOVARIK. Yes, sir. It does.

Mr. HUBBARD. What incentives are there for a loan officer to put a loan that he or she objected to on the watch loan report and, therefore, bring the fact that the loan had begun to have problems to top management's attention?

Mr. KOVARIK. First of all, it has been our experience that the sooner a loan becomes known as a problem, the better chance there is of working that loan out and maximizing either recovery or repayment on that loan.

Second, in a number of banks the fact that a loan officer would not place something on the watch loan report would be a black mark against him, as it should be. The loan officer not only has the responsibility of making the loan, but he has the responsibility to the bank to ensure that that loan is of the highest quality he can possibly make it, and if it starts to deteriorate, he should let everybody up above him know as fast as he can so that it can be dealt with quickly.

Mr. HUBBARD. Are there any instances where a loan officer was punished for putting a loan on the watch loan lists?

Mr. KOVARIK. For putting one on? Not that I am aware of.

Mr. HUBBARD. This last question—what is the importance of having all loans reviewed on a timely basis and what was the relationship between the loan review process and the watch loan reporting system at Continental?

Mr. KOVARIK. The second part of your question, the relationship between the loan review and the watch loan reporting, as I said earlier, the committee, if it rated it a "D" or if they rated it a "C", they could require that it be placed on the watch loan. Excuse me—I forgot the first part.

Mr. HUBBARD. What is the importance of having all loans reviewed on a timely basis?

Mr. KOVARIK. In order to maintain or to attempt to maintain that quality they should be reviewed—in most places I have seen, and I believe annually is sufficient for a loan that has not deteriorated.

And that is the other reason that you need the loan officer to initiate the watch loan report if it is necessary. For instance, if a loan is reviewed by the loan review department in January, and they call for an annual review of that credit by that body, and troubles begin in June of that year, unless that officer puts it on the watch loan report, it won't get reviewed until the next January, and you would have 6 months pass before it may be brought to light that it is a problem.

Mr. HUBBARD. Again, thank you for being with us, all four of you.

Chairman ST GERMAIN. Ms. Kenefick, I consulted with Mr. Wylie, and he has no further questions of you. Neither do I.

But we do want to express our deep appreciation to you. I would ask you not to charge your attorney too much for allowing him the honor and the privilege to come with you to this hearing, because there are not too many attorneys from out of town who are allowed in this room—so he is very fortunate and he should be very grateful to you.

But don't charge him too much.

Ms. KENEFICK. Thank you.

Chairman ST GERMAIN. Thank you very kindly for your assistance. You are a great citizen and a great lady. You can leave.

I am going to keep chatting with our friends here.

First of all, I would ask unanimous consent to put the charts—capital adequacy, growth of loans, and net chargeoffs to total loans in the record, subsequent to my first round of questioning.

Without objection, so ordered.

Second, Mr. McCarte, you went with the bank in the latter part of June 1982, as I recall, and are still there now.

Mr. MCCARTE. Correct.

Chairman ST GERMAIN. At the time you went with the bank was it for an increase in salary, and better benefits, or were there other reasons for your leaving the Comptroller's Office and going into private industry?

Mr. MCCARTE. Well, for a variety of reasons, I suppose. I mean there was the incremental increase in my salary. There seemed to be greater opportunities for growth, not only monetarily, but nonmonetarily.

Chairman ST GERMAIN. At the time you made that decision, you obviously had another offer from outside the region, so you obviously felt in 1982 when you made that decision as a bank examiner with the Comptroller's Office that Continental Illinois, as you just stated, would be an opportunity for you to grow in many ways, and, therefore, you must have had confidence in the condition of Continental.

Mr. McCARTE. That is correct.

Chairman ST GERMAIN. OK.

Mr. Kovarik, you told us about seeing the Kenefick memo in August 1982.

Mr. KOVARIK. I believe August or September.

Chairman ST GERMAIN. How did that come to your attention? She told us she had given a copy to Mr. Lytle, one to Mr. Rudnick, and one to her successor. Did one of those gentlemen give you that memo, or how did it come to your attention?

Mr. KOVARIK. No, sir; I was reviewing the work papers that the phase I review committee of Continental had done, which covered the officers of the bank following Penn Square. Those work papers were made available to me, and that memo was included in them.

Chairman ST GERMAIN. Now, Mr. McCarte, you say significant credit quality and loan documentation deviations. Talking about Penn Square, do I get the impression that in your opinion the loans that proved to be almost worthless at Penn Square were one of the major causes of the problems of the midcontinental division of Continental Illinois?

Mr. McCARTE. Yes, sir.

Chairman ST GERMAIN. The reason I ask that question is because I look here and I see that significant credit quality and loan documentation deviations—which were spotlighted by the Penn Square National Bank failure in July 1982. However, these problems were not limited to oil and gas alone.

The 1982 Continental examination report classified $3.6 billion in loans as substandard or as loss. Now, let's go back just to energy.

Of these, $1.2 billion were oil and gas loans with Penn Square related classified loans totaling $620 million. Now, $620 million to a $40 billion institutional really isn't that much, is it?

Mr. KOVARIK. If you look at the portion that was doubtful and loss in that $620 million, it was very significant, though. My recollection is that of the $230 million in total loss, at the 1982 examination, I believe it was approximately $150 million that was related to Penn Square.

Chairman ST GERMAIN. This is in the energy field or in the overall exam?

Mr. KOVARIK. In the overall examination, $230 million was classified as loss.

Chairman ST GERMAIN. How much of that was in the energy field?

Mr. KOVARIK. I am not sure how much was in the total energy field, but I believe that Penn Square's portion was $150 million, or thereabouts.

Chairman ST GERMAIN. But obviously there were oil and gas, $620 million related to Penn Square classified loans out of a total of $6.2 billion, so you have approximately $500 million in energy, oil and gas related loans other than Penn Square that were classified, is that correct?

Mr. KOVARIK. Yes. Was the figure used $5.6 million?

Chairman ST GERMAIN. No, $1.2 billion were oil and gas loans with Penn Square related classified loans totaling $620 million, the difference being about $500 million.

Mr. KOVARIK. Oh, OK, yes.

Chairman ST GERMAIN. So that $100 million would be other energy related loans that were classified?

Mr. KOVARIK. Yes.

Chairman ST GERMAIN. Penn Square was unique, let's face it, a lot of banks decided not to buy Penn Square loans, right?

Mr. KOVARIK. Yes.

Chairman ST GERMAIN. Because they met Wild Bill Patterson? Did you ever meet Wild Bill Patterson in your examinations and meanderings on Continental?

Mr. KOVARIK. No, sir, I have not.

Chairman ST GERMAIN. I can't find the testimony, but someone sat at this table and told us they by chance he met Wild Bill Patterson at the water cooler at Continental and decided to do business with him. You know, it seemed so odd that that chance meeting would come about in that way. But it seems as though truthfully—and as you know, we looked at Penn Square thoroughly—that Penn Square loans were pretty much reaching in like a grab bag and hoping you got a bag that had a prize in it that was worthwhile.

Does that tell us that the energy lending department of Continental for a period of time was either understaffed or not properly staffed, not technically qualified, technically competent or that they were just not doing the job they were supposed to do as far as examining these loans were concerned?

Mr. KOVARIK. If we can just talk about the non-Penn Square loans.

Chairman ST GERMAIN. Non-Penn Square, yes.

Mr. KOVARIK. Continental had a history of lending on reserves, oil and gas reserves, as most banks had. If you remember between 1981 and 1982, there was a drop in oil prices, so the value of their collateral was reduced, causing first that diminishment of collateral; second, sales of oil and gas products were declining so these companies were facing losses, their balance sheets were deteriorating, so that the loans outside of Penn Square in my opinion were more related to the fact that the price of oil had dropped, sales had dropped, and these companies were experiencing financial difficulty.

Chairman ST GERMAIN. Mr. McCarte, you told us that you requested in your budget for the 1982 examination additional moneys, as well as an expert from one of our other regions to look at these energy-related loans in oil and gas, which indicates that you must have had some evidence before you.

Was it just because of the decline in the price of oil and gas or did you have other reasons for asking for additional funds to look into the Penn Square loans and for asking for an expert from the Oklahoma area on oil and gas loans?

Mr. MCCARTE. The reason we requested additional resources or an expert, to use your term, somebody more familiar with the energy sector, was for a combination of reasons. The energy prices were softening, the bank was a major lender to the energy sector, and the fact that in the Chicago subdistrict, we did not have any examiners with any hands-on experience in that particular side of the business. So the combination of all those things just justified or seemed to suggest that as we went forward that we would be better off with some outside help.

Chairman ST GERMAIN. Let me ask all three of you this question, let's look at Continental and let's look at Penn Square, but merely as a model or example.

You go in and you examine with a peak team of 50 at one point in time and other times, you are down to 12, 10-12 people. How—absent a call from the Washington Office as a result of a call from the Dallas Office, absent that type of red flag waving—how can you discover independently the type of problems that existed at Penn Square? We keep harping on this. It is an unusual situation that these two banks are interrelated with their problems.

By the same token, it gives us a model we can look at without having to be fearful of naming Penn Square because we have to be cautious not to name other borrowers who may have been classified or had classified loans as Continental did. So it makes it a little easier for us.

First, Mr. McCarte, let me ask you, in your experience as chief examiner, how does the Comptroller's Office discover or arrive at the fact that there might be problems with these loans? We know what happened at Penn Square. Penn Square Bank was paying the interest on nonperforming loans, so they could continue selling new participations to Continental without telling Continental that the previous participations were not performing.

Does the Comptroller in an examination have the capacity to discover something like that?

Mr. MCCARTE. Well, I think your question was without somebody calling stating that they have this specific problem, how would you do that?

Chairman ST GERMAIN. Absent an indication from Penn Square, for example? This could be Penn Square, or it could be the Zippety Doo Dah Machinery Co. that has international sales and is a heavy borrower.

Mr. MCCARTE. Right. The primary way I think that examiners establish an asset problem is through direct review of the credits. Now, if the scope of the review that is being performed is not sufficient to encompass those credits, they could go undetected unless the account officers would offer up a watch list report on them.

So, in other words, rephrased, in the 1981 examination, the scope of what we did was $10 million and over, C&D rated credits, past due, nonperforming, plus two samples taken totaling 120 outstanding items. If by chance the Penn Square credits did not fall within the sample, over $10 million, past due, or nonperforming, they could go undetected.

We just happened to stumble across the fact that there was $300 million in the bank when they were there in June—or in 1981, sorry.

Chairman ST GERMAIN. Mr. Kovarik.

Mr. KOVARIK. If I could answer through the sampling method, if something like that would go undetected, it would not be significant—I can't say for certain—but even the $300 million that Mr.

McCarte looked at in June 1981, I am sure some of that would have come up on the sample just because of the total size of that, so it would have been much less than that for it to slip through our sample when we are looking at somewhere in the neighborhood of 70 percent of the outstanding dollars at a Continental or a bank that size, the majority of the loans that we don't look at are very small in dollar amount. And I am talking about very small, I am talking about less than $1 million for the most part.

Chairman ST GERMAIN. You fellows——

Mr. KOVARIK. I agree; that is not small to me personally, but in the scheme of Continental, if you look at capital of $2.2 billion and take a $1 million loan, how many of those $1 million loans does it take to get up there?

Chairman ST GERMAIN. Right.

Mr. KOVARIK. I think our line cut at $10 million, and sampling techniques gave us great coverage. I think what you are getting at is—maybe what I am interpreting your question to be is, if nobody would have said anything about Penn Square, say it wouldn't have failed, would we have found it? I think we would have, yes.

Chairman ST GERMAIN. Mr. Meade?

Mr. MEADE. I might add that in addition to those factors that were enumerated before, you know, examiners are expected to be aware of the environment in which we are operating. I mean, a softening of energy prices is something that should prompt a typical examiner to maybe pay greater attention to that sector of the portfolio.

Other factors that may be a basis for looking deeper in a particular area are—as if there has been a change in management in that area, we might want to take a little closer look than if, you know, there hasn't been those changes.

Another factor may have been to look at the bank's history of chargeoffs or in that area where they generally have difficulty in that area.

Another factor would be the sheer growth and volume where you want to look at it a little closer if it was growing real fast as opposed to a department where the outstandings were perhaps running off.

It is a lot of those factors, coupled together that—coupled with examiner judgment which we are encouraged to use, utilize, that would probably preclude us from missing, you know, any significant amount of those credits.

Chairman ST GERMAIN. Now the lady whom we allowed to leave pointed to a number of deficiencies in a memorandum—but the fact is that was not news to us because those loans were the subject of a report prepared by the special litigation committee for the board of directors. We know this from the Penn Square hearings as well, that the documentation and the ordinary information that is usually required was not present. The number of people who are supposed to look into particular participations prior to committing themselves to lending the money or making the commitment until after thorough investigation, were not utilized. This is what occurred with the Penn Square loans.

In other words, I mean what I said earlier, they were like a grab bag. They reached in blindly. It was more like playing that game where you pin the tail on the donkey. Isn't that a fact, that that is what many of those loans were that Continental bought from Penn Square, that they really didn't know what the quality of the loans were, but they knew the interest rates they were getting on those participations were high, and that was sort of an incentive?

The people who made those statements and those conclusions, are they in error, gentlemen?

Mr. KOVARIK. I don't think they are in error.

Chairman ST GERMAIN. OK. Now, that being the case, absent the Ms. Kenefick memo, which as you said, you wish you had seen before—absent Ms. Kenefick's memo, how, under the procedures you describe for us, do you discover the fact that certain loans and certain procedures that should be followed are not being followed—how do you conclude that?

Do you have a methodology for discovering that as well?

Mr. KOVARIK. Yes, sir. When we do an examination as we said, we would look at certain loans. If those loans came up in any portion of the loans over our cutoff, they had been listed previously as problem loans by the bank, were past due, nonaccrual, or came up in our sample—and when I get to the sample I am talking about loans below $10 million for Continental; I am talking about a loan that is not perceived by the bank to be a problem, is not past due, is not a nonaccrual, is outwardly a good loan, OK?

If a loan would not fall into one of those categories or group of loans would not fall in, it would be a very small portion.

Chairman ST GERMAIN. What were the total loans on, participations classified for Penn Central? Wasn't it $300 million?

Mr. KOVARIK. From Penn Square, sir?

Chairman ST GERMAIN. Yes, sir.

Mr. KOVARIK. Classified was $620 million.

Chairman ST GERMAIN. $620?

Mr. KOVARIK. Right.

Chairman ST GERMAIN. Were those loans all under $10 million each?

Mr. KOVARIK. No, sir.

In 1982 those would have—a number of those would have been over $10 million. A number of those, assuming that they were not past due and knowing that they were not on the watch loan report, would have turned up in the sample and——

Chairman ST GERMAIN. Were some of those in the August 1981 examination? Was it August 1981?

Mr. MCCARTE. It was April 30.

Chairman ST GERMAIN. In the April 30 examination?

Mr. KOVARIK. I have no knowledge of the oil loans on April 30, 1981.

Chairman ST GERMAIN. Were some of them there, Mr. McCarte?

I am not trying to be critical of any of you people. What I am getting at is the procedures that you are armed with—I shouldn't say "armed with,"—that you were supplied with. Let's go back to the 1981 examination; what were the number of classified loans in Penn Square at that point or were there any?

Mr. MCCARTE. In 1981 we had no credit from Penn Square that was classified or criticized.

Chairman ST GERMAIN. None were classified or criticized?

Mr. McCarte. Not at that time.

Chairman St Germain. In that sampling, some of the Penn Square loans fall into your sample?

Mr. McCarte. I just don't recall if there were any Penn Square-related credits that came up in the sample.

I recall that we had a series of credits that were secured by standby LC's and specifically how large they were or the number of them—I just remember the total.

Chairman St Germain. I will ask my staff to review those examination reports to see if indeed that was the case. Maybe Mr. Conover can explain that to us tomorrow. I am sure he would like to do that. Mr. Kovarik, there was a Mr. Perkins at Continental.

Mr. Kovarik. Yes, sir.

Chairman St Germain. Ms. Kenefick and Mr. Meade.

Mr. Meade. Mr. Perkins was the president.

Chairman St Germain. And Mr. Anderson?

Mr. Meade. Right. They had just taken over.

Chairman St Germain. Mr. Perkins is the one who testified. He testified on behalf of the ABA, and we were sort of contentious. In fact, one time we had a picture taken together here and it appeared on the front page of the ABA magazine and my next opponent said because of that I was a friend of the big banks.

Getting back to Mr. Perkins and Mr. Anderson, Mr. Meade, did you ever go into the office of Mr. Perkins and Mr. Anderson to discuss your examination report with them?

Mr. Meade. I did following each examination with one of them or both of them.

Chairman St Germain. Mr. Kovarick explained to Mr. Wortley the meetings with the board of directors. I didn't want to interrupt Mr. Wortley, but I was wondering in addition to that, did you meet with the chief executive officer ordinarily or one of them, the chairman of the board of the president, to discuss the exam and whatever deficiencies there were?

Mr. Meade. Yes, very definitely.

I might point out I did not meet with the board of directors when I did the examinations. That was not our requirement at the time and I did not meet with them.

Chairman St Germain. When did that requirement come in?

Mr. Kovarik. In 1976.

Chairman St Germain. 1976, just after you.

Mr. Meade. Right about then, yes.

Chairman St Germain. Mr. Kovarik, how about you and Mr. Perkins and Mr. Anderson?

Mr. Kovarik. Did we meet? Yes.

Chairman St Germain. Did you meet personally with them to discuss these reports?

Mr. Kovarik. Yes, sir.

Chairman St Germain. Was this after each examination?

Mr. Kovarik. Yes, sir.

Chairman St Germain. You met with each of them?

Mr. Kovarik. Right at the conclusion probably; within the last week of the examination.

Chairman ST GERMAIN. It was part of the examination, is that what you are telling me, or did you met with them to discuss the report of the examination?

Mr. KOVARIK. It was both, to discuss the report and also to get their views on the future.

Chairman ST GERMAIN. And would they be receptive to your recommendations in the areas where you felt changes or improvements should be made?

Mr. KOVARIK. Yes, sir; they were.

Chairman ST GERMAIN. You had no problems with them?

Mr. KOVARIK. No, sir.

Chairman ST GERMAIN. You said there were three; some, no cooperation; others, cooperation; others, very cooperative.

Mr. KOVARIK. No.

Chairman ST GERMAIN. You would rate them a 10 on a Bo Derek scale?

Mr. KOVARIK. No, sir. On a Bo Derek scale I would not.

Chairman ST GERMAIN. I mean as to cooperation.

Mr. KOVARIK. In cooperation? As I said before, they fell somewhere between that. I mean the bank fell somewhere between that full——

Chairman ST GERMAIN. On a scale of 1 to 10.

Mr. KOVARIK. Five. Before 1982.

Chairman ST GERMAIN. Right. Subsequently?

Mr. KOVARIK. Ten and a half.

Chairman ST GERMAIN. They needed you.

Mr. McCarte? Did you meet with Mr. Perkins and Mr. Anderson in your capacity as the chief examiner at the bank?

Mr. MCCARTE. We would have had meetings, yes.

Chairman ST GERMAIN. I asked you if you did?

Mr. MCCARTE. Yes.

Chairman ST GERMAIN. OK.

Mr. MCCARTE. There may have been a meeting—at one point in time, to be perfectly honest, maybe Mr. Perkins may have been out of the bank.

Chairman ST GERMAIN. If he were not there, did you meet with Mr. Anderson to discuss the report?

Mr. MCCARTE. Absolutely, yes.

Chairman ST GERMAIN. What was your perception of cooperation?

Mr. MCCARTE. Positive.

Chairman ST GERMAIN. Mr. Wylie.

Mr. WYLIE. Thank you, Mr. Chairman.

Our witnesses have been very patient and we thank you very much for your testimony. It has been very revealing to this member. I think you are all to be commended for a job extremely well done.

I am not going to take any more of your time, but I would ask unanimous consent of the Chair to include in the record three pages from the Comptroller of the Currency's report of December 6, 1982, pages 42, 43, and 44, having to do with the internal controls.

[The information submitted for the record by Congressman Wylie from the Comptroller of the Currency's report of December 6, 1982, regarding internal controls follows:]

INTERNAL CONTROLS

Our review of Internal Controls reflects an overall satisfactory condition, with regard to the accounting controls employed. However, as pointed out by recent events, the administrative controls have not functioned properly in the lending area.

If the administrative controls had worked, the magnitude of the Penn Square problem could have been greatly lessened. Management, in its review (Phase II) has recommended numerous changes which, if implemented will enhance the bank's administrative control system. These include: increased monitoring of non-possessory collateral; revised collateral deficiency requirements; enforcement of complete collateral documentation on participation loans; reporting of participation concentrations; among many others.

Additionally, a number of recommendations were made to review and upgrade the Management Information Systems employed and to design additional systems to aid in monitoring global exposures, exception and past due information, and improve accounting systems to further allocate capital and loan loss reserves to individual lending units.

The major recommendation proposes to improve administrative control by establishing a Credit Risk Evaluation Division. This Division would provide management and the Board an independent, internal review of credit quality and be available to pursue special projects for such groups as the Credit Policy Committee.

Phase II was a comprehensive review, and the recommendations presented should be implemented wherever feasible.

INTERNAL-EXTERNAL AUDIT ACTIVITIES

The competence, independence, adequacy, and overall effectiveness of the bank's internal and external auditors were evaluated in order to determine the acceptability of their work. As a result, both the internal and external audit functions are considered fully acceptable.

During examination, the management team formed to review the bank's involvement with the failed Penn Square Bank recommended that Executive Vice President William D. Plechaty replace Edwin J. Hlavka as the bank's Auditor. Mr. Plechaty had served as Auditor from 1969 to 1972, and more recently managed the Personal Banking Services Division.

In another change recommended by the management team, the Loan Administration Division will report to the Auditor; however, the manner in which this function will operate will be determined after the management team concludes its review of the bank's policies, procedures, internal controls and practices. Aside from the integration of the Loan Administration Division, Mr. Plechaty does not envision any other immediate, significant changes in either the Auditing Division's structure or personnel.

The examination of the Auditing Division first focused on the following areas: Cash Accounts, Compliance with 31 CFR 103, Due From Banks, Bank Premises, Other Assets/Other Liabilities, Deposit Accounts, Consigned Items, Employee Benefits, Insurance Coverage and Review of Regulator Reports. Later the scope was expanded to include more audits performed under the supervision of each of the four audit managers. Audit procedures, reports, and supporting workpapers were organized and documented in accordance with divisional standards. The audit reports, which are issued at the conclusion of each audit, are distributed to the management of the area audited. Written responses are required for all exceptions noted, and these responses become part of the permanent audit file.

When the scope of the examination was expanded, twenty additional audits were reviewed. In two of these audits, the same or very similar exceptions were noted in each of the last three audit reports. In both instances the corrective action indicated in the management responses to each of the audit reports was not implemented. While it is agreed that the continuation of these particular exceptions is not likely to adversely impact the financial condition of the bank, the failure of management to implement the indicated corrective action detracts from the overall effectiveness of the audit function. In order to insure that audits requiring the attention of management are acted upon in a timely and uniform manner, it is recommended that the Auditing Division clearly identify and label all recurring exceptions, and also consider the development of a ratings system for both individual deficiencies and the overall audit. As part of such a system, it is recommended that management of a higher level be required to respond to deficiencies which exceed a predetermined rating. The implementation of a ratings system that calls for the more direct involvement of senior management would contribute towards increased accountability and a reduction in the number of recurring exceptions.

The bank's external audit function continues to be performed by the public accounting firm of Ernst & Whinney. The 1981 audit included a review of the bank's systems for internal control and revealed no significant weaknesses. The firm expressed an unqualified opinion on the bank's year-end 1981 financial statements, and has been retained for the 1982 annual audit.

Mr. WYLIE. I would like for your specific comment on the fact that some changes were made in internal controls and were observed and noted there and maybe why changes were noted and recommended, and if that indicated that at that time there was something wrong.

You may have noticed this morning I sort of concentrated on this internal control operation at the bank to see if that is a place where we should look to future endeavor, vis-a-vis, the House Banking Committee.

So, with that, Mr. Chairman, thank you very much. I have no further questions.

Chairman ST GERMAIN. I also want to add my thanks and my congratulations to you. You are all in great physical condition and you did quite well. You were very helpful and we are seriously most appreciative.

We do have additional questions which we will submit to you in writing, but that will save you from having to sit here another 2 hours, so I figured you won't mind answering the questions in writing that are referred to you.

I would like to make a point here. I read quite a few articles discussing the fact that the hearings were starting today and you read quotes from all kinds of bankers and their opinion as to why you were the leadoff witnesses with the delightful Ms. Kenefick.

All of their speculation was so far off target, including the financial press writers using their crystal balls, trying to decide why you were the leadoff witnesses. Very plain and simple, you are the examiners. It makes sense—to start at the beginning and you are the beginning.

So, to all those speculators out there and those pundits and what-have-you, gosh, they ought to relax and just look at logic, pure, simple logic, and they wouldn't have to write these ridiculous stories with all kinds of speculations that make me laugh.

So, gentlemen, we thank you because you gave us the foundation; you are the beginning, and we go on from here.

You have been most helpful. Thank you.

The subcommittee stands adjourned until tomorrow morning, when we will have the Comptroller of the Currency as our witness, at 10 o'clock.

[Whereupon, at 2:43 p.m., the subcommittee was adjourned, to reconvene at 10 a.m., Wednesday, Sept. 19, 1984.]

[A copy of the letter of invitation of witnesses to testify from the Office of the Comptroller follows:]

FERNAND J. ST GERMAIN, R.I., CHAIRMAN
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U.S. HOUSE OF REPRESENTATIVES

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION AND INSURANCE
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
NINETY-EIGHTH CONGRESS
WASHINGTON, D.C. 20515

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DAVID DREIER, CALIF.

September 11, 1984

Honorable C. Todd Conover
Comptroller of the Currency
490 L'Enfant Plaza, S.W.
Washington, D.C. 20219

Dear Mr. Conover:

To assist this Subcommittee in its inquiry regarding why Continental Illinois National Bank came to require federal assistance, you are requested to authorize and arrange for John Meade, Richard Kovarick, and Allan McCarte to appear before this Subcommittee on September 18, 1984, at 10:00 a.m., in Room 2128 of the Rayburn House Office Building. Each individual is requested to provide testimony on the examinations of Continental Illinois National Bank from 1976 to 1983 for which he served as Examiner-in-Charge.

If the individuals named have prepared statements, you are asked, as required by Committee rules, to deliver 175 copies of each prepared statement to Room B303 Rayburn before 12:00 p.m. on September 17, 1984. To enable all Subcommittee Members sufficient time for questioning, it is requested that oral testimony be limited to 10 minutes. Each prepared statement will be distributed to all Members of the Subcommittee in advance of the hearing and will be included in its entirety in the hearing record.

Sincerely,

Fernand J. St Germain
Chairman

FJStG:jOe

cc: William Ogden
Chairman of the Board
Continental Illinois National Bank

INQUIRY INTO CONTINENTAL ILLINOIS CORP. AND CONTINENTAL ILLINOIS NATIONAL BANK

WEDNESDAY, SEPTEMBER 19, 1984

HOUSE OF REPRESENTATIVES, SUBCOMMITTEE ON FINANCIAL INSTITUTIONS, SUPERVISION, REGULATION AND INSURANCE, COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,

Washington, DC.

The subcommittee met, pursuant to call, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Fernand J. St Germain (chairman of the subcommittee) presiding.

Present: Representatives St Germain, Annunzio, Hubbard, Barnard, LaFalce, Vento, Patman, Neal, Cooper, Wylie, Leach, McKinney, Shumway, and Wortley.

Also present: Representatives Kleczka and Roemer.

Chairman ST GERMAIN. There are usually few silver linings around the edges of major bank failures. But, I will admit that failures—and the suggestion that the Congress wants to ask questions—seems to stir the sleeping giants of the Federal bank supervisory bureaucracy.

Back in 1973, I was very concerned about the plunder at U.S. National Bank in San Diego, CA, and I announced my intention to have the Financial Institutions Subcommittee look into that failure in detail.

No sooner was my announcement on the street than the then Comptroller of the Currency, Jim Smith, came up with a grandiose plan for what he called a retroactive analysis of the OCC. Eventually this analysis was turned over to a consulting firm—Haskin and Sells—at a price. They delivered a hefty document calling for a brandnew system for grading bank performance and what was dubbed—in the very best public relations fashion—an "early warning" system.

For a long time, that "early warning" system was the centerpiece at OCC. If a problem arose in the supervision of national banks, we were told that the "early warning" system was being developed and that in the future—unspecified, of course—that would take care of the problem.

The committee has never been sure just what the early warning system warned the OCC about. * * * These days OCC seldom mentions early warnings in explaining away its problems. Maybe we should be thankful, for the sake of national security, that OCC didn't peddle their system to the Defense Department.

In the wake of Continental, we see the OCC stirring once again. At one time the mere thought of an examination report being mentioned in front of a new reporter would send the OCC into apoplexy. But, in recent days, we have been treated to the sight of senior officials discussing the contents of examination with Washington reporters—albeit selected passages. Mimeographed documents discussing the supervisory procedures have been circulated around the city, and the Comptroller, himself, has been out on the hustings talking about strengthening capital, increasing disclosure, improving examination techniques, and strict enforcement policies. Such stirrings.

The New York Times has been so lacking in generosity as to suggest that some of this activity is designed to "preempt the congressional hearings." I won't be so unkind. I'm just happy to see the agency talking about better supervision whatever the motivation.

But, it is not enough to gin up the supervisory vigor just while the spotlight of congressional oversight and media attention is focussed on OCC. It has to be a full-time, 12 months a year operation.

Frankly, I am not sure that either the supervisory bureaucracy or the banks really get the right message out of Washington.

We often see Presidents—of both parties—delay and ignore appointments to key posts in the Federal financial supervisory system. The present Comptroller, for example, did not take office until the last days of 1981—7 months after his predecessor had resigned. This kind of delay sends a message down through the ranks and among the industry that OCC regulates.

In 1982, right at the height of bank problems nationwide, the number of OCC examiners dropped to 1,835 compared with 2,282 in 1979. Apparently, alarmed by continuing supervisory problems the number crept back up to 2,080 last year. But, these cuts in personnel couldn't have sent a message of vigor and concern to the personnel on the firing line of the examination process.

While his staff was being reduced, Mr. Conover became something of the Marco Polo of Comptrollers—appearing coast to coast with a ready speech in hand. Many of these pronouncements seemed less about bank supervision than they did about the big banks' legislative wish lists in the Congress. The big concern, if one followed Mr. Conover's trail from city to city, seemed to be about less regulation, less Government—presumably less OCC—and more power for the banks.

At times, Mr. Conover seemed to take on more the role of a cheerleader for the industry than he did that of a regulator. This, too, must filter down through the ranks of the agency. Does the examiner, about to write a sharp directive to a bank's board of directors, hear the echoes of "Get the Government off the backs of the banks" and decide to take the softer line?

While I personally dissent, there may be some who feel that the industry does, indeed, need a Government sponsored cheerleader. If so, I don't think it is appropriate that cheerleading and regulating be combined.

The highly costly nature of the sweeping bailout of Continental should establish, once and for all time, the fact that every citizen in this Nation has a stake in a solid regulatory system. We should hear fewer arguments that regulatory standards should be based solely on industry needs and desires.

Yesterday's testimony did not increase confidence that OCC has gotten its act together. Even when the information was in hand—the problem spotted—OCC seemed paralyzed, unable or unwilling to force remedial action. And communication within the agency—much less between agencies—still seems to be something that predates Alexander Graham Bell. Despite our best efforts in the Penn Square hearings and yesterday's session, we still can't be sure just when, and how thoroughly the message about the disaster in Oklahoma City reached Chicago, Seattle and other points that had been infected by the Penn Square plague.

Leaving aside any thought of partisanship, I am firmly convinced that we must start sending a stronger and clearer message about the need for no nonsense, hard-nosed regulation of financial institutions that utilize Government insurance and enjoy other Federal subsidies. The message has to come from the top—the White House and the Congress both. And it must be echoed—with no equivocation and no mixed messages—by the Federal regulatory agencies.

Our witness today, C.T. Conover, is an essential link in that communication link—the kind of message he sends to his troops and to the banks has a lot to do with the quality of regulation.

The Chair now recognizes Mr. Wylie.

Mr. WYLIE. Thank you, Mr. Chairman.

I want to thank the Comptroller of the Currency for his appearance here today and for your excellent statement.

As I said in my opening statement yesterday, this is an extremely serious matter. It deserves thorough congressional oversight, and it does raise some profound issues for this committee to explore for the future.

I am pleased that you, Mr. Conover, have acknowledged these issues up front in your statement where you say that the Continental case deserves a thorough review by both Congress and the public. Let me say that I am hopeful that the administration, Members of Congress, the regulatory agencies and the public will benefit from these hearings.

In my view, we need to learn precisely what factors contributed to the deterioration of Continental Illinois to the point where this unique Federal assistance was required. More importantly, perhaps, we need to consider what measures might be taken in the future as to prevent a similar situation from occurring. We should make certain we do not create the expectation that as long as an institution is big enough, there will be no limit to the amount of risk the Federal Government will accommodate.

Mr. Conover, I was particularly encouraged by your statement because on page 21 and throughout your testimony, you stress seven key issues which not only are pertinent in Continental's case, but also of a larger meaning for the safety and soundness of the banking system in the United States.

I will want to return to these areas in my questions, but you have identified the salient points. (1) supervisory techniques; (2) internal controls; (3) loan loss reserves; (4) capital levels; (5) funding; (6) financial disclosure; and (7) enforcement policy.

Mr. Chairman, these hearings are unprecedented since Continental Illinois is an open, ongoing bank which should have an excellent chance to put its own house in order and rid itself of what I am sure is unwanted Federal assistance, as well as Federal intrusion. I am sure that I speak for all Members of my side of the aisle when I say that we hope that Continental prospers and likewise that we do not have to repeat this experiment.

Hopefully, these hearings will be the kind of learning process from which we can all benefit. Thank you very much, Mr. Chairman, for affording me the opportunity to make this opening statment.

Chairman ST GERMAIN. Chalmers, I want you to know that I and the Members on our side, as well, are hopeful that we need not have another hearing of this type and that we need not have another bailout of the magnitude and of the character we have seen in this instance. So we are in total sync on this.

Mr. WYLIE. We are presenting a united front on that score. Thank you, sir.

Chairman ST GERMAIN. Would you please rise, Mr. Conover.

[Witness sworn.]

Chairman ST GERMAIN. Mr. Conover, we will put your entire statement in the record, along with the appendages thereto. You may proceed.

TESTIMONY OF HON. C.T. CONOVER, COMPTROLLER OF THE CURRENCY

Mr. CONOVER. Thank you, Mr. Chairman.

Mr. Chairman, I would like to read excerpts from my written statement as my opening remarks. And because of the importance of this subject, I ask your indulgence as to time this morning. I think this will take about 20 minutes.

Chairman ST GERMAIN. We agree wholeheartedly.

Mr. CONOVER. Fine. Thank you very much.

Mr. Chairman, members of the committee, I am pleased to be here to discuss Continental Illinois National Bank & Trust Co. The serious problems encountered by Continental and the regulators' actions concerning Continental are obviously a matter of public concern and deserve a thorough review by Congress and the public.

Today, I will address what happened at Continental by first describing the economic factors that have buffeted Continental—and other banks—since 1980. These include back-to-back recessions as well as a sharply declining energy industry. Second, I will briefly review the internal policies and practices at Continental that rendered it incapable of weathering these adversities. Third, I will discuss what we could have done differently. Finally, I will focus on what we are doing to assure the continued safety and soundness of the banking system.

The 1980's have been difficult years for the banking industry. In early 1980, a recession caused real economic growth to drop sharply. By mid-1980 the economy was growing again, but that recovery only lasted 12 months. In mid-1981, the economy fell back into a recession that lasted 17 months.

Although the economy as a whole is now experiencing a strong recovery, the pattern of back-to-back recessions was particularly hard on lending institutions. Loan quality typically begins to deteriorate after an economic slowdown begins, and continues to decline well into the recovery. Many loan portfolios thus have continued to deteriorate since 1980, and many banks are still having problems stemming from the recessions.

In addition to having to contend with the effects of the two recessions, many banks have also been affected by the severe problems in the energy industry over the last few years.

Most U.S. banks have weathered these difficulties with impressive resilience, but almost all have felt some impact. Return on assets and return on equity are down for the industry as a whole. Asset quality is still suffering, with net loan losses rising even faster for large banks than for small.

The difficult economic environment had a particularly devastating effect on Continental. Its problems stemmed from management strategies and policies that depended on strong growth in the economy in general and the energy industry in particular. These strategies and their consequences are detailed in the appendix to this testimony. In sum, Continental adopted a policy of rapid growth that was not accompanied by the necessary management controls and policies to maintain adequate asset quality in the face of an economic slowdown and a declining energy industry.

In implementing this goal, Continental adopted a strategy of decentralized lending that permitted its account officers to respond to customers and make loans more quickly and competitively. Although this approach required fewer controls and levels of review, management believed the potential rewards of such a strategy outweighed the associated risk.

Continental's management targeted the energy sector for its most aggressive lending expansion. During the latter half of the 1970's, the United States was attempting to develop a program for energy self-sufficiency in the face of uncertainty about actions of the OPEC nations. At that time, some economic analysts were projecting the price of oil to increase to some $60 a barrel.

Continental's management strategy of rapid growth with a specialty in energy was quite successful for several years. During the late 1970's, Continental outperformed its peers in growth, earnings, and market perception, and its loan loss record was excellent. In 1978, "Dun's Review" described Continental as one of the five best managed companies in America.

In 1981, the very strategy that generated praise began to turn against the bank. A slowing economy meant that the quality of available lending opportunities was deteriorating at the same time that Continental was increasing its corporate lending, inevitably resulting in the making of loans to weak borrowers. By 1982, it became clear that the bank's rapid growth had been achieved at the expense of asset quality.

The declining energy industry in late 1981 dealt a particularly serious blow to Continental for two reasons. First, it had a heavy concentration in oil and gas loans that left the bank extremely vulnerable to the industry's sudden decline. Second, from 1980 to 1982, the bank had purchased a large volume of energy loans from Penn

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Square Bank, N.A. The quality of these loans proved to be very poor, particularly those loans that were purchased in late 1981 and early 1982 when Continental's growth was peaking.

Considering the disproportionate contribution that Penn Square loans made to Continental's losses, it is important to analyze how such a questionable relationship could develop in a bank that had been a top performer for so many years. It now appears that Continental's purchase of problem loans from Penn Square involved significant misconduct on the part of officers of both institutions.

However, the problem extends beyond employee misconduct. Management processes should be in place to guard against, and detect, employee misconduct as well as other risks.

Continental's management controls were the subject of considerable attention in our examinations over the past 6 to 10 years. Although we judged the bank's system of loan controls to be generally satisfactory, we directed a number of specific improvements. For example, we cited, at various times during the period from 1974 to 1981, problems with the past-due loan report, the completeness of credit files, the identification and rating of problem loans, and collateral deficiencies. Bank management was generally responsive to our concerns and made a number of improvements in its systems for controlling and detecting risk in the loan portfolio.

These improvements were not enough. In retrospect, it is clear that there was not sufficient management support for the control systems. Top management had created an environment where aggressive lending was not only condoned but encouraged. In this atmosphere, a high quality system of controls was secondary. Moreover, those warning signals that the existing system did generate were ignored by senior lending officers.

In the final analysis, the bank's internal controls did not prevent the purchase of massive amounts of bad loans from Penn Square. With the benefit of hindsight, it is clear that our generally favorable assessment of Continental's internal controls was overly influenced by the bank's outstanding performance during the years 1974 through 1981.

It became clear, during our examination that began in May 1982, that Continental's management practices and policies had led to serious loan problems. We responded to this in a number of ways. We extended our examination through November. During the course of the examination, we directed Continental to begin a number of corrective measures, which were immediately initiated by the bank. We informed management of our intention to formalize these directives by placing the bank under a formal agreement, enforceable under our cease-and-desist authority.

The agreement required improvements in numerous areas, including loan policies and procedures, asset and liability management, and funding. It also required regular reports by a board committee on the bank's compliance with the agreement. Bank management complied with the terms of the action and took significant steps to revamp its operations. However, the loans that crippled Continental were already on the books.

Market confidence had begun to turn against the bank in July 1982 when its Penn Square loan problems surfaced publicly. Despite nearly constant OCC supervision and presence in the bank over the next 2 years, and the efforts by bank management and the board of directors, Continental was unable to fully regain market confidence. In May of this year, the market reacted adversely to rumors of further problems at Continental, and large depositors began withdrawing funds. The bank was unable to stem the run, and Federal intervention was required to prevent the bank's collapse.

An obvious question that we and others have asked is whether there was anything that the OCC should have done differently in the course of Continental's deterioration. In addressing this question, it is important first to clarify the role of the bank supervisor.

Our charge is to maintain the safety and soundness of the national banking system. To do so requires sufficient oversight of and interaction with bank management to minimize the likelihood of bank failure. We do not take over and manage institutions; we cannot substitute for private management in making lending or any other decisions. The primary responsibility for any bank's performance rests with its management and board of directors. However, as supervisors we do monitor risk exposure, work to see that policies and controls are appropriate to that level of risk, and enforce compliance with the law. When we identify major weaknesses, we institute corrective measures, and follow up on their implementation. This results in significant improvement in the vast majority of institutions that we identify as having problems.

For some institutions, even prompt and stringent corrective measures are unsuccessful. The safety and soundness of the banking system also requires allowing such poorly managed, financially weak institutions to disappear from the system in an orderly manner. In an important sense, this is what has happened to Continental. The doors are still open, but the officers who allowed the bank's deterioration are no longer part of Continental. Moreover, those that bear responsibility for approving management policies have paid a price. The shareholders face substantial, if not total, loss, and the directors and former management face potential legal liability.

Chairman St Germain. Mr. Conover, I am constrained to interrupt you at this point, because your timing is excellent because we have a quorum call. So I am interrupting you at this point to clarify something.

I think every one should be aware of the full import of your comment about Continental management paying the price for their mistakes. I will quote from page 17 which you just read.

"The doors are still open, but the officers who allowed the bank's deterioration are no longer a part of Continental. Moreover, those that bear responsibility for approving management policies have paid a price."

Now, Mr. Conover, again I say all should know that the full price being paid by Continental's former management may not be as heart rendering as you might imply. Let's take a look at the facts. Mr. Anderson, former chairman of Continental, retired, now, let's keep in mind, is the fellow who was the go-go-banker, the aggressive banker that really took over the reins of this institution and decided he would make it big, and we will get to that issue of bigness again later in these proceedings—but he is the fellow who said, "Well, we will let lower management be responsible for making the loans." And very frankly, I think one of the big problems here is that the top-level management just disassociated itself and insulated itself from responsibility for many of the mistakes that were made at the lower level.

But let's look at what poor Mr. Anderson is undergoing. And I think we should all take out our crying towels. What did he end up with? A one-time lump sum pension supplement of $269,792. And then a monthly consulting fee of $12,212 through July 1986. When cited, they gave it on a monthly basis, but that works out to $145,000 a year. He received a cash payment of $77,000, reflecting the value of forfeited shares of certain stock, about which we have no idea what the value might be. Then certain financial advisory services from 1 year after retirement and payment of dues to certain clubs.

Now, Mr. Perkins and Mr. Miller also received handsome separation packages when they retired from Continental. A full explanation of the termination benefits Continental's top management received are discussed in an OCC memorandum dated July 3, 1984. If there is no objection, I shall place that memorandum in the record at this point.

Is there objection? The Chair hears none.

[The OCC memorandum of July 3, 1984, referred to by Chairman St Germain and the Continental Illinois Corp. proxy statement, dated August 24, 1984, follow:]

MEMORANDUM

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

To: Andrea Salloom, Attorney
Enforcement and Compliance Division

From: Ronald Goldberg, Law Clerk
Enforcement and Compliance Division

Date: July 3, 1984

Subject: **Possible OCC Action Against "Golden Parachutes" at Continental Illinois**

Issue

Would the OCC be authorized to institute an enforcement action against Continental Illinois Corporation (CIC) or its former officers with respect to the "golden parachute" retirement/termination contracts granted to three former top officers and if so, on what basis could such an action be sustained?

Short Conclusion

Under a different factual situation it might be possible to compel the non-enforcement of bank employment contracts containing unreasonably excessive compensation through a cease and desist order under 12 U.S.C. §1818(b), alleging that such contracts constitute an unsafe or unsound banking practice. However, given the moderate amount of the contracts in comparison with Continental's asset size and the industry-wide practice with respect to such termination agreements it will be difficult to establish a violation of either §1818 or our interpretative ruling on the subject contained in 12 C.F.R. §7.5220.

Scope of this Memo

This memo will discuss the validity of employment contracts entered into by national banks and their officers or employees. The rise of "golden parachute" contracts, industry-wide compensation standards and the facts of CIC's retirement settlements with three former officers will be examined, focusing on the Comptroller's statutory authority to act against excessive remuneration or benefits in banks' employment or termination agreements. The discussion will focus on the interaction of 12 U.S.C. §§24(5) and 1818(b) and 12 C.F.R. §§7.5220 and 563.39(a) as construed in recent cases. The more general question of reasonableness in executive compensation, the standards for establishing violations by directors and officers of their fiduciary duties and the business judgment rule will also be addressed in connection with excessively generous compensation schemes.

The Termination Agreements at CIC

Effective April 30, 1984 Roger E. Anderson, Chairman of the Board of Directors and Chief Executive Officer at CIC, Donald C. Miller, Vice-Chairman of the Board and John H. Perkins, President, voluntarily entered early retirement. According to an executive vice president at the bank, two factors led to the decision of Miller and Perkins to retire early: (1) the opinion of the Board of Directors that the bank's corporate office organizational structure had not functioned as it should have, necessitating a concentration of power in one CEO, and 2) the need to accelerate the bank's management succession process. Negotiations for their retirement were initiated in May 1983 and it was decided that in order to avoid the appearance of penalizing them in any way their termination agreements were to treat them as if they had completed their full careers. Originally, Anderson was to remain as CEO, but in late December 1983 and early January 1984 it had become clear to the Board of Directors that the bank's earnings were not rebounding as expected; visible action needed to be taken to retain confidence in the corporation's recovery from the Penn Square failure. After discussions with members of the Board's Compensation and Nominating Committee, it was mutually agreed that Anderson would also retire early. The Board felt it was appropriate to offer Anderson terms similar to those given Miller and Perkins since the retirement was not punitive in nature and the Board did not wish to create more notoriety for the corporation.

At its meeting on August 15, 1983, the Board approved the termination packages arranged for Miller and Perkins and on February 27, 1984, the Compensation Committee approved Anderson's retirement agreement. According to inside sources at the Bank, at the times these three retirement plans were developed and approved there was no premonition of the devastating effects of the rumors of May 1984 and no reason to assess personal penalties against the three former officers.

A. Terms of the Agreements

General Terms	Anderson	Miller	Perkins
Length of Service	37 years	25 years	37 years
Amount of annual Pension Supplement	$38,150	$12,500	$21,500
Consulting fees (monthly)	5/1/84-7/1/86 $12,212; 8/1/86-6/30/88 $1500	5/1/84-3/85 $15,375	9/1/84-8/30/8 $12,682 (to rise by $1,850 if nc elected to Board in 1984 or 198
Lump sum payment to reflect orfeited restricted shares	$77,000	$51,000	$57,000
Membership payments to be made by bank	One country club and one luncheon club for five years	One country club and one tennis club for five years	One country c one luncheon club for 5 ye and Old Elm club for life
Office with secretarial support	5 years	5 years	5 years
Eligibility for corporation's professional services in the year of retirement and and the year following retirement	Yes	Yes	Yes
Reimbursement for all legitimate business expenses incurred on behalf of the bank	Yes	Yes	Yes

B. Industry Standards on Termination Agreements and the Rise of "Golden Parachute" Contracts

Negotiated termination settlements such as those obtained by Anderson, Miller and Perkins have become a standard practice in almost all corporations. A 1983 survey conducted for The THinc. Consulting Group International revealed the following "standard" severance settlements for three levels of executives in banking, insurance and service industries:

Below Mid-Range Executives:

- Average of 6 months severance;
- Benefits continuance, often structured as "Bridging Pay" whereby the financial commitment ceases upon relocation;
- Out-placement;
- Off-site office with secretarial assistance when feasible;
- sometimes short-term travel/lodging allowance.

Mid-Range Executives:

- Plus/minus 1 year of severance or 1 week per year of service, infrequently spaced over additional years;
- Benefits continuance, sometimes structured as "Bridging Pay" whereby financial commitment ceases upon relocation;
- Key executive level out-placement;
- Off-site office with secretarial assistance;
- Short-term travel/lodging allowance.

Above Mid-Range Executives:

- Usually negotiated settlements;
- Over 1 and up to 3 years of severance, sometimes spread over 1 to 5 years;
- Benefits continuance, up to 5 years bridging to early or full retirement;
- Key executive level out-placement;
- Off-site office with secretarial assistance;
- Substantial travel/lodging allowance.

In comparison to the "standard" termination package for top-level executives, it would not seem that the packages obtained by the CIC officers are unduly excessive.

According to a 1982 survey conducted by Ward Howell Int'l., Inc. approximately 40% of U.S. corporations on the Fortune 1000 list provide employment contracts for top officers. The rise of so-called "golden parachute" contracts are symptomatic of the accelerating merger trend and are normally intended to both minimize the ramifications of hostile tender offers by protecting both the positions and responsibilities of key officers, and discourage hostile tender offers through the disincentive of large management payoffs to current officers in the event of a takeover. Haggerty, Golden Parachute Agreements: Cushioning Executive Bailouts in the Wake of a Tender Offer, 57 S. John L.Rev. 516 (1983). Although normally golden parachutes are negotiated shortly before or during the tender offer, many corporations have given their top executives golden parachutes despite the present threat of a takeover. Id. at 577. Generally, "golden parachutes" have the following characteristics:

- the contracts are usually given to 2-5 top executives;
- the contracts normally extend from 1-7 years;
- benefits range from salary incentives to health, pension and stock purchase plans;
- over 50% of the contracts are valued at $1-5 million;
- some provide for lump-sum payments, others for periodic payments.

Cooper, "The Spread of Golden Parachutes", August 19 Institutional Investor at 65; Haggerty at 529. Given these general characteristics of "golden parachutes" it is unlikely one would describe the contacts obtained by Anderson, Miller and Perkins as "golden parachutes."

C. The Validity of Employment Contracts Entered into by National Banks

Among the corporate powers granted to national banking associations dating back to the National Bank Act of 1864 is the power to "[e]lect or appoint directors...and other officers...[and] dismiss such officers or any of them at pleasure." 12 U.S.C.A. §24 Fifth (West Supp. 1983). Courts have consistently interpreted this provision to allow the board of directors of a national bank to dismiss an officer without liability for breach of any employment agreement that the bank might have entered into with the employee. In re Paramount Publix Corp., 90 F.2d 441, 443 (2d Cir. 1937); Mahoney v. Crocker National Bank, 571 F.Supp. 287, 289 (N.D. Cal. 1983); Kozlowsky v. Westminster National Bank, et al., 6 Cal. App. 3d Supp. 573, 86 Cal. Rptr. 52 (Cal. Dist. Ct. App. 1970). As stated in 7A Michie on Banks and Banking, §127: "Under the federal statute providing that a national bank shall have power by its board of directors to appoint the president, vice-president, cashier and other officers and to dismiss such officers or any of them at pleasure, the board may dismiss an officer without liability for breach of an agreement to employ."

The Comptroller, in an interpretative ruling contained in 12 C.F.R. §7.5220 gave the boards of directors of national banks the power to enter into employment contracts with their officers pursuant to 12 U.S.C. §24 Fifth. However, the ability of banks to contract for employment is qualified in that the contracts must be entered into "upon reasonable terms and conditions." 12 C.F.R. §7.5220 (1984). In a leading case examining the interrelationship between 12 U.S.C. §24 Fifth and 12 C.F.R. §7.5220, a former bank president unsuccessfully sought damages for wrongful discharge. The court held that the power to contract for a definite term given to banks in 12 C.F.R. §7.5220 is consistent with the power to discharge an employee before the end of that term. Kemper v. First National Bank in Newton, 94 Ill. App.3d 169, 418 N.E.2d 819, 821 (Ill. App. Ct. 1981). The court interpreted the various cases dealing with both the statute and regulation and concluded that "[a]lthough a national bank may contract to employ an officer for a definite period of time, it may not bargain away its right, granted by statute, to discharge those officers at pleasure". Id. Therefore, it would appear that employment contracts which are otherwise valid and enforceable may be disallowed by national banks without liability for wrongful discharge. However, the decision to actively seek avoidance or disaffirmance must be made by the board of directors.

D. Proving a Violation of 12 C.F.R. §7.5220 -- Factors Determining the Reasonableness of Executive Compensation

Although no cases have defined the term "reasonable" as used in 12 C.F.R. §7.5220, a 1976 memorandum from Charles F. Byrd, Assistant Director, LASD, to John E. Shockey, Deputy Chief Counsel, concluded that unless an employment contract "is blatantly unreasonable," an effort to prove the contract is not within the terms of I.R. 7.5220 "would be extremely difficult." The task of proving the unreasonableness of employment contracts was not made easier by the defeat of a 1976 proposal to add to I.R. 7.5220 illustrations of provisions in employment contracts that OCC would consider unreasonable. Nevertheless, courts have had to develop guidelines for determining the reasonableness of executive compensation in other contexts. As noted in an American Law Reports Annotation, the reasonableness of compensation involves a question of fact and although generally within the exercise of the board of directors' business discretion, courts have looked to the actual services rendered by the officer, the financial condition of the corporation and have made comparisons with other officers' salaries in the same company or other firms in similar businesses. See Annot. 53 A.L.R. 358 (1973). A federal district court explicitly held that the reasonableness of an officer's compensation, as approved by the board of directors of which he was a member, may be determined in light of the corporation's financial condition. Irwin v. West End Development Co., 342 F.Supp. 687 (D.Colo. 1972), modified, 481

F.2d 34 (1973). As noted by another court, the salaries of officers of an efficiently managed corporation must bear a reasonable relation to the services rendered and the income of the business since corporate directors and officials must have regard for the financial condition of the corporation. Baker v. Cohn, 42 N.Y.S.2d 159 (N.Y Sup. Ct. 1942), modified, 266 A.D. 715, 40 N.Y.S.2d 623 (N.Y. App. Div. 1943), aff'd 292 N.Y. 570, 54 N.E.2d 689 (1944). A reviewing court may look at compensation paid by other corporations in similar businesses. Backus v. Finkelstein, 23 F.2d 531, 536-37 (D.C. Minn. 1924). A general guideline for determining the reasonableness of compensation is that the remuneration must be in proportion to the officer's ability, services and time devoted, corporate earnings and other circumstances. Glenmore Distilleries Co. v. Seidman, F.Supp. 915, 919 (E.D.N.Y. 1967). The Seidman court went on to stress that "[s]alaries of officers in an efficiently managed corporation must bear a reasonable relation not only to the services rendered but to the income of the business." Id. Given the inherent vagueness in a term such as "reasonable", the preceding material is offered merely as an indication of the types of factors a reviewing court might consider in a determination of the reasonableness of executive compensation agreements.

E. Unreasonable or Excessive Executive Compensation as an Unsafe or Unsound Banking Practice Within 12 U.S.C. §1818

Although it would prove difficult to establish a violation of I.R. §7.5220 due to the ambiguity of the term reasonable, there is substantial authority that given the proper circumstances, excessive or unreasonable employment or termination agreements could constitute unsafe or unsound banking practices within 12 U.S.C. §1818. Bank Circular No. 115 dated August 30, 1978, stated that practices OCC views as unsafe or unsound include excessive salaries and bonuses, excessive director fees and fees paid where there is no corresponding benefit to the bank.

The legislative history of 12 U.S.C. §1818 reveals the breadth of the term unsafe or unsound. As John F. Horne, Chairman of the Federal Home Loan Bank Board testified before Congress:

> [d]espite the fact that the term "unsafe or unsound practices" has been used in the statutes governing financial institutions for many years, the Board is not aware of any statute, either Federal or state, which attempts to enumerate all the specific acts which could constitute such practices. The concept of "unsafe or unsound practices" is one of general application which touches upon the entire field of the

> operations of a financial institution. For this reason, it would be virtually impossible to attempt to catalogue within a single all-inclusive or rigid definition the broad spectrum of activities which are embraced by the term. The very formulation of such a definition would probably operate to exclude those practices not set out in the definition, even though they might be highly injurious to an institution under a given set of facts or circumstances or a scheme developed by unscrupulous operators to avoid the reach of the law. Contributing to the difficulty of framing a comprehensive definition is the fact that particular activity not necessarily unsafe or unsound in every instance may be so when considered in the light of all relevant facts. Thus, what may be an acceptable practice for an institution with a strong reserve position, such as concentration in high risk lending may well be unsafe or unsound for a marginal operation.

Hearings on S. 3158 Before the House Comm. on Banking and Currency, 89th Cong., 2d Sess., at 49-52 (Sept. 15-22, 1966).

An early case treating this question at a different bank found that excessive bonuses and salaries to bank officers constituted an unsafe and unsound practice and upheld the Comptroller's Cease and Desist Order given the poor financial performance of the bank. First National Bank at Eden, South Dakota v. Department of the Treasury, Office of the Comptroller of the Currency, 568 F.2d 610, 611 (8th Cir. 1978). The court adopted the Comptroller's defintiion of unsafe and unsound practices as encompassing "[w]hat may be generally viewed as conduct deemed contrary to accepted standards of banking operations which might result in abnormal risk or loss to a banking institution or shareholder." Id.

In the most significant case on point the Seventh Circuit upheld the determination of the District Court for the Northern District of Illinois that employment agreements entered into by a federally-insured savings association with two of its officer-directors were null and void because they constituted an unsafe and unsound banking practice. Federal Savings and Loan Insurance Corporation v. Bass, 576 F.Supp. 848 (N.D. Ill. 1983), app. dismissed, No. 83-3305 (7th Cir. April 28, 1984). The agreements involved large termination payments voted by the board of directors of Unity Savings Association at a time when the institution was experiencing serious financial difficulties; several board members were contract beneficiaries. Eventually Unity became insolvent and the FSLIC took over as its receiver. The court relied heavily on a Federal Home Loan Bank Board regulation requiring that an insured institution "[n]ot enter into an employment contract with any of its officers or other employees if such contract would contitute an unsafe or unsound practice." 12 C.F.R. §563.39(a)(1983). The court also applied a Fifth Circuit holding that restricted the breadth of the unsafe or unsound practice formula to practices with a reasonably direct effect on an association's financial soundness. Bass, 576 F. Supp. at 852 (quoting Gulf Federal Savings and Loan v. Federal Home Loan Bank Board, 651 F.2d 259, 264 (5th Cir. 1981), cert. denied, 458 U.S. 1121 (1982)). The court found that "[U]nity could ill afford to part with $200,000 for even the best of reasons," and certainly not to disburse funds for this "[b]latent attempt to secure...[the officer-directors'] position at Unity's expense." Id.

The FSLIC in its briefs before the court, argued that the employment contracts threatened a loss of public confidence in the entire savings and loan industry by allowing officers to remove substantial amounts of cash from an instituion as a result of its failure. More basically, the FSLIC contended that the agreements were inconsistent with sound financial practices which would involve reduction rather than increase of expenses for a financially troubled institution. What may be more significant for future litigation involving the OCC is the fact that the court agreed with the FSLIC that judicial deference to bank regulators would be "particularly appropriate" in a factual situation such as that presented by Bass. When faced with a question of statutory construction, the Supreme Court has mandated that federal courts accord "[g]reat deference to the interpretation given the statute by the officers or agency charged with its administration." Ford Motor Credit Co. v. Milhollin, 444 U.S. 555, 566, (1980) (quoting Udall v. Tallman, 380 U.S. 1, 16 (1965)). With respect to the deference which has been accorded the OCC in its interpretation of 12 U.S.C. §1818 the D.C. Circuit has held that the Comptroller's discretionary authority to define and eliminate 'unsafe and unsound' conduct is to be liberally construed. Independent Bankers' Association of America v. Heimann, 613 F.2d 1164, 1168-69 (D.C. Cir. 1979), cert. denied, 449 U.S. 823 (1980). The Fifth Circuit has held that the exercise of the Comptroller's discretion will not be disturbed unless it is arbitrary, capricious or contrary to law; so long as the Comptroller can substantiate his actions in a reasonable manner, a reviewing court will defer to the agency's judgment. First National Bank of Bellaire v. Comptroller of the Currency, 697 F.2d 674, 680 (5th Cir. 1983).

In light of Bass and the series of decisions stressing judicial deference to administrative agency interpretations, there is clearly a legal basis upon which to argue that in certain circumstances, employment or termination agreements can constitute unsafe or unsound banking practices within 12 U.S.C. §1818. In order for a court to uphold a Cease and Desist Order, several requirements would probably have to be met. First, the bank's financial condition would have to be precarious enough that the compensation would have a "reasonably direct effect" on the institution's financial soundness. Additionally, the contracts themselves must be "unreasonable" in some manner. A violation of the guidelines enumerated in Banking Circular No. 115, a financially unsound decision to reward poor managerial performance or a contract of the "golden parachute" genre could all fall within this prohibition. However, when one examines the three termination agreements for Anderson, Miller and Perkins at CIC, it is unlikely that any action under §1818 would succeed. The contracts were relatively meager in terms of industry standards. Additionally, the lengths of service of the former officers was very long while the duration of the payments was fairly short. The net present value of each agreement constituted only the amount each officer would have received in salary and benefits if he had not retired early. More significant is the fact that a plausible argument could not be made, given Continental's size, that the payments would have a direct and detrimental effect on the institution's financial soundness. In a smaller and more "insolvent" or "illiquid" institution and under a more egregious set of facts such as those presented by Bass, the Comptroller would have a much better chance of sucessfully arguing that the contracts were null and void as an unsafe or unsound banking practice.

F. Potential Arguments that Bank Boards or Officers Might Raise to an Action Under 12 U.S.C. §1818 Seeking a Cease & Desist Order

Any action brought under 12 U.S.C. §1818 attempting to nullify an employment or termination agreement will be subject, as a first defense, to the claim that the agreement was entered into in accordance with 12 C.F.R. §7.5000. This interpretative ruling reads, in pertinent part:

> A national bank may adopt any reasonable bonus or profit-sharing plan designed to insure adequate remuneration of bank officers and employees.

12 C.F.R. §7.500 (1984) (emphasis supplied). Given the representative standard compensation/termination practices described in Section B, it might be difficult to argue that a contract which is typical of those in the industry is "unreasonable." However, a bank's challenge to an §1818 action on this ground would probably be unsuccessful as the Comptroller need prove only that the agreement constitutes an unsafe or unsound practice, not that it is "unreasonable."

A bank board's next argument would probably focus on the deference courts give to directors' decisions as a result of the business judgment rule. Under the business judgment rule, corporate directors are presumed to have acted properly and in good faith and are called to account for their actions only when they have acted in bad faith. Treadway Companies, Inc. v. Care Corporation, 638 F.2d 357,382 (2d Cir. 1980). As one court has stated, directors will be held to a standard which requires them to exercise honest business judgment, defined as the exercise of "[t]hat care which businessmen of ordinary prudence use in managing their own affairs." Northwest Industries, Inc. v. B.F. Goodrich Company, 301 F.Supp. 706, 711 (N.D. Ill. 1969). While corporate management has a high fiduciary duty of honesty and fair dealing with shareholders, and it will be given wide discretion in decision-making under the business judgment rule, Berman v. Gerber Products Company, 454 F.Supp. 1310, 1319 (W.D. Mich. 1978), the business judgment rule does not apply to situations involving self-dealing, where there is a conflict of interest. Lewis v. S.L.& E., Inc., 629 F.2d, 764, 769 (2d Cir. 1980). In an action brought under the Labor-Management Reporting and Disclosure Act, 29 U.S.C. §501 et seq. (1976), the Second Circuit held that corporate officers could be liable for breach of their fiduciary duties by authorizing and receiving excessive compensation for themselves. Morrissey v. Curran, 650 F.2d 1267 (2d Cir. 1981). Similarly, if bank director-officers were to vote themselves large employment or termination agreements, the business judgment rule would not apply. Although the Comptroller would probably not have standing to assert an action for breech of fiduciary duty, any action under 12 U.S.C. §1818 to have the contracts rescinded as unsafe or unsound banking practices would not be subject to the business judgment rule defense. As fiduciaries, directors and officers are obligated to act solely to benefit the corporation and must forego any personal advantage that may result from their position. Pepper v. Litton, 308 U.S. 295, 311 (1939); Burden v. Sinskey, 530 F. 2d 478, 489-90 (3d Cir. 1976).

Conclusion

It is unlikely that the Comptroller would be successful in an enforcement action against Continental and/or Anderson, Miller and Perkins given the nature of their contracts, the bank's size and financial condition, and industry practices with respect to termination agreements. As Eugene Katz, Assistant Director, Litigation, stated in a memo to Robert Serino, Deputy Chief Counsel, it might be advisable for the FDIC, considering the leverage it now has over Continental, to "suggest" that these contracts should be rescinded as they are not in the bank's best interest. It is clear, however, that given a more blatant use of insider advantage as is the case with true "golden parachutes" at a financially troubled bank, the Comptroller could successfully bring an action against such agreements, alleging them to be unsafe or unsound banking practices.

cc: Ralph Sharpe
Robert Davis
Stacy Powers

FROM CONTINENTAL ILLINOIS CORPORATION'S PROXY STATEMENT DATED AUGUST 24, 1984

Bank in the ordinary course of business during 1983. All loans and commitments included in such transactions were made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other persons and did not involve more than normal risk of collectibility or present other unfavorable features.

The following table sets forth all 1983 cash compensation for services rendered to CI Corp and its subsidiaries by (i) the five most highly compensated executive officers of CI Corp and (ii) all executive officers of CI Corp, as a group, while they held such positions.

Name and Capacities in Which Served	Salary	Profit Sharing (1)	Incentive Compensation (2)
Roger E. Anderson (3)	$ 515,000	$14,909	$ -0-
Former Chairman of the Board of Directors of CI Corp and the Bank			
John H. Perkins (3)	430,000	12,448	-0-
Former President of CI Corp and the Bank			
Donald C. Miller (3)	325,000	9,409	-0-
Former Vice Chairman of CI Corp and the Bank			
David G. Taylor (3)	269,455	7,801	-0-
Former Vice Chairman of CI Corp and the Bank			
Edward M. Cummings (3)	207,500	6,007	-0-
Former Executive Vice President of CI Corp and the Bank until December 31, 1983			
All executive officers as a group (18 in number)	3,838,574	115,404	-0-

(1) The figures in this column represents amounts paid in 1984 for 1983 pursuant to CI Corp's cash and deferred profit-sharing plan.

(2) The Board of Directors has determined that no awards for 1983 will be made pursuant to CI Corp's incentive compensation plan.

(3) All of the executive officers named in the table above have resigned from CI Corp and the Bank, except for David G. Taylor. Mr. Taylor, who served as Chairman of the Board of Directors of CI Corp and the Bank from April 23, 1984 to August 13, 1984, now serves as a Vice Chairman of the Bank.

For a description of certain of CI Corp's benefit plans, see "Stock Options, Stock Appreciation Rights and Restricted Stock" and "Other Employee Benefit Plans".

In addition to the amounts set forth in the table above, Mr. Perkins received during 1983 other compensation of $31,294 in the form of dues paid by CI Corp for certain associations and clubs and the value of financial advisory services provided by the Bank. Mr. Cummings received during 1983 other compensation of $131,786 in the form of reimbursement for various expenses incurred in connection with duties overseas during 1982, for moving expenses incurred in returning to the United States and for dues paid by CI Corp for certain clubs. During 1983 no other executive officer named in the table received any other compensation in an amount in excess of $25,000 and all executive officers as a group did not receive other compensation in excess of 10% of the compensation for that group as reported in the table.

In connection with Mr. Anderson's retirement, he received (i) a one time lump sum pension supplement of $269,792; (ii) a monthly consulting fee of $12,212 through July 1986 and $1,500 thereafter through June 1988; (iii) a cash payment of $77,000 reflecting the value of forfeited shares of restricted stock to which he would have been entitled if he had retired at the age of 65; (iv) certain financial advisory services until one year after retirement and (v) payment of dues for certain clubs.

In connection with Mr. Perkins' retirement, he received (i) an annual pension supplement of $19,720; (ii) a monthly consulting fee of $14,532 through August, 1986; (iii) a cash payment of $57,000 reflecting the value of forfeited shares of restricted stock to which he would have been entitled if he had retired at the age of 65; (iv) certain financial advisory services until one year after retirement and (v) payment of dues for certain clubs.

In connection with Mr. Miller's retirement, he received (i) an annual pension supplement of $12,500; (ii) a monthly consulting fee of $15,375 through March, 1985; (iii) a cash payment of $51,000 reflecting the value of forfeited shares of restricted stock to which he would have been entitled if he had retired at the age of 65; (iv) certain financial advisory services until one year after retirement and (v) payment of dues for certain clubs.

CI Corp directors who are not regular salaried officers of CI Corp or its subsidiaries receive an annual retainer of $15,000, a fee of $600 for each board meeting attended, a fee of $500 for each committee meeting attended, and an annual fee for service on committees as specified below. The Chairman and each other member of the Audit Committee receive an annual fee of $7,500 and $4,000, respectively. The Chairman and each other member of the Compensation and Nominating Committee receive an annual fee of $5,000 and $3,000, respectively. Each member of the Board Credit Committee and each member of the Bank's board's Committee on Private Banking, Trust and Investment Services receives an annual fee of $3,000. Directors may elect to defer payment of any of their director fees, which then accrue earnings at a rate determined from time to time by the Compensation and Nominating Committee. Deferred fees are paid in a lump sum or in installments, generally commencing after a director ceases to be a director of CI Corp and the Bank.

Stock Ownership of CI Corp

CI Corp has been advised by Dean LeBaron, doing business as Batterymarch Financial Management ("Batterymarch"), 600 Atlantic Avenue, Boston, Massachusetts 02210, that as of June 30, 1984, Batterymarch was the beneficial owner (as defined by the Securities and Exchange Commission) of 2,057,050 shares, representing 5.1% of the outstanding shares of Common Stock of CI Corp. Batterymarch has sole voting power with respect to 623,500 shares and has sole investment power with respect to 2,057,050 shares. CI Corp does not know of any other person who is the beneficial owner of more than 5% of its Common Stock.

The following table sets forth the beneficial ownership of Common Stock of CI Corp and directors' qualifying shares of the Bank as of August 20, 1984 (i) by each director, and (ii) by all directors and officers of CI Corp as a group. As of that date, each director of CI Corp beneficially owned less than .1%, and all directors and officers as a group owned less than 1%, of the outstanding shares of Common Stock of CI Corp.

	CI Corp	Bank
John E. Swearingen	100	100
William S. Ogden	100	100
Raymond C. Baumhart, S.J.	None	100
James F. Beré	1,000	100
Weston R. Christopherson	200	100
William B. Johnson	1,220	100
Jewel S. Lafontant	400	100
Vernon R. Loucks, Jr.	200	100
Frank W. Luerssen	200	100
Robert H. Malott	1,000	100
Marvin G. Mitchell	1,000	100
John M. Richman	200	100
Paul J. Rizzo	200	100
Thomas H. Roberts, Jr.	200	100
William L. Weiss	248	100
Blaine J. Yarrington	1,000	100
All directors and officers as a group (33 in number)	356,484(1)(2)	

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Chairman St Germain. I simply want the record to reflect that, yes, Mr. Anderson has paid a price since he no longer earns $515,000 a year. But the man has apparently not been left to pauperism, or destitute since his departure from Continental.

The subcommittee will be in recess for 10 minutes in order to allow the Members to answer the quorum call. Then we will resume Mr. Conover's testimony.

[Recess.]

Chairman St Germain. The subcommittee will come to order.

Mr. Conover, you may proceed.

Mr. Conover. Thank you, Mr. Chairman.

The demise of Continental was clearly not desirable. It would have been far better if management had made better decisions and taken actions that would have been more appropriate for the ensuing circumstances. It would also have been preferable if we as supervisors could have done something to change the course of Continental.

As we review the history of Continental, it is possible to identify several points in time and ask whether it would have been appropriate for the supervisors to step in forcefully to change the course of the bank's direction. We did this, of course, after our 1982 examination when we took a formal enforcement action against the bank. Most banks, including Continental, respond to this type of corrective measure. What made Continental different from most of these cases was that the market did not wait for the bank's recovery plan to restore it to health.

I am persuaded that since mid-1982, there was nothing more that we could have done to speed Continental's recovery and thereby increase market confidence.

We have asked ourselves whether we should have taken action as early as 1976 to prevent Continental from embarking on a course of rapidly becoming a top lender to corporate America. In my view, it would have been inappropriate to have done so. It is not the proper function of regulators to decide what business strategy an individual bank should undertake. The regulator's role is to see that whichever business strategy a bank chooses, it has the mechanisms in place to implement that strategy in a safe and sound manner.

In retrospect, it is clear that management, buoyant with the bank's years of financial success, placed too little value on risk control mechanisms in the implementation of its strategy.

If there is anything that OCC could have done differently, I believe it would have been to place more emphasis on our evaluation and criticism of Continental's overall management processes. Had we done so, we might have been alerted to management's lack of commitment to controlling risk sooner than 1982. Had we been less swayed by management's successful track record from the early 1970's through 1981 and its previous responsiveness to our supervision, we might have been able to see more clearly the risks inherent in its rapid growth strategy.

Continental's demise has highlighted the need for banks and supervisors to continue to work to maintain the public's confidence in individual banks and the banking system as a whole.

Supervisory techniques continue to be improved. The OCC's supervisory process has continued to improve as technological innovations have been made and industry conditions have changed.

Our supervision of banks of all sizes has been enhanced by the establishment of an Industry Review Program. This program includes a computerized information system to collect data on industry concentrations in individual bank portfolios and the banking system as a whole. Our examiners will use the information in their analyses of individual banks to identify concentrations and to help position banks to withstand problems emerging from them.

The near-complete development of two additional computer systems will provide us with a much improved ability to respond to examination needs and follow up on examination results.

We have also taken steps to ensure communication within the OCC of examination findings on individual banks that may affect other banks in the system. These steps include changes in OCC internal procedures, examination manuals, and training.

Our multinational bank program has been expanded, and we are examining multinational banks more frequently than in the past. Our examinations are targeted on the areas of supervisory concern and take place two to three times a year, rather than annually. Moreover, we have reorganized and significantly increased our resources committed exclusively to the supervision of our largest banks. In addition to the more frequent examinations we have undertaken, the examiners will also monitor trends and developments in the banks between examinations. This new approach results in near-constant supervision of each of our large banks.

Second, internal controls must be emphasized. The OCC is placing more emphasis in the examination process on banks' internal controls and systems. This includes increased testing of control procedures and their application and more stringent follow-ups to ensure that internal control deficiencies are corrected. In addition, we have issued specific procedures that banks must follow when they purchase loan participations.

Three, loan loss reserves are being evaluated. Since the allowance for possible loan losses [APLL] is the first line of defense against loan deterioration, we are taking additional steps to assess the adequacy of a bank's APLL relative to the total risk in its portfolio. We are concerned that for some banks, increases in the APLL have not kept pace with increases in nonperforming and classified loans. We are addressing this concern by developing more specific criteria for use by our examiners in evaluating the adequacy of reserves and by focusing our examinations of large banks to make sure that reserves are adequate.

Four, capital levels are being increased. Congress reemphasized the critical role of capital in maintaining the safety and soundness of the banking system when it enacted in 1983 the International Lending Supervision Act that authorizes the banking agencies to enforce capital requirements. Under regulations proposed by the OCC and the FDIC, all banks, regardless of size, would be required to maintain a minimum ratio of primary capital to total assets of 5.5 percent and a total capital ratio of 6 percent.

The implementation of this standard would not replace our supervisory evaluation of capital adequacy. Banks of all sizes will be encouraged to maintain higher capital levels. Furthermore, the OCC retains the right to impose higher ratios for banks whose circumstances necessitate a stronger capital base.

Five, sources and uses of funds are being scrutinized. The OCC is devoting more resources to monitoring regional and multinational banks' global funding. Banks will be placed under special surveillance if they are especially vulnerable to eroding market confidence or reliance on particular funding markets is deemed to be excessive. Where we find a high volume of volatile liabilities, we will require a larger percentage of liquid assets.

Six, increased financial disclosure is being promoted. The market's evaluation of the banking system depends, in large part, on the information that is publicly available. To enhance the credibility of bank financial statements and reduce the likelihood that the market will overreact to incomplete information, the OCC is considering requiring increased disclosure of information about banks. To that end, it is seeking public comment on increasing the disclosure requirements for banks via an advance notice of proposed rulemaking.

Chairman ST GERMAIN. If I may for a moment, Mr. Conover, I want to encourage you in that area. Unfortunately, we had thought we would see that earlier, as you recall, right after or during Penn Square I made the point that increased disclosure was very, very essential. I got the impression that the FDIC was going to really move in that direction.

But the movement has been very slow. So I really encourage and commend you on that point, because I think it is most important, and on capital adequacy, you do recall that, as I think you stated, the International Lending Supervision Act as a result of this committee's insistence, required this increase in capital.

Mr. CONOVER. Correct.

On the subject of increased disclosure, we have been pushing for that for some time. I think the action we are taking now is significant because it is not jawboning. It is not a voluntary thing. We are talking about putting a firm regulation in place.

Chairman ST GERMAIN. Well, that is very gratifying.

Mr. CONOVER. The seventh area we have been focusing on is maintaining a strict enforcement policy. We have been utilizing our enforcement power more vigorously to correct violations of law and imprudent banking practices. For instance, last year we took 274 formal actions against national banks compared to 156 for the previous year and only 65 in 1978. The total for the first 8 months of this year is 250 formal actions. These actions have been taken against banks of all sizes. We have outstanding enforcement actions against 17 percent of the banks with assets over $1 billion and 12 percent of the banks with under $1 billion in assets. Last year, we also imposed civil money penalties against 127 bank officials. To put that into perspective, in 1981 we imposed only 19.

In summary, Continental pursued a growth strategy without adequate controls that proved to be its downfall in adverse economic circumstances. Management has been removed, and shareholders have incurred substantial losses. At the same time, we have avoided major disruption to the financial system. Upon implementation of the long-term solution, Continental will be well capitalized and have stronger assets and management. It will be returned to private ownership at the earliest possible date.

We continue to focus our supervisory efforts on enhancing the ability of banks to remain sound even under difficult circumstances. Such action will strengthen the banking system and assure the continuing confidence of depositors.

Mr. Chairman, that concludes my prepared remarks. I will be happy to answer questions.

[Mr. Conover's prepared statement follows:]

Statement of

C. T. Conover

Comptroller of the Currency

Before the

Committee on Banking, Finance, and Urban Affairs

U. S. House of Representatives

September 19, 1984

Mr. Chairman, members of the Committee, I am pleased to be here to discuss Continental Illinois National Bank and Trust Company (Continental). The serious problems encountered by Continental and the regulators' actions concerning Continental are obviously a matter of public concern and deserve a thorough review by Congress and the public. It is my hope that these hearings will generate a broader understanding of the bank regulatory process, and the events surrounding the financial deterioration of Continental and the ensuing federal assistance. I would like to express my appreciation to the members of the Office of the Comptroller of the Currency (OCC) staff as well as the other financial regulatory agencies who have devoted countless hours in working toward a resolution of Continental's difficulties.

In the Spring of 1984, Continental began experiencing liquidity problems that reached crisis proportions in May. The liquidity problems resulted from a rapid decline in market confidence brought about by severe deterioration in the quality of Continental's loans.

On May 17, a temporary assistance program was implemented by the federal regulators to allow time to work out a solution while minimizing any adverse impact on global financial markets. The long-term solution, which was announced July 26 and on which shareholders will vote on September 26, is intended to restore Continental to health and allow it to continue to serve its marketplace without interruption.

I fully appreciate the Committee's need to receive full and complete information on this Office's supervision of Continental. For that reason, we have provided the Committee's staff complete access to all OCC documents relating to the condition of Continental and our supervision of the bank. At the same time, we have been careful to protect the legitimate rights to privacy of bank customers and other third parties. I hope that these hearings will also contribute to the Committee's understanding of what happened at Continental.

There are many important aspects to the Continental situation that need to be aired at these hearings. I can best contribute to the process by focusing on the bank itself, and this Office's supervision of it. I understand the FDIC will discuss the temporary assistance plan and subsequent long-term solution. Similarly, the holding company, Continental Illinois Corporation, and certain aspects of the federal assistance plan are more appropriately discussed by the Federal Reserve.

Today, I will address what happened at Continental by first describing the economic factors that have buffeted Continental -- and other banks -- since 1980. These include back-to-back recessions as well as a sharply declining energy industry. Second, I will briefly review the internal policies and practices at Continental that rendered it incapable of weathering these adversities. Fundamentally, the bank undertook an aggressive growth strategy without adequate safeguards against the ensuing adverse events. Third, I will discuss what we could have done differently. Finally, I will focus on what we are doing to assure the continued safety and soundness of the banking system. The Appendix includes a ten-year chronology of Continental's internal policies, strategies, and decisions; describes the prevailing economic environment; and details this Office's supervisory involvement with the bank.

ECONOMIC PROBLEMS HAVE IMPAIRED BANK PERFORMANCE

The 1980s have been difficult years for the banking industry. In early 1980, a recession caused real economic growth to drop sharply. By mid-1980 the economy was growing again, but that recovery only lasted 12 months. In mid-1981, the economy fell back into a recession that lasted 17 months. This latter recession proved to be deep and pervasive, with virtually no sector of the economy left untouched. It was a particularly difficult recession because unlike most, it was not accompanied by declining real interest rates.

Although the economy as a whole is now experiencing a strong recovery, the pattern of back-to-back recessions was particularly hard on lending institutions. Loan quality typically begins to deteriorate after an economic slowdown begins, and continues to decline well into the recovery. When the 1981 downturn occurred, banks were still dealing with increasing loan losses from the 1980 recession. The second downturn not only added new problem loans, but hindered attempts to work out existing problem loans. Many loan portfolios, thus, have continued to deteriorate since 1980, and many banks are still having problems stemming from the recessions.

In addition to having to contend with the effects of the two recessions, many banks have also been affected by the severe problems in the energy industry over the last few years. Oil prices began to drop sharply in early 1980. Although they rose again during the last half of 1980, by 1981 oil prices were clearly on a downward spiral. This caused a sudden and unexpected decline in the profitability of energy exploration and production in late 1981. Banks that had lent money to a booming industry suddenly found many of their customers facing severe financial difficulty, and in many cases, bankruptcy. The energy sector continues to be a problem area for lenders today, as oil prices continue to soften.

These economic factors have posed challenges to all bankers. In an earlier era of strong domestic and international economic growth and relatively stable interest rates, bank managements' abilities were not sorely tested. However, over the last few years, the margin for error in banking has shrunk dramatically.

Most U.S. banks have weathered these difficulties with impressive resilience, but almost all have felt some impact. Return on assets and return on equity are down for the industry as a whole. Asset quality is still suffering, with net loan losses rising even faster for large banks than for small.

One important consequence of the industry's problems has been a heightened public concern about the condition of U.S. banks. Market confidence is an unpredictable but crucial element in the stability of individual banks and the banking system as a whole. Whether a bank survives adverse circumstances is often a matter of whether the market allows it the needed time to work out problems. In the case of Continental, the market didn't provide this needed time.

WHAT HAPPENED AT CONTINENTAL?

The difficult economic environment had a particularly devastating effect on Continental. Its problems stemmed from management strategies and policies that depended on strong growth in the economy in general and the energy industry in particular. These strategies and their consequences are detailed in the Appendix to this testimony. In sum, Continental adopted a policy of rapid growth that was not accompanied by the necessary management controls and policies to maintain adequate asset quality in the face of an economic slowdown and a declining energy industry.

Management Strategy Showed Early Signs of Success

Continental management announced its decision in 1976 to become one of the top three banks lending to "Corporate America". Located in the heart of industrial America, Continental was already the leading commercial lender in the Midwest. Moreover, because it could not establish a significant retail customer base due to state restrictions on branching, the bank's corporate lending function was a natural area for expansion. Continental set out to quickly become a major lender to corporate customers.

In implementing this goal, Continental adopted a strategy of decentralized lending that permitted its account officers to respond to customers and make loans more quickly and competitively. Although this approach required fewer controls and levels of review, management believed the potential rewards of such a strategy outweighed the associated risk. Management felt confident about the depth and experience of the bank's staff and its analysis of the direction of the economy. Obviously, this judgment proved to be incorrect.

Continental's management targeted the energy sector for its most aggressive lending expansion. During the latter half of the 1970s, the United States was attempting to develop a program for energy self-sufficiency in the face of uncertainty about actions of the OPEC nations. The 1973 oil embargo had propelled energy independence to the forefront of our national goals. Prices were skyrocketing and gas lines forming when Continental targeted energy lending as an area for growth. The federal government was giving serious consideration to gas rationing and even printed a million rationing coupons.

The Administration and Congress in 1977 emphasized the critical nature of energy to the United States by establishing a separate Department of Energy. At that time, some economic analysts were projecting the price of oil to increase to some $60 a barrel. In June 1980, Congress enacted the Energy Security Act establishing the Synfuels Corporation and authorizing $20 billion for synthetic fuels development.

Continental's management strategy of rapid growth with a specialty in energy was quite successful for several years. During the late 1970s, Continental outperformed its peers in growth, earnings, and market perception, and its loan loss record was excellent. In 1978, Dun's Review described Continental as one of the five best managed companies in America.

Asset Quality Ultimately Deteriorated

In 1981, the very strategy that generated praise began to turn against Continental. A slowing economy meant that the quality of available lending opportunities was deteriorating at the same time that Continental was increasing its corporate lending, inevitably resulting in the making of loans to weak borrowers. In addition, many of Continental's existing corporate borrowers were seriously affected by the back-to-back recessions; existing loans to these companies became problems. By 1982, it became clear that the bank's rapid growth had been achieved at the expense of asset quality.

The declining energy industry in late 1981 dealt a particularly serious blow to Continental. The end of the energy boom put a severe strain on the bank's energy-producing borrowers. Many of Continental's energy loans, which had been performing well and had been extremely profitable, suddenly turned into serious collection problems.

Continental's problems in the energy area were two-fold. First, it had a heavy concentration in oil and gas loans that left the bank extremely vulnerable to the industry's sudden decline. Since July 1982, oil and gas loans have accounted for approximately two-thirds of the bank's losses, although those loans have averaged only about 20 percent of the total loan portfolio.

Second, from 1980 to 1982, the bank had purchased a large volume of energy loans from Penn Square Bank, N.A. The quality of these loans proved to be very poor, particularly those loans that were purchased in late 1981 and early 1982 when Continental's growth was peaking. Loans purchased from Penn Square constitute a disproportionate amount of Continental's losses. During our May - November 1982 examination, for example, Penn Square loans accounted for approximately 3 percent of all Continental's loans. However, they accounted for 16 percent of classified loans and 65 percent of the charge-offs directed by our examiners.

Inadequate Management Controls Permitted Huge Losses

Considering the disproportionate contribution that Penn Square loans made to Continental's losses, it is important to analyze how such a questionable relationship could develop in a bank that had been a top performer for so many years. It now appears that Continental's purchase of problem loans from Penn Square involved significant misconduct on the part of officers of both institutions. There are also indications that criminal fraud may have been involved. In fact, on September 10, 1984, William G. Patterson, the former head of Penn Square's energy lending division, was brought to trial on a 34-count indictment that charged, among other things, that he engaged in deceitful and fraudulent conduct to conceal his illegal banking practices from OCC examiners and the banks that purchased loans from Penn Square.

However, the problem extends beyond employee misconduct. Management processes should be in place to guard against, and detect, employee misconduct as well as other risks. These include policies and controls governing loan approval, review, and classification; mechanisms for determining provisions for losses; loan workout functions; management information systems; and loan officer compensation systems. For banks such as Continental that undertake aggressive growth strategies, top quality controls are essential.

Continental's management controls were the subject of considerable attention in our examinations over the past eight to ten years. Although we judged the bank's system of loan controls to be generally satisfactory, we directed a number of specific improvements. For example, we cited, at various times during the period from 1974 to 1981, problems with the past-due loan report, the completeness of credit files, the identification and rating of problem loans, and collateral deficiencies. Bank management was generally responsive to our concerns and made a number of improvements in its systems for controlling and detecting risk in the loan portfolio.

These improvements were not enough. In retrospect, it is clear that there was not sufficient management support for the control systems. Top management had created an environment where aggressive lending was not only condoned but encouraged. In this atmosphere, a high quality system of controls was secondary. Moreover, those warning signals that the existing system did generate were ignored by senior lending officers.

In the final analysis, the bank's internal controls did not prevent the purchase of massive amounts of bad loans from Penn Square. With the benefit of hindsight, it is clear that our generally favorable assessment of Continental's internal controls was overly influenced by the bank's outstanding performance during the years 1974 through 1981.

Continental Was Dependent on Volatile Funds

Although Continental was weakened by asset deterioration, its losses never exceeded capital, and thus it never reached book insolvency. Rather, its near-collapse was triggered by funding problems. Beginning in the second half of 1982, the bank was forced to rely increasingly on foreign funding, as federal funds and certificates of deposit rapidly eroded. For

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almost two years, the overseas funding provided Continental with relatively stable, much needed liquidity. It also made the bank vulnerable to the liquidity problems that occurred in May 1984 when uncertainty about Continental's condition caused the overseas markets to close completely.

Clearly Continental's reliance on uninsured, short-term funds meant that it was particularly vulnerable to a loss of confidence. However, Continental's earlier decision to become a major corporate lender made the wholesale market a natural funding source. The wholesale market was practically a necessity given the restrictive branching statutes in Illinois that made establishment of a broad retail customer base difficult.

Although reliance on uninsured, short-term funds makes a bank sensitive to market perceptions, it is not by itself an imprudent banking practice. If a bank maintains sufficient liquidity and asset quality, periodic shortfalls in funding can be readily accommodated.

In Continental's case, the heavy reliance on wholesale funds was not accompanied by enough liquidity to sustain it through funding shortages. The bank's aggressive lending strategy was pursued to the exclusion of sufficient liquidity, resulting in a higher proportion of loans relative to assets than any of its peers. Even an extremely conservative liquidity position would not have protected Continental from the major funding crisis it experienced last spring. Nevertheless, it is an area we could have paid more critical attention to; we are doing so in large banks now.

Continental Never Regained Lost Confidence

It became clear, during our examination that began in May 1982, that Continental's management practices and policies had led to serious loan problems. We responded to this in a number of ways. We extended our examination through November. During the course of the examination, we directed Continental to begin a number of corrective measures, which were immediately initiated by the bank. We informed management of our intention to formalize these directives by placing the bank under a Formal Agreement, enforceable under the cease and desist authority of 12 U.S.C. 1818. My staff and I met several times with senior management and board members over the next few months to discuss the bank's condition and the impending Agreement.

The Agreement required improvements in numerous areas, including loan policies and procedures, asset and liability management, and funding. It also required regular reports by a board committee on the bank's compliance with the Agreement. Bank management complied with the terms of the action and took significant steps to revamp its operations. However, the loans that crippled Continental were already on the books.

Market confidence had begun to turn against the bank in July 1982 when its Penn Square loan problems surfaced publicly. Despite nearly constant OCC supervision and presence in the bank over the next two years, and the efforts by bank management and the board of directors, Continental was unable to fully regain market confidence. In May of this year, the market reacted adversely to rumors of further problems at Continental, and large depositors began withdrawing funds. The bank was unable to stem the run, and federal intervention was required to prevent the bank's collapse.

WHAT COULD HAVE BEEN DONE DIFFERENTLY?

An obvious question that we and others have asked is whether there was anything that the OCC should have done differently in the course of Continental's deterioration. In addressing this question, it is important first to clarify the role of the bank supervisor.

The Supervisor's Role is to Maintain Systemic Soundness

Short of nationalizing the banking system, no bank regulatory system can prevent all bank failures. I do not believe that the American public would support either the cost or the kind and degree of regulation and supervision that would eliminate all possibility of failure. To do so would require removing all risk-taking from banks, and would make banks unable to carry out their role as financial intermediaries in fueling the nation's economic growth. At the same time, however, it is clear that the nation is not well-served by a banking industry where the potential for failure is unrestricted.

Our charge is to maintain the safety and soundness of the national banking system. To do so requires sufficient oversight of and interaction with bank management to minimize the likelihood of bank failure. We do not take over and manage institutions; we cannot substitute for private management in making lending or any other decisions. The primary responsibility for any bank's performance rests with its management and board of directors. However, as supervisors we do monitor risk exposure, work to see that policies and controls are appropriate to that level of risk, and enforce compliance with the law. When we identify major weaknesses, we institute corrective measures, and follow up on their implementation. This results in significant improvement in the vast majority of institutions that we identify as having problems.

For some institutions, even prompt and stringent corrective measures are unsuccesful. The safety and soundness of the banking system also requires allowing such poorly managed, financially weak institutions to disappear from the system in an orderly manner. In an important sense, this is what has happened to Continental. The doors are still open, but the officers who allowed the bank's deterioration are no longer part of Continental. Moreover, those that bear responsibility for approving management policies have paid a price. The shareholders face substantial if not total loss, and the directors and former management face potential legal liability.

Could OCC Have Taken Other Actions?

The demise of Continental was clearly not desirable. It would have been far better if management had made better decisions and taken actions that would have been more appropriate for the ensuing circumstances. It would also have been preferable if we as supervisors could have done something to change the course of Continental.

As we review the history of Continental, it is possible to identify several points in time and ask whether it would have been appropriate for the supervisors to step in forcefully to change the course of the bank's direction. We did this, of course, after our 1982 examination when we took a formal enforcement action against the bank. Most banks, including Continental, respond to this type of corrective measure. What made Continental different from most of these cases was that the market did not wait for the bank's recovery plan to restore it to health.

I am persuaded that since mid-1982, there was nothing more that we could have done to speed Continental's recovery and thereby increase market confidence. One possible action was to force out top management in addition to those dismissed following the failure of Penn Square. We decided not to do this, for several reasons. First, existing management had proven more capable than most at bringing the bank out of the serious difficulties that many large banks faced following the REIT problems of 1975 and 1976. Second, management recognized the bank's problems in 1982 and put a program in place to identify and correct them. Finally, a thorough, independent management review undertaken by the board of directors in mid-1982 had indicated which officers had been directly responsible for the Penn Square loans, and those officers were removed.

One other possibility would have been to force the bank to curtail dividend payments. However, management and the board of directors felt that maintaining dividend payments was crucial to regaining market confidence and to raising additional capital. Moreover, the amount of money involved would not have added appreciably to capital. In all, once the bad loans were on the books, OCC -- and the bank -- took every action that could have been reasonably expected to restore Continental to health.

We have asked ourselves whether we should have taken action as early as 1976 to prevent Continental from embarking on a course of rapidly become a top lender to Corporate America. In my view, it would have been inappropriate to have done so. It is not the proper function of regulators to decide what business strategy an individual bank should undertake. The regulator's role is to see that whichever business strategy a bank chooses, it has the mechanisms in place to implement that strategy in a safe and sound manner.

In retrospect, it is clear that management, buoyant with the bank's years of financial success, placed too little value on risk control mechanisms in the implementation of its strategy. Continental's record shows that neither financial success nor the esteem of the financial community that flows from that success can substitute for sound and effectively enforced controls.

If there is anything that OCC could have done differently, I believe it would have been to place more emphasis on our evaluation and criticism of Continental's overall management processes. Had we done so, we might have been alerted to management's lack of commitment to controlling risk sooner than 1982. Had we been less swayed by management's successful track record from the early 1970s through 1981 and its previous responsiveness to our supervision, we might have been able to see more clearly the risks inherent in its rapid growth strategy.

SAFETY AND SOUNDNESS MUST BE MAINTAINED

Continental's demise has highlighted the need for banks and supervisors to continue to work to maintain the public's confidence in individual banks and the banking system as a whole. All reasonable steps must be taken to strengthen the ability of banks to weather adverse circumstances and thereby earn the continuing confidence of depositors. I would like to focus briefly on seven areas where the OCC has taken steps to enhance its examination and supervision and to strengthen the banking system.

1. Supervisory Techniques Continue to be Improved

The OCC's supervisory process has continued to improve as technological innovations have been made and industry conditions have changed. In the aftermath of Penn Square's failure and the problems experienced since mid-1982 by Continental and other banks, we have made a number of improvements in our supervision of national banks generally, and of large banks in particular.

Our supervision of banks of all sizes has been enhanced by the establishment of an Industry Review Program. This program includes a computerized information system to collect data on industry concentrations in individual bank portfolios and the banking system as a whole. Through the use of outside information sources we are monitoring significant industries in an attempt to better anticipate developments that might result in problems for banks. Our examiners will use the information in their analyses of individual banks to identify concentrations and to help position banks to withstand problems emerging from them.

Industry analyses and developments will be available to each examining team through its own portable microcomputer. Each team is being provided with extensive training in the full range of analytical techniques and will be equipped to perform more sophisticated analyses of banks' activities than were possible previously.

The near-complete development of two additional computer systems will provide us with a much improved ability to respond to examination needs and follow up on examination results. The first will facilitate examination scheduling by establishing system priorities. The second is our Supervisory Monitoring System, an automated tracking system that provides our examiners with access to all supervisory information sources, particularly examination findings and recommended actions. This will require a more orderly tracking and efficient follow-up of important supervisory concerns.

We have also taken steps to ensure communication within the OCC of examination findings on individual banks that may affect other banks in the system. These steps include changes in OCC internal procedures, examination manuals, and training. A newly developed course for evaluation of problem banks, in particular, addresses this concern.

Our multinational bank program has been expanded and we are examining multinational banks more frequently than in the past. Our examinations are targeted on the areas of supervisory concern and take place 2 to 3 times a year, rather than annually. Moreover, we have reorganized and significantly increased our resources committed exclusively to the supervision of our largest banks. A corps of our best and most senior examiners has been devoted solely to supervision of the multinational banks. In addition to the more frequent examinations we have undertaken, the examiners will also monitor trends and developments in the banks between examinations. This new approach results in near-constant supervision of each of our large banks.

We are now better able to identify and devote attention to items of supervisory concern in individual large banks and significant practices emerging in the large bank population as a whole. We are committed to continually improve our supervisory process and to maintaining an examination force that, in its training, support systems and overall quality is of the highest caliber.

2. Internal Controls Must be Emphasized

The OCC is placing more emphasis in the examination process on banks' internal controls and systems. This includes increased testing of control procedures and their application, and more stringent follow-ups to ensure that internal control deficiencies are corrected.

To accomplish this, we are focusing our examiners' attention to four basic control questions:

- What systems are in place to permit early detection of actions or trends that, if continued, might seriously affect the bank's condition;
- What actions are taken by senior management once adverse trends and deficiencies are disclosed;
- What individuals in the bank are in a position to materially affect the accurate recording of transactions; and,

- o What safeguards are in place to mitigate the chance that individuals could conceal irregularities from their superiors, bank auditors, and examiners.

These questions are particularly important in the area of problem loan identification systems and will receive greatest attention in that area.

In 1983, the OCC issued specific procedures that banks must follow when they purchase loan participations. The circular spells out that the purchase of loans and participations in loans may constitute an unsafe and unsound banking practice in the absence of documentation, credit analysis, and other controls over risk. The circular also warns banks that the absence of satisfactory controls over risk is unacceptable and may cause the OCC to seek appropriate corrective action through enforcement actions.

3. Loan Loss Reserves Are Being Evaluated

Since the allowance for possible loan losses (APLL) is the first line of defense against loan deterioration, we are taking additional steps to assess the adequacy of a bank's APLL relative to the total risk in its portfolio. We are concerned that for some banks, increases in the APLL have not kept pace with increases in nonperforming and classified loans. We are addressing this concern by developing more specific criteria for use by our examiners in evaluating the adequacy of reserves and by focusing our examinations of large banks to make sure that reserves are adequate.

4. Capital Levels Are Being Increased

Congress reemphasized the critical role of capital in maintaining the safety and soundness of the banking system when it enacted in 1983 the International Lending Supervision Act that authorizes the banking agencies to enforce capital requirements. Under regulations proposed by the OCC and the FDIC, all banks, regardless of size, would be required to maintain a minimum ratio of primary capital to total assets of 5.5 percent. The implementation of this regulation will require over 200 national banks to raise a total of over $5 billion in new capital. The Federal Reserve has proposed similar guidelines on capital.

Stricter regulatory capital requirements will strengthen the trend towards stronger capitalization of the nation's largest banks. For example, in the first quarter of 1984 the average ratio of primary capital to total assets stood at 5.67

percent for the holding companies of the 11 multinational banks supervised by the OCC. This is almost 16 percent higher than the average level at those banks two years ago.

Adoption of this standard would not replace our supervisory evaluation of capital adequacy. Banks of all sizes will be encouraged to maintain higher capital levels. Furthermore, the OCC retains the right to impose higher ratios for banks whose circumstances necessitate a stronger capital base.

As another means of ensuring adequate capital, OCC will be scrutinizing each bank's dividend payout policies in light of its overall capital structure. We will not hesitate to restrict dividend payments when necessary.

5. Sources and Uses of Funds are Being Scrutinized

The OCC is devoting more resources to monitoring regional and multinational banks' global funding. Banks will be placed under special surveillance if they are especially vulnerable to eroding market confidence or reliance on particular funding markets is deemed to be excessive. A key element in our increased supervision of funding is constant monitoring of the attitudes and concerns of market participants. Supervisory actions on individual banks will vary but, at a minimum, they are expected to include the development of alternative funding plans. In some cases, supervisory actions could also constrain growth. Finally, where we find a high volume of volatile liabilities, we will require a larger percentage of liquid assets.

6. Increased Financial Disclosure is Being Promoted

The market's evaluation of the banking system depends, in large part, on the information that is publicly available. To enhance the credibility of bank financial statements and reduce the likelihood that the market will overreact to incomplete information, the OCC is considering requiring increased disclosure of information about banks. To that end, it is seeking public comment on increasing the disclosure requirements for banks via an advance notice of proposed rulemaking (ANPR).

The ANPR highlights questions such as what additional information is needed; who should have the responsibility of making information public; and how the integrity of financial statements used for disclosure should be maintained.

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The OCC has also taken steps to enhance the accuracy of information that is already disclosed. Recently OCC took enforcement actions against six major banks and required them to restate some of their financial information to eliminate "window dressing" that could mislead depositors, investors, and the regulatory agencies.

In addition, along with the Federal Reserve Board, the OCC issued a statement on June 11, 1984 reaffirming its policy on nonaccrual loans. Such loans must be placed on nonaccrual status (by virtue of being more than 90 days past due) on contractual dates and must be brought current before being returned to accrual status. Finally, we are continuing to work with other federal banking agencies and the Securities and Exchange Commission to review additional means of improving bank disclosure.

7. Strict Enforcement Policy is Being Maintained

We have been utilizing our enforcement power more vigorously to correct violations of law and imprudent banking practices. For instance, last year we took 274 formal actions against national banks compared to 156 for the previous year and only 65 in 1978. These actions have been taken against banks of all sizes. We have outstanding enforcement actions against 17 percent of the banks with assets over $1 billion and 12 percent of the banks with under $1 billion in assets. Last year, we also imposed civil money penalties against 127 bank officials. To put that into perspective, in 1981 we imposed only 19.

Over the last several years our enforcement actions have covered a wide variety of banking activities. In the large banks alone, we have recently taken a number of enforcement actions following targeted examinations that found inadequate loan losses reserves. In one instance, we took formal enforcement actions against some 21 national bank subsidiaries of a regional company to prevent improper transactions among affiliates. In addition to numerous cases addressing problem assets, lending controls, capital and management, actions against large banks have also been directed at inadequate procedures governing banks' securities activities. Moreover, we have worked jointly in enforcement actions with the SEC and have made referrals to the SEC when it appeared that holding companies failed to make adequate disclosure of OCC's enforcement actions on a subsidiary bank.

CONCLUSION

In summary, Continental pursued a growth strategy without adequate controls that proved to be its downfall in adverse economic circumstances. The bank has suffered the consequences. Management has been removed, and shareholders have incurred substantial losses. At the same time, we have avoided major disruption to the financial system. Upon implementation of the long-term solution, Continental will be well-capitalized and have stronger assets and management. It will be returned to private ownership at the earliest possible date.

We continue to focus our supervisory efforts on enhancing the ability of banks to remain sound even under difficult circumstances. Such action will strengthen the banking system and assure the continuing confidence of depositors.

* * *

Mr. Chairman, that concludes my prepared remarks. I will be happy to answer questions.

Appendix to

Statement of C. T. Conover

Comptroller of the Currency

Before the

Committee on Banking, Finance, and Urban Affairs

U. S. House of Representatives

September 19, 1984

CONTINENTAL ILLINOIS NATIONAL BANK AND TRUST COMPANY

TEN-YEAR REVIEW

This Appendix provides a ten-year historical overview of the principal events leading up to the federal rescue of Continental Illinois National Bank and Trust Company. Continental's history, for this purpose, falls naturally into two distinct time periods: the period from 1974 through 1981 when Continental grew rapidly and acquired many loans that ultimately turned into losses, and the period from the beginning of 1982 until July 1984 in the aftermath of the discovery of significant loan problems. This Appendix reviews the effects of the U.S. economy on the bank, significant actions taken by the bank, and OCC's supervisory involvement. The discussion and accompanying charts relate to the bank and not the bank holding company. Unless otherwise indicated, the peer group referred to in the charts and analysis is composed of eight wholesale money center banks.*

CONTINENTAL: 1974 - 1981

Located in America's industrial heartland, Continental historically focused on domestic corporate lending. Because state restrictions on branching limited the establishment of a significant retail customer base, corporate lending was a natural area for Continental to emphasize. As the U.S. emerged from the 1974 - 1975 recession, economic growth was strong and many new lending opportunities emerged.

Roger E. Anderson became Chairman and Chief Executive Officer in 1973. He and his new management team set ambitious strategic business goals to make Continental a world class bank. In describing those goals, a bank executive was quoted in a 1980 Institutional Investor article:

> We're a country bank. . . What we would like to do is demonstrate that a Midwestern country bank can become the most magnificent force in the banking world.

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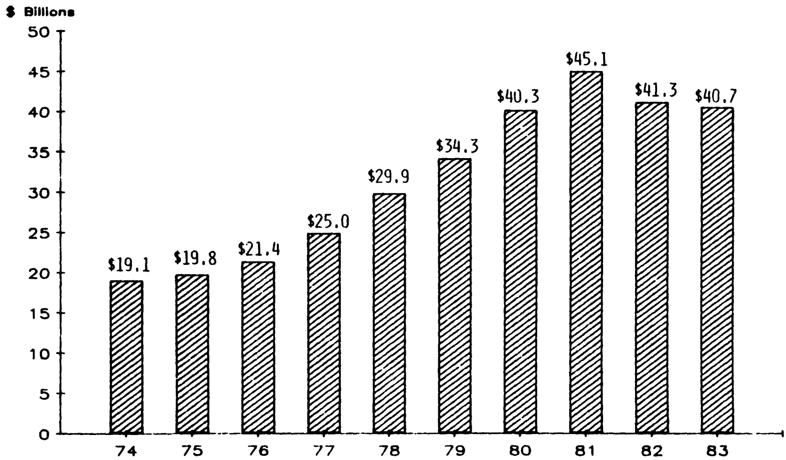
*The eight wholesale money center banks included in the peer group are Bankers Trust, Chase Manhattan Bank, Citibank, First National Bank of Boston, First National Bank of Chicago, Irving Trust Co., Manufacturers Hanover Trust Co., and Morgan Guaranty Trust Co.

Between 1974 and 1981, Continental's assets grew an average of over 13% per year. Its $45.1 billion in total assets at year-end 1981 made it the sixth largest bank in the nation, up from the eighth largest in 1974.

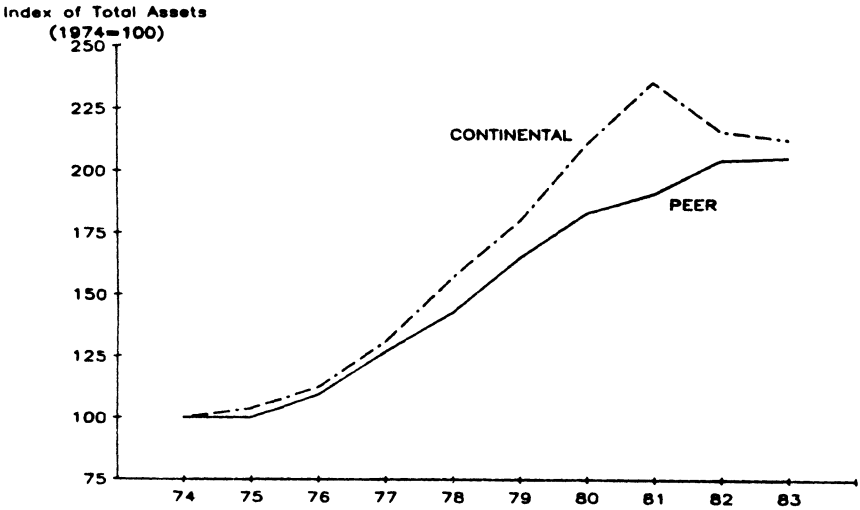
Continental's Year-end Total Assets



Source: Call Reports

As illustrated in the following chart, Continental generally grew faster than other wholesale money center banks during this period.

Growth in Total Assets



Source: Call Reports, OCC

Beginning in 1973, Continental embarked on an aggressive assault on selected segments of the banking market. The bank rapidly built up its consumer loan portfolio. A private placement unit was created that secured a foothold in the market by arranging placements of debt for small companies. Its international effort was expanded by structuring syndicated Eurodollar loans, making advances in direct lending to European multinational companies, and becoming active in project financing.

Like most banks, Continental suffered during the collapse of the real estate investment trust industry in the mid-1970s. Continental's management, however, handled this problem well; recovered the bank from its real estate problems more successfully than most other large banks with similar problems. As a result, Continental continued to remain active in real estate lending throughout the 1970s. Its mortgage and real estate portfolio grew from $997 million at the end of 1977 to approximately $2.3 billion at the end of 1979.

Continental emerged from the 1974 - 1975 recession with one of the best loan loss records among its peer group, reflecting management's ability to steer the bank through economic downturns. Financial problems at some of Continental's prime competitors in the late 1970s also provided the bank with a competitive opportunity to increase its market share and become the "premier bank in the Midwest."

OCC's assessment of Continental's management and the bank's performance during the eight examinations conducted by this Office in the 1974 - 1981 period was favorable. The bank was particularly strong as it emerged from the 1974 - 1975 recession. Earnings were rising and the bank's handling of its problem loans following that recession was superior to that of most other wholesale money center banks.

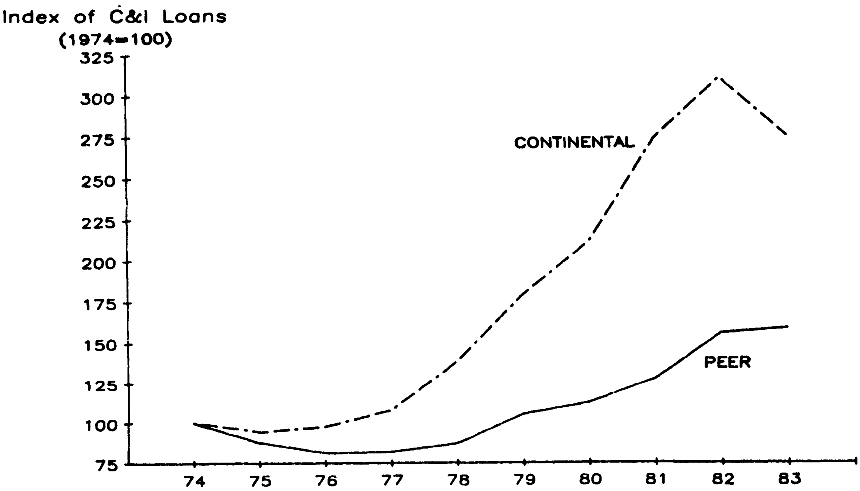
In 1972, the bank expanded individual lending officers' authority and removed the loan approval process from a committee framework. Continental revamped its organization in 1976 and eliminated more of the "red tape" in its lending procedures. Major responsibility was delegated to lending officers in the field, resulting in fewer controls and levels of review, in order to provide lending officers with the flexibility to rapidly take advantage of lending opportunities as they arose. While decentralized lending operations were common among money center and large regional banks, Continental was a leader in this approach. Management believed that this organizational structure would enable Continental to expand its market share and eventually meet its goal of becoming "one of the top three banks lending to corporate America."

In light of Continental's rapid growth, OCC examiners stressed the importance of adequate controls, especially in the loan area. Certain internal control problems within the bank were noted by examiners. In particular, exceptions were noted in the timeliness of putting problem loans on the bank's internal watch list.

In reaction to these criticisms, management implemented new control features, including computer-generated past due reports and a system to track exceptions in the internal rating process. Given the bank's historical loan loss experience and proven ability to deal with problem situations, supervisory concerns were not of a serious nature.

During the period from 1974 - 1981, Continental sought to spur loan growth by courting companies in profitable, although sometimes high risk businesses. Lending officers were encouraged to move fast, offer more innovative packages, and take on more loans. This aggressive lending strategy worked well for the bank; Continental's commercial and industrial (C&I) loans expanded from $4.9 billion in 1974 to $14.3 billion in 1981. Moreover, it was able to expand its market share during a period in the late 1970s when many other major U.S. banks experienced declining market shares because of increasing competition from foreign banks, the commercial paper market, and other nontraditional lenders. By adding numerous multinational and middle-market companies that previously did no business with the bank, Continental's share of the domestic C&I loan market rose from 3.9% at the end of 1974 to 4.4% at year-end 1981.

Commercial and Industrial Loan Growth

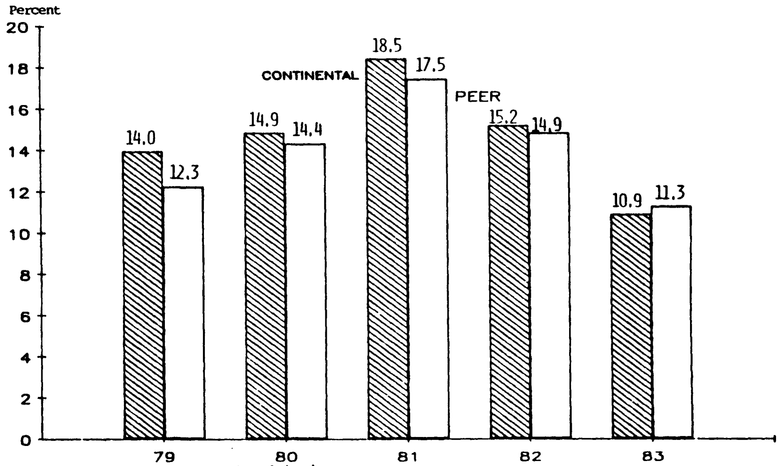


Source: Call Reports, OCC

As part of its corporate expansion, Continental became particularly aggressive in the energy area. The bank created a special oil-lending unit in the early 1950s -- reportedly the first major bank to have petroleum engineers and other energy specialists on staff. The economic consequences of the 1973 oil embargo and the resulting four-fold increase in world oil prices pushed energy self-sufficiency to the forefront of our national goals. A number of actions were taken by various Administrations and Congress following the first embargo and subsequent oil price hikes to both reduce U.S. energy consumption and to increase domestic production. The Department of Energy, created in 1977, sought to develop ways of encouraging higher investments in U.S. exploration, development, production, and refining capacity. Cultivation of this niche had made Continental a premier energy lending bank and contributed significantly to its rapid, and profitable, expansion.

Continental's C&I loans, including its energy loans, produced high returns for the bank. Average yields were consistently higher than those of other wholesale money center banks.

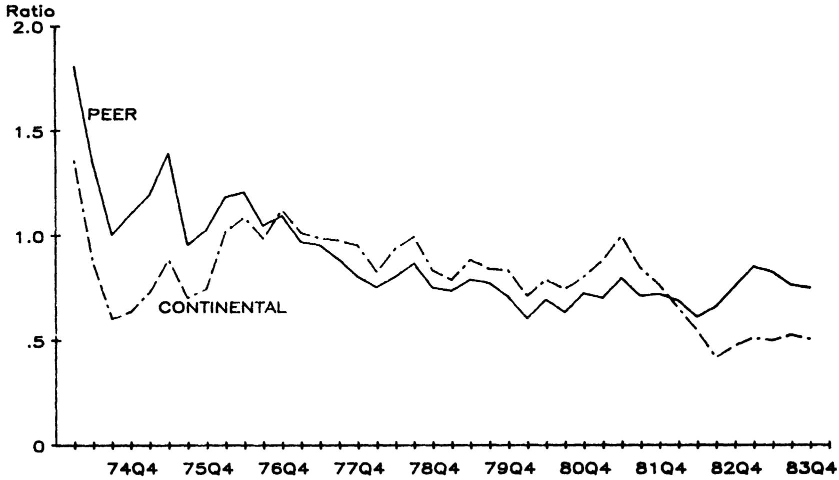
Average Annual Yield on C&I Loans



Peer group includes only national banks.
Source: Call Reports

The financial markets reacted favorably to Continental's aggressive growth strategy. In 1978, Dun's Review described Continental as one of the five best managed companies in America. Many analysts regarded it as a preeminent wholesale money center bank, citing its stable asset and earnings growth, its excellent record in loan losses, and its expertise in energy lending. Continental Illinois Corporation's ratio of market price to book value, which had lagged behind other money center bank holding companies in the early 1970s, began rising in 1976.

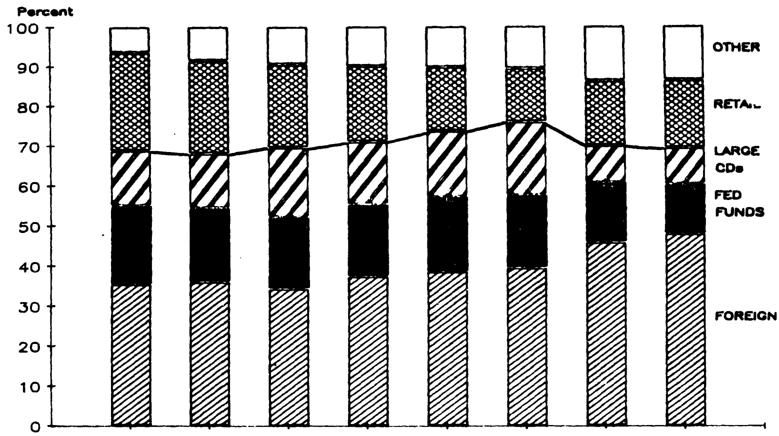
Market Price/Book Value



SOURCE: Data Resources, Inc.

With limited access to retail banking markets and core deposit funding because of restrictive branching statutes in Illinois, Continental funded its rapid growth through purchased wholesale money such as federal funds, negotiable certificates of deposit, and the interbank market. Its reliance on purchased funds, approximately 70% of total liabilities, was much higher than its peer group average.

Continental's Liability Distribution



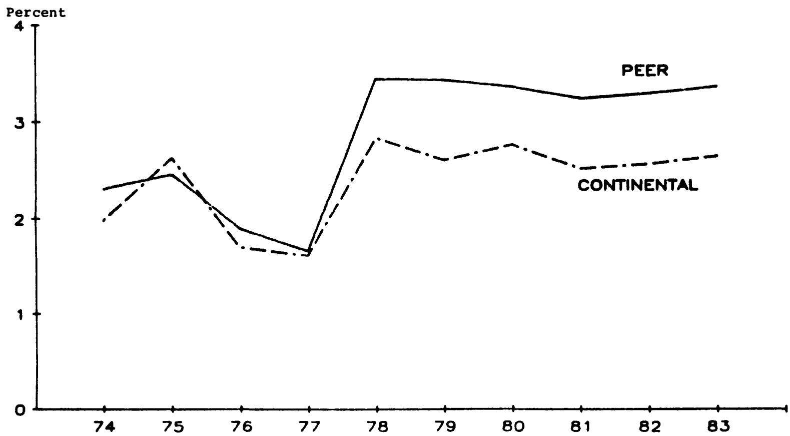
Source: Call Reports

Concerns were raised by OCC examiners in the 1976 examination over the bank's liquidity and its reliance on Fed Funds, foreign deposits, and negotiable CDs. By the time of the summer 1977 examination, Continental had improved its liquidity position and had enhanced its monitoring systems.

OCC examiners concluded that the Office's funding and control concerns were being adequately monitored by the bank. The bank was requested, however, to submit quarterly status reports on classified assets over $5 million and monthly financial statements.

Continental's heavy reliance over this period on purchased money, which had a higher interest cost than retail deposits, offset much of the gain that accrued from Continental's higher loan yields. High funding costs reduced Continental's net interest margin to a level well below its peer group.

Net Interest Margin



Net Interest Margin = Net Interest Income (TE) to Average Earning Assets
Source: Call Reports

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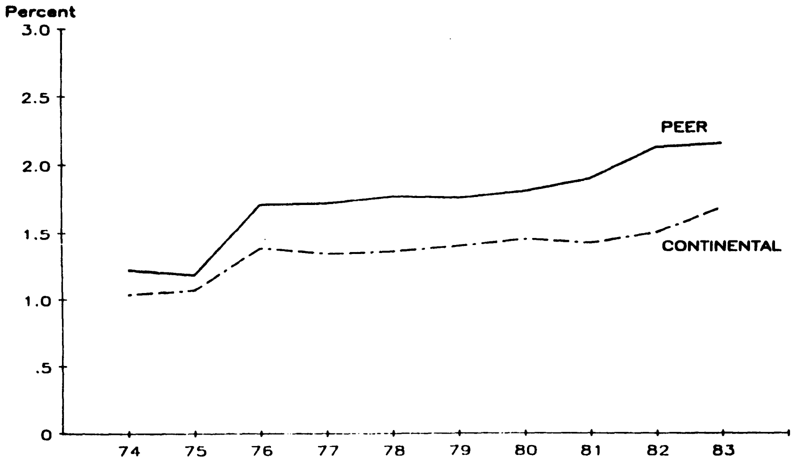
Continental was, nevertheless, able to maintain its superior earnings growth because of low overhead and non-interest expenses. The absence of domestic branches and relatively few foreign branches, compared to other money center banks, held down Continental's overhead expenses and, therefore, compensated for some of its high funding costs. As illustrated in the following chart, Continental's ratio of non-interest expenses to average assets was far below its peer group average.

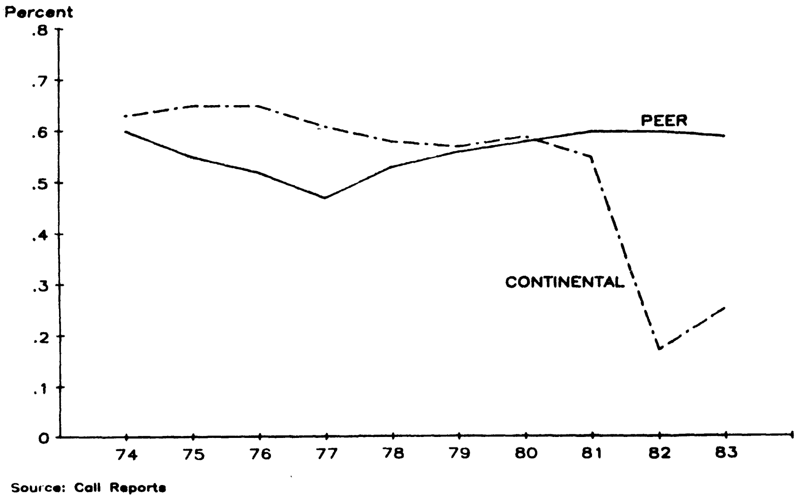
Non-Interest Expenses/Average Assets



Source: Call Reports

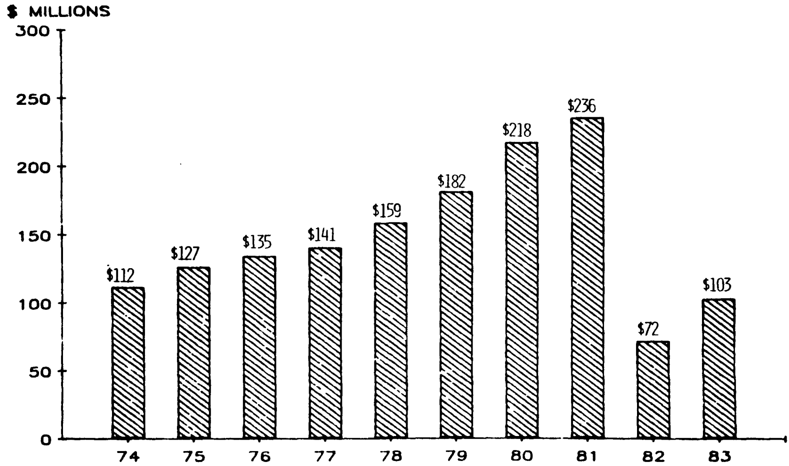
As a consequence, through 1980, Continental was able to achieve one of the best and most consistent performance records among money center banks. Its ROA was consistently above the average of other wholesale money center banks.

Return on Average Assets



The bank showed record earnings while its assets grew to a high of $45.1 billion in 1981. As shown in the following chart, net income rose rapidly before peaking at $236 million at year-end 1981.

Continental's Net Income

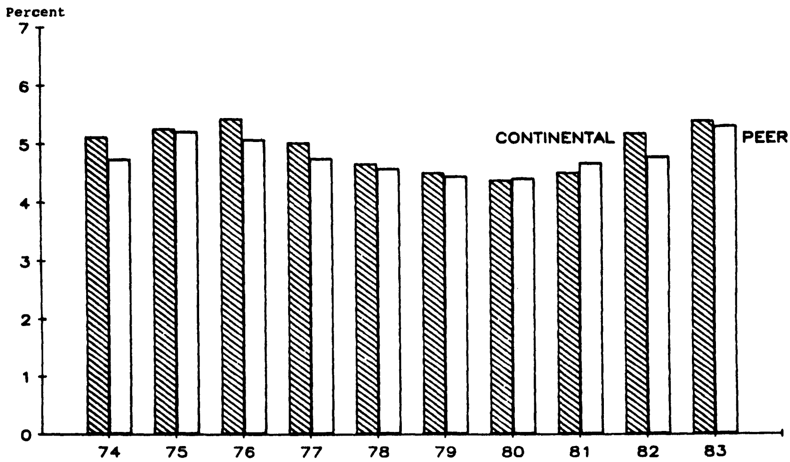


Net Income After Tax, Before Securities Transactions and Extraordinary Items
Source: Call Reports

As noted earlier, in the examinations conducted by this Office in the 1974 - 1981 period, Continental's overall condition was found to be good and it generally compared well with other multinational banks under our supervision. In addition to liquidity and internal controls, our concerns during this time period centered on capital adequacy and asset quality.

While Continental's capital to asset ratio compared favorably to other money center banks, OCC examiners expressed concern throughout the late 1970s about the bank's ability to generate sufficient capital to keep pace with its rapid expansion.

Primary Capital to Total Assets



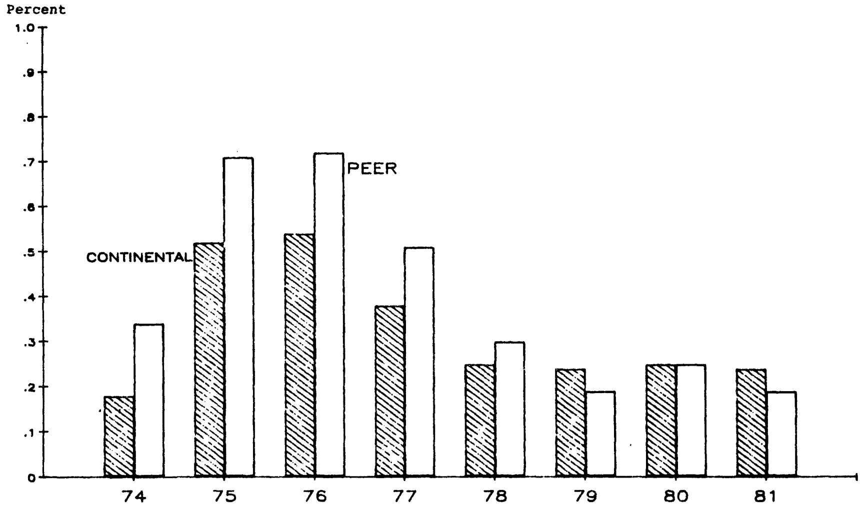
Source: Call Reports

During the 1976 examination, the Office pointed out that unlike most other large national banks, Continental had no definite capital growth plan. As a result, the bank prepared a three year capital plan and took immediate measures to increase capital, including cutting the size of its 1976 dividends to the holding company, by $15 million, to $45.6 million. In addition, the bank holding company issued debt and used the proceeds to inject $62 million into the bank's surplus account. Despite these efforts, capital failed to keep pace with asset growth and continued to decline through 1980.

Continental had an excellent loan loss experience, with one of the lowest percentages of nonperforming assets and net loan losses in the industry. Asset quality, which was a major concern at most money center banks in the 1975 - 1976 period, showed steady improvement at Continental throughout the late 1970s. Its classified assets decreased dramatically following the recession, demonstrating management's ability to deal effectively with problem assets. By the end of 1977, Continental had classified assets representing 86% of gross capital, down from 121% of capital the previous year. In the

1975 - 1977 period, Continental's ratio of net loan losses to average total loans and leases was 25% lower than the average of other wholesale money center banks.

Net Loan Losses/Average Total Loans and Leases



Source: Call Reports

OCC's 1979 examination of Continental noted continuing improvement in asset quality. Classified assets had declined from 86% to 80% of gross capital funds. Liquidity was also considered adequate at this time. Some problems, however, were noted in the bank's internal credit review system. Deficiencies were cited in the identification and rating of problem loans and the completeness of credit files. In light of the bank's rapid asset growth, OCC examiners once again emphasized the importance of building a strong capital base.

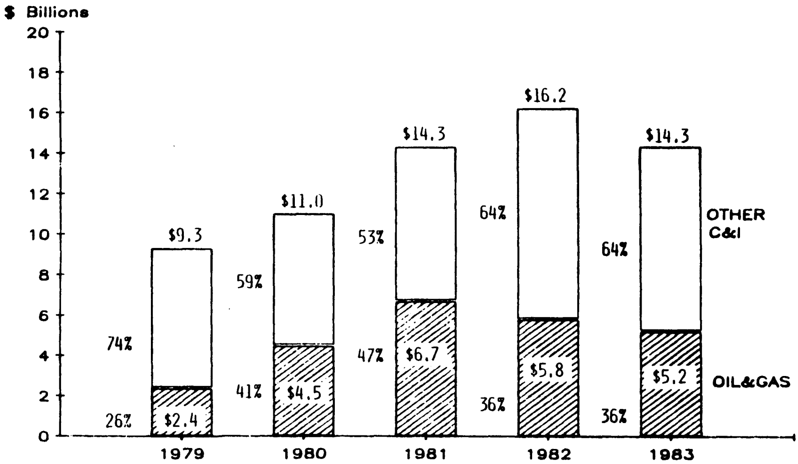
Similar conclusions were drawn during the 1980 examination. Liquidity was still considered acceptable. Asset quality continued to improve; classified assets as a percent of gross capital funds declined to 61%. Management was encouraged to perform some type of on-site review of information submitted to the loan review committee, such as periodic visits to foreign offices and other loan origination sites. Although not keeping pace with asset growth, capital was considered adequate. The bank was thought to have sufficient capability to meet external pressures and to fund projected growth.

In its response to the 1980 examination, Continental management indicated that although they believed the bank's present internal credit review system had been successful, some type of on-site review might be appropriate, particularly in light of the bank's expansion. Accordingly, management had been exploring various methods of accomplishing this shift in a cost-effective manner. An experimental field review was subsequently conducted.

During the 1981 examination, the OCC placed special emphasis on the review of Continental's energy and real estate lending, since the bank was targeting these areas for additional growth. Continental's energy portfolio nearly doubled between 1979 and 1980 and increased by an additional 50% the following year. By 1981, energy loans represented 20% of Continental's total loans and leases and 47% of its total C&I loans. With energy prices skyrocketing and drilling and exploration activity booming, Continental was well-positioned to meet the burgeoning credit demands for development of energy sources.

Continental historically had made loans to energy producers that were secured by "proven reserves" or by properties surrounded by producing wells that were almost guaranteed to produce oil and gas. As part of management's intensified commitment to energy lending in the late 1970s, the bank had begun expanding its energy portfolio, including making loans secured by leases on undeveloped properties with uncertain production potential. The bank also became particularly aggressive in extending loans to small, independent drillers and refiners.

Energy Share of Continental's C&I Loans



Source: OCC

In 1981, Continental had over $6.7 billion in oil and gas loans outstanding. Despite this high commitment to a single sector of the economy, Continental's management felt confident about the strength of the energy industry and its knowledge of specific oil fields and companies. Losses from Continental's energy loans had consistently averaged less than half the net loan losses from its non-energy loans. According to Gerald Bergman, former head of Continental's Special Industries lending department, the bank was simply demonstrating "a reasonable way to leverage [its] expertise in the oil industry" (American Banker, August 25, 1981).

While conducting the 1981 examination, which used information as of April 30, 1981, OCC examiners noted a significant level of participations from Penn Square that were backed up by standby letters of credit. Recognizing that the amount of these loans was large in comparison with Penn Square's size, additional time was spent examining them. The OCC's review determined that these standby letters of credit were issued by banks other than Penn Square, including several money center banks, alleviating our concerns. Moreover, since the energy industry still appeared strong and the energy loans were continuing to perform, we saw no cause for concern at that time. In all, only two oil and gas loans, totaling $85 million were classified. Neither loan had been purchased from Penn Square.

As part of the 1981 examination, OCC examiners sampled new account relationships, in particular, and devoted further efforts to judging the quality of the credit rating system. Classified assets as a percent of gross capital had increased from 61% at the previous examination to 67%. The trend, which was also noted at other large banks, however, was attributed by OCC examiners to deteriorating economic conditions rather than a relaxation of credit standards.

OCC examiners again reviewed Continental's internal loan review systems during the 1981 examination. Although examiners did classify several loans for which watch loan reports had not been prepared, each of these loans had been internally rated in accordance with bank policy. Neither the dollar amount nor the number of these loans was considered significant. However, it was noted that approximately 375 loans, totaling $2.4 billion, had not been reviewed by the bank's rating committee within one year; 55 of these had not been reviewed within two years. Management was aware of these exceptions and was in the process of reassessing its loan review system.

Continental's quality and consistency of earnings were considered good at the time of the 1981 examination. Examiners noted that a program of holding down dividends had resulted in a steady source of capital augmentation, but that capital still needed to be brought in line with asset growth. Liquidity was considered sufficient to meet any external pressures. Suitable systems for managing funding and rate sensitivity were found to be in place.

In response to the 1981 examination, Continental's management indicated that they did not feel there was a problem with the loan portfolio quality, in light of the economic environment at that time. In fact, management expressed surprise that more difficulty had not surfaced, given the prolonged period of record high interest rates and the state of the economy. Nevertheless, they stated that close, continued attention would be provided to the quality of the portfolio. Management further stated that the issue of loans not being reviewed on schedule for rating purposes was receiving attention and that improvement was expected.

Through most of 1981, the majority of Wall Street analysts believed that Continental would continue to experience superior growth due to its position as a prime lender to the energy industry, its potential for improved return on assets, and its record of loan losses. The Wall Street Transcript gave its silver runnerup award for outstanding money center bank CEOs to Roger Anderson in June of 1981. Bank analysts strongly supported the selection, with one analyst noting:

> I give Continental credit for doing what they do best, and that is lending money. They've been able to pick out certain niches. I'm continually amazed by their reception as energy lenders. They positioned themselves well early on, and they have been reaping the benefits of that. I used to be skeptical that they could manage their costs when things slowed down, but they've shown me recently that they've done a good job of managing people and costs and pushing employees toward productive areas.

Another analyst commented that:

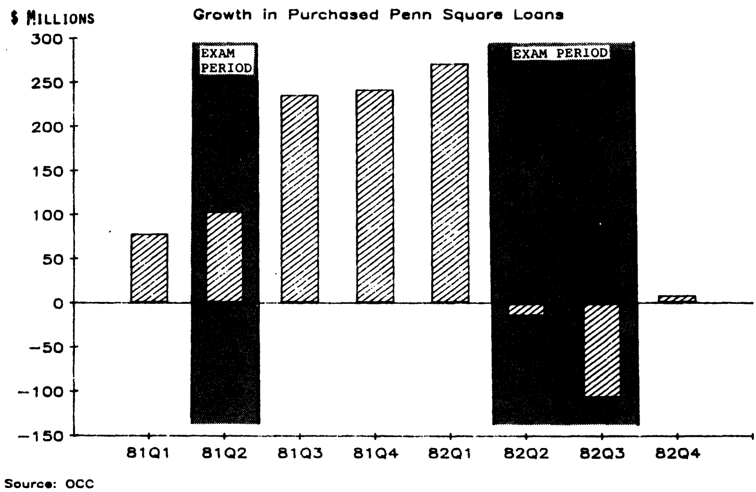
> With Continental possessing one of the best loan loss records among money center banks, one can assume it is carrying the same credit standards into the current period of economic weakness as it did in the prior period and will not suffer large loan losses.

CONTINENTAL: JANUARY 1982 - JULY 1984

To fully understand the demise of Continental, it is first necessary to review the history of Penn Square Bank's involvement with Continental. Penn Square was one of the most aggressive lenders in one of the hottest energy drilling areas of the country. Because its loan generating ability exceeded its legal lending limit as well as its funding ability, Penn Square would originate loans and then sell them to other banks, including Continental and Seattle First National Bank.

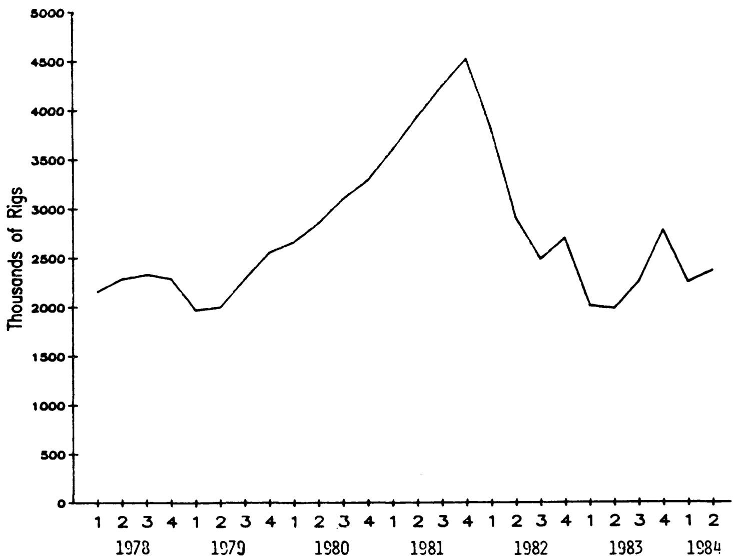
Although Continental began purchasing loans from Penn Square as early as 1978, significant growth in loan purchases did not occur until the beginning of 1981. For example, as of the end of 1980, Continental had purchased energy loans from Penn Square totaling only $167 million. By the conclusion of this Office's 1981 examination of Continental in August, loans purchased from Penn Square were in excess of $500 million. From that time period until the start of the 1982 examination, another $600 million in participations from Penn Square loans were booked at Continental, bringing the total amount to $1.1 billion. At their peak in the Spring of 1982, Penn Square loans represented 3% of Continental's total loans and leases and 17% of its total oil and gas loan portfolio.

Major Purchases of Penn Square
Loans Occurred Between Examinations



In a quarterly visit with Continental management in March of 1982 prior to the general examination, OCC examiners discussed the general health of the energy industry. Since the end of 1981, the energy industry, as represented in the following chart showing drilling activity, had declined significantly.

Drilling Rigs Operating in the U.S.



SOURCE: STANDARD & POOR'S

In spite of this decline, bank officials said they felt comfortable with their expertise in the energy area and planned to continue to stress it. Notwithstanding the thorough review of the energy portfolio in the 1981 examination, the intervening decline in the oil and gas industry made energy a principal focus of the OCC's 1982 examination scheduled to begin in May. At the request of the examiner-in-charge of the Continental examination, an energy lending specialist from the OCC's Southwestern District was assigned to assist in the 1982 examination of Continental.

Our concerns became serious when OCC examiners in Penn Square learned that Continental had purchased a significant quantity of bad loans from Penn Square. An examination of Continental was underway and OCC examiners in that bank were immediately informed of irregularities in the Penn Square loans.

The OCC responded to this in a number of ways. After informing Continental's management in June of the serious condition of Penn Square and its implications for Continental's loan portfolio, the OCC extended its examination through November and worked closely with Continental's internal auditors and independent accountants to assess the damage. On July 5, 1982, Penn Square Bank failed.

Continental's serious condition prompted the OCC to direct a number of corrective measures, which were immediately initiated by the bank. The OCC informed management in August

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of its intention to formalize these directives by placing the bank under a Formal Agreement, enforceable under the cease and desist authority of 12 U.S.C. 1818. The Comptroller and his staff met several times with senior management and board members over the next few months to discuss the bank's condition and the impending Agreement.

Continental moved quickly to determine the extent of its exposure in loans originated by Penn Square, to get a fix on the size of the loan loss provision necessary for the second quarter, and to stabilize funding. OCC examiners also reviewed all of the loans Continental had purchased from Penn Square and evaluated their effect on Continental's loan portfolio and provision for loan losses. Our examiners held numerous meetings with Continental's Board of Directors to discuss the bank's provision for loan losses and its recovery effort.

OCC's 1982 examination determined that many of the loans purchased from Penn Square, particularly in the months just prior to Penn Square's failure, had failed to meet Continental's typical energy-lending standards. Many were also poorly documented and were, therefore, not being internally rated in a timely manner. Accordingly, increasing numbers of these loans appeared on Continental's late rating reports. In addition, numerous loans had appeared on

Continental's internally-generated collateral exception report. The reliability of Continental's internal reporting systems, however, had been spotty in previous years. As a consequence, officers in the Special Industries Division who were purchasing the loans from Penn Square were able to persuade senior lending officers to disregard the internal reports. Early internal warning signals were, therefore, largely ignored.

During the office's 1982 examination, OCC examiners also learned that a team of internal auditors had been sent twice in 1981 by Executive Vice President Bergman, head of Continental's Special Industries Group, to review the Penn Square loans Continental was purchasing. The auditors' report on their first visit in September 1981 noted several items that they felt merited "special attention", including: incomplete and inaccurate records, questionable security interests, and a high level of loans to parties related to Penn Square. The Special Litigation Report of the Board of Directors issued in 1984 concluded that this audit report, although submitted to Bergman, was not seen by senior Continental management prior to the collapse of Penn Square.

The written report of the bank auditors' findings of their second visit to Penn Square in December 1981 expressed concern with loans secured by Penn Square-issued standby letters of credit (representing approximately one-third of that bank's equity), questionable lien positions, and several loans in which the bank had purchased more than Penn Square's current outstanding balance. This audit also uncovered $565,000 in personal loans from Penn Square to John R. Lytle, manager of Continental's Mid-Continent Division of the Oil and Gas Group, and the officer responsible for acquiring the Penn Square loans.

The Special Litigation Report once again indicated that while senior Continental management did receive news of these loans to Mr. Lytle, they once again did not receive the full auditors' report from the December review of the Penn Square lending operations. No action was taken by Continental to remove or discipline Mr. Lytle until May of 1982.

In July of 1982, following the collapse of Penn Square, Continental sent a staff of experienced energy lenders to Oklahoma City to review Penn Square's records and assess the dimensions of the problem. Each of the loans Continental purchased from Penn Square were reviewed during the first two weeks of July. After analyzing the probable risk associated with each credit, senior Continental officers recommended an addition to loan loss reserves of $220 million. This Office, as well as the bank's accounting firm of Ernst & Whinney, reviewed this figure and concluded that it was supported by the information available at that time. This figure was then published on July 21 along with a full statement of Continental's second-quarter results.

Continental auditors, supported by accountants from Ernst & Whinney, remained in Oklahoma City reconciling Continental's records with Penn Square data, assisting in the Penn Square portfolio assessment program, and preparing the loan workouts. OCC examiners also reviewed in late August and early September each loan purchased from Penn Square and discussed their findings with senior Continental management before release of third quarter earnings. That review resulted in an additional $81 million being added to the bank's provision for loan losses in the third quarter, as reported in Continental Illinois Corporation's October 14 press release. The holding company also indicated that its nonperforming assets had reached $2 billion as of September 30, 1982, up $700 million from the previous quarter.

Simultaneously with the credit review, Continental undertook an extensive review of the people involved in the Penn Square relationship and the lending policies, procedures, and practices which might have contributed to the crisis. In its first phase, an independent review committee appointed by Continental's Board of Directors recommended a series of major staff changes beginning with the July 14 suspension of John R. Lytle. Mr. Lytle was permanently released from the bank on August 30. Resignations and early retirements, including those of Executive Vice President Bergman and his superior, Executive Vice President George Baker, soon followed. In addtion, various other bank personnel were reassigned.

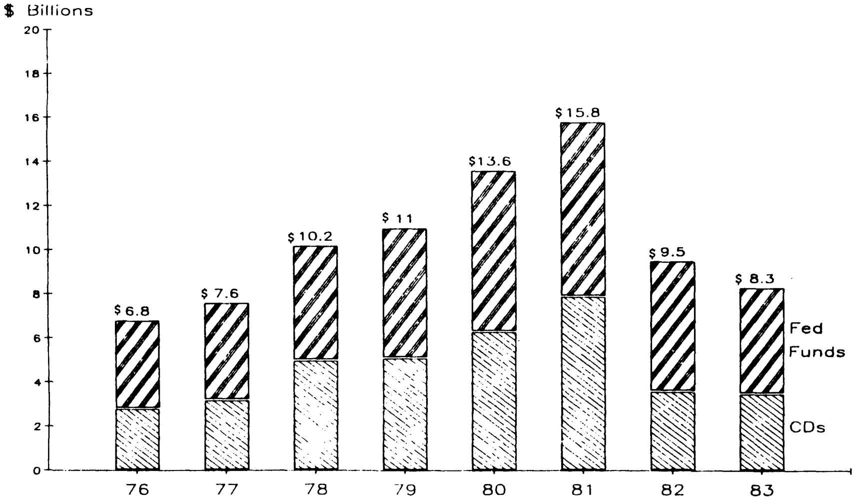
In its second phase, the internal review committee assessed bank policy and recommended:

- codification of bank lending policies and procedures;
- enhancement of secured lending and related support systems;
- improvement in cooperation between loan operations and the line;
- revision of loan operations activity to improve its reliability and productivity; and
- formulation of a Credit Risk Evaluation Division, as had been recommended by the OCC, to strengthen the bank's credit rating system and enhance credit risk identification, evaluation, reporting, and monitoring.

Following the Penn Square collapse, the domestic money market's confidence in Continental was seriously weakened.

The bank's access to the Fed Funds and domestic CD markets quickly dried up. As illustrated below, Continental lost 40% of its purchased domestic funding in 1982.

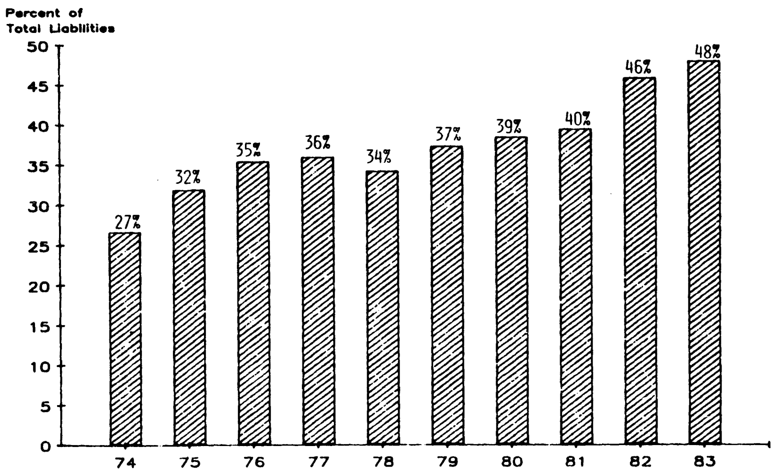
Continental's Domestic Purchased Funds



Source: Call Reports

Continental moved quickly to stabilize and restore its funding. Meetings were held with major funds providers, rating agencies, and members of the financial community. Public disclosures were periodically issued to correct misinformation. In the fall of 1982, liquid assets were sold or allowed to mature. As the domestic funds market dried up, Continental shifted to the European interbank market for funding. Foreign liabilities soon began to approach 50% of the bank's total liability structure.

Continental's Foreign Liabilities/Total Liabilities



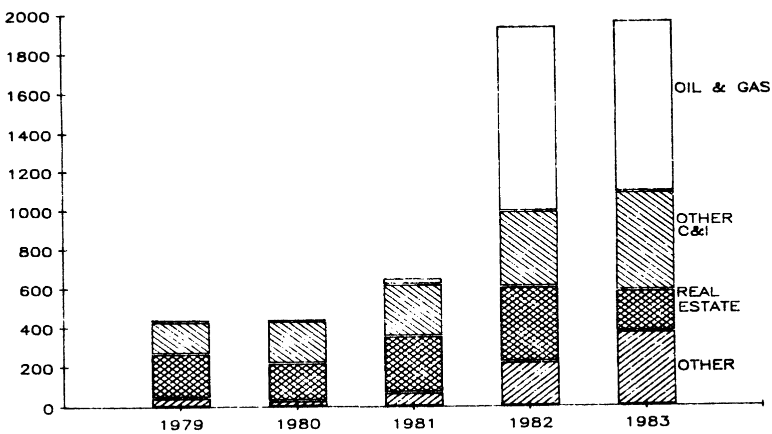
Source: Call Reports

Continental's parent holding company maintained its $0.50 per share dividend on common stock in August 1982. While the dividend may not have been merited by the earnings level, holding company management felt it was a necessary step in attempting to restore the confidence of the financial markets and to raising capital in the marketplace.

Despite these actions, Continental's condition deteriorated throughout 1982. Many of its energy loans that had performed well and been extremely profitable in the 1970s and well into 1981 were now serious collection problems.

Nonperforming assets at the holding company level, which totaled $653 million at the end of 1981, grew to $844 million at the end of the first quarter of 1982. While most of these nonperforming assets were concentrated in real estate loans and nonenergy-related corporate loans through the first quarter of 1982, this changed dramatically in the following quarters when a number of energy loans were nonperforming. By the end of 1982, close to half (over $900 million) of Continental's nonperforming assets were energy-related.

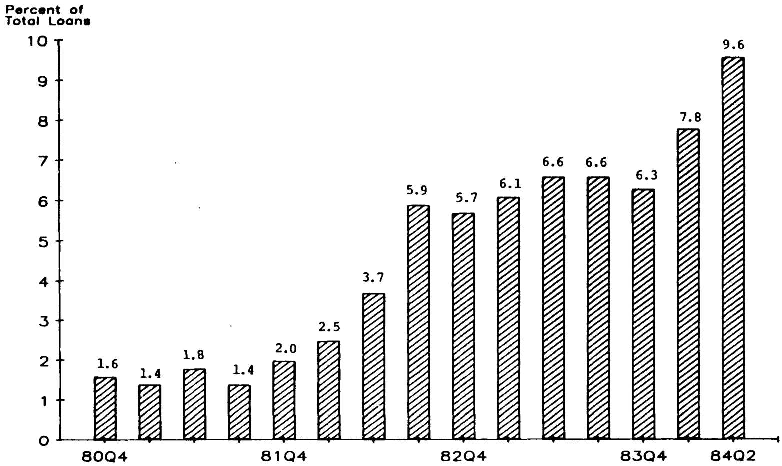
Nonperforming Assets by Industry



Source: OCC

In all, $1.2 billion in nonperforming assets were added in 1982, bringing them up to nearly 6% of the total loan portfolio.

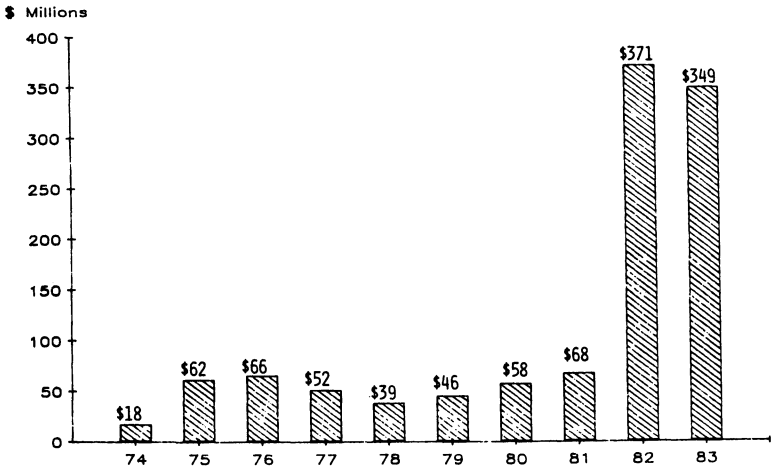
Continental's Nonperforming Assets



Source: OCC

Continental's net loan losses reached $371 million by December 1982, nearly a five-fold increase over the previous year's losses. Despite an improving economy in 1983, many of Continental's borrowers continued to experience difficulties and Continental's losses remained high.

Continental's Net Loan Losses

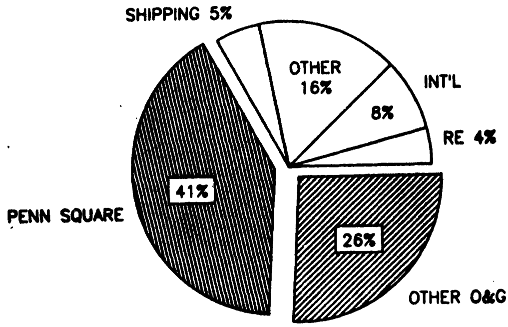


Source: Call Reports

Energy-related loans represented a disproportionate share of Continental's loan losses. While oil and gas loans comprised approximately 20% of Continental's average total loan portfolio in 1982 and 1983, they represented approximately 67% of its June 1982 through June 1984 loan losses.

Composition of Continental's June 1982

through June 1984 Loan Losses

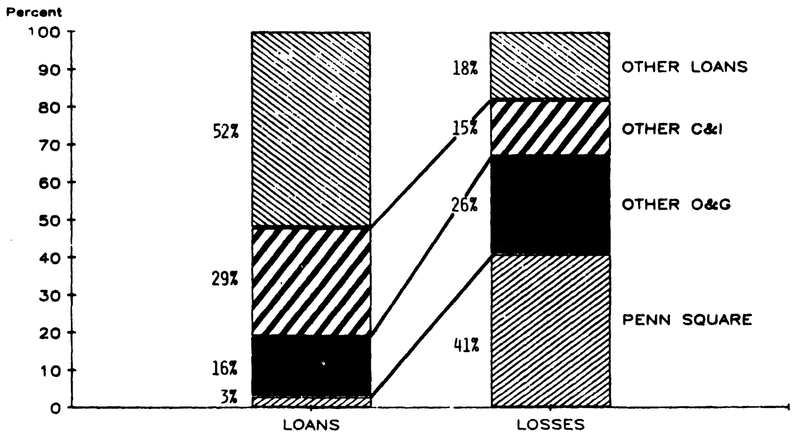


Source: OCC   NOTE: OCC estimate based on a review of losses in excess of $2 million per loan taken between June 30, 1982 and June 30, 1984

Most of Continental's oil and gas loan losses were a direct result of its purchase of loans from Penn Square. Although loans purchased from Penn Square averaged less than 3% of Continental's total loans over the past 2 1/2 years, they accounted for 41% of the bank's losses between June 1982 and June 1984. Penn Square loans have thus far resulted in nearly $500 million in loan losses for Continental.

Continental's Losses Since June 30, 1982

Compared to Average Outstandings

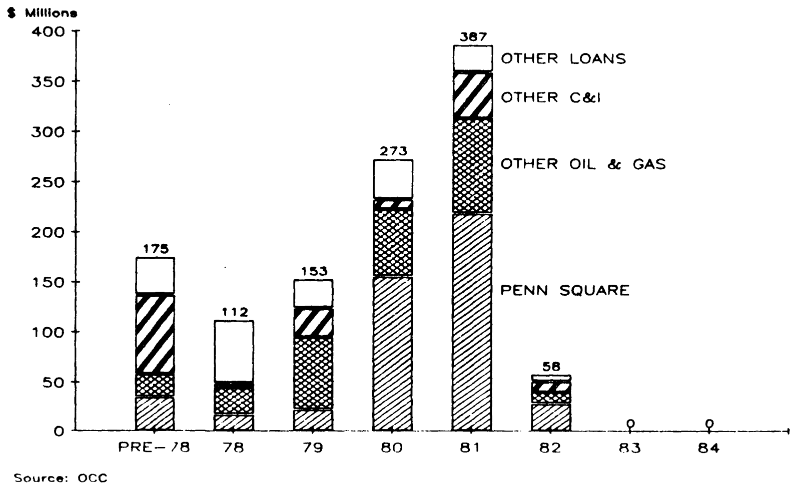


LOANS = Annual Average 1982–1983
LOSSES = Losses since June 1982

Source: OCC

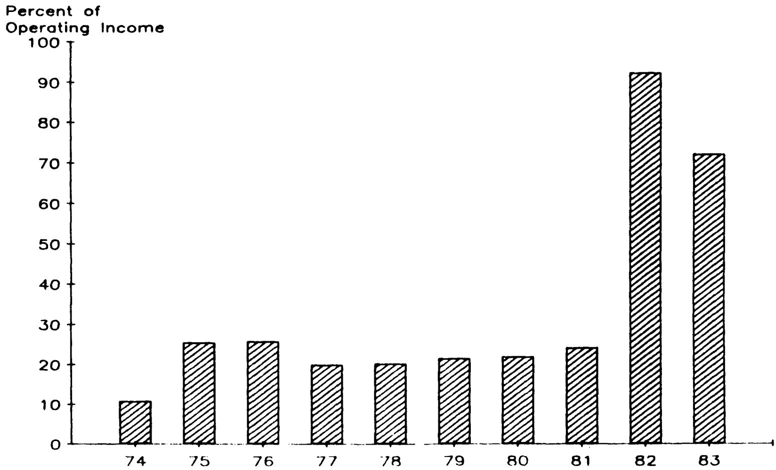
As illustrated in the following chart, most of Continental's loan losses since June 1982, including those purchased from Penn Square, were from loans that originated in 1980 and 1981.

Origination Date of Continental's
Post-June 1982 Loan Losses



These loan quality problems caused Continental's earnings to collapse. The bank's provision for loan losses consumed 93% of its 1982 operating income, reaching $476.8 million. Resulting net income fell from $236 million in 1981 to $72 million at year-end 1982.

Continental's Loan Loss Provision



Source: Call Reports

The collapse of Penn Square and the energy industry forced Continental's management in 1982 to reassess the bank's overall direction. Continental's Credit Risk Evaluation Division, which had been created at the urging of the OCC in the fall of 1982, was strengthened in early 1983 to provide improved risk evaluation and to report regularly to the Board of Directors and senior bank management. The Division also monitored the effectiveness of Continental's early warning credit quality systems and served as an important check on corporate lending activities.

The Formal Agreement, signed on March 14, 1983, primarily covered asset and liability management, loan administration, and funding. It required the bank to continue to implement and maintain stronger policies and procedures designed to improve performance. In addition to quarterly progress reports regarding compliance with the terms of the Agreement, Continental was also required to report periodically to this Office on its criticized assets, funding, and earnings.

In April 1983, OCC examiners visited Continental to review the first quarter financial results. Nonperforming assets, at $2.02 billion, were higher than anticipated by the bank, but market acceptance had improved and premiums on funding instruments had declined.

Continental submitted the first quarterly compliance report required by the Formal Agreement to this office in May 1983. It indicated that appropriate actions required by the Agreement were being taken by the bank.

Continental's 1983 recovery plan called for a reduction in assets and staff and a more conservative lending policy. Two executive officers, David Taylor and Edward Bottum, were appointed to Continental's Board of Directors in August of 1983. Immediately after their appointment, they instituted key management and organizational changes to further lay the groundwork for recovery. External market conditions during the second half of 1983, however, slowed Continental's recovery. Increasing interest rates squeezed net interest margins. Loan demand was weak. Nonperforming energy loans rose further as the energy industry continued to decline.

The general sentiment of bank analysts toward Continental in 1982 was negative following Penn Square. It had become apparent to bank analysts by early 1983 that Penn Square wasn't Continental's only problem. Few analysts felt that Continental stock had any short-term turnaround potential.

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Robert Albertson of Smith, Barney, Harris, Upham & Co. in the March 28, 1983 Wall Street Transcript summarized these opinions:

> Continental Illinois' problems are something that, in retrospect, we perhaps should have been better prepared for than we were. Recognizing how fast they grew should have alerted us to the fact that at least the potential for unusual problems was definitely there . . . The most disconcerting thing about [Continental's difficulties] is the fact that the worst hit occurred in its principal area of expertise. Therefore, I have to remain uncertain as to where Continental will be going in the near term.

The 1983 examination of the bank's condition as of June 30, focused on energy and real estate credit, overseas exposure, funding, earnings, capital adequacy, and compliance with the Formal Agreement. The overall condition of the bank had further deteriorated since the 1982 examination. Asset quality and earnings remained poor. Capital was adequate on a ratio basis, but under pressure due to asset and earnings problems. Funding had improved, but was still acutely sensitive to poor performance and other negative developments. The bank was found to be in compliance with the provisions of the Formal Agreement. Following completion of the examination in December 1983, the Comptroller and senior OCC staff met with Continental's Board of Directors on January 23, 1984 to discuss these findings.

A revised recovery plan for 1984 called for a further reduction in assets, enhanced capital-raising efforts, and a reduction in non-interest expenses and staff. Non-essential businesses, such as real estate and the bank's credit card operation, would be sold to improve capital and refocus the bank on wholesale banking. Merger alternatives would be pursued wih the assistance of Goldman, Sachs & Co. which had been retained in September 1983. Plans were also accelerated to transfer additional responsibilities to Taylor and Bottum.

On January 31, 1984, OCC staff met with Continental's Vice Chairman and its Controller to review the bank's 1983 performance, the 1984 recovery plan, and contingency planning. Part of the discussion concerned the bank's own strategy for a "good bank/bad bank" separation, similar to that eventually provided for in the long-term assistance program.

David Taylor replaced Roger Anderson as Continental's CEO in February of 1984 and Edward Bottum was elected President. External events in the first quarter of 1984, however, produced further problems for this new management team. Asset quality continued to deteriorate and Continental recorded an operating loss for the first quarter of 1984.

Continental's condition as of March 31, 1984 remained poor. An OCC examination begun March 19 and targeted at asset quality and funding, concluded that continued operating losses and funding problems could be anticipated unless the bank's contingency plan to sell nonperforming assets was successful. Details of this plan were not, however, available at the close of the examination on April 20.

The Comptroller and his staff met with Continental's Chairman/CEO and President on May 2 to discuss the bank's dividend policy and contingency plan for selling nonperforming assets. It was the Comptroller's conclusion following the meeting that our approval of the payment of the bank's second quarter dividend to the holding company, in part, depended on the successful implementation of the provisions contained in the contingency plan, specifically the sale of nonperforming assets.

Later that month, market confidence in Continental slipped even further as rumors about the bank's impending bankruptcy were fueled by two erroneous press reports on May 8 that concerned the purchase of or investment in the bank. From that point on, the Office was in constant contact with the bank and other bank regulatory agencies, particularly the FDIC. On May 10, the OCC issued a news release stating that the Office had not requested assistance for or even discussed Continental with any bank or securities firm and that the Office was unaware of any significant changes in the bank's operations that would serve as the basis for rumors concerning the bank's fate.

OCC examiners established an onsite presence in Continental's trading rooms in Chicago and London on May 10 to more closely monitor the bank's rapidly deteriorating funding situation. Initial reports from OCC examiners indicated that major providers of overnight and term funds were failing to renew their holdings of the liabilities of the bank and Continental Illinois Corp. The bank was forced to prepay the deposits in Eurodollar and domestic markets and seek replacement of the CD funding in the domestic market. Because other funding sources were not available, the bank resorted to borrowings from the Federal Reserve Bank of Chicago.

From May 12 - 14, a safety net of 16 banks put together a $4.5 million line of credit for Continental. But, by May 15, the safety net began to unwind due to a heightened lack of confidence. The Comptroller and staff held meetings on May 16 and 17 with Continental, other money center banks, and regulatory agencies in Chicago, New York, and Washington to consider alternatives. These meetings resulted in the formation of the "temporary assistance package".

Under the temporary assistance plan publicly announced on May 17, Continental received a $2 billion subordinated loan for the period necessary to develop permanent sources of funds. The loan was evidenced by a demand subordinated note; $1.5 billion was provided by the FDIC, with the balance provided by a group of seven major U.S. banks. In addition, a consortium of 28 banks provided Continental with a $5.5 billion standby line of credit. By virtue of this capital injection, the FDIC in effect provided assurance that Continental's problems would not be resolved through a pay-off of insured depositors. It, therefore, also provided assurance that the funds of all depositors, both insured and uninsured, were thereby fully protected.

During the next two months, the regulators held meetings with both domestic and foreign financial institutions and other parties interested in merging with or investing in Continental. It became apparent fairly early on in these discussions, however, that it would be difficult to arrange a completely private sector solution. Furthermore, proposed private sector/government-assisted transactions were likely to be too costly to the FDIC.

The regulators' efforts were, therefore, directed toward devising a permanent solution to Continental's problems that was not dependent on private sector investment. Small working groups comprised of representatives from all three bank regulatory agencies met on a daily basis to develop and refine a long-term solution. At the same time, a search began to find new management for the bank. The Comptroller and other senior officials met at least weekly with the FDIC to discuss planning details; telephone contact between the principals occurred frequently.

Continental's financial situation, while stable for most of June, began to deteriorate again in July. Despite FDIC assurances, there was unease about just how the FDIC "assurances" would be honored if Continental failed. As a result, many large depositors began to again withdraw their funds as they matured.

During the 60 days after the erroneous press reports, Continental's deposits, Fed Funds, and repos had fallen nearly $10 billion. By July, Continental had borrowed $4 billion from 28 banks, another $3.55 billion from the Federal Reserve Bank of Chicago, and $2 billion more from the FDIC and the seven banks holding subordinated notes.

Throughout this period, OCC held several meetings with senior bank management and with various members of the bank's Board of Directors. Numerous meetings were held internally to analyze and refine the proposed plan. Intensive monitoring of the bank's funding continued and a joint OCC/FDIC review of the loan portfolio was conducted.

The long-term solution, announced on July 26 and subject to shareholder approval on September 26, is intended to restore Continental to health and allow it to continue to serve its marketplace without interruption. It entailed two key elements: top management changes and substantial financial assistance.

The solution will result in the creation of a smaller and more viable Continental. Management has been removed, and shareholders have incurred substantial losses. At the same time, major disruption to the financial system has been avoided. Upon implementation of the long-term solution, Continental will be well-capitalized and have stronger assets and management. It will be returned to private ownership at the earliest possible date.

Chairman ST GERMAIN. Thank you, Mr. Conover.

Now, Mr. Conover, immediately after the Penn Square failure, Continental's management began an in-depth review of its operations. And in 1983, the Office of the Comptroller of the Currency required Continental to enter into a supervisory agreement. Almost 2 years after Penn Square, and a year after the supervisory agreement was signed, banks that went into Continental to evaluate its merger potential, last May, found conditions that surprised them.

What they reported to the FDIC is recorded in two FDIC memoranda. To preserve the identity of the banks whose officials commented to the FDIC, I will refer to them simply, all of them rather simply as the "X-Y-Z" bank. Let me cite two of the recorded comments.

And I quote:

X-Y-Z banks compared their internal loan rating system on a scale of 1 to 9 against the rating system at Continental, 1 to 9, on 21 borrowers who were common to both banks. Only 6 of the 21 credits were given the same rating by both banks.

On another situation, Continental's rating was one better than the rating at X-Y-Z. On another five, Continental's was two better than X-Y-Z, and on another four, Continental's rating was three or more better than X-Y-Z.

Based on this review, X-Y-Z indicated that Continental's internal loan review process was very lenient and that the volume of classified loans was really much higher than presented or contended by Continental.

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

Now, from the information developed yesterday, it is clear that examining and supervising a large money center bank is a difficult task. From the evidence reflected in the FDIC memos from which I have just quoted, it appears it takes a long time for a large bank to correct its problems. And I believe you sort of indicated that in your testimony as well.

I am confident that with its new management, Continental will quickly become a strong bank once again and its problems will be solved. However, we need to know whether the length of the time Continental is taking to correct its operating practices is normal.

How long does it usually take for a large money center bank to correct the problems cited by your examiners? And would you please provide the subcommittee with a tabulation of the length of time it takes national banks to move from the lowest soundness category to one we view as acceptable? On the second, naturally, I expect you to submit that for the record.

May I just add that in regard to this issue of bigness, in 1976, management determined that they would become very aggressive, and they would become the third largest commercial lender in the United States of America. Why? Why did they feel this need?

They were doing fine. It was a strong bank. It was a well-run bank. In order to accomplish this they used some very innovative practices. They said that, from here on in, as you cited earlier, loan decisions will be made at the lower level and we will insulate ourselves from that. Then they were aggressive in seeking funds, actually hot money, a lot of money.

You wonder why. What is the motivation? What is it? I shouldn't say a disease, but it seems to be an addiction of some in the banking industry to get bigger and bigger. So I ask you again, how long does it usually take a large bank, one of the money center banks, to correct the problems cited by your examiners in the Continental situation? What is the normal period of time?

Mr. CONOVER. Mr. Chairman, I am not sure I can give you a precise answer to that. It will depend on the nature of the deficiency, how widespread it was, whether it means changing behavior throughout the bank or simply modifying a practice in a particular department, and so forth. Since the situations are so different, I am not sure that I can tell you that it takes a month or 2 months or whatever.

What we generally do, and I intend to do in the future with more vigor, is to identify clearly the specific actions we want banks to take and have a followup mechanism in place to assure that those corrections are being made between examinations. One of the early steps in the followup examination will be to go back and review the banks progress in taking corrective actions.

Chairman ST GERMAIN. Mr. Conover, Acting Comptroller Bloom, and we have had a lot of acting Comptrollers, in a 1976 appearance, had this to say and I quote:

> Now, I would like to turn to the new system which we are developing which we hope will give us an earlier and clearer and more accurate way of singling out banks for special supervision. The new system will be a computerized early warning system called the National Bank Surveillance System, which we call NBSS. NBSS will help in detection of impending problems before they become serious cases. It should, however, substantially aid in the prevention of future bank failures.

Now is NBSS still in operation and alive and well at the Comptroller's Office?

Mr. CONOVER. Yes; it is. It is alive and well. It has been improved several times, and we have plans for improving it in the future.

Chairman ST GERMAIN. Was NBSS utilized in the case of Continental?

Mr. CONOVER. The NBSS system is really more appropriate for evaluating the vast number of smaller banks. We have in place a multinational bank division that gets much more complete information on multinational banks, not just information from call reports and examination reports, which are the primary data sources for the NBSS. For the multinational banks, then, we use a separate information system and do separate analysis of those banks directly.

Thus, the NBSS system is alive and well and being improved. But it really isn't the most appropriate mechanism for tracking a bank like Continental.

Chairman ST GERMAIN. Are you saying NBSS does not have the capacity to take the input that you would get from a multinational bank?

Mr. CONOVER. I am saying it is designed to take information on 4,700 banks and that we have a much more precise and direct way of getting and manipulating data on the 11 multinational——

Chairman ST GERMAIN. Are you telling me that the methods you use for the 11 multinationals is superior to NBSS?

Mr. CONOVER. Yes, I am, because there is more information that is available for examination and analysis.

Chairman ST GERMAIN. Well, in view of that statement, this question arises in my mind, if the system utilized for the multinationals is superior to the NBSS system, what do you feel happened at Continental? It seems as though, as I recall, what was the date of that reassuring statement you gave to the world at large? Was it May?

Mr. CONOVER. May 10.

Chairman ST GERMAIN. May 10. Now as I recall in that statement, you said that everything was fine at Continental and that no one should be perturbed and people shouldn't remove their funds.

So that means as of May 10, 1984, the superiority of the NBSS system utilized for the multinational banks did not indicate any problems at Continental Illinois. Well, that being the case, I have to scratch my head and say how much faith can we put in NBSS and the superior system utilized for the multinationals as an early warning system? Or is it perhaps that when you get to the multinationals that they are so big that there is no way to really and truly and effectively have an early warning system?

Mr. CONOVER. No, I don't think that is the case.

Chairman ST GERMAIN. Because, remember at Franklin National the examiners were in Franklin National. They had left one section of the bank; its operations. It was so vast that they were in another section of the bank's operations when all of a sudden the Federal Reserve Board said, hey, come on now. We have pumped enough money into this situation. Let's find a merger partner.

Some of the examiners who were working in the bank at that time didn't know how bad Franklin National was. With these large money center banks is it perhaps that there is no way to really know?

Mr. CONOVER. No, I don't think that is true. I think we get a sufficient amount of information. The information we get and the analysis we do, don't enable us to reach a conclusion, per se, about the situation in the bank, but they do raise red flags. They help identify areas that ought to be looked at in greater depth.

Chairman ST GERMAIN. Where were the red flags on May 10, 1984? Were there no red flags flying?

Mr. CONOVER. Let me clarify what I said in the release on May 10, because I think there has been a significant amount of misunderstanding.

I did not say that the bank was just fine, thank you. What I did say was that the Comptroller's Office was not aware of any significant changes in the bank's operations that would serve as a basis for the rumors that were being circulated. The release also denied a report that had been carried by a Japanese news service that our office had discussed the bank with or requested aid for Continental from any Japanese bank or securities firm.

Obviously, the condition of the bank, as was reported in its financial statements, was well-known to the banking industry and to the public at large. We were not denying that the condition of the bank was poor or shaky. We were simply saying that we knew of no change in its condition, the condition that everybody knew about, that could have served as the basis for those rumors that were flying around all over the place.

Chairman St Germain. Excuse me. Are you telling me that John and Jane Q depositor, who were constituents of Mr. Annunzio in Illinois—this is the little old man and the little old lady who have worked hard all their lives, and as a result of very penurious living, they happened to have, instead of $100,000, they have $150,000 in Continental Illinois.

Now do we expect that these unsophisticated day laborers read the financial reports in such a manner as to be able to reassure themselves of the fact that Continental did have problems? Because as Comptroller of the Currency, you issued a statement. I know how to make these statements, too. You can make a statement that really is designed to do one thing, but you have got yourself covered so that if the implications that are derived therefrom are what you want them to be, but yet are not accurate, then you can say, well, here is what I said exactly.

Mr. Comptroller, as a matter of fact, word went out to the effect that you, the Comptroller, said that there were no big problems that people should be concerned about at Continental. That was the interpretation of your statement. That was on May 10, 1984. Now if you or one of your successors should make that type of statement in the future, how much credence do you think will be given to it?

That is my concern in this instance. Again, where were the red flags?

Mr. Conover. The words in the statement were carefully chosen to have only the meaning that they had.

Chairman St Germain. OK, how about——

Mr. Conover. There was no intent on our part to give any other meaning to any potential reader of that statement as to the condition of Continental Illinois.

Chairman St Germain. Was this before or after, help me out here, the statement by Bill Isaac stating all accounts would be covered?

Mr. Conover. Oh, this was before.

Chairman St Germain. Before.

Mr. Conover. That statement was not made until the temporary assistance package had been put together, around May 7.

Chairman St Germain. The purpose of this, then, obviously, was to attempt to stem the outflow of funds, right?

Mr. Conover. It was to indicate that there were rumors that clearly were bashing Continental and that in our view those rumors were unjustified. We didn't know what the basis of them was.

Chairman St Germain. Excuse me, Mr. Conover. My question is, wasn't it the purpose of this to stem the outflow of funds that were occuring at that time in a very dramatic way?

Mr. Conover. It was intended to say, again, that we knew of no basis for the rumors so that the run, if you like, that was the result of those rumors, would stop.

Chairman St Germain. You were attempting to stop the run on the bank?

Mr. CONOVER. We were attempting to provide accurate information to the marketplace so that any run that was based on misinformation would stop.

Chairman ST GERMAIN. And you feel that this was accurate information? It is a cute statement. It says there haven't been any significant changes; right, essentially it says this.

Mr. CONOVER. That is what it says.

Chairman ST GERMAIN. No significant changes. It doesn't say, however, that there should be some significant changes so that there wouldn't be a reason for a run.

Mr. CONOVER. Of course it doesn't say that. That wasn't the situation we were in.

Chairman ST GERMAIN. It wasn't?

Mr. CONOVER. No; the point, Mr. Chairman——

Chairman ST GERMAIN. Well, if that is the case why did we put new management in? Why did we get rid of Mr. Taylor and all those wonderful things?

Mr. CONOVER. The point was that the bank was having funding difficulties as a result of rumors and that we had no knowledge of any reason that those rumors were circulating.

Chairman ST GERMAIN. Mr. Conover, I have got——

Mr. CONOVER. The alternative was not to issue the statement.

Chairman ST GERMAIN. That's right. But, remember, the rumors that gave rise to funding difficulties came about as a result of actual factual information that international money managers and domestic money managers were aware of. Is that not the case?

Mr. CONOVER. I wouldn't put it that way, sir. I would say that the rumors had the effect they did because the bank was in fact extremely vulnerable to rumors due to its financial condition, due to the known weaknesses in its loan portfolio, and due to its funding strategy. Where the rumors started from and why they started, I don't know to this day.

Chairman ST GERMAIN. But the rumors were not inaccurate?

Mr. CONOVER. Sure they were. There were rumors that were circulating and had circulated in the previous several days, for example, that the bank was going to declare bankruptcy. That got a little coverage in the press. Anybody who knew anything about how——

Chairman ST GERMAIN. Why would that type of rumor arise?

Mr. CONOVER. Mr. Chairman, I don't know how the rumor arose.

Chairman ST GERMAIN. Because some financial analysists in New York a year previously had said they wouldn't even analyze that stock any further and they wouldn't recommend its purchase by anyone. Isn't it things like that that led to this eventually?

Mr. CONOVER. Well, we can speculate as to what the cause and source of the rumors were. But I don't know to this day what they were.

Chairman ST GERMAIN. Do you to this day feel comfortable with the statement that you issued on May 10, 1984, to the world at large?

Mr. CONOVER. I am comfortable that the statement that was issued on May 10, 1984 was accurate based on the information that I knew at that particular time.

Chairman ST GERMAIN. And you are comfortable with the fact that it didn't accurately document the situation—accurate and as you agree, meaning carefully worded? You are comfortable with the fact that it could not have misled people?

Mr. CONOVER. It certainly was not intended to mislead anybody.

Chairman ST GERMAIN. Whether it was intended——

Mr. CONOVER. Whether it did or not, I obviously couldn't control. As I said at the outset when we touched on this subject, I think that that particular statement has been widely misinterpreted.

Chairman ST GERMAIN. Well, Mr. Conover, you have got to be very cautious when you are in a position of the Comptroller of the Currency or chairman of the Banking Committee.

Mr. CONOVER. I am——

Chairman ST GERMAIN. You have got to be very careful about what you say.

Mr. CONOVER. I am well aware of that.

Chairman ST GERMAIN. Because people will try to interpet anything. They try to interpret me even when I don't speak.

Mr. CONOVER. The fact that it was rumored that our office was actively engaged in meetings and discussions with Japanese banks or securities firms to try to arrange a sale of Continental was one of the things that caused me to decide that it was appropriate at that time to make an exception to a longstanding policy of not making statements about individual banks and that we ought to put that issue to rest then and there.

Mr. ANNUNZIO. Will the chairman yield?

Chairman ST GERMAIN. Sure, Mr. Annunzio.

Mr. ANNUNZIO. Mr. Conover, when we are talking about rumors, isn't it true that there were rumors in the Chicago paper about the First National Bank of Chicago having an interest in taking over the Continental Bank? There were rumors of an Arab group. There were rumors of a Japanese group. There were rumors of Citicorp. There were all kinds of rumors.

Every day there was a rumor of a new group that was ready to take over Continental, because Continental was ready to close its doors.

Mr. CONOVER. Yes, that is true.

Mr. ANNUNZIO. I feel, personally, that what really destroyed confidence in Continental were these rumors. And no one knows where they really got started.

Chairman ST GERMAIN. Incidentally, Mr. Conover, the rumors of the possible purchase or merger of Continental with all these institutions was not all—these were not all that inaccurate because we know of the fact, don't we, that three major banks went in and spent substantial amounts of time, effort, and manhours analyzing Continental to determine whether or not they indeed did wish to make a merger offer.

Mr. CONOVER. Oh, yes, we do. That was after the temporary assistance package was announced.

Chairman ST GERMAIN. Yes. Let's look at a letter dated May 17 from the Comptroller to Mr. Isaac:

This is to inform you of developing circumstances which may soon threaten the solvency of Continental Illinois National Bank and Trust Co. of Chicago, Charter

No. 13539. As of March 31, 1984, the bank had assets of approximately $40 billion and deposits of $28 billion.

The bank is with the exception of directors' qualifying shares, wholly owned by Continental Illinois Corp. There are over 21,000 shareholders of Continental Illinois Corp. None own over 5 percent of the common stock of the corporation. Both the bank and Continental Illinois Corp. own a significant number of subsidiaries.

On March 14, 1983, the bank entered into a formal agreement with the Office.

This is 14 months prior to the May 10 statement. The bank entered into a normal agreement with the office. That means the Comptroller's Office.

However, the bank's condition has continued to deteriorate. An examination as of January 31, 1984, revealed that nonperforming assets had reached approximately $2,300,000,000. Although, the bank's capital structure appears sufficient to absorb the probable losses in its portfolio, rumors and speculation regarding the bank's condition have received prominent coverage in the news media. As a result, the bank has experienced increasing problems in meeting its short term funding needs. Reflecting this fact the bank's borrowings from the Federal Reserve System have increased from $850,000,000 on May 9, 1984, to $4,700,000,000 on May 16, 1984.

That was the day before your letter. That was typed in, I guess, so you could fill in the blanks.

If the bank's ability to obtain funding continues to deteriorate, the bank may become unable to meet its obligations as they become due.

Now that is 7 days after your May 10 statement. And it appears to me that this letter probably was written a few days before May 17, because there were blanks left for the May 16 insertion of the borrowings from the Fed.

So you are telling us that in 7 days the condition changed that dramatically?

Mr. CONOVER. First of all, the letter was written on May 17. And the fact that there were blanks left in it was simply so that those numbers could be filled in as soon as we had them accurately. That letter was a standard kind of letter in which we request the FDIC to consider providing assistance under 13(c) of the Federal Deposit Insurance Act. That type of letter is written a number of times a year when a bank is in jeopardy and the FDIC awaits official notification from the primary supervisor——

Chairman ST GERMAIN. Mr. Conover, I am sure you don't write this type of letter several times a year. Maybe this form, but not this type of letter. I think the magnitude of this one is not a common occurrence, is it?

Mr. CONOVER. Of course not, because this is the biggest——

Chairman ST GERMAIN. This is the biggest biggy ever.

Mr. CONOVER. Absolutely.

Chairman ST GERMAIN. Right. So——

Mr. WYLIE. Will the chairman yield?

Chairman ST GERMAIN. Sure.

Mr. WYLIE. Isn't it part of your role to try to maintain some confidence in the banking system and to try to maintain confidence in Continental Illinois, in this case? And wasn't that the case on May 10, 1984? You were trying at that particular time to make something out of this to try to see that the Continental Illinois was to continue as an ongoing financial institution.

Wasn't it your role to be optimistic rather than to view it with alarm, which would have only made matters worse?

Mr. CONOVER. Well, it certainly is our responsibility to try to maintain the health of the system and of individual banks within it. Because we felt that the bank was being battered unfairly due to the rumors that were circulating, we issued the statement that we did.

Now, between May 10 and May 17 a lot of things happened. The bank continued to have serious funding difficulties. A temporary funding arrangement put together with a number of banks to the tune of $4.5 billion began to unravel by May 15. That led to discussions between myself and Chairman Volcker and Chairman Isaac and a number of banks in New York, which ultimately resulted in the temporary assistance package.

The statement issued on May 10 did little, as it turned out, to calm the marketplace. The bank continued to have funding difficulties. The so-called safety net that had been put together over that weekend, I don't recall what day of the week the 17th was, began to fall apart, or there was good evidence that it had fallen apart by Monday noon. So we were dealing with a very rapidly changing situation. This letter was written as one of the things that had to be done in order to put the temporary assistance package into place.

Chairman ST GERMAIN. Mr. Conover, do you at this point feel that this press release was wholly consistent with the unpublished information that your office had concerning the condition of Continental Illinois?

Mr. CONOVER. Yes; I do.

Chairman ST GERMAIN. All right. Now, I agree with Chalmers that you do have a duty to try to maintain confidence in the system, as well as in individual institutions. And it is for that reason that I am concerned about this particular statement, its timing, the fact that 7 days later a letter that is—it is not a usual letter. It is an unusual letter because it served to trigger one of the biggest bailouts—the first nationalization in many, many years of a bank in the United States of America.

My concern is that in the future, when the Comptroller, as I stated earlier, either yourself or one of your successors, attempts to make this type of statement, the marketplace, and this is very important as you are dealing in big numbers, is going to say:

> Aha, is this another carefully worded pronouncement that can give no more credence to than we should have given to that one of May 10, 1984 with respect to Continental Illinois? Is it a repeat?

That is my concern.

Mr. CONOVER. I share your concern about any decision to make a similar statement in the future and how the marketplace might react to that statement. I just want to make it absolutely clear that in issuing the statement we did, we acted with the full knowledge of the facts that were available to us at the time. And there was never any intent to mislead anybody as to the condition of Continental Illinois.

[Under unanimous consent the press release dated May 10, 1984, and the letter to FDIC Chairman Isaac dated May 17, 1984 from Comptroller Conover referred to by Chairman St Germain are placed in the record at this point:]

NEWS RELEASE

Comptroller of the Currency
Administrator of National Banks

NR 84-45

Washington, D.C. 20219

For Immediate Release

Date May 10, 1984

Statement on Continental Illinois

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

Contrary to a report carried on a Japanese news wire service, the Comptroller of the Currency has not discussed Continental with or requested aid for Continental from any Japanese bank, any other bank, or any securities firm.

Continental Illinois Corporation, the parent of the bank, is the eighth largest bank holding company in the U.S. As of March 31, its assets totaled $41.4 billion. Total equity for the corporation exceeded $1.8 billion, and its reserves for possible loan losses totaled more than $400 million, or 1.32 percent of total credits. Total primary capital was $2.2 billion. Continental's equity-to-asset ratio was 4.41 percent, and its ratio of primary capital to total assets had increased to 5.84 percent. These ratios compare favorably to those of other major multinational banks.

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Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

May 17, 1984

The Honorable William M. Isaac
Chairman of the Board
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Dear Mr. Isaac:

This is to inform you of developing circumstances which may soon threaten the solvency of Continental Illinois National Bank and Trust Company of Chicago, Charter No. 13639. As of March 31, 1984, the bank had assets of approximately $ 40,000,000,000 and deposits of $28,000,000,000. The bank is, with the exception of directors' qualifying shares, wholly owned by Continental Illinois Corporation. There are over 21,000 shareholders of Continental Illinois Corporation. None own over 5% of the common stock of the corporation. Both the bank and Continental Illinois Corporation own a significant number of subsidiaries.

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

Further administrative action by this Office will not alleviate the bank's immediate funding problems. Therefore, the Office suggests that the Corporation consider providing appropriate assistance to the bank under Section 13(c) of the Federal Deposit Insurance Act. Among many possibilities under the Act, this assistance may be in the form of a purchase by the Corporation of a demand subordinated note which would be treated as an increase in the bank's capital account. Such a note could be retired on the demand of the FDIC. To this end, this Office has issued, a letter to the bank granting approval of any decrease in capital which would result from such a demand by the Corporation.

As always, we will respond to any informational requests or provide assistance as you deem necessary. Should that be the case, please feel free to contact National Bank Examiner James W. McPherson or National Bank Examiner Bobbie Jean Brookins in our Multinational Banking Department at (202) 447-1522.

Sincerely,

C. T. Conover

C. T. Conover
Comptroller of the Currency

Chairman St Germain. Mr. Annunzio.

Mr. Annunzio. Thank you, Mr. Chairman. Mr. Chairman, I would like to ask unanimous consent that I been given an additional 5 minutes for a total of 10. I want to be fair to the other members. Please keep the time for me. Mr. Conover, there has been much criticism leveled at the regulatory agencies for saving Continental. Will you please tell me and this committee what would have happened if Continental was not saved?

I am interested in the 12,000 jobs that would have been lost and the 66 banks that have deposits, that have more than 100 percent of their equity capital on deposit in Continental. What would have happened to those banks, and what would have happened to all those employees, and to the banking communities in the Midwest where these 66 banks are located?

Mr. Conover. Sixty-six banks, as you know, had deposits in Continental in amounts in excess of the total net worth of the bank. Another 113 banks had deposits in Continental amounting to between 50 and 100 percent of their net worth. If Continental had failed and had been treated as a payoff, certainly those 66 banks would have failed and probably a goodly number of the other 113 would have failed, if not immediately thereafter, then certainly within some period of time afterward. So let us say that we could easily have seen another hundred bank failures.

Mr. Vento. Will the gentleman yield to me to that? I have just a short question, an informational question.

Mr. Annunzio. I yield to Mr. Vento briefly because I still want to get my answer on these people losing their jobs.

Mr. Vento. Yes, OK. I just would like to know for the record, Mr. Conover, how many foreign banks were involved and what percentage of the assets were affected by the actions taken in terms of the agreement? That is a question I asked yesterday and your examiners couldn't answer it. So I want to again state it for the record.

I thank the gentleman for yielding.

Mr. Conover. The 66 and the 113 that were cited are domestic banks. I do not have available right here the number of foreign banks that might have been impacted, but I will be happy——

Mr. Vento. And the deposits.

Mr. Conover. I would be happy to provide that information for the record.

Returning to Mr. Annunzio's question, it happens that of those 66 banks, 54 were in Illinois, and 70 of the 113 were in Illinois. The impact would have been much greater than simply that of an additional number of bank failures.

There could also have been a significant number of corporate bankruptcies that would have resulted as depositors were unable to get their cash and given receivership certificates in their place. It is difficult to buy not only groceries but industrial equipment as well, with receivership certificates.

We debated at some length how to handle the Continental situation—whether it ought to be done on an open bank or a closed bank basis, what the consequences of a payoff might be, and so forth. Participating in those debates were the directors of the FDIC, the Chairman of the Federal Reserve Board, and the Secretary of the Treasury. In our collective judgment, had Continental failed and been treated in a way in which depositors and creditors were not made whole, we could very well have seen a national, if not an international, financial crisis the dimensions of which were difficult to imagine. None of us wanted to find out.

Mr. ANNUNZIO. Mr. Conover, what you are telling the committee is that without action, there would have been sweeping repercussions in the entire economy of the country and in the banking system of this country. Is there any way that you can tell this committee how much money would have been lost by closing these 179 banks. How much money would have been lost to the corporations in this country, to the individuals in this country, to the individual job holders I described yesterday?

I am not interested in upper echelon bankers. I am talking about the cashiers, janitors, clerks, and the lower echelon people in all of these institutions throughout Illinois. Are there any figures available as to what has been lost? What I am trying to point out is that the biggest factor in every one of the bailouts of various companies by this committee, as far as I was concerned, was saving jobs of people and keeping them working in private industry, off of the unemployment compensation roles where it would be like a double taxation.

And this could have happened in this case. Now if it is possible, I would like you to supply some kind of a dollar figure. But before I end my question, I want to say that, fortunately, this committee has a 100-percent track record in every one of the bailouts, including the two bailouts for New York City. All loans have been paid back, and the Government actually made money, Mr. Barnard, just like we did on our George Washington commemorative coin where we made millions of dollars on that particular silver coin.

And for the first time it was designated, in a bill, that the profit be used to repay the national debt. So what I would like to know from you is, what is your feeling about—we will call it a bailout. We will call it whatever you want to call it. But in the end, what is the dollar amount that would have been lost? Do you feel that we are in the ballpark? Just like the Cubs ball team, you know, on its way to winning a pennant, are we in the ballpark to really pull this off with Continental and keep it going on a sound basis in the city of Chicago?

Mr. CONOVER. Let me try to provide some perspective in response to your question. In the case of the 66 banks that I referred to that had more than 100 percent of their equity deposited in Continental, their total assets were approximately $4.8 billion. In the case of the 113 banks that had between 50 and 100 percent of their equity on deposit in Continental, their total assets were $12.3 billion. I don't know what portion of the $12.3 billion to count, nor do I have a way of assessing the impact of lost jobs in those institutions or in businesses that were customers of those institutions. But I think it is safe to say that we are clearly dealing in this case with a multi-billion-dollar situation in which many people, many businesses, and many financial institutions could have well have been hurt to a significant degree.

Now let's look at the condition of Continental today. Assuming that shareholders approve the deal on September 26, it will be an institution under a new management team with a substantially improved asset portfolio, with a sound balance sheet in terms of the proportion of capital to assets, and with the continued support of the FDIC and Federal Reserve System. Another way of describing all that is to say it is probably the safest bank in the world to deal with today.

The regulators, working together, put this package together over a period of several months. I think that the American public, the banking community, and the international financial community ought to take some solace from the fact that the U.S. Government has stood behind its banking system, that the regulators have worked together effectively to accomplish this goal. The package is not without some weaknesses, however, and we can discuss those later, if you like. But I think the important thing is that the overall goal of maintaining the financial stability of the Nation's banking system has been achieved.

Mr. ANNUNZIO. I have tried to get a loss figure. And I realize how difficult that is. But would you estimate that the Government placed about $16 billion in Continental?

Mr. CONOVER. I heard the chairman refer to that number yesterday, and I am not quite sure where he got it. I understand the $4.5 billion in loans that are being purchased by the FDIC.

Chairman ST GERMAIN. The discount window.

Mr. CONOVER. Discounted loans.

Chairman ST GERMAIN. Discount window. The Fed.

Mr. CONOVER. OK, the billion dollars of capital infusion and the *x* billion—what number do you want to use for the discount window?

Chairman ST GERMAIN. Well, it varies constantly. It was up to $7.5 billion——

Mr. ANNUNZIO. Say they used $10 billion. Ten and $4.5 billion is $14.5 billion.

Mr. CONOVER. I get up to about $12.5 billion in that case.

Chairman ST GERMAIN. How about the other banks that have put funds in?

Mr. CONOVER. The other banks have provided an additional $5.5 billion.

Chairman ST GERMAIN. Doesn't that come to $17 billion?

Mr. CONOVER. All right. That comes to $17 billion.

Chairman ST GERMAIN. I add pretty good, Mr. Conover.

Mr. CONOVER. You did just fine.

Chairman ST GERMAIN. I add pretty good. If the fellows at Continental, before we put in this good managing team added as well, it would be great.

Mr. ANNUNZIO. The chairman is absolutely right. We will say $17 billion. Now, my question to you, Mr. Conover, is what would the total loss have been to all these institutions, jobs, welfare, unemployment compensation, the American people if we hadn't put this $17 billion in?

Mr. CONOVER. I don't know how to come up with that number.

But let me go back to the $17 billion because the presumption is that the $17 billion has been spent and is gone, and I don't believe that is the case. The FDIC will work out the $4.5 billion loan portfolio. That is not 100 percent loss; they would not tell you that it is.

The $7 billion loan at the discount window is secured by quality assets that the Federal Reserve Bank of Chicago has on assignment there. The $5.5 billion that has been provided by the other banks as an overnight funding facility is, in the first place, not free. The banks are earning a market rate of return on those funds and have every intention of being repaid.

Of course, this is all going to take some time. Continental has got to get back on its feet. It needs to start reporting profits on a quarter-to-quarter basis.

Mr. ANNUNZIO. We have to find some way to end rumors which destroy confidence.

Mr. CONOVER. I agree with that.

Mr. ANNUNZIO. Confidence is the one thing that the people have always had in the banking system of this country. What makes banks institutions that are respected by people, is the amount of confidence that they have.

We cannot destroy confidence in the banking system. What the regulators tried to do is save that confidence.

My time is almost up.

Mr. BARNARD. Will the gentleman yield?

Chairman ST GERMAIN. Mr. Barnard.

Mr. ANNUNZIO. Yes.

Chairman ST GERMAIN. Mr. Annunzio, we are going to give you another opportunity. Your time is up now.

Mr. ANNUNZIO. I just have one more question. That is all.

You have already made the statement that Continental, in your opinion, at this time, is a sound institution. And that in your judgment, Continental will survive.

Mr. CONOVER. Yes, I did.

Mr. ANNUNZIO. All right.

Chairman ST GERMAIN. Mr. Conover, that was a delightful exchange. But did you ever stop to estimate how much grief and how many lost jobs occurred when W.C. Grant went down the tube?

How many banks were affected? How many developers and shopping centers went into dire difficulty and how many actually failed? How about WPPSS?

How many senior citizens who put their life's savings into WPPSS have been destroyed? How about Baldwin-United? We could have gone in and saved all those people. And Penn Square. How many people ended up with no money and, therefore, couldn't buy the groceries, like you said in your answer?

What we have to look at in this instance is, and certainly it is laudable that you can save these banks from failing, that these banks have more than a $100,000, far in excess of that obviously, and large portions of their assets were in Continental Illinois. These were Illinois banks you told us. Quite a few of them.

Sure, that is unfortunate. But you have to question the judgment of those bankers, as well.

Maybe they should have known a little more or paid a little more attention to their deposits and investments. But the big question is, what do we do with the next big bank that ends up in this situation? Do we have to come in and do the same thing all over again?

How do we say no in the future? That is what we have to address.

I don't have any time right now, but I couldn't let that go.

I ask unanimous consent, incidentally, that at the end of my first round of questioning where I was citing the press release and letter to Mr. Isaac from Mr. Conover that these be placed in the record at that point.

Without objection, so ordered.

[The press release and letter referred to may be found on pages 285, 286.]

Chairman St Germain. Mr. Wylie.

Mr. Wylie. Thank you, Mr. Chairman.

I was beginning to think it was my turn. There are a couple of points that I want to clear up. The chairman made much of the letter of May 10, 1984 and some of the rumors that surrounded that.

I think the point to be made there is that you were still trying to work something out between May 10 and May 17. Things happened very quickly and very rapidly there.

Is that a fair statement?

Mr. Conover. Yes, it is. During that time period we were monitoring Continental's funding situation not just on a daily basis, but literally on an hourly basis, and tracking its funding from the Far East through Europe, as well as domestically. The conditions that the bank was facing in funding itself were changing rapidly. So while the time between May 10 and May 17 may seem short in terms of 7 days, that was an eternity in terms of what was happening to the funding position of the bank.

Mr. Wylie. Exactly right. Then when you weren't able to work something out within the existing frame work, you came up with the package which you say now you have reason to be optimistic about again, that Continental Illinois will indeed be an ongoing institution.

And you have expanded on that sufficiently. The impression has been left, it seems to me, that somebody came up with a $17 billion gift to Continental Illinois. I want that to be cleared up.

In the first place, a part of that comes out of FDIC, which is insurance money, not taxpayer money. Another part comes out of the discount window which has to be repaid. The other part of it comes from other banks.

But the point there is, and you make in your statement, that although Continental was weakened by asset deteriorations, its losses never exceeded capital and thus it never reached book insolvency.

Rather, its near collapse was triggered by funding problems. Would you like to expand on that?

Mr. Conover. That is correct. At the time that the final package was put together, Continental's losses had still not wiped out its capital. We were confident of that because the 1984 examination was done jointly by the Comptroller's Office, the FDIC, and the Fed. We reached a uniform agreement as to the classification of the loan portfolio, including the losses that were to be charged. Even after those losses were taken, I believe the bank published some pro forma statements as to what its balance sheet would look like after the deals were consummated, and there was at least $600 million of shareholders' equity remaining in the bank. So the bank never reached book insolvency.

Mr. WYLIE. It was never insolvent, so this $17 billion is, in effect—is this the proper word—it was collateralized.

Mr. CONOVER. The $17 billion is not an appropriate measure of the cost of this transaction. It would be nice if we could know the costs instantaneously, but we can't. We won't know them until the loans purchased by the FDIC are worked out and we are able to see what kind of proceeds they yield. As I said, the $5.5 billion to the banks will be paid back with interest. I think that the Fed's loan will also be paid back with interest. The FDIC could very well break even and could even make a profit on this deal.

Mr. WYLIE. Perhaps a more important issue which the chairman touched on, Mr. Conover, and there has been much debate surrounding Continental and the fact that there was a serious policy question which had to be resolved, simply stated, does a dual system exist—and this may be difficult for you to answer—but does a dual system exist for deciding if banks are allowed to fail, or are given a chance to survive?

The Federal regulatory agencies that have come to the assistance of a $45 billion Continental Bank, one of the largest money center banks in the world in its heyday, while smaller community banks, as has been pointed out, in the Midwest have been allowed to fail.

Have the agencies been able to promulgate a dual policy and do we now have a policy where banks or savings and loan associations above $5 billion, $10 billion, or $25 billion simply are not allowed to fail or cannot be allowed to fail no matter for what reason?

I think this policy question has implications for all depositors and for the insurance agencies and for the monetary and financial stability and for consideration of the Financial Institutions Subcommittee.

Mr. CONOVER. I would agree with you, Mr. Wylie, that that is an important question. And let me say at the outset that I think it is essential that we have a policy and practices in place to handle large bank failures and small bank failures in a consistent way.

Now, let me talk about what was done at Continental versus how small banks have been handled. In the Continental case, although, as was just pointed out, the bank never became technically insolvent, it was treated as if it had failed. Management has been removed. Shareholders face a major, if not total, loss, just as they would if the bank had been declared insolvent. And managers and directors face potential liability because I am sure the FDIC intends to pursue action against them.

Chairman ST GERMAIN. Excuse me. You say the shareholders face a total loss if this bailout plan succeeds?

Mr. CONOVER. The shareholders' interest has immediately been diluted by 80 percent. They face the risk of losing the remaining 20 percent.

Chairman ST GERMAIN. How would that happen?

Mr. CONOVER. It would happen if the FDIC's losses in the liquidation of the $4.5 billion portfolio that they purchased exceed the remaining shareholders' equity in the bank.

The shareholders are totally at risk in this case, just as they would be if the bank's doors had been closed and it had been technically declared insolvent.

Mr. WYLIE. But on the other hand, they have a chance of coming out of it.

Mr. CONOVER. They have a chance, that is true.

When the FDIC infused the $2 billion of subordinated capital notes as part of the temporary package on May 17, that immediately created a condition. That condition was that any action other than a payoff would be $2 billion cheaper to the FDIC than a payoff.

We discussed whether to leave that condition for people to try to analyze and interpret or whether the FDIC ought to make an explicit statement saying what the effect of that capital infusion was. In order to avoid confusion, the FDIC elected to make an explicit statement, that the bank would be handled in a way that all depositors and creditors would be made whole in the final long-term solution. That statement has been widely misunderstood and misinterpreted to mean that the FDIC extended, perhaps illegally, deposit insurance to amounts above $100,000. That was not the case.

Chairman ST GERMAIN. Because the bank was not closed.

Mr. CONOVER. That is correct.

Chairman ST GERMAIN. But had the bank closed, then you would have had a difficult situation. You would have to look into the legality of living up to the Bill Isaacs' commitment.

Mr. WYLIE. Right.

Mr. CONOVER. Had the bank closed, the FDIC would have taken the action which was the least costly to it. By virtue of putting in $2 billion into the bank, that meant that doing a payoff had a $2 billion disadvantage compared to alternative actions.

Now, let's contrast that situation with what has happened in small banks. I think we are up to 57 bank failures this year. That means that since January 1982, we have had 147 bank failures—approximately 1 percent of the total number of banks in this country.

The vast majority of those—well in excess of 80 percent of the 147—have been handled through purchase and assumption transactions. In those transactions, the bank is sold to another bank and usually opens its doors on the following morning. And the effect is that all depositors and creditors remain whole. So Continental's depositors and creditors were treated in a way that was certainly consistent with the way 80 percent of the small banks that have failed during that time period were treated.

Now, if we look at the remaining 20 percent that were treated differently, they fall into three categories. The first category would be those in which there was some massive fraud or contingent liability in existence such that the FDIC felt that it could not put the risk on the insurance fund, and so a payoff was arranged. A second category would be where an attempt was made to arrange a merger with another bank, which usually involves having people submit bids, and no bids were forthcoming. Again in that case, a payout was arranged.

The third category would be eight banks where in 1984 the FDIC experimented with something known as a modified payout. In those cases when the bank failed, rather than providing the uninsured depositors with receivership certificates for the total amount in excess of $100,000, a payout was made based on an estimate of what——

Chairman ST GERMAIN. You may proceed.

Mr. CONOVER. In the modified payout case, a partial payment was made to uninsured depositors based on an estimate made by the FDIC of what they would be able to garner through liquidation of the bank's loan portfolio. There were eight of those, which were done as an experiment. In some of them, a complete payout was probably more appropriate. The FDIC is writing up the results of that experiment, but I have not yet seen the final report.

The bottom line on all this, however, is that those who say that large banks, specifically Continental, have been treated significantly differently from the way small banks have been handled, at least during the period from 1982 to the present, are incorrect. Basically, the treatment of large banks has been consistent with the way small banks have been treated.

Mr. WYLIE. My time has expired, and I think that has been very elucidative and information we can use. One-hundred-fifty-seven banks have failed. Now that doesn't mean that any depositors have lost money, and most of those institutions have been folded into some other institution.

How many new banks have been chartered by the OCC in that time period?

Mr. CONOVER. I don't have that number at hand, Mr. Wylie, but there were a good number of them. I am sure there were enough that the total number of banks has not declined.

Mr. WYLIE. That is the point. Can you provide that for the record?

Mr. CONOVER. I certainly will provide that for the record.

[In response to the request of Congressman Wylie, the following information was submitted for the record by Mr. Conover and may be found on page 366.]

Chairman ST GERMAIN. Mr. Hubbard.

Mr. HUBBARD. Thank you, Mr. Chairman.

Thank you, Mr. Conover, for being with us today. I listened to your comments in response to what Mr. Wylie asked. There were 54 small banks across the United States forced to close thus far this year. There were 48 small banks closed last year. The theory I am told for closing small banks is that it is cheaper to liquidate the bank, sell its assets and pay off the depositors.

Just 1 minute ago I heard you say that you didn't treat Continental any differently than you do these small banks that were forced to close. Forgive me, but I didn't catch your thinking on that. How is the continuation of Continental Illinois National Bank justifiable to a Member of Congress from a State like Kentucky where we have had several bank closings and where we have seen several of our banks collapse because of the Butcher empire in Tennessee? A lot of people in my State were put out of work too.

Of course, I don't represent Chicago, but I represent Mayfield, KY, where jobs are just as important to us as they are in Chicago.

Mr. CONOVER. I understand, Mr. Hubbard, but I am afraid I have to take exception to your initial statement, which was, I think, that when a small bank fails, the preferred or cheaper way is to pay off the insured deposits, liquidate the bank, and provide the depositors having in excess of $100,000 with receivership certificates so they, in effect, see what they get over time.

In my exchange with Mr. Wylie, I think I pointed out that well over 80 percent of the small bank failures in the last three years have not been handled that way at all. In fact, the vast majority of failed banks have been merged with another bank, or, where State laws don't permit that, they have been sold to a bank newly chartered to take over the failed bank. In the vast majority of cases, this happens on a Friday night or over the weekend, and they open for business Monday morning under a different name. I can't assure you, however, that that has happened in every case in your State over the last 30 or so months.

Mr. HUBBARD. What about the other 20 percent? Could you tell us what is happening there?

Mr. CONOVER. Yes; I said that the other 20 percent fell into three categories. The first category would be those situations in which there was significant fraud or contingent liability that the FDIC insurance fund would have to face such that in the FDIC's judgment, it was cheaper to do a payoff of insured——

Chairman ST GERMAIN. By that, you mean they shut the bank down, people lost their jobs and couldn't buy their groceries in many instances; right?

Mr. CONOVER. That is correct.

Chairman ST GERMAIN. Sure. Let's put it in factual language, rather than the——

Mr. CONOVER. That is——

Chairman ST GERMAIN. Those people took a hit.

Mr. CONOVER. They did. That is absolutely right.

Chairman ST GERMAIN. To say to those people that took the hit, Well, too bad for you, buster. And your bank wasn't big enough, you see. You weren't a Continental Illinois. That is what Mr. Hubbard is concerned about.

Mr. CONOVER. I understand that, but that isn't the reason, in the case I am citing, that those banks would have been paid off by the FDIC. They would have been paid off because there was significant fraud or other contingent liability such that it was cheaper for the FDIC to pay off insured depositors in order to comply with their statutory mandate.

Mr. HUBBARD. Up to $100,000.

Mr. CONOVER. They have to meet a cost test in dealing with failed banks. One of the costs they take into account is the potential claims against the insurance fund.

Mr. HUBBARD. What were the results of the cost tests regarding Continental Bank?

Mr. CONOVER. It was very clear that the way to deal with Continental was not to do a payoff of insured depositors.

Chairman ST GERMAIN. If the gentleman would yield, when was the cost test performed on Continental, and when can we have the results of that test?

Mr. CONOVER. I believe cost analyses of the various alternatives were carried out between the time the interim assistance package was put together and the final one was enacted—between May and July of this year.

Chairman ST GERMAIN. Our staffs have not been able to get any copies of these cost tests. Do you mean you ran the models on various alternatives that you have described to us, in very much detail just now?

Mr. CONOVER. They were evaluated.

Chairman ST GERMAIN. They were evaluated the same way as you evaluate those little banks.

Mr. CONOVER. Exactly.

Chairman ST GERMAIN. Determining what the cost would be—why is it we haven't been able to get copies of those evaluations?

Mr. CONOVER. I don't know, Mr. Chairman. You will have to ask Mr. Isaac about that.

Chairman ST GERMAIN. My staff tells me that no one has been able to locate them. Did you see them?

Mr. CONOVER. Yes, I did.

Chairman ST GERMAIN. You saw the actual computer runs? [Witness nods yes.]

Gentlemen, maybe you could find out for us where they are, because no one has been able to locate them.

Mr. CONOVER. As I said, they are not in our files, they are in the files——

Chairman ST GERMAIN. But they do exist?

Mr. CONOVER. There are cost analyses——

Chairman ST GERMAIN. Of the same type you have described just now for the smaller banks?

Mr. CONOVER. Of the same type.

Chairman ST GERMAIN. And scope?

Mr. CONOVER. But recognizing that in the case of Continental, the long-term solution that was put into effect hadn't been tried before.

Chairman ST GERMAIN. I want to know how much a payoff would have cost. Therefore, if they exist, perhaps you could help us to find them.

Mr. CONOVER. I believe they do exist, and I believe I recall seeing——

Chairman ST GERMAIN. And you saw them. So, then, we can continue to pursue those. I thank the gentleman for yielding.

Mr. HUBBARD. Reclaiming my time, Mr. Conover, what would have been the liquidation value of Continental Bank approximately?

Mr. CONOVER. I am not sure precisely what you mean by the term.

Mr. HUBBARD. Could the depositors be paid off on liquidation?

Mr. CONOVER. There were roughly $3 billion of insured deposits in the bank. That means that there were roughly $37 billion of uninsured deposits in the bank. That leads rather quickly to the conclusion that you couldn't pay off the bank. You could pay off the $3 billion. Then you would be in the position of liquidating $37 billion worth of assets. And, as I indicated earlier, that would have had a tremendous effect on a large number of other banks and borrowers and on the national financial system, if not the world's. Nobody wanted to find out what the full effect was.

Chairman St Germain. Do you, when you are closing a small bank, take a look into the effect it would have on other banks and borrowers, and all the borrowers? That happens in every bank, doesn't it?

Mr. Conover. Yes.

Mr. Hubbard. Mr. Conover, let me say there is that feeling in rural America that these small banks that have been closed, 48 last year, 54 thus far this year, are indeed treated differently than the FDIC and OCC treated Continental Illinois National Bank because it was so big and because in Chicago, and an important State, this particular year, et cetera.

But in rural America, we are also confused as to how the OCC and FDIC could not find earlier than we did the gross problems involved with the Butcher banks, the United America Bank of Knoxville and all those banks under it. That, of course, is in east Tennessee, and I represent the western part of Kentucky, the most western area, but its ripples definitely affected several banks and depositors in my area.

Just these few questions, and I will conclude. On page 9 of your statement, Mr. Conover, you describe the difficulties Continental had in its oil and gas portfolio 2 years ago. Can you say to what extent the problems with these oil and gas loans were attributable to the fact that Continental was extending loans or participating in loans for which the collateral was oil rigs, undeveloped property, lease line arrangements or other nontraditional, to say the least, types of collateral?

Mr. Conover. Yes, we have that information. I do not have it here, but we would be happy to provide it.

[In response to the request of Congressman Hubbard, the following information was submitted for the record by Mr. Conover and may be found on page 366.]

Mr. Conover. There is a chart on page 40 of the appendix that indicates the composition of Continental's losses from June 1982 through June 1984. Some two-thirds of the losses charged to the bank were the result of oil and gas loans. Approximately 41 percent was attributable to Penn Square loans, and 26 percent was attributable to other oil and gas loans. As I say, we have the breakdown by category of oil loan if that is of interest to you, and we would be happy to provide it.

Mr. Hubbard. On page 21 of the appendix, you also point out Continental began to lend to small independent drillers and refiners more aggressively in the late 1970's. This, of course, was a factor in Continental's problems. With respect to these new forms of collateral and lending to smaller companies, to what extent was OCC aware of these trends?

Mr. Conover. We were aware that Continental had focused on energy lending. The bank had developed a reputation as an energy lender from the early 1950's and had had many years of profitable results from its energy lending. In 1979, 1980, and 1981, however, two things happened. Their lending standards changed. And the internal controls that might have been effective in enabling them to make loans under new lending standards were either not developed or were developed and subsequently ignored by Continental management.

Mr. HUBBARD. Did OCC issue any warnings about these trends, given the concentration of oil and gas in Continental's portfolio?

Mr. CONOVER. Your question deals with two factors, I think: concentrations and internal controls. Let me deal with concentrations first.

It is our responsibility to identify and point out concentrations to the bank. We criticize them if we think there is a problem in the way they are dealing with the loans they are making and if their policies and practices need strengthening. We have to be careful in the concentration area, however, because some concentrations are inevitable. For example, in some parts of the country, you almost can't avoid having a concentration in agricultural loans, auto-industry-related loans or forest product loans. We don't want to be in the business of allocating credit. If we do choose to criticize a concentration, we ask management and the board to reconfirm their policy or change it. If they decide to change it, we ask them to develop a strategy and a timetable for reducing their concentration.

Given the emphasis on energy self-sufficiency and the like at the time, and Continental's expertise and good track record in the energy industry, we did not criticize them for their concentration in oil and gas lending. In retrospect, I think that we should have criticized them, at least for their Penn Square exposure and for aggressively making oil and gas loans without adequate controls.

Did I answer your question?

Mr. HUBBARD. Right. You did.

Let me please ask you this. Was Continental solvent?

Mr. CONOVER. It was and is.

Mr. HUBBARD. Does that mean it has a positive liquidation value?

Mr. CONOVER. That depends.

Mr. HUBBARD. Why does it depend? Can't you give me a yes or no on that simple question? Does that mean Continental has a positive liquidation value?

Mr. CONOVER. It depends on the time over which the liquidation would take place. Just as with any corporation, if you liquidate it on a fire sale basis, you may not have a positive liquidation value. If you liquidate it carefully and prudently over time, getting the best price for your assets, you may very well have a positive liquidation value. So I am not trying to duck the question. I just think it really can vary.

Now Continental had, subsequent to the assistance package but not including the capital that was infused as part of it, a remaining net worth of some $600 million. In that sense, Continental was and is solvent.

Mr. HUBBARD. Continental was and is solvent. Assuming it has a positive liquidation value, doesn't that mean that you could have paid off the depositors under those circumstances, assuming it was solvent?

Mr. CONOVER. No, I don't think it does. If you pay off the depositors under those circumstances, one of the things you do immediately is have a big impact on that liquidation value. For example, an awful lot of those borrowers, who may be perfectly good borrowers, may require additional funding in order to complete projects that they have underway. They may be depending on that funding from the bank under a commitment that would not be honored by the FDIC because the FDIC does not make additional loans to customers, and the like.

Mr. HUBBARD. Lastly, just let me say that there still is that feeling in rural America that the smaller banks are treated differently than the OCC and FDIC did in regard to Continental Illinois. There were 22 banks closed in Kentucky and Tennessee in 1983 and 1984. Twelve of these banks were closed last year. Ten of these banks have been closed this year. Of course, we realize Chicago is big. I guess it is the same thing that we have when a small corporation in Russellville, KY closes and is forced to close, and they are gone. But the Federal Government also bailed out Chrysler Corp. in big Detroit.

Mr. CONOVER. Mr. Hubbard, let me say that I understand the feeling still exists in rural America, as you say it does. And I think we need to work toward some mechanism—I will be the first to admit that I don't have that mechanism in my hip pocket—so that we do treat large banks and small banks in a consistent way that is fair to both of them. The Continental situation and how we dealt with it was obviously influenced by our judgment as to the impact of failure on the Nation's, if not the world's, financial system.

Mr. HUBBARD. Forgive me for saying this, but folks in rural America also think the decision was influenced by the 1984 Presidential election.

Mr. CONOVER. Sir, I can assure you that the 1984 Presidential election never came up, was never discussed. We didn't take it into account for 1 second.

Chairman ST GERMAIN. Mr. Conover, where does Continental Illinois' rank in size among the banks of the United States of America? Is it 11th, 10th, 9th, 8th?

Mr. CONOVER. It seems to be moving.

Chairman ST GERMAIN. Where was it?

Mr. CONOVER. It was eighth, approximately.

Chairman ST GERMAIN. Number eight?

Mr. CONOVER. Yes.

Mr. WYLIE. You have 11 multinationals?

Mr. CONOVER. Right.

Chairman ST GERMAIN. All right.

Ever see the fellow who is painting himself into that corner? He doesn't realize there is no door back there. And there is less floor for him to walk over. I got news for you. You are painting yourself in a corner because my question now is: Can you foresee, in view of all the reverberations internationally that you described, had Continental Illinois been allowed to fail, and all those people put out of work and all those corporations out of money and all those other banks that would have failed, in view of that, can you ever foresee one of the 11 multinational money center banks failing? Can we ever afford to let any one of them fail?

Mr. CONOVER. The answer to that, Mr. Chairman, is that we have got to find a way to. In order——

Chairman ST GERMAIN. You are not answering.

Mr. CONOVER. In order to have a viable system.

Chairman ST GERMAIN. Mr. Conover, you said you don't have in your hip pocket the solution for the small banks, and you are never going to have it.

The fact of the matter is, as a practical matter, neither you nor your successors are ever going to let a big bank the size of Continental Illinois fail.

Mr. CONOVER. Mr. Chairman, it isn't whether the bank fails or not. It is how it is handled subsequent to its failure that matters. And we have to find a way. I admit that we don't have a way right now. And so, since we don't have a way, your premise appears to be correct at the moment.

Chairman ST GERMAIN. That is one of the prime reasons for these hearings. We have quite a few, but one of our principal reasons is we have to make a decision. Do we allow, ever, a large bank to fail?

Mr. Barnard.

Mr. CONOVER. I think it is important that we find a way to do that.

Mr. BARNARD. Thank you.

Mr. MCKINNEY. Would Mr. Barnard yield for a moment so I could follow through on the chairman's statement?

Mr. BARNARD. I want to follow through too, if you don't mind.

Mr. MCKINNEY. With all due respect, I think seriously, we have a new kind of bank. And today there is another type created. We found it in the thrift institutions, and now we have given approval for a $1 billion brokerage deal to Financial Corporation of America.

Mr. Chairman, let us not bandy words. We have a new kind of bank. It is called too big to fail. TBTF, and it is a wonderful bank.

Chairman ST GERMAIN. The time of the gentleman has expired. Mr. Barnard.

Mr. BARNARD. You know, I have six questions. I am sure I am not going to cover all six. But each time I add one to the top.

Here is what concerns me, Mr. Chairman. All of a sudden, I am having to do these in inverted order. What happens to that resolution Congress passed in 1982 that says that the full faith and credit of the U.S. Government is behind the insurance fund?

Chairman ST GERMAIN. Maybe we ought to repeal it.

Mr. BARNARD. Anyway, though, I think in a way that has a relationship as to why the big banks don't fail. How do you respond to that, Mr. Comptroller? Do you all take that resolution into consideration?

Mr. CONOVER. No, not really.

Mr. BARNARD. It just didn't make any difference, did it?

Mr. CONOVER. No.

Mr. BARNARD. Well, that is good. That solves that one.

You know, I want to draw a scenario. Here is a bank that is a good bank, a survivable bank. All of a sudden a rumor begins. It starts to rumbling. This is a big bank. All of a sudden, the international press grabs hold of this. Here is a bank that is subject to bankruptcy. Here is a bank subject to insolvency. Here is a bank that is going to be taken over by a foreign government. And it hits the press. East, west, across the Pacific, into Japan, across to China. Here we go. Aleutian Islands, Alaska, and Australia.

But here we go, all across the world, that this bank is failing. What is your remedy? Is there a remedy in law, especially when the information is false?

Mr. CONOVER. When the information is false, you get into the dilemma that I found myself in.

Mr. BARNARD. But you don't have a remedy in law, do you?

Mr. CONOVER. No, I don't believe we do.

Mr. BARNARD. There are some State laws which say that anyone who starts rumors that cause failure of a bank can be prosecuted, isn't that true?

Mr. CONOVER. I understand that that is true in several States. It is, as I understand it, not a Federal law.

Mr. BARNARD. Isn't it just as serious in this instance?

Mr. CONOVER. Absolutely.

Mr. BARNARD. As crying "fire" in a crowded theater?

Mr. CONOVER. It is. You may not solve that problem, however, by simply passing a law that says if you yell the equivalent of "fire" in a movie house or a church, that becomes a crime because it is virtually impossible to trace the source of rumors and how they get started, just as it is virtually impossible to find a leak that originate in your agency.

Mr. BARNARD. Are you telling us that in this instance, though, there had to be unusual steps taken because of this singular situation with Continental?

Mr. CONOVER. Oh, absolutely.

Mr. BARNARD. Although Continental had been rumored previously not to have been in the greatest of condition, on the other hand, the rumors you feel like were tantamount to causing a run on the bank?

Mr. CONOVER. The condition of Continental was well known. It had not only been reported in the business press but had been reported in the popular press, in newspapers and magazines throughout the country.

Mr. BARNARD. You know, the thing about it that concerns me, though, as common as this practice could be, do you think we need some Federal laws addressing unfounded rumors?

Mr. CONOVER. I think it would be wonderful to have them if they could be crafted so that somehow you were able to track down how the darn thing got started. I guess I would like to have the tool. I am uncertain as to how effective it would be in a lot of cases.

Mr. BARNARD. My question number three. One of the things that is hard to understand, and I think this hasn't come up yet, I believe is an unusual treatment of the Continental Bank holding company. You know, I can see for my own benefit that what was done, as far as the bank was concerned, was to save the bank, to save the depositors and look after their interest.

Wasn't there some unusual aspect of the refinancing as far as the holding company was concerned?

Mr. CONOVER. Yes, there was. As a result of this transaction, there was one undesirable outcome that I will describe. In order to do so, I have to step back and describe the two options that we had available to us.

Mr. BARNARD. Mr. Chairman, since this is so important, I don't think this ought to count against my time. Thank you.

Mr. LEACH. Mr. Chairman, on behalf of the minority, I think we ought to have a semblance of some order, but I would certainly hope that that order would include full response to the gentleman from Georgia's question, which is so important, and certainly in relation to any other question any other member has, I am sure more important.

Mr. BARNARD. Well, thank you. Thank you, Mr. Chairman, and Mr. Leach.

Proceed, Mr. Conover.

Chairman ST GERMAIN. Don't press your luck.

Mr. CONOVER. We had two options. One option would have been——

Mr. BARNARD. Now, my question was, wasn't there some unusual feature of the holding company?

Mr. CONOVER. That is correct. I will get to that. It may take me a while, but this is an important——

Chairman ST GERMAIN. Mr. Conover, if you take too long, you will run out of time. I think you want him——

Mr. CONOVER. This is important for the committee to follow because it may be that there is some potential legislation that should grow out of this particular situation to correct the problem at hand.

We had two options. We could put capital in the form of debt directly into the bank. We couldn't put preferred stock into the bank because there were covenants in the bond indentures of the holding company which said you couldn't do that unless you had the permission of the bondholders. In this case, they were holders of bearer bonds which had been sold in Europe. Since we didn't have a chance of getting the bondholders' approval, the FDIC could not have acquired preferred stock in the bank. Its only alternative was to put debt into the bank.

The disadvantage of putting debt into the bank was that we would have ended up with a very strange looking balance sheet. There would have been a little bit of the remaining shareholders' equity and a big pile of debt. We figured that it was not going to help the bank recover as it published its quarterly financial statements to have a balance sheet that didn't look like a bank balance sheet ought to look.

So we considered the other option—buying preferred stock in the holding company and having the holding company downstream it into the bank in the form of common stock equity. That satisfied our goal of having a sound looking bank balance sheet when the bank's financial statements were published. It had the undesirable feature of propping up the holding company bondholders and commercial paperholders.

We knew that at the time, and there was significant debate back and forth about which was the preferable way to go. The Treasury Department felt, and several memos were written to Mr. Volcker and Mr. Isaac and myself, that the alternative of putting debt into the holding company was the preferable one because you could always say "Oh, look, the Federal Government is standing behind this bank, anyway." I felt and my fellow directors at the FDIC felt and Mr. Volcker felt that the appropriate way to go was the way we went—buying preferred stock in the holding company.

Mr. BARNARD. Isn't that a dangerous precedent, though?

Mr. CONOVER. It is a dangerous precedent. It is bad public policy as far as that particular item goes. It can be corrected in one of two ways. Since we knew there was a way to correct it, we thought we ought to do what was right for Continental, then discuss the problem and identify the ways to correct it and see if we could get some corrective action taken.

There are two ways to correct it. One is that you can simply prohibit those kinds of covenants in bond indentures of holding company——

Mr. BARNARD. Why would a bank want to issue bearer bonds?

Mr. CONOVER. The holding company issued the bearer bonds.

Mr. BARNARD. Why would the holding company want to issue bearer bonds? Does it need money that bad?

Mr. CONOVER. I don't know. That was a technique they used in——

Mr. BARNARD. Is that a common practice with bank holding companies?

Mr. CONOVER. I am not sure how common a practice it is.

The second way that you could deal with that problem is simply to grant the FDIC the authority to purchase preferred stock, or common stock for that matter, in a bank when certain emergency conditions exist. In other words, the FDIC would be able to do that without getting a vote of either the bondholders or stockholders because of the emergency situation and because it was essential to save the banking institution. The language that would be required to enact that into law can be put on one side of one piece of paper. It is a minor change in the Federal Deposit Insurance Act. That is something that you may as a committee want to consider discussing thoroughly.

Chairman ST GERMAIN. Excuse me. Hopefully, we won't have to because we won't have another Continental Illinois. Then why should we need this?

Mr. CONOVER. That is true, Mr. Chairman, but I think you also want to make sure that you have a regulatory system that is armed with appropriate arrows and quivers to deal with any circumstance that might arise.

Mr. BARNARD. Mr. Conover, in your first classification of banks, which have not been supported and which have been permitted to fail, you mentioned fraud and similar——

Mr. CONOVER. Ones that have significant amounts of contingent liability that might fall to the fund.

Mr. BARNARD. Does Penn Square fall into that category?

Mr. CONOVER. It certainly does. The primary reason Penn Square was treated as a payoff was that there were massive contingent claims well in excess of $1–$2 billion. Of course, because they were contingent, no one knew what the total downside risk might have been.

Mr. BARNARD. Mr. Comptroller, what has been done to correct the problems of communications that developed between the divisional supervisors of the Comptroller's Office in regard to Penn Square and Continental?

Mr. CONOVER. Mr. Barnard, we were criticized, as you know, 2 years ago for a weakness in communications between our Dallas office and the examiners who were dealing with Continental. We achnowledged the weaknesses in the system at the time and took corrective action as follows. First, we made changes in the call report. As of June 1983, the call report contains a figure for participations sold, a clear flag we can look at to see if there are banks that have a significant amount of participations sold. Second, reorganizing our field offices into six districts enabled us to more conveniently get the deputy comptrollers who run those six districts together. They meet monthly and discuss managerial and administrative problems, as well as problems of a supervisory nature involving individual banks where a problem in one bank might spill over and become a problem at another bank. Third, we have issued specific written procedures in 1983 and 1984 to examiners, as well as to banks, on how to deal with these kinds of problems. Finally, we have included these kinds of instructions in a training course we give our examiners on how to deal with problem banks. So, as I said, that was a weakness we were criticized for 2 years ago. We recognized it, and it has been fixed.

Mr. BARNARD. What about brokered funds? Do these call reports also identify the amount of brokered funds that banks are negotiating?

Mr. CONOVER. At the moment, the call reports provide information as to certificates of deposit of over $100,000, but they are not broken out by source. That is an improvement that would be helpful to us in monitoring banks which suddenly start taking on——

Mr. BARNARD. You do support further disclosure of brokered funds by financial institutions?

Mr. CONOVER. In a big way. Yes, I do.

Mr. BARNARD. I am interested in knowing what part is played by the individual audits of banks, the outside directors' audits? I mean, why weren't some of these difficulties with Continental alerted through the internal audit? And did you get to see a copy of the internal audit? I mean of the audit?

Mr. CONOVER. Of the external audit?

Mr. BARNARD. Yes.

Mr. CONOVER. We normally get to look at both internal and external audit information. As to why the external auditors didn't uncover something that would have been helpful in the Continental case, or in any other case for that matter, I am not sure. I think there is a——

Mr. BARNARD. You know, we found some continuity in that problem. We found the problem in Penn Square. We found the problem in the United American, where they were certified as a good, sound institution. Two weeks later they were closed.

You know, this disturbs me. Is there a point in time when we need to impose liability on these certified public accountants for truth in auditing?

Mr. CONOVER. Well, I think there is a liability that gets imposed upon them in the form of suits that are filed against them in exactly those kinds of cases. I am sure that the firms you have alluded to in both the Penn Square and the Butcher cases are involved right now in litigation that could be quite costly to them.

Mr. BARNARD. What about in the Continental situation?

Mr. CONOVER. I think that remains to be seen.

Mr. BARNARD. Do you think there is a possibility?

Mr. CONOVER. I don't really know. I think, if anything, the FDIC may——

Mr. BARNARD. There have to be actual losses and——

Mr. CONOVER. The FDIC may pursue a claim. I am not sure.

Chairman ST GERMAIN. Excuse me. Maybe they ought to at least file suit now in the event that the nationalization bailout doesn't work. Then there will be a loss to the FDIC, and we don't want the statute of limitations to run.

Mr. CONOVER. Usually, as you know, Mr. Chairman, the FDIC sues everybody in sight.

Chairman ST GERMAIN. All right.

Mr. BARNARD. Mr. Chairman, I appreciate the time.

Chairman ST GERMAIN. Now, the moment we have all been waiting for.

Mr. Leach.

Mr. LEACH. The minority does appreciate the chance to participate at the hearings, Mr. Chairman. So I thank you.

I would like, just for a moment, to begin at the beginning and plough over some of the ground that has been covered before. As I listened to your very careful testimony, Mr. Conover, I am struck by the justification, which I think is plenty for the Continental bailout.

But the question still remains whether there is any justice in it. Can you, as Comptroller of the Currency, tell us explicitly whether in your view the big, as well as the small, have the right to fail, whether there are absolute guarantees that exist today for big banks that don't apply to small? And don't you see some irony in the notion that, if a big bank gets into trouble and oversteps itself, punishment will be in the form of Federal aid to compete against rivals as a quasi-nationalized entity?

Mr. CONOVER. I am not sure what the question is, Mr. Leach.

Mr. LEACH. Can you tell——

Mr. CONOVER. Is there equity today between small and large banks?

Mr. LEACH. Yes.

Mr. CONOVER. I have said I think there ought to be, which, I think, implies that there probably isn't at present.

Mr. LEACH. Second, are you implying a large bank does not have the right to fail? That the repercussions are too great?

Mr. CONOVER. Well, I would say that Continental did fail in several major respects. Remember, when a bank fails, the shareholders get wiped out. That applies to Continental. Management——

Mr. LEACH. Not as yet.

Mr. CONOVER. Not as yet.

Mr. LEACH. There has been an 80 percent dilusion of stock, but that was already reflected in the market. If this bank survives, there is some prospect that the stockholders will——

Mr. CONOVER. There is some chance.

Mr. LEACH. I understand your reluctance to answer specifically. But let me go on then a little bit more. As you know, this Congress and this committee had major jurisdiction over a lot of this, funded legislation to bailout Lockheed, Chrysler, New York City.

These acts were very controversial, but they were debated. They received the support of Congress. They received the signature of the President of the United States.

Do you see any irony or unseemliness in the fact that the only approval required for the regulator's approach is a formal vote of the shareholders of the bank to be saved rather than from the taxpayers and their representatives in Congress who may have to foot the bill.

Mr. CONOVER. I certainly see it as ironic that the shareholders, acting last, seem to have the final word in effect on whether the deal as proposed goes through.

What I thought you were going to get at was the fact that in the Lockheed, the New York City, and the Chrysler cases, those things were debated before the Congress and signed by the President. In this particular case, as the chairman has pointed out, this was done, in effect, without such a process; the regulators got together and did it.

Do I see anything inappropriate about that? Frankly, I don't. But what I am relying on is the fact that Congress established a mechanism to deal with exactly these kinds of problems. There was no mechanism established in law with a long-time organization in place to deal with a Lockheed, a Chyrsler, a New York City, et cetera. The FDIC and the Fed did, in this case, what Congress set them up to do. Now if you want to, I suppose we could have a debate on that and rethink what the role of FDIC and the Fed and the Comptroller's Office ought to be.

Mr. LEACH. Let me approach it in a different way. I think you have a valid point. What we are dealing with is valid legislation on the books granting the regulators wide discretion in how they deal with book failures.

Here, then, the question is whether Congress should continue to grant the regulators such broad powers and should pass sense of the Congress resolutions stating that full faith and credit of the U.S. Government rests behind the deposit insurance fund. And so one of the interesting questions is to ask, why the problem in the first place.

Second, what to do about this or similar problems in the future?

Let me in terms of confidence in Congress go back to why the problem. And then talk a little bit about the future.

In terms of why the problem, it appears we had a bank that enjoyed rather rapid growth. It was defined as a "go-go" bank.

The regulators weren't the only ones fooled. Duns Review mentioned it as one of the five best managed companies in America. So it isn't just that the regulators alone were out of step.

Perhaps the press had as poor judgment as a Federal bureaucrat. But it should be stressed that Continental didn't operate just as any other bank.

As this committee looked at Penn Square, we found it was unusual in that it operated as a merchant bank rather than commercial bank and it didn't have particular adequate safeguards. With regard to Continental, it appears what we have is a merchant bank's bank. Also, without adequate safeguards.

And yet, despite the unusualness of both of these banks, but I don't want to put Continental quite in the same category as Penn Square, the examiners gave an "A OK" approval to the adequacy of the capital ratios. And I just think it isn't good enough for you to imply in your statement today that you didn't foresee, as many in the economy didn't foresee, a downturn in oil prices. Regulators clearly missed the mark.

If Continental had had the same capital ratios as the superintendent of Iowa Banking requires for Iowa banks, that is, about 9 percent, and if the bank had been forced to writeoff loans as rigorously as the superintendent of Iowa banks requires of Iowa banks, this problem would not have existed.

That is why we are where we are today. The way you solve the solvency problem is with more capital and this committee certainly feels very strongly that the private sector solution is better than the public and that is that the regulators simply demand that banks have a stronger capital base.

Mr. CONOVER. I couldn't agree more. I am sincere in that. We have been working to increase capital levels in the multinational banks for some time. And, as you know, we are about to take the next step in that regard.

Mr. LEACH. Let me stress under your leadership that has been happening and this committee and the Congress is observing that. And I would only add as a footnote that the strongest and the most secure way you add to capital is the old fashioned way.

That is selling equity. One of the odd ironies in the capital base calculation is that items that are debt reserve are allowed to be called capital. This raises some doubts in the views of some that have looked carefully at the issue.

I would certainly stress to you that what is happening at this time under your leadership is to be appreciated. I would also stress that as we look back over the last decade, it appears that the Comptroller's Office, to some degree, has been caught with its pants down. It isn't a wild, new phenomenon that was not observed 7, 8 years ago, whether it be in Congress or by a number of observers of the banking system, that problems were bound to arise when you had 25 percent real growth in Eurocurrency markets and large banks growing at a faster rate than their capital base.

So what you are doing now is catching up with what I think was a little bit of looseness in past years, that 1975 to 1982 period, in particular. So what you are doing now is correct.

But let's not assume that regulators have anything but a little bit of blot on their record. Let me just come back to the issue which I think is the most important one for this committee, and that is where we go from here.

From several of your statements, but more importantly, from a number of comments that have been made privately, as well as publicly, it appears that one of the reasons that is really at the forefront for moving in on Continental the way you did is concern about this international issue of what do we do if one of our banks fails and a lot of international banks lost a lot of money?

Do we have a real confidence crisis in international banking, per se? Here I would only suggest that there is more than one way to skin a cat.

That is, a 100-percent security for 100 percent of depositors makes sense only if there is no clearly understood alternative in advance that is well worked out internationally.

In that regard, it strikes me that if there is a little bit of a failure in the regulators approach up to this point in time, it has been that there has been no clear standard or alternatives, and no preparation in the sense of a warning to international depositors as well as domestic that in essence, management of funds involves risks.

When you take risk, you may lose something. That is why it strikes me that the regulators might well want to consider the notion that, in the event of a large bank insolvency or failure, perhaps the role of the FDIC should be to step in and guarantee a percentage or pro rata portion immediately of deposits that are uninsured.

And, for example, if you take the Continental issue, you have argued to this committee—and I am not, frankly, totally persuaded that basically at all times you had a solvent institution. If it were terribly solvent, one presumes the marketplace would have vindicated it and another bank or private investors would have come in and taken it over.

So at least the marketplace disagrees with that assessment. In any regard, most who have looked at the bank think it might have been insolvent at the most up to about $5 billion. Five out of forty would imply that the most that would have been lost would have been 15 cents on the dollar for the uninsured depositors.

Therefore, if the regulators had in place a mechanism that everyone knew and understood in advance that there would be a payout, and let's say it is 80 cents on the dollar for uninsured deposits, you would have a system by which there would be risk management of funds in which risks would be taken and in which the FDIC would not be on the line which the taxpayer also would not be on the line.

And I think that type of approach ought to seriously be considered by the regulators. And let me just ask, are there other alternatives that are being considered? Or is a 100-percent payout the only thing that you are considering at this time?

Mr. CONOVER. I agree with you if we can design such a system and put it in place so that everybody knows in advance. I am not sure exactly how you do that, but you say starting January 1, 1986, we are putting you all on notice that it is going to be like this from now on. Of course, nobody will believe you until the first one is really done that way.

You have touched on the fact that the deposit insurance system needs to be reevaluated and perhaps revamped. We think so, too. The approach that we tried as an experiment in 1984—the so-called modified payout system—was an attempt to provide some market discipline on the part of large depositors by letting them know in advance that they were going to be subject to some loss in the event that a bank failed.

There has been a lot of hue and cry about that particular practice. And, as I say, I haven't seen the final report on the evaluation of it. But it was an attempt to try something different, to see if we couldn't get large depositors to pay more attention to where they were putting their funds and thereby provide leverage on the management of those institutions to keep their house in order and run their affairs in a prudent way.

I think that is still a fundamentally sound principle. Whether the modified payout practice is the one that ends up being adopted, I am not prepared to say. But we need something like that, and we need to implement it carefully over time, in a way that does not provide a tremendous shock to the system and does not have people screaming, "Gee, we didn't know."

Mr. LEACH. I appreciate that and I couldn't agree more fully with what you have just said. Let me conclude, Mr. Chairman, with the observation we all know that there is some concern in the financial community that gets quickly reflected in this committee between divergences between small banks and big banks and their guarantees.

But I would like to move away from that and stress two things. One, that there are implications for how the money supply is managed if one doesn't have a given kind of prudence in the banking system.

But, second, in a way, more importantly, there are implications for where there is economic growth in the economy, nationally and worldwide. Let me just give a contrast.

I have a hometown called Davenport that has a marvelously safe, dominant bank. It makes few loans, has an exceedingly high capital ratio.

But, in a way, the bank has operated for less growth and more security, and the community itself has somewhat suffered in comparison with a larger community that has a less safe bank and more growth in the banking system.

And as we look at where the growth in banking is, it is not too foolish to suggest that, if you allow bank growth abroad, you, in effect, allowing foreign governments to grow at a pace faster—foreign economy at a pace faster than the domestic and that the real issue is not so much the big bank/small bank contrast in terms of who gets the earnings, but who gets concerned.

And in that service area, all of us have a great deal of concern. That is why I think it is so important that regulation be evened out, not so much for small banks to compete in an earning sense with large banks, but for small communities to compete and receive funds in comparison with the larger communities, or in the case of the last several decades, with other countries who are being better served by the American banking system than the hinterland parts of this country, all as a function of regulation.

In other words, that you, sir, as Comptroller of the Currency, have governed the largest amount of foreign aid ever given by this country, including the Marshall plan, including the sum total of AID, as a function of regulation.

That may be good, or it may be bad. But I think we have to understand that what regulation is all about is where money flows. And if you regulate in one direction, it flows one way. If you regulate in another, it flows another.

And that is the primary reason I think this committee ought to be very concerned about evenness and fairness in the actions and rules and regulations that you as Comptroller of the Currency put forth.

Mr. CONOVER. I agree with you, Mr. Leach. I think you may have just given a very strong argument for interstate banking. Many of those——

Mr. LEACH. The argument I have given is for fairness in regulation.

Mr. CONOVER. I would agree with that, but I think fairness in regulation also means having the freedom to operate in domestic geographic markets. Many of our banks which are being criticized for having gone overseas and made loans overseas did so because they didn't find domestic outlets and domestic opportunities.

Chairman ST GERMAIN. And they didn't do so because the interest rates were so much higher, and the potential profits so much larger.

Mr. CONOVER. I am sure that had something to do with it, but that changes over time, too, as you know.

Chairman ST GERMAIN. Incidentally, how many oil and gas wells are there in Chicago, IL?

Mr. CONOVER. None that I know of.

Chairman ST GERMAIN. You know, earlier you said in answer to one of the questions that it was inevitable that banks go into certain areas of lending, like forestry, agriculture, automobiles, steel, and so forth.

That is why I wondered, how inevitable was it for Continental Illinois to go into lending on oil wells and gas fields. I think they did that by choice because they were looking for a high return.

My next question is going to be to you, for the record, I would like to know, what amount of the loan portfolio was lent within the city limits of the city of Chicago, IL, by Continental Illinois Bank?

Mr. CONOVER. I think we can provide you with that.

Chairman ST GERMAIN. You can provide that for us?

Mr. CONOVER. Yes.

Chairman ST GERMAIN. I think some of my colleagues, one in particular might be interested in that. He and I, I bet, would enjoy that.

It goes beyond the trivial pursuit question.

Mr. CONOVER. Yes, I understand. I think you will find that it will be a relatively small percentage.

[In response to the request of Chairman St Germain, the following information was submitted for the record by Mr. Conover and may be found on page 367.]

Chairman ST GERMAIN. Mr. Vento.

Mr. VENTO. Thank you, Mr. Chairman.

Mr. Conover, maybe now you understand why I would like that information on foreign investment in the bank and loans that we are talking about in terms of this particular problem.

I followed with interest some of your responses. I can't really let the problem pass in terms of suggesting you treated both the small and large institutions similarly in terms of the past 2 years.

The fact is that this bank has been nationalized, with 80 percent of the stock in the holding company and the downstream method that you commented about. The question is whether you took 80 percent of the small banks. Instead you provided for merger, that was a market type of transaction, other than whatever the value was to expand that bank into that marketplace.

Is that accurate?

Mr. CONOVER. Yes, that is accurate. In this particular case, we——

Mr. VENTO. Where is the market test in this?

Mr. CONOVER. The only market test in this is that we tried very hard for a private sector solution before we ended up——

Mr. VENTO. I mean the point is this is far and away different. I understand that, but this is far and away different to any type of comparable treatment to what was divied out to the others when there were mergers. Whether or not there should have been mergers is a different question.

This is far different treatment. There is no market test in this particular example, is that accurate?

Mr. CONOVER. Well, I agree with that in that, as I said, we looked for a private sector solution and didn't find one.

Mr. VENTO. How long will it be before the nationalization of this bank is concluded? How many years into the future are we going to have this 80 percent stock in this bank?

Mr. CONOVER. It is hard to say. Here is what I think has to happen. First of all, obviously, the stockholders need to approve the deal. Then the bank has to get back on its feet in a way that will attract the marketplace back to it. It has to start reporting quarter to quarter profits. It ought to be positioned to do that because we positioned it that way. Then it is a question of how many quarters of profitable operations have to pass until it makes sense——

Mr. VENTO. What is the order of payout that will occur?

I assume you or someone else will be doing the voting in the national government from the regulatory standpoint; is that accurate? You will be voting that 80 percent stock in the holding company?

What would happen first? Will the discount window be paid off first? How will this work? Will the FDIC get their billion dollars back first? What is the order of managing this particular matter?

Mr. CONOVER. The order is that the shorter term debt will get paid first, debt to the Fed and the banks, because that is debt. And the FDIC has a preferred stock investment in the holding company.

Now as the bank gets healthy, and let's say it reports x quarters of good earnings and it pays back the Fed borrowings and the bank borrowings, there comes a time when it is appropriate for the FDIC to make the bank private again. It has several options in doing that. No. 1, it could sell what is then a healthy institution to another domestic or foreign bank. No. 2, if it seemed like it would get a better price, it could hold a public offering. It would have an underwriting and sell the shares to the public, thereby returning the bank to total widespread private ownership.

The intent is to return the bank to private ownership as soon as possible.

Mr. VENTO. Can you give us any type of timeframe at all, Mr. Conover?

Mr. CONOVER. I think you are going to get different judgments on this. You ought to ask Bill Isaac for his and Paul Volcker for his. As far as I am concerned, I think we are looking at a couple of years of reported profits before it would make any sense to——

Mr. VENTO. What is the position of the bearer bonds you talked about in the bank that are held by a multiplicity of individuals? What would have been the loss if the bank, if you had permitted the bank to fail?

Mr. CONOVER. The bearer banks were in the holding company. And if the bank had failed, chances are the holding compay would have become bankrupt. The assets and liabilities of the holding company were a close, but not an identical, match.

Mr. VENTO. How much?

Mr. CONOVER. I said a close, but not an identical, match, so that there probably would have been some loss to those bearer bond holders.

Mr. VENTO. I was trying to get an amount.

Mr. CONOVER. I don't have it.

Mr. VENTO. You have no idea how much we are protecting in that instance. One of the nagging problems this obviously is the supervisory role that you played.

I am sure it is troublesome to you and to your predecessor with regards to Continental Illinois. After all, it involved a supervisory agreement. It involved management.

In a sense, I suppose one might say that really you had your shot in terms of trying to correct this bank, but for some reason that didn't happen. I would like to try and establish some of the problems that existed, Mr. Conover.

As you know, the national bank examination reports are transmitted to the bank board of directors with a cover letter from the Deputy Comptroller for Multinational Banks which sets forth these matters upon which the board is expected to act.

It is our understanding the board is supposed to review the transmittal letter and the examination report and reply in a timely fashion. Mr. Chairman, I have a series of those letters that will be presented to the members that are still with us.

I would like them to be made a part of the record. They result from materials starting in 1979, I think, going all the way through 1982.

Chairman ST GERMAIN. The gentleman asks unanimous consent. Is there objection?

The Chair hears none.

[The material submitted for the record by Congressman Vento follows:]

PERTAINING TO OCC EXAMINATION
COMMENCED: May 21, 1979
CLOSED: August 3, 1979

Washington, DC, October 25, 1979.

BOARD OF DIRECTORS,
Continental Illinois National Bank and Trust Company of Chicago, Chicago, IL.

LADY AND GENTLEMEN: This letter is supplemental to, and part of, the enclosed combined specialized report of examination. The examination, performed by National Bank Examiner Allan J. McCarte, was concluded on August 3, 1979. The purpose of this letter is to highlight matters in the examination report which deserve the attention of the Board of Directors. Since it is part of the report of examination, its content is to be treated with the same degree of confidentiality. The report is divided into five sections: Commercial, International, Trust, Electronic Data Processing, and Consumer Affairs. Each director is requested to review this report with particular emphasis on the examiner's Letter to the Board of Directors and letters to management accompanying individual sections. Viewed in the aggregate, the examination results reflect favorably on management, however, we direct your attention to the certain areas warranting attention.

Classified assets remain high equaling 80% of gross capital funds. This figure does not include [words deleted] and related lines which were classified as Uniform National Credits subsequent to the close of the examination. While the decrease in assets classified as doubtful and loss is favorable and encouraging, intensified efforts on the less severe classifications are important in view of current economic uncertainty.

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 were 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.

Another area of concern is the credit card program. The mass mailing of credit cards produced significant growth in outstandings, but also resulted in a number of problems. A breakdown in controls at the inception of the program was a contributing factor in the $10MM in charge-offs recorded in the first four months of this year. While management expects a substantial moderation of these losses through the remainder of the year, careful monitoring of the program will be required.

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.

The bank has developed a well-managed program for funding purposes. Liquidity world-wide is satisfactory. Vulnerability to a high level of purchased rate sensitive funds is regarded as a part of the bank's funding environment.

There were a number of violations of law and regulation cited in the report of examination. Violations of the consumer laws has resulted in uncertainty regarding overcharges to some of your customers. Violations outlined require remedial attention.

Several parcels of other real estate owned are cited in the report which are carried in excess of the appraised value. In accordance with Interpretive ruling 7.3025(e), carrying values which exceed appraised values must be charged-off.

For the purpose of monitoring compliance with laws and regulations, please provide a response outlining action taken or contemplated to correct violations. In addition, please indicate the dates on which entries are processed for the amounts classified as loss in the report of examination, and respond to Other Matters Requiring Attention in the Trust section of the report of examination.

All correspondence should be addressed to Comptroller of the Currency, Administrator of National Banks, Attention: Billy C. Wood, Deputy Comptroller for Multinational Banking, Washington, D.C. 20219, with a copy to Rufus O. Burns, Jr., Regional Administrator of National Banks, Sears Tower, Suite 5750, 233 South Wacker Drive, Chicago, Illinois 60606.

Sincerely,

BILLY C. WOOD,
Deputy Comptroller for Multinational Banking.

Enclosure.

CONTINENTAL BANK,
Chicago, IL, June 13, 1980.

Mr. BILLY C. WOOD,
Deputy Comptroller for Multinational Banking,
Office of the Comptroller of the Currency,
Washington, DC.

DEAR MR. WOOD: As requested, we are writing in response to the last Combined Report of Examination reflecting work done by your staff at our Bank. As agreed in advance with you, we are responding to the comments referenced in your transmittal letter which accompanied the Report.

It was noted that classified assets "remain high equaling 80% of gross national funds." Recognition was also given to decreases in the more severe classification categories, but current economic uncertainties were also noted. We are heartened by the substantive reduction in the ratio of classified assets to capital that has occurred since the high point of 1977 (as reported in the examination of that year), and with the noted shift into the less severe categories, but we are by no means satisfied with the ratio level as reported in the current examination. Further, we share your concerns about the effects of a probable recession. Please be assured of management's continual and close attention to this matter.

Comment was made about the credit review system with respect to both the identification of, and the rating of, loans. In addressing the first comment, concerning unrated credits, we have implemented a control feature which includes a periodic reporting mechanism to monitor unrated credits. We feel the mechanism is working well. The second comment, concerning the rating of loans is more difficult to address because of the subjective nature of the evaluation and rating process. A review of the specific loans in which there was material evaluative difference disclosed an appreciable incidence of timing difference. That is, there had occurred a change in the borrower's fortunes of a material nature between the time the credit had last been rated internally and the time the examiners rated it; for those cases, our credit review team would agree that the examiners' rating constituted a more adequate evaluation with the benefit of the information obtained subsequent to the internal rating date. There were, however, several instances in which the rating differences appear to stem from judgmental positions. We must confess that, in retrospect, we were somewhat surprised that such instances of judgmental differences have not been noted in the past. Given the necessarily subjective element in a credit rating process, occasional differences of opinion would perhaps not be unusual. We would anticipate, however, that such instances would involve rather narrow judgmental differences and would in all cases call for re-review by the internal rating staff.

Your letter commented on the level of charge-offs in the Credit Card program and acknowledged managment's expectation of a moderation in the loss factor. We are pleased to report the loss levels have moved approximately as we anticipated.

Mention also was made of a decrease in the ratio of equity capital to total assets since 1976, and the observation was made that if the rate of growth continues to outpace internal capital formation, external sources should be identified to support asset leverage. We consider the issue of capital adequacy and the leveraging levels to be matters of paramount importance and they remain under constant review and analysis. Be assured we continue to seek opportunities to take advantage of favorable market situations.

We are pleased to advise you that all amounts classified as "loss" or which were directed to be charged off were charged off shortly after receipt of the Combined Reports of Examination. Thus, all charge-offs were reflected in our 1979 Financial Statements.

The Trust Section of the Report contained a comment on the "Other Matters Requiring Attention" page concerning the manner in which the Trust Department fulfills the obligation to audit or review individual Trust accounts. The thrust of the comment concerned a discrepancy between the written policies and procedures of the Trust Department, and the policies and procedures of the Auditing Division. We are pleased to advise you that the written procedures in the Trust Department have been brought up to date and now agree with the written procedures of the Auditing Division.

A number of instances of non-compliance with regulations were noted in the Consumer Section of the Report. We are pleased to report that corrective action has been taken for each instance of noted non-compliance. Also, the examination noted three violations of the Municipal Securities Rule Making Board rules; we are pleased to report that all have been corrected. To return to the area of consumer protection, we have completed a review of our consumer protection law compliance mechanism, and we are revising our internal structure and methodology better to assure an acceptable level of compliance in the future.

We would like to take this opportunity to offer some observations on the new Combined Examination concept which, on the whole, we consider beneficial and which we encourage you further to follow and develop. We do feel unused lines of credit should be excluded from reports of classified credits and from country outstandings. As you know, our feelings is that, as a practical matter, banks will take appropriate action when either an individual credit or a country deteriorates in credit quality, and unused lines (which we differentiate from unused legally binding commitments) should not be included in evaluative totals. While the absolute dollar diference caused by this definitional difference is not great with respect to our Bank, we made the suggestion, both as a matter of principal and of practicality.

Finally, the Trust Section of the Report contains a full reproduction of the annotated list of pending litigation facing our Trust Department. The criteria used to develop this list was, by decision of the examiners involved, different than the criteria used to request similar litigation reports for the Bank as a whole. We suggest that, first, the criteria for Trust be the same as for the rest of the Bank, and second, that the entire list of Trust litigation not be reprinted in the Report. Our concern here revolves around the continuing erosion we observe in the confidentiality of Examination.

If you have any questions, please do not hestitate to call.

Sincerely,

DONALD C. MILLER.

COMPTROLLER OF THE CURRENCY,
ADMINISTRATOR OF NATIONAL BANKS,
Washington, DC, June 20, 1980.

Mr. DONALD C. MILLER,
Vice Chairman Continental Illinois National Bank and Trust Company of Chicago, Chicago, IL.

Dear Mr. Miller:

Thank you for your letter responding to the combined Report of Examination of May 21, 1979. We have noted those areas in which corrective action has been initiated or effected and took note of your concerns.

With regared to your response to the comment on the credit review system, we acknowledge that the process of evaluating credit quality contains a fair measure of subjective analysis. However, one of your comments cause us particular concern. You state:

"A review of the specific loans in which there was a material evaluative difference disclosed an appreciable incidence of timing difference. That is, there had occurred a change in the borrower's fortunes of a material nature between the time the credit had been last rated internally and the time the examiners rated it; for those cased, our credit review team would agree that the examiners' ratings constituted a more adequate evaluation with the benefits of the information obtained subsequent to the internal rating date."

We feel that this situation reflects a need to focus on the timeliness of your problem loan identification system. It is important to identify potential deterioration at the earliest possible time in order to respond appropriately. The full impact of the current recession is unknown at this time, however, we do know that detection of financial deterioration of borrowers generally lags behind economic indicators. Based on this knowledge, an increase in loan problems can be expected in the months ahead. Generally, the credit officer is the first to become aware of changes in a company's financial condition. In order to improve the timeliness of the credit rating system, the credit officers could serve as the vanguard of an early warning system to alert management and the Loan Rating Committee of impending problems.

A copy of your letter has been forwarded to the examiner-in-charge of the 1980 examination. Your comments will be given full consideration during the examination.

Sincerely,

BILLY C. WOOD,
Deputy Comptroller for Multinational Banking.

39-133 O—84——21

PERTAINING TO OCC EXAMINATION
COMMENCED: JUNE 23, 1980
CLOSED: OCTOBER 30, 1980

Washington, DC, January 13, 1981.

BOARD OF DIRECTORS,
Continential Illinois National Bank and Trust Company of Chicago, Chicago, IL.

MEMBERS OF THE BOARD: Enclosed with this letter is the combined report of examination which was completed on October 30, 1980 by Senior National Bank Examiner Allan J. Mc Carte. The purpose of this letter is to highlight matters discussed in the report which deserve your attention. Since it is part of the report of examination, this letter is to be treated with the same degree of confidentiality. The report is comprised of four sections: Commercial, which also includes comments on International Operations; Trust; Data Processing; and Consumer Affairs. Each director is requested to review this report with particular emphasis on the examiner's Letter to the Board of Directors and letters to management accompanying individual sections.

The results of the examination indicate that, overall, the institution is sound and well managed. Although no major problems were disclosed, there is concern over asset quality and the several violations of regulation in the trust area. Earnings have reached new highs, primarily on increases in assets; such growth has also resulted in increased leverage.

The level of criticized assets remains high at 82% gross capital funds. Although the preponderance of such assets do not carry a high loss potential with actual classifications declining since the previous examination, there are, nevertheless, continuing significant losses from the consumer portfolio, especially credit cards.

It is recognized that reduction of criticized totals may be difficult given the current environment. In this context, appropriate consideration should be given to the comments concerning the internal credit review program which appear in the examiner's "Letter to the Board."

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. Earnings, the primary source of the institution's capital, continue to reach new highs. However, the increases have emanated primarily from higher levels of earning assets. On a quarterly basis for 1980, earnings have fluctuated significantly. The unprecedented movements in interest rates were a major factor in those results. Such volatility also underscores the importance of quality in earnings and the need to continue considering alternative sources of capital.

For the first time, all three of the primary segments of trust activities were examined: domestic, stock transfer and international. The results indicate there is a need to enhance the audit process and improve certain operational controls in several areas both domestically and overseas. There were several violations of regulation dealing with administration of fidiciary powers, funds awaiting investment and records accessibility.

In Consumer Affairs, several violations of the regulations were disclosed. Progress achieved to date in improving the compliance performance should be continued. The bank's community reinvestment program is conducted satisfactorily with no noncompliance situations disclosed.

The Data Processing function was found to be managed satisfactorily. Threats posed by a major disaster involving data processing activity are recognized by management and while steps have been taken to minimize the risks, it is an area deserving continued awareness.

Several violations of law or regulation other than those mentioned before are noted in the commercial and consumer affairs areas. All such citings require remedial action.

For the purpose of monitoring compliance with laws and regulations, please provide a response outlining action taken or contemplated to correct violations. Also, please furnish responses to comments in the examiner's Letter to the Board of Directors and Matters of Major Importance Requiring Attention in the Trust section.

All correspondence should be addressed to Billy C. Wood, Deputy Comptroller for Multinational Banking, Comptroller of the Currency, Washington, D.C. 20219, with a copy to Rufus O. Burns, Jr., Regional Administrator of National Banks, Sears Tower, Suite 5750, 233 South Wacker Drive, Chicago, Illinois 60606.

Sincerely,

BILLY C. WOOD,
Deputy Comptroller for Multinational Banking.

Enclosure.

CONTINENTAL ILLINOIS NATIONAL BANK
AND TRUST COMPANY OF CHICAGO,
July 9, 1981.

Mr. BILLY C. WOOD,
Deputy Comptroller for Multinational Banking, Office of the Comptroller of the Currency, Washington, DC.

DEAR MR. WOOD: We are writing in response to Combined Reports of Examination (as of June 30, 1980) sent to us by your office. Our response includes, but does not repeat in detail, the discussion you had with our Directors' Audit Committee and with our Corporate Office, and it includes the results of the meeting in your offices between Messrs. Bottum, Hlavka, Miller, Johnson, and you. As is customary, we are touching upon the the comments referenced in your letter of transmittal.

The Reports noted that criticized assets totaled 82% of gross capital funds, and the percentage was referenced with a comment about concern over asset quality. The level of criticized assets has been declining for five years in terms of absolute dollars, in terms of relationship to gross capital, and in terms of severity of classification. We hope to see the trend continue as it is our goal to have the lowest possible level of criticized assets consonant with a balanced portfolio that provides an adequate return while providing our customary level of service to an expanding market share.

Comment was made that we have experienced ". . . continuing significant losses from the consumer portfolio, especially credit cards." The consumer banking credit losses in 1980 totalled $27.6 million vs. $30.2 million in 1979, and the 1980 experience indicated a quarter-to-quarter declining trend over the year. We anticipated an increase in losses at the time we embarked on a program of national expansion. Frankly, what we did not anticipate was the effect of the economic turn-down and the sharp rise in bankruptcies because of the new Federal law. Overlayed on those market factors were some unexpected developments such as problems in our collection unit and problems with changes in technology. The combined result has been a loss factor greater than we anticipated. We think we have overcome the internal factors, especially by restaffing our collection unit in suburban locations, a move which is showing very positive results. The level of losses and delinquencies are coming down slowly, but they are still well in excess of the levels we desire. This will continue to be a priority effort in the Personal Banking department.

The Examiners' comments regarding our internal credit review and rating system indicated it is functioning very well and appears to be cost effective. The comment was, ". . . raised because the existing procedure followed by the Rating Committee does not include any on-site or interim independent review." This comment contains two points. The first refers to our program of having documentation sent to Chicago from branch and subsidiary units, with all credit rating work being done there. Because of our genesis as a unit bank, the natural evolution of the loan evaluation process was a highly centralized effort. To date it has been successful and cost effective, and we do not see any particular stresses or inadequacies resulting from it. We do recognize, though, that as our business becomes more complex and we continue to expand with other offices, the time may well come when it will be more appropriate to shift to some form of on-site reviews. To that end we have been exploring the methodologies and examining the specific mechanisms by which this can be done in a cost effective way. We contemplate an experimental field review run some time in the next six to twelve months. The second point in the Examiner's suggestion, that of interim review, relates to the practice of preparing a quarterly Watch List report in which the individual lending officers submit information on all deteriorating credits they are handling. In almost all cases the individual lending officer is the first one to spot potential problems, or a deteriorating situation, and we concur in recognizing the importance of inducing the individual lending officers to report deteriorating situations as soon as possible so that appropriate steps can be taken, but we feel the best way to elecit appropriate behavior is through the commercial banking line organizations as opposed to the credit rating staff function. We will continue to stress this with our lending officers.

Your letter of transmittal comments that capital adequacy for banks in general is a matter of growing concern to the Office of the Comptroller. It was noted that our current level of capital is ". . . considered adequate," but that the asset structure has been growing more rapidly than the capital base, and that for the past two years capital generation has occurred through retained earnings. You call on management to continue seeking alternative sources to bring the capital and asset growth rates into balance. We have been to external markets, notably debt markets, a number of times in the past ten years, and we will have no hesitancy in going again. Unfortunately, market conditions have ranged from bad to disastrous, and we prefer not to go until conditions are favorable.

The Combined Reports of Examination cite three violations of law and regulation in the commercial section and several in the consumer section. Needless to say, any such violations at Continental Bank are inadvertant. We are pleased to report that all citations have been corrected. The corrective action relating to the consumer affairs findings were as outlined in the Report itself. The actions taken with respect to the findings in the commercial section were appropriate to the nature of the items (Board resolution, property appraisal, etc.)

The Turst Examination portion of the Reports contains several comments and recommendations which we accept, and concerning which corrective action has been taken. There are, however, several comments with which we must respectfully disagree. A number of alleged violations of Regulation subsidiaries; legal counsel advises us that Regulation Nine does not apply to the trust activities of these foreign subsidiaries. The possibility exists, of course, that new trust business in those subsidiaries may well bring Regulation Nine into force at some future time, and—even currently—Nine is one of several possible standards for use as a managerial tool; accordingly, we are making a study of these subsidiaries' trust activities using Regulation Nine as one of the evaluative yardsticks.

In the domestic trust Report a request was made that income cash be reinvested for the time period between receipt and periodic distribution to income beneficiaries. After careful study by management, we conclude such reinvestment at bank discretion is inappropriate under Illinois law.

A request was made for the internal auditors to increase the number of so-called "administrative audits" performed and to review our Law Department's work safeguarding against conflict of interest and self-dealing in the Trust Department. Both of these citations and requests were made because of lack of conformity with the "guidelines" contained in the Examiners Handbook. As we have discussed with you at length, both in our offices and in yours, we feel we have been undertaking actions in appropriate places in our organization that more than adequately meet the underlying needs that are the basis of the "guidelines" themselves. As we agreed, the 1981 examination effort will, we hope, demonstrate this to our mutual satisfaction.

If you have any questions, or if we may be of further assistance, please let us know.

Sincerely,

DONALD C. MILLER,
Vice Chairman.

COMPTROLLER OF THE CURRENCY,
ADMINISTRATOR OF NATIONAL BANKS,
Washington, DC, July 22, 1981.

Memorandum to Thomas M. Fitzgerald, Director, Multinational Examinations.
From: Bruce Ellard, National Bank Examiner.
Subject: Continental Illinois—Report response.

The recently received response to the June 30, 1980 examination does not address all matters highlighted either in the transmittal letter or in McCarte's Letter to the Board. In several cases, the responses are simply a statement of disagreement; no comments are given in particular instances although no critical issues were left unaddressed. The letter appears to have been put together hastily—bank personnel apparently were embarrassed when it was realized a response had not been prepared. Also, the letter does not follow directly either one of our pieces. While the letter is not fully responsive, any follow-up would be better handled through the current examination. McCarte has a copy of the letter and has been monitoring concerns from the previous examination. Our lingering questions, generally, can thus be easily answered through McCarte.

Major outstanding items continue in the Trust area: (1) applicability of Regulation 9 to overseas subsidiaries of the holding company or bank, (2) investment of income cash and (3) administrative audits. Number 1 has been referred to Doyle for clarification; number 2 represents a point of contention between this Office and several banks—a call for legal briefs seems to be the next step; and number 3 awaits, at the least, bank submissions to the Trust examiner which the bank hopes will fulfill our requirements in a less onerous fashion.

PERTAINING TO OCC EXAMINATION
COMMENCED: JUNE 1, 1981
CLOSED: AUGUST 21, 1981

Washington, DC, October 19, 1981.

BOARD OF DIRECTORS,
Continental Illinois National Bank and Trust Company of Chicago,
231 South LaSalle Street, Chicago, IL ~~60693~~

DEAR BOARD MEMBERS: Enclosed with this letter is the combined report of examination completed August 21, 1981 by Senior National Bank Examiner Allan J. McCarte. The results of the examination show the institution has sound management and good earnings. There are, however, areas of concern including the high level of classified assets.

The primary focus of the examination again was on an evaluation of the credit portfolio. That credit review revealed a deterioration in the level of classified assets to 67% of gross capital funds (GCF) and criticized assets to 99% of GCF from 61% and 82% respectively the previous examination. A significant increase was shown in the level of doubtful assets which more than doubled. The sharp increase is primarily attributable to one large credit which was entering bankruptcy at the time of the examination. Management reports that, since that time, collateral documentation has improved and the balance reduced significantly. While Continental's historical loan loss experience is among the best of the multinational banks, the current level of classified assets is quite high. Continued close monitoring will be required to reduce classified to a more satisfactory level.

The system for internally identifying problem credits works reasonably well; however, a number of credits are criticized/classified in the report which do not appear on the bank's "Watch Loan Report." While neither the number nor dollar amount of those loans is currently a cause for concern, we feel the system could be strengthened by performing random supplemental reviews in addition to the scheduled reviews as they are now performed. The examiner indicates that the Rating Committee is considering initiating on-site loan reviews. As part of those reviews, it is suggested that a random sampling of loans, not appearing on the "Watch List," be tested for credit quality.

In the installment lending area, no formal charge-off policy has been formulated. Such a policy should be developed and implemented in the context of the policy of this Office as stated in Banking Circular 140.

Earnings continue at record levels on an absolute basis. Also, the quality of those earnings appears to be good. 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.

The examination of the Data Processing function disclosed no significant problems. The area has sound controls and is well managed. Management is encouraged to continue, without delay, the development of measures to be taken in the event of major disruption or disaster with respect to data processing capability.

The Trust Department is operating under sound fiduciary principals. While the level of administrative audits is acceptable, given the present scope of those audits, management is encouraged to increase the number of those audits.

The institution conducts a satisfactory program with respect to Consumer Affairs and Community Reinvestment. There were no noncompliance situations cited.

Please outline the remedial steps taken with respect to the violations of law cited in the report of examination and furnish the date requested charge-offs were effected. A copy of a formal installment loan charge-off policy should be provided when adopted. Also, provide responses to comments in the examiner's Letter to the Board of Directors, Matters of Major Importance Requiring Attention in the Trust Section, and Conclusions in the Data Processing Section. Responsses should be directed to Billy C. Wood, Deputy Comptroller for Multinational Banking, Comptroller of the Currency, Washington, D.C. 20219 with a copy to Rufus Burns, Regional Administrator of National Banks, Suite 5750, Sears Tower, 233 South Wacker Drive, Chicago, Illinois 60606. As this letter is part of the report of examination, it should be treated with the same degree of confidentiality.

Sincerely,

BILLY C. WOOD,
Deputy Comptroller for Multinational Banking.

Enclosure.

CONTINENTAL BANK,
Chicago, IL, February 19, 1982.

Mr. BILLY C. WOOD,
Deputy Comptroller for Multinational Banks, Office of the Comptroller of the Currency, Washington, DC.

DEAR MR. WOOD: As requested, we are writing in response to the last Combined Report of examination reflecting work done by your staff at our Bank. As directed in your transmittal letter which accompanied the report, we are responding to the comments you have referenced.

It was noted that "this examination showed the level of classified assets increasing from 61% of gross capital funds to 67%" and "the level of total criticized to 99% of gross capital funds." We are concerned with monitoring the level of classified loans in the portfolio, and keeping them to a minimum without establishing overly restrictive credit policies. We do not feel there is a problem of loan portfolio quality, either in absolute terms or in terms of trend when one considers the current state of economic environment. Indeed, given the prolonged period of record high interest rates and the state of the economy, it is surprising that more difficulties have not surfaced. You may be assured that mangement will provide close, continued attention to this matter.

Comments regarding the loan review system were generally very positive in nature: however, three suggestions for improvement were offered. In addressing the first comment, regarding credits not rated on schedule, this matter has been receiving attention and we expect to see imporvement. We have emphasized to lending personnel the need to address and resolve in an expedient manner loans not rated on schedule. Furthermore, consideration is being given to the need to review certain types of credits as frequently as they have been in the past, thereby allowing the staff more time to review other credits that will benefit from increased coverage. The second suggestion concerned the strengthening of reports to the Board by including, "A total stratification of the remaining assets by quality rating." We feel this comment is due in large part to the fact that our internal loan rating categories do not coincide with categories used by your examiners. The quarterly reports currently received by the Board track quite closely the more severe rating categories and the movements "in" and "out" of those categories. The cost/benefit to modify our operating systems to compile the information necessary to aggregate loans by ratings and to track rating histories is unclear to us. The final suggestion deals with your examiners feeling that a form of independent review by Loan Administration, such as on-site reviews of loans made from non-Chicago offices, could be instituted to insure the accuracy and timeliness of information presented to them. As you will remember, all loans over $500,000 have always been reviewed by the staff here in Chicago. The Loan Administration Division performed its first experimental on-site review at the Continental Bank International Miami Branch Office in October, 1981. Additional exercises are being scheduled, and an on-site review is currently underway in Taiwan.

Your examiners comments regarding installment lending indicated that "A formal realistic charge-off policy should be developed." This comment stems from a sector of the examination in which we did not communicate with your examiners as effectively as we should have. The Bank does, in fact, have a written policy governing the charge-off of installment loans. This policy is under revision, and the lending area is following an approximation of the anticipated revised policy; however, some of the credits cited by the examiners should have been charged-off sooner. This matter will be put in order in the near future.

Comments regarding capital adequacy identified the need to "Bring capital growth in line with asset growth." Management recognizes the need to keep the Bank's leverage position within reasonable constraints. A great deal of time has been spent on this issue in the past, and it is an implicit part of our strategic planning. This issue will continue to receive priority attention in the years ahead.

The cited violation of the U.S. code involving unsecured credits to affiliates and violations of the Municipal Securities Regulatory Board rules were noted. Management has taken appropriate steps to ensure that these violations do not reoccur.

We are pleased to advise that all credits classified as "Loss" in the Report of Examination were charged off during the examination or in the third or fourth quarters. Thus, all charge-offs are reflected in our 1981 financial statements.

The Trust section of the report contained two comments requiring response. The first comment indicates that the Trust Department should be temporarily investing income cash generated in trusts, whether or not the governing instrument authorizes it to do so. Management continues to feel that under Illinois law, a fiduciary has no authority to invest income cash. This position has been supported by legal opinions from our own Legal Department and the Corporate Fiduciaries Association of Illinois. In the final point, your examiners have again recommended that the Audit Division should monitor the outside interests of Trust Department officers and managers. We continue to feel that the annual survey and monitoring of all officers' and managers' outside business interests performed by the Law Department adequately addresses this issue. It makes more sense for attorneys, rather than accounting graduates, to review questions concerning conflict of interests.

If you have any questions, please do not hesitate to call.

Sincerely,

DONALD C. MILLER.

Copy to Mr. Rufus O. Burns, Jr., Regional Administrator of National Banks, Sears Tower, Suite 5750, 233 South Wacker Drive, Chicago, Illinois 60606.

Mr. VENTO. I am sure you are aware of the concerns we have here. We are especially concerned about the lack of a timely response, it seems to me, with regards to receiving the letter and the response from the board. Continental Illinois Bank took 8 months to reply to a Deputy Comptroller Billy Woods' letter in 1979 transmittal letter, 7 months to reply to his 1980 letter and 5 months to respond to a letter in 1981. Are these time periods comparable to length of time other large multinational banks take?

I state this in the context of your pointing out how important 6 days were in terms of your impression of what was going on.

Mr. CONOVER. I understand. Those were rather longer response times than we would normally expect from other multinational banks.

Let me make a couple of points about something you said earlier. The banks are required to read not only the letter of transmittal but the examination report, period, all of it. In addition, with the multinational banks, we meet with the board of directors, or its auditing and examining committee, and present the results of the examination. At least since I have been here, this is usually done with a slide presentation given by the examiner in charge, who conducted the examination. We spend several hours with them, discussing points in the examination, corrective actions that need to be taken, and so forth, so that in many cases the actions that we are proposing they take have been taken long before we get the written response from the board.

Mr. VENTO. That is very interesting because in some of these letters—look them over—it seems first of all that some of the transmittal letters at least are very specific, but that the tendency is that many of the key points are either not responded to or are downplayed in terms of their importance.

I call to your attention that the first letter there was also from Mr. Wood, October 1979, examination report, put Continental's board of directors on notice regarding significant problems in the bank's system for identifying rating problem loans—I quote. "The importance of reliability of internal loan evaluation procedures, as is an early warning mechanism, to control credit quality in a growth environment cannot be over emphasized."

It took Miller of Continental 8 months to reply to that and come up with, in his reply, as I said, it downplayed the significance of Mr. Wood's comments. Mr. Woods' 1981 transmittal letter contained a variety of comments to the board regarding such matters as the 1982 percent ratio of criticized assets to growth capital funds. In fact, the capital had not kept pace with the asset growth.

Internal Office of Comptroller of Currency memorandum, July 22, 1981, said regarding Continental's response sent 7 months later; this is what it said:

> The recently received response, dated June 30, 1980, does not address all the matters highlighted either in the transmittal letter or in Mr. McCarte's letter to the board. The letter appears to have been put together hastily. Bank personnel were apparently embarrassed when it was realized the response had not been prepared.

So I think the point is that they are not even responding to some of the concerns or many of the key concerns that are being raised. How would you answer that particular type of criticism, Mr. Conover?

Mr. CONOVER. I would agree with you that incomplete responses and responses that downplay something that we think is important for the bank to do certainly call for us to tighten our procedures and approaches to identify clearly what it is we want the bank to do and to follow up to ensure that the bank does it.

Mr. VENTO. Do you think you have the leverage to get banks to respond? We have a lot of money center banks in the country. It appears to me you either don't have the will, determination or ability perhaps. And I probably chose the latter. The Government simply is trying to deal with the large institutions, money center banks; simply has been too timid.

Even as I look at some of the transmittal letters, they seem to me to say on this hand you have serious problems. On the other hand, they seem to be taking a different attitude. Let me get to a different problem that points up——

Mr. CONOVER. May I answer your question?

Mr. VENTO. Yes.

Mr. CONOVER. We have the capability, and we have the will, and we are in the process of doing just that.

Mr. VENTO. Well, the thing is you had supervisory agreements that were in place. I want to refer to one other instance. That deals with the ratings of Continental and a dispute that occurs with regard to what they call the CAMEL rating between the FDIC and Office of the Comptroller. I am sure you are familiar with that dispute. It is a CAMEL rating of three or four and, of course, the Office of Comptroller of the Currency is on the liberal side in terms of trying to provide a more generous rating than the FDIC.

Here is what your Mr. Martin said with regard to the FDIC. Mr. Martin, of course, who is working for the Office of the Comptroller of the Currency,

> The FDIC has no appreciation of the understanding of the strength and staying power of large institutions, but rather continues to make assessments based upon unclassified assets as a percentage of capital.

It sounds as though you are suggesting that a more generous rating is in line. This is occurring in 1983, Mr. Conover, in light of the whole record that existed. Maybe you ought to explain to the committee what a CAMEL rating is and why Mr. Martin took the position that he took with regards to this issue and what do you mean by strength and staying power of money center large banks—what Mr. Martin meant in that instance.

Mr. CONOVER. First of all, there is a uniform CAMEL rating system that is used by all the bank regulatory agencies as a way of describing and classifying individual banks. Ratings are assigned for capital, asset quality, management, earnings, and liquidity. Then a composite rating is developed out of the previous five ratings.

We provide all of our examination reports as a routine matter to the FDIC. Included in those examination reports are the CAMEL ratings.

Mr. VENTO. Are there frequent differences betwen FDIC and yourself with regards to these issues?

Mr. CONOVER. Occasionally that happens, just as you would expect that it would. After all, we are talking about a shorthand method of putting a grade on a bank that was developed as a mechanism for communicating among bankers. It is not unreasonable to expect that one agency might in certain circumstances come up with a different rating than the other. I can't cite for you how many times that happens in a given year, but it is probably relatively few. Nevertheless, it is not a totally abnormal kind of thing to have happen.

In the case of the dispute, if you will, our office in the person of Mr. Martin and the FDIC went back and forth over the CAMEL rating of Continental. At the time, we felt Continental warranted a three rating. The FDIC felt it warranted a four rating. We felt that they were focusing more intently on the asset quality of the bank in assigning that rating. We were focusing more on the definition of the rating, which indicated that in a four-rated bank there was significant probability of failure. So a number of memos were written by the two agencies. The fact that that occurred did not have any impact on the manner in which we dealt with the bank.

Mr. VENTO. Except that——

Mr. CONOVER. In fact, at the end of the 1982 examination, we downgraded the bank's CAMEL rating to four. I think the difference of opinion on this subject has been overplayed.

Mr. VENTO. Mr. Chairman, I ask unanimous consent to have the documents placed in the record.

Chairman ST GERMAIN. Without objection.

[The following documents in regard to the CAMEL rating of Continental Illinois National Bank were submitted for the record by Congressman Vento:]

FDIC

OFFICE OF DIRECTOR · DIVISION OF BANK SUPERVISION

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D.C. 20429

H. Joe Selby

Beach

Fitzgerald

CONT IL BANK FILE

May 2, 1983

Mr. H. Joe Selby
Senior Deputy Comptroller
Office of the Comptroller of the Currency
Washington, D.C. 20219

Dear Mr. Selby:

This is in response to former Deputy Comptroller Martin's March 31, 1983 letter relative to conversations with Review Examiner Ralph Hartman and Associate Director Stanley J. Poling, with respect to the Continental Illinois National Bank of Chicago.

The primary issues, as I see it, are the composite rating definition and how the FDIC distinguishes the differences between a "3" and "4" rated bank. It is obvious from the rating which we have assigned to the subject institution that we feel "there is an immoderate volume of asset weaknesses or a combination of other conditions that are unsatisfactory -- they could reasonably develop into a situation that could impair future viability and a potential for failure is present but is not pronounced." That is precisely the reason for the rating assigned. We do not feel that the rating assigned is inconsistent with the composite definition contained in the Guidelines and Procedures for the Uniform Evaluation and Rating of Banks (CAMEL).

The other issue discussed in Mr. Martin's letter is, and I quote, "the side issue of the problem that could occur if composite ratings by total assets are published by the two agencies." This concern is valid and one which we share. However, to allow a fear of public disclosure to mitigate the application of consistent standards would, to a large degree, compromise our efforts to measure the risk to the deposit insurance fund.

We are certainly willing to discuss this situation further with you and attempt to reconcile our differences. We should, however, recognize that our agencies will continue to have honest differences of opinion.

Sincerely,

James L. Sexton

James L. Sexton
Director

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MEMORANDUM

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

To The Files

From William E. Martin WEM

Date February 18, 1983

Subject Continental Illinois National Bank

In late December I was contacted by Ralph Hartman of the FDIC who stated that they had reviewed the Continental Illinois report and had concluded that it should be accorded a composite rating of 4. Mr. Hartman stated he was contacting me for the purpose of getting my reaction. I asked him on what basis he had reached that conclusion and he stated that he had "looked at the loans and they don't look too good and the classified was high." I asked him if he had recently familiarized himself with the definition of a composite 4 and he stated that he reviews it every day. I asked him if he felt the bank was in danger of failure on the fairly near term and he stated no. I then asked if he had focused on the prospect of failure language that is contained in the definition and he said yes but he was unable to reconcile his two statements. Mr. Hartman at no time mentioned funding as an issue but rather said that asset quality was the basis for his determination. I asked him if he gave any credence at all to the fact that the bank made an extraordinary loan provision of $482MM pre-tax and still resulted in a profit for the year of $81 million and he stated he was unaware of the full year's earnings for the bank but was working with third quarter figures. He was unimpressed with the fact that the earnings trend had absorbed the massive losses. I stated that before he reached his final determination, I felt that we should make sure he had as complete a picture as possible and perhaps we could sit down and talk about it and he agreed.

About two weeks ago, I spoke with Jim Sexton and told him that there seemed to be some disagreement on this and I felt that perhaps the FDIC was limiting its views strictly to total classified rather than looking through to the real threat to solvency that such classified might present. I stated that I would appreciate the opportunity to sit down and discuss it before final determination was made and he agreed.

Yesterday I received a call from Bob Ahrens who stated that Stan Poling had phoned and stated that he was sending over a letter stating their disagreement with the composite 3 and that they were signing a composite 4. This morning I spoke with Stan and related to him that both Ralph and Jim had agreed that we would sit down and discuss the matter and I was a little surprised that they had chosen to go ahead and stick with their 4 rating and merely submit a letter to us. He stated that he viewed it as a 4. I again asked him about the definition of composite 4 and the bank's prospects of failure. He also stated he really didn't think the bank would fail but he felt the ingredients in the bank were sufficient to justify the rating and he further stated that he felt that they used a different standard for assigning 4 ratings and since that was their conclusion, he really didn't see any value to discussion. I reminded him that the definition of a composite 4 was subject to interagency agreement but he again stated that they viewed the rating system somewhat differently. He then suggested that we might discuss it in Tucson next week but clearly that indicates they have no intention of seriously discussing it if he expects it to take place in that remote location without benefit of records. We did tentatively agree that we would get together at a future time to discuss it.

I raised this issue by memo for two reasons: First, if the agencies ever report composite rating categories by asset totals there will be a substantial discrepancy which will no doubt be easily traced to Continental. Second, I do find the FDIC's attitude slightly shocking in that they admit that they are applying a different set of standards for assigning such a rating rather than following the definition which was arrived at through interagency agreement. And third, it confirms for me again, that FDIC has no appreciation or understanding of the strength and staying power of large institutions but rather continues to make assessments based upon classified assets as a percentage of capital.

I am surprised that they did not follow through with our agreement to discuss the matter and when they did decide discussion was appropriate obviously indicated a cursory meeting at a remote location, I see no need to have a formal meeting later and do not intend to follow up.

This morning I was speaking with Jack Ryan on a number of items and told him of the disagreement over the rating and he told me his concern was that if those numbers ever got reported by asset size that Continental would stick out and we would have disclosed the rating for that institution and students of that rating system would certainly perceive the insolvency implications.

cc: H. Joe Selby
William Robertson
Michael Patriarca

Mr. VENTO. In other words, you are suggesting—obviously, Office of Comptroller is taking the attitude that the strength and power of that bank is such that they deserve a lower rating simply because they are a large institution. That is what this statement says, of course. It may be taken out of the total letter.

The point is that is what it says. Obviously, you are aware of it. And that is the attitude, I guess. Is that right?

Mr. CONOVER. The letter says what it says. The judgment made at that particular time was that the bank was more appropriately rated three for the reasons spelled out in Martin's memo. As I say, I think much too much is made of this because it didn't have any impact on the manner in which Continental Illinois was supervised from that point on.

Mr. VENTO. Thank you, Mr. Chairman.

Chairman ST GERMAIN. Mr. Conover, did you, meaning you and your very excellent personnel, at any point, have reason to suspect that there was insider abuse at Continental? Frankly, I am referring to Mr. Lytle, who as we found out, was the man who was doing the Tennessee Waltz with Bill Patterson.

Mr. CONOVER. We certainly didn't suspect that there was any insider abuse on the part of the top management of Continental. As far as Mr. Lytle goes, I am not sure what his current status is.

Chairman ST GERMAIN. I am asking——

Mr. CONOVER. I know he has been dismissed by the bank.

Chairman ST GERMAIN. When did you and your office discover that indeed there was some hanky-panky going on?

Mr. CONOVER. Probably not until after the Penn Square Bank had failed and the investigation took place as to the manner in which the loans——

Chairman ST GERMAIN. Remember, we had our hearings at the time and brought out the fact Mr. Lytle——

Mr. CONOVER. I am aware of that.

Chairman ST GERMAIN. Would that be about the correct date?

Mr. CONOVER. I would think so. I don't think we suspected or knew that there was any potential insider abuse on Mr. Lytle's part, or anybody else's part in the bank, prior to the Penn Square Bank failure and the subsequent hearings relating to it.

Chairman ST GERMAIN. At that point, did you insist that he be removed from office?

Mr. CONOVER. We didn't need to. The bank removed him from office.

Chairman ST GERMAIN. In a timely fashion?

Mr. CONOVER. I believe he was let go in July 1982.

Chairman ST GERMAIN. Mr. McKinney?

Mr. MCKINNEY. Thank you, Mr. Chairman. Mr. Comptroller——

Chairman ST GERMAIN. Wait a minute, Mr. McKinney, I have to say this. I want you to know that we have been in contact with the FDIC's office. We informed them that the computer runs on what the alternative costs would have been for infusing capital or the bailout, had you allowed Continental to fail.

They tell me they are looking for it. That was at a quarter to 1. So I am going to give you every half hour a report on how we are doing with this. Let me ask you this: I will bet you could find it

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within your files within a matter of minutes, right, because of the efficiency of your office?

Isn't that an important document?

Mr. CONOVER. My colleagues are laughing because of the piles of things that are stacked in my office.

Chairman ST GERMAIN. But whatever important things are stacked, I promise you can.

So, too, in mine, Mr. Conover, but no matter how high they are stacked I can tell you I can find them in a moment's notice.

Mr. CONOVER. If you want to look into the evaluation of different potential courses of action vis-a-vis Continental and why the decision was made to go as we did, you would probably want access to those documents.

Chairman ST GERMAIN. I think they are rather important documents. I just want you to know they are looking for them. Mr. McKinney?

Mr. MCKINNEY. Mr. Chairman, if they should be as fast as the Defense Department, you will still be here next Christmas.

Mr. Comptroller, I think whatever they want to concentrate on, we have been through all the implications. It is semi-staggering what has happened, and I will stay away from my diatribe on the two types of banks. What I really want to look at are two aspects of the situation. One, why didn't we move faster, and, two, just what can you do? I know on page 19 you say we have asked ourselves whether we should have taken action as early as 1976 to prevent Continental from embarking on a course of rapidly becoming a top lender to corporate America.

In my view it would have been inappropriate to have done so. It is not the proper function of regulators to decide what business strategy an individual bank should undertake. A regulator's role is to see that whichever business strategy a bank chooses, it has the mechanisms in place to implement that strategy in a safe and sound manner.

Then we move over to pages 25, 26, and 27. On page 27, you list a whole pile of things that could be done and you say there is another means of insuring adequate capital, OCC will be scrutinizing the pay out policies in light of its overall capital structure. We will not hesitate to restrict dividend payments when necessary. There is a great deal of talk about the adequacy of capital, but then I go back to Penn Square.

When Penn Square failed I asked the direct question. I asked why, in fact, did Seafirst which no longer exists except as part of Bank of America and Continental draw into Penn Square so heavily when the Chases and Citibanks and the rest were not?

I was told by many people including my New York banker constitutents that, Seafirst was a poorly run bank and had to be taken over and, in fact all of this was an aberration with Penn Square. You go back to articles in the newspapers of July and August 1982, "Business Week," 1982, October, "Continental Illinois' Most Embarrassing Year" and so on.

What is our problem in not getting that red warning flag up sooner? We certainly knew Penn Square was in trouble a long time before it collapsed. Far more important, when the red flag goes up, what can you really do or what are you able to do? It seems to have you in the same spot as the high sheriff on the highway without the powers of arrest, and that really makes your job somewhat superfluous.

Mr. CONOVER. In terms of the red flags, most of Continental's loan purchases from Penn Square took place in late 1981 and early 1982. In fact, they took place between examinations. It happened very quickly. If you recall from the Penn Square discussions, it was at precisely that time that Penn Square went on a lending binge of the first order. They must have sold virtually all of the loans that they produced during that time to Continental.

Now, we have done some things since then to improve the red flag system. One of the things we did, as I indicated earlier, was to change the call report so we get some information on participations for review quarterly.

Mr. MCKINNEY. Let me stop you in the process. We have gone I think, from roughly $300 million invested in Penn Square to over $1 billion, correct?

Mr. CONOVER. Yes.

Mr. MCKINNEY. Over how many months?

Mr. CONOVER. About $300 million in April 1981. By the fall of 1981, we are talking about $500 million and by March 1982, $1.1 billion.

Mr. MCKINNEY. I really want to find out this answer because we are going to have to legislate something in here sooner or later. What blows a whistle? Suddenly you have a storefront bank in a shopping center in Oklahoma that borrows $800 million from a big, supposedly sound fiduciary bank in roughly a very short period of time.

Does a whistle blow somewhere in your organization to alert you to this unusual activity?

Mr. CONOVER. The whistle blows if you know about it. And we now have the mechanism for knowing about it.

Mr. MCKINNEY. All right, now you have the mechanism to know. I have a degree in history from Yale which doesn't help me here but the minute I see the participation there I say there is something wrong. If there is something wrong with the energy loans from Continental there has to be something wrong with the energy loans period.

So the whistle blows in your office. What do you then do?

Mr. CONOVER. You have to get into, in this case, Continental Bank and take a very long hard look at the loan portfolio including the loans participated out from Penn Square which you focus on first. And then you ask the obvious question or make the obvious observation, which you just made, that if the oil and gas loans they are getting from Penn Square are bad, the other oil and gas loans are probably bad, too. That turned out to be the case.

Mr. MCKINNEY. We have done that in a miraculous 30 days investigation. We are quite right. The loans stink. Now what do you do?

Mr. CONOVER. At that point, if they are on the books, you have got a problem. One thing you can do is change all the policies and procedures and restrict further purchases and the like. That is no problem. The question is what do you do with the loans that they already bought when their system was either out of control or they were being defrauded.

If they were being defrauded——

Mr. McKinney. It is tougher to find.

Mr. Conover. It is tougher to find, but it may also provide them with some recourse. Once the loans are on the books, you are in a workout situation.

Mr. McKinney. But you say the loans were on the book. Continental continued on the same—I mean $800 million is an awful lot for, as I say, a shopping center bank which has all of a sudden gone crazy in Oklahoma. Can you issue a cease and desist order on any further energy loans until such time as or something of that sort?

Mr. Conover. Oh, sure, you can say don't make any more energy loans. But you almost don't have to at that point. I mean, there isn't any point.

Mr. McKinney. But you see, I don't want to get to that point. That is my big problem. I have a bank in Oklahoma operating out of an old storefront in a shopping center. All of a sudden it expands and I see a supposedly prestigious bank that has increased its loans by $800 million.

They shouldn't be able to make that increase of $800 million without a whistle blowing somewhere. They shouldn't have gotten past the——

Mr. Conover. Oh, that is correct. I agree with you on that. The control mechanisms broke down in Continental, and we didn't have a mechanism for discovering participations then. We do now.

Mr. McKinney. Let me tell you what I think is the crux for this committee. What can you really do in cases like this and how fast are you going to find out about it to be able to do anything in time? You know, we all know and we don't talk about it much. We have this wonderfully cozy system.

We have the internal auditor, whom we find out is next to worthless at Continental followed by the external auditor, who in the case of Continental got paid $3½ million for writing his report with the internal auditor. Then we have the internal auditor who also is being investigated, who checks whether or not the bank is in debt and what is the collateral positions, which most people ignore and big borrowers can phone in.

You say we may have been carried away by the fantastic growth and success in the seventies of Continental Illinois. We may have been carried away by its management mystique. But is it possible for a mere human being working for a division of the Federal Government to come in at that salary level? Could he walk into Walter Wriston and stop Mr. Wriston lending to Brazil? I doubt it.

Mr. Conover. You are raising another question—whether examiners in general and the Comptroller's Office in particular have the chutzpah, if you like, to walk into top management and say, "Stop, or we are going to take some action against you." There is no doubt in my mind that the examiners in the Comptroller's Office—and I have been involved in meetings with them in an awful lot of banks in the last couple of years—have the guts to say directly to the top management of any bank you want to name that they have got a problem in a particular area. "It is wrong." "It has got to be fixed, et cetera." They grow up on that.

Mr. McKinney. What if management says buzz off, which is what they did at Penn Square?

Mr. Conover. It depends on how management says buzz off. If management says buzz off where they are literally trying to defraud you by pretending they are doing something that they are not doing, that makes it very difficult to uncover the wrongdoing. On the other hand, if you have a management that says go away, I don't agree with you, we have ample power, and we use that power to get them to do what we want them to do.

Mr. McKinney. You see, I see——

Mr. Conover. You needn't be concerned about that.

Mr. McKinney. I am not firing at you.

Mr. Conover. I understand.

Mr. McKinney. It seems the Comptroller of the Currency at the present time has two big problems. First, the speed alarm on his speedometer isn't working to tell him he is about to get arrested for going too fast and No. 2, he is like the sheriff with a gun without any bullets or car without any tires because essentially your people were in Continental Illinois every 90 days and missed this one.

Continental Illinois management knew they were making some rotten loans. Sometimes I feel the quality of management, the three-piece suit and Chicago Club and marble overcomes the fact that it is still a pretty rotten institution. And I don't know what you need, so this kind of thing doesn't happen again because, you see, I have a different theory than a lot of people.

I listened to Mr. Rohatyn and a few others in New York and read what they said in the New York Times. They said, "Well, this isn't the taxpayers' money." Sorry. It is the taxpayers' money. Every single American taxpayer who has a depository account with an FDIC or FSLIC insured institution is paying higher bank charges because those banks and institutions are paying higher insurance premiums.

So we are dealing with the taxpayers' money in every sense of the word. It is just a different form of taxation. It is called an insurance premium rather than a tax. You say in your testimony that there is a low margin of error allowable in the financial world.

Mr. Conover. Yes.

Mr. McKinney. What do you need from the Congress of the United States, No. 1, to give you a system that works better; and, No. 2, what do you need from the Congress of the United States so that you can do something instantaneously? The saddest picture has got to be the 1½ years of wobbling around in Oklahoma before the crash hit.

Everybody isn't saying it is a rotten bank. It is a classified bank. The loans are still no good. And it is still bouncing around on a day-to-day basis. Recently one of my banking friends said, "Well, Stewart, you are proposing we nationalize a bank." I said, "No, we already have nationalized a bank, so that is no longer an issue."

Mr. Conover. I think the machine on which the red flag goes up is fixed. The mechanism is in place so that we can get information on significant changes in bank activity, in their balance sheets, et cetera, that will raise questions that require followup.

Now, I have to put one caution on that. That—going back to the question of fraud again, somebody who willfully wants to get his bank in trouble. The fact of the matter is that if you owned a bank today, you could go home to Connecticut and fail that bank before anyone would know, if you really wanted to.

Mr. McKinney. In a heartbeat.

Mr. Conover. You really could. And the problem there is that any regulatory system that would keep you from doing that would be an incredible system. I don't think you or I want that kind of system.

Mr. McKinney. I agree.

Mr. Conover. So I would say, first of all, that we have the tools to get the information that we need.

Do we need any new enforcement powers or tools of that nature? I honestly don't think so. I will engage in all kinds of conversations with you to get different points of view on the subject, but we have cease and desist powers, civil money penalty powers, authority to remove officers.

Somebody asked me the other day if we shouldn't have a system where we don't have to wait until the bank fails or almost fails to take some action, where we could go in much, much earlier. That sounds good except when you start defining what that trigger point would be. You could say that when you get to 3 percent capital, the regulators can go in and seize the bank. We are seizing private property if we do that. When classified loans get to a particular level do you then, through some emergency power granted to the regulators, automatically let us go in and do something we couldn't otherwise do? Those are possibilities. But they would have to be thought through very carefully.

Mr. McKinney. Thank you. My time has run out and I am sure we will be having many discussions over the ensuing months.

Chairman St Germain. History at Yale University. We are impressed.

Mr. McKinney. I might add that the Comptroller and was 2 years behind me.

Chairman St Germain. You know, Mr. Comptroller, and believe me, I am going back to many Comptrollers. You are not the first one to sit in this particularly comfortable chair that you are ensconced in at the moment, and the thing that bothers me is that each and every time we go through hearings like this we are told, "Well, we now have it in hand. It won't happen in the future. We will be able to detect this ahead of time in the future. The early warning system, the NBSS, it is really going to function."

Now let me ask you this, Mr. Conover. We now know we have got to watch out for the energy-related loans. But one of the new fields I have been reading about is genetic engineering. You have heard about that. All right. Now suppose you find an institution that suddenly decides to go into genetic engineering and they go belly-up, too.

Are we going to be told, "Well, we really didn't have enough information on genetic engineering or whether or not there was concentration on genetic engineering loans." What assurance do we have that 6 months, a year or, 2 years from now you or your successor won't be here telling me, "Well, we have got it in hand this time. It won't happen again."

Mr. CONOVER. First of all——

Chairman ST GERMAIN. That is a sincere question.

Mr. CONOVER. I understand it is. First of all, there are no absolute, 100 percent guarantees so I can't promise you that that could never happen. Taking the example you cite, however, let me tell you about the mechanism we have put in place to try to deal with that problem.

When we reorganized our field structure and our Washington office structure, we did two things. We created an industry review program in the Washington office which looks at particular industries where banks may have some significant concentration, traces through the potential problems that might develop in those industries, and translates them into the potential impact on the banking system. We have done a lot of studies, for example, as to the impact on the banking system if oil were to fall to $25 a barrel or $20 a barrel. At the same time, we have established in our district offices an important position responsible for more local industry analysis. For example, the industry analyst in a particular office might take a look at the local real estate market, assessing whether the area is being overbuilt and whether banks have a number of commitments outstanding to fund buildings that either may never get built or, if they get built, are going to end up sitting vacant and be a terrible drain on their owners for some time.

The mechanisms are in place. The challenge to us is to be sure we use them well. And we have a commitment to doing so.

Chairman ST GERMAIN. Thank you. Mr. Schumer, the word that was used, I didn't want him to repeat it then because I wanted to use it now. Now we have our chutzpah kid.

Mr. CONOVER. Did I mispronounce the word, Mr. Schumer? I apologize.

Mr. SCHUMER. I am sure Mr. McKinney didn't learn this in his history courses at Yale, but the word is chutzpah.

Mr. CONOVER. I stand corrected.

Mr. SCHUMER. It will serve you well in the future to learn the correct pronunciation. Anyway, I have a group of questions. The first question I have relates to something Mr. McCarte told us about yesterday. It seems to us he was the auditor of Continental in 1979, 1980, and 1981. Then in 1982 he was no longer auditor. He was left the job kind of suddenly because he acquired a new position, working for the Continental Illinois Bank.

I imagine he got a nice increase in salary. I didn't want to put him through questions like this. He had had a tough day. But I imagine he got a nice increase in salary, et cetera.

Don't you think that it is a bad policy to allow auditors of a bank to then immediately thereafter go and work for the bank? Doesn't it tend to create conflicts of interest?

Mr. CONOVER. The alternative would be to restrict people's post-Government employment opportunities and to tell bank examiners that they can't go to work for a bank.

Mr. SCHUMER. Plus the bank that they have examined within the last 3 years.

Mr. CONOVER. I don't think that that is a problem. We have specific procedures for dealing with cases like that. When Mr. McCarte was approached by the bank, and, incidentally, the bank asked his supervisor first if they could approach him, he made that approach known immediately to his supervisor and informed his supervisor that he would pursue those conversations. We have looked very carefully at the practice to see if there were any improprieties, et cetera and our conclusion is that it ought to be written up as a model for how Government employees are to deal with those kinds of situations.

I don't think there ought to be restrictions on post-Government service employment by bank examiners. I can tell you that is where we have lost most of our bank examiners. Banks hire them. Now, I don't know the exact breakdown.

Mr. SCHUMER. You are helping me make my point, but I am not objecting to banks hiring. What I am saying is that to go immediately of from auditing a bank, to working for that bank, wouldn't it put strains on Mr. McCarte?

What about the next guy who comes in and audits Continental or the people with him? They ought to be asking themselves at least subliminally, "where are my job opportunities if I am not going any further in the Comptroller's Office? I can go right to this bank." Yesterday, we talked about the difficulty for an examiner to go to a board of directors or go to his superiors and say, this bank is in trouble. I can understand that and sympathize with that. It seems to me, however, that this puts an undue strain on the examiner. Take your own job, for example, you can't go work for a bank for 2 years after you leave this job, am I correct in that?

Mr. CONOVER. That happens to be true, not by virtue of being Comptroller, but by virtue of being a Director of the FDIC.

Mr. SCHUMER. In other words, it seems to me that you should consider the problem because, given all the difficulties that we have, it just creates an appearance of impropriety.

There may be none in reality, but more importantly than that, when you are dealing in such a subjective area as bank examination—and it is a subjective area in terms of the the judgments that people have to draw from the specifics they find—that it just makes no sense to allow somebody who has examined a bank 3 years in a row to then go immediately and work for that same bank. I don't think that this should just apply to bank examiners.

I think it should be a rule that applies to public service commissioners. They should not be allowed to go to work for the utility immediately thereafter. I think we do have such a rule, in New York State, for the Public Service Commissioners.

It is something that I think is wrong, but I guess you don't agree with me on that,

Mr. CONOVER. I understand your point and the sensitivity of it. I think it might cause us a lot more problems than it would provide benefits. If the banking industry is one of the places that people go when they leave the Comptroller's Office, and that is particularly true in certain parts of the country where there are a lot of unit banks, I think it would significantly limit our ability to attract and hold people if that restriction were put in place. There are two sides to the coin.

Mr. SCHUMER. I understand that.

Mr. CONOVER. That is all.

Mr. SCHUMER. OK

The second question. I asked this yesterday and was kind of perplexed that I couldn't get much of an answer, and it is a general question and your testimony doesn't quite answer it, but it touches on it.

What went wrong? What went wrong in the Comptroller's Office that allowed Continental to go under 2 years after you knew there was a problem?

Mr. CONOVER. In order to answer that question, I have to give a quick overview of what went wrong with Continental per se.

Mr. SCHUMER. That I am pretty much aware of, and I think the committee is.

Mr. CONOVER. If you combine the bank's strategy and either the lack of controls or lack of commitment to those controls, and add to that the two recessions, the energy focus and the energy downturn, and the funding situation of the bank, that is how the bank got into the position that it did.

As to our office's handling of the situation, I think there are several instances in my prepared testimony where I said that, with the benefit of hindsight, we could have been more forceful in dealing with the internal control system.

Mr. SCHUMER. That is after 1982 or before?

Mr. CONOVER. Before 1982. I think that is where you break it: up to 1982—Penn Square—and then subsequent to 1982. I think the seeds were very well planted prior to 1982. I think they go all the way back to 1976.

Mr. SCHUMER. Mr. McCarte, who did the examination in 1979, 1980, and 1981, seemed to have no idea that anything was wrong with the internal control system.

Mr. CONOVER. I think he indicated that there were weaknesses in the internal control systems in specific areas and then made an overall judgment, which I think one tends to do, to try to put the whole thing in perspective and say net you are probably OK, although you need to make corrections in these five areas.

Now, I indicated——

Mr. SCHUMER. He didn't say you are probably OK. He gave it a much cleaner bill of health than that as I remember his language.

Mr. CONOVER. Nevertheless, he made a statement which was intended to put his specific criticisms in perspective. I have already indicated that I thought the judgments that were made about the bank and its control system in those years were swayed by the performance of the bank and the responsiveness that management had displayed in dealing with criticisms we had made in the past.

Mr. SCHUMER. I take real dispute not with what happened before 1982, but what happened—in terms of what the Comptroller's Office did—between 1982 and 1984. You say in your statement that you are persuaded that since mid-1982 there was nothing more that we could have done to speed Continental's recovery, and thereby increase market confidence.

You admit that it was the lack of market confidence that finally caused Continental to fall in 1984?

Mr. CONOVER. Yes.

Mr. SCHUMER. You are saying then that there was nothing the Comptroller could have done to help bolster that confidence, is that correct?

Mr. CONOVER. I think it is.

Mr. SCHUMER. Then let me ask a couple of questions.

Don't you think that changing management, not just the Penn Square people, but management at the top, would have helped restore confidence, and don't you think the Comptroller's Office was much too timid?

I know that the president of Continental was known as a very nice man and all of that. I don't think that enters into it, at least objectively, but I talked to some experts in the field and they say that the Comptroller's Office was terribly remiss, once the 1982 damage was done, in not replacing top level management because, first of all, even though, as you testified they had done a good job of bringing the bank back to health before any management that had no internal control system had to have something severely wrong with it even beyond its Penn Square Loans. That ill existed for an area of lending beyond Penn Square.

No. 2, when you replace management, you are telling the world, OK, things are new. We can have new confidence in this bank.

Mr. CONOVER. You may also be telling them that things are a lot worse than——

Mr. SCHUMER. They couldn't be worse than they ended up being.

Mr. CONOVER. That is certainly true, but you have got to put this in perspective of what was known at the time. You may be telling the marketplace that things are a lot worse than they are.

Mr. SCHUMER. I look at Continental's sister big bank, First Chicago, and wonder why you didn't follow that pattern. There were all sorts of rumors earlier that First Chicago was in trouble. I don't know the details, and I don't know what the Comptroller's role was either, but I do know that when the president of that bank was replaced, it seemed that the markets gained a great deal of confidence in First Chicago. Is there an analogy there?

Mr. CONOVER. There may be, but in this particular case I think you have to go back and consider what was known at that particular time. I think what we had was a management which had been responsive to criticisms in the past, had gotten the bank out of the 1975–76 problems with the REIT's, had recognized the problems of 1982, and had put in place a mechanism using outside directors, lawyers, and accountants to figure out what had happened and what they ought to do about it.

Why did the thing break down? There was evidence that management was committed to doing something about it, and I realize that two different minds can have a different view.

Mr. SCHUMER. It just seems to me if the bank didn't fail or come as close to failing as it did, let's not get into semantics at the moment, but it seems to me that if there were 2 years between the time you knew there were real problems and the time the crisis of confidence wave undid everything that there might have been more things that your office could have done.

We have had our dispute on that. You can answer that and this question.

In effect, what you have said is, there was no reason to suspect anything was wrong with Continental before 1982, and nothing could have been done about it after 1982. You have made a very persuasive argument that your whole operation of bank examination is useless.

Mr. CONOVER. No; I don't think so. I think you are overstating the case rather dramatically.

Mr. SCHUMER. That is because I think you did when you said those two things.

Mr. CONOVER. Well, all right. I have outlined in the testimony what our role is as bank supervisor. I have also indicated precisely what the causes of this particular situation were, noted that there were some weaknesses in the way we handled it, and identified the improvements that we have made in our process for the future.

Now, I don't think you can take the particular case at hand and extend it logically to a conclusion that you ought not to have a Comptroller's Office or a bank regulatory function, or whatever because it can't get the job done. I think that before even entertaining such a judgment you have to consider the condition of the rest of the banking system and the timely corrective actions that have been taken by the regulators vis-a-vis any number of other problem banks that have restored them to health.

Mr. SCHUMER. Can you give me an example?

Mr. CONOVER. I will not give you an example.

Mr. SCHUMER. That is the problem.

Mr. CONOVER. Let me finish what I was going to say. I will not give you an example of a specific bank because I don't want to name a bank that is open today, and by definition we are talking about a bank that is open today. I will, however, provide you with the following information.

As of 1980, when Penn Square became a 3-rated bank originally, there were some 250 banks that were also rated 3 at that particular time. We have gone through and traced exactly what has happened to those banks since then, and I will provide this to you in writing. Now, recognize that you could do this for banks that were rated 3 or 4, or whatever, at any point in time. The data for that particular group of banks indicates that some 65 percent of them have been returned to health and are now rated 1 or 2. Another very large number of them remain rated 3 today but have not deteriorated from that status. A much smaller percentage have declined to 4 or 5 or have failed.

Mr. SCHUMER. How many have been money center banks or extremely large banks? You never let us see the details so we are sort of groping in the dark here too, but it is my hunch that you do a much better job in examining little banks than big banks.

I mean, the people here yesterday didn't even know what was going on in the oil and gas division of midcontinental division of Continental Illinois until it was in their words "too late."

How many were large banks? How many of those banks were in the top 50 banks of this country?

Mr. CONOVER. I don't know off the top of my head.

Mr. SCHUMER. Could you get me that?

Mr. CONOVER. I will.

Mr. SCHUMER. Was it more than one?

Mr. CONOVER. As I said, I don't know. I will provide you with that information.

Mr. SCHUMER. My guess is it wasn't very many.

My time has expired.

Chairman ST GERMAIN. Mr. Conover, we have been in touch through staff with the FDIC and I will ask Mr. Dugger on our staff to tell you what we determined.

Mr. DUGGER. Basically, Mr. Northup and Mr. Unthank do not have a clear idea of what you mentioned, the exact analysis you talked about.

Chairman ST GERMAIN. You asked for what?

Mr. DUGGER. I asked them pursuant to the chairman's request, that a copy of the analysis——

Chairman ST GERMAIN. What type of analysis? Be specific.

Mr. DUGGER. A payoff analysis or liquidation value analysis, a purchase and assumption analysis, comparable to what is done with banks in terms of analyzing whether they should be liquidated, assisted, or merged.

Chairman ST GERMAIN. And the answer was?

Mr. DUGGER. The answer is that while they have looked and looked, they don't have any specific formal analysis of that sort.

Chairman ST GERMAIN. And then they asked Mr. Isaac.

Mr. DUGGER. Mr. Northup asked Mr. Isaac. Mr. Isaac said he was not aware of one. I am reporting what Mr. Northup said.

Chairman ST GERMAIN. What type of analysis did you see, Mr. Conover?

Mr. CONOVER. Well, there were analyses that were performed as——

Chairman ST GERMAIN. So you can be more specific with the FDIC.

Mr. CONOVER. I don't think we are going to reach a conclusion on that while we are sitting here today.

Chairman ST GERMAIN. I don't want to wait too much longer. We have been trying for 3 or 4 weeks now to get this.

Mr. CONOVER. I understand.

Chairman ST GERMAIN. And I am looking to you to help me.

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

Chairman ST GERMAIN. All right.

Mr. CONOVER. That information exists.

Chairman ST GERMAIN. OK, because you saw those analyses.

Mr. CONOVER. It may not be on the same form that is normally used when the FDIC calculates the cost of doing a purchase and assumption.

Chairman ST GERMAIN. For a smaller bank, because this is a great big institution?

Mr. CONOVER. That is correct.

Chairman ST GERMAIN. So it would seem to me it would be easier to find.

Mr. CONOVER. But the substance of that information is available.

Chairman St Germain. The substance. I hope you are not saying that the analysis couldn't be made because there isn't substantive information available to make the analysis.

I am hoping that the analysis was made.

Mr. Conover. No; I am not saying that. I am saying the information is available. I am saying don't be surprised if it isn't on the same form that is normally used when an evaluation of a bank is being made.

Chairman St Germain. Now I will ask Mr. Dugger to go back and maybe we will have Mr. Northup here with Mr. Isaac so he can talk to the Comptroller before he leaves.

Mr. Patman.

Mr. Patman. Thank you, Mr. Chairman.

Mr. Conover, is it correct to say that the decisions made on what the Government would and would not do with respect to Continental Illinois and its holding company, those decisions were made by yourself, Mr. Volcker, Mr. Regan, and Mr. Isaac?

Mr. Conover. Yes; that is correct.

Mr. Patman. Did you have any communication with the White House or Executive Office building during this time that you were working on this issue?

Mr. Conover. No; we did not.

Mr. Patman. You didn't have any idea about the White House position on this?

Mr. Conover. No; we didn't.

Mr. Patman. None of you did to your knowledge?

Mr. Conover. That is correct.

Mr. Patman. Each one of you is a White House appointee?

Mr. Conover. That is correct.

Mr. Patman. You didn't check to make sure you were doing what the White House wanted you to do in this?

Mr. Conover. That is correct. We were operating under statutory authority contained in the various acts that grant the FDIC and the Fed powers in such situations, and there wasn't any particular reason to contact the White House since we knew that the right way to handle it was in a way that was totally devoid of any political input.

Mr. Patman. I don't know that you can say it is totally devoid of any political input. You are all political appointees, but let me ask you was there any dispute among you about what should be done?

Mr. Conover. Was there any dispute among us? There were conversations throughout the process as to what the right way to go was.

Mr. Patman. And there were differences of opinion?

Mr. Conover. And there were differences of opinion throughout, just as you would expect there to be.

Mr. Patman. Who came up with this solution?

Chairman St Germain. Mr. Patman, why don't you ask if it was an opinion whether or not they should bail it out or let it fail?

Mr. Patman. That is what I would like to get to.

Who came up with the final decision that was adopted for the final proposal?

Mr. Conover. Well, the FDIC——

Mr. Patman. Did you do it or did the FDIC?

Mr. CONOVER. The FDIC played the lead role in negotiating with the banks and structuring the deal.

Mr. PATMAN. Did any of the four of you suggest that the bank should be allowed to fail?

Mr. CONOVER. We talked at some length as to whether the bank should be closed or not.

Mr. PATMAN. Did one or two of you or three of you perhaps advocate that the bank be closed?

Mr. CONOVER. No; I don't think so.

Mr. PATMAN. Did any of you ask and strongly recommend that the bank be closed?

Mr. CONOVER. We laid out and discussed the pros and cons of doing it open versus doing it closed. There were differences of opinion as to the importance of various pros and cons. When all was said and done, there was a unanimous conclusion that the bank ought to be handled through an open bank transaction, as it was, in fact, handled.

Chairman ST GERMAIN. Bill, ask about Secretary Regan. What was his opinion?

Mr. PATMAN. Did not Secretary Regan put out a statement at one time casting strong doubt as to the legal basis for any takeover of the bank, or what you did?

Mr. CONOVER. Secretary Regan's statements focused not on whether the bank ought to be provided with assistance in an open bank fashion, but on whether the FDIC ought to buy preferred stock in the holding company or debt of the bank, a highly technical aspect of the deal that we had discussed at some length earlier.

Mr. PATMAN. Were you prevented from extending a loan to the holding company? Why buy prefered stock where you have a place in line behind the bondholders?

Mr. CONOVER. That was precisely the technical issue that was brought up.

Mr. PATMAN. In other words, they could not issue preferred stock because of some agreement with the bondholders, and furthermore, they could not issue additional bonds, is that what you are saying?

Mr. CONOVER. They could not issue preferred stock in the bank, where it would have been preferable for the FDIC.

Mr. PATMAN. Right, but did you take preferred stock in the holding company or the bank?

Mr. CONOVER. We took preferred stock in the holding company, with the negative result that it provided a direct propping up of holding company bondholders and commercial paper holders.

Mr. PATMAN. Could you not have taken a position as a bondholder to the holding company?

Mr. CONOVER. No; that wouldn't have worked because we wanted to gain 80 percent control of the shares in the overall corporation.

Mr. PATMAN. But you have the power to take complete control over the bank; do you not?

Mr. CONOVER. In what sense? By closing the bank, sure.

Mr. PATMAN. Do you not also have the power to remove the officers and substitute others of your choice?

Mr. CONOVER. Yes.

Mr. PATMAN. Is that not taking over the bank?

Mr. CONOVER. Well, that was done as part of the agreement with the FDIC.

Mr. PATMAN. Is your power limited to simply closing the bank? Is that what you want us to think? Were you limited in the powers?

Mr. CONOVER. I am not sure whether you are focusing on what the Comptroller's Office powers are or whether you are talking about the structure of the deal.

Mr. PATMAN. All of the powers really, but first of all, the Comptroller's Office doesn't have sufficient powers in your judgment.

Mr. CONOVER. I didn't say that.

Mr. PATMAN. With respect to the holding company.

Mr. CONOVER. The Comptroller's Office doesn't have any power with respect to the holding company.

Mr. PATMAN. Then the only powers you have in this four-part agreement came from the Federal Reserve, is that true?

Mr. CONOVER. The deal was struck between the Federal Deposit Insurance Corporation and the bank.

Mr. PATMAN. Does the FDIC have any powers over the holding company?

Mr. CONOVER. They have the power under the Federal Deposit Insurance Act to provide aid to the holding company if it is pursuant to the rescue of an insured bank.

Mr. PATMAN. But would you not say then that your agency, the FDIC and the Treasury Department have no powers with respect to holding companies as far as compelling the performance of certain things you would like to see performed by the holding company?

Mr. CONOVER. That is correct.

Mr. PATMAN. Only with the Fed do you get any power in this case?

Mr. CONOVER. The FDIC had powers vis-a-vis the holding company in this particular transaction, as I have just indicated. The Fed, of course, has authority over the holding company as its primary Federal regulator.

Mr. PATMAN. Do they have as many powers as you do over the bank, over the holding company?

Mr. CONOVER. Do they have as many powers over the holding company?

Mr. PATMAN. Do they have fairly complete powers?

Mr. CONOVER. As I understand it, they do.

Mr. PATMAN. With the holding company.

Chairman ST GERMAIN. Bill, would you yield for a second?

Mr. PATMAN. Yes, sir.

Chairman ST GERMAIN. I think I would like to pursue the same trend along with you.

Mr. CONOVER. Please.

Chairman ST GERMAIN. The FDIC now owns, or will own, how many shares of stock?

Mr. CONOVER. Oh, I don't remember the number of shares, but it amounts to 80 percent.

Chairman ST GERMAIN. That is what I mean, 80 percent of the stock.

Mr. CONOVER. Yes.

Chairman ST GERMAIN. Therefore, they appoint a new board of directors.

Mr. CONOVER. Well, not precisely. The bank will elect the board of directors.

Chairman ST GERMAIN. Who elects the board of directors? The shareholders?

Mr. CONOVER. The shareholders.

Chairman ST GERMAIN. And who owns 80 percent of the shares? The FDIC?

Mr. CONOVER. The FDIC does.

Chairman ST GERMAIN. So who is going to elect the board of directors?

Mr. CONOVER. I am not sure how the FDIC exercises its voting rights.

Chairman ST GERMAIN. And if Ogden and Swaringen don't perform well, the FDIC, I hope will remove them and replace them?

Mr. CONOVER. That is correct.

Chairman ST GERMAIN. Because of the moneys involved?

Mr. CONOVER. That is correct.

Chairman ST GERMAIN. Is that what you are looking for?

Mr. CONOVER. That is correct, but not because of the moneys involved—because they were not doing the job in turning the bank around that they ought to be doing.

Chairman ST GERMAIN. The fact of the matter is, because 80 percent of the shares have been purchased by the FDIC, all of the billions of dollars going in there are from the FDIC.

Mr. CONOVER. That is correct.

Chairman ST GERMAIN. So they better watch over it. If the bank starts going to energy loans again, the FDIC will say stop; won't they?

Mr. CONOVER. The FDIC has said that it will exercise its rights as a shareholder, that it will try not to interfere in the day-to-day management of the bank.

Chairman ST GERMAIN. But the shareholders control the board of directors.

Mr. CONOVER. That is right.

Chairman ST GERMAIN. The board of directors have a fiduciary responsibility?

Mr. CONOVER. That is correct.

Chairman ST GERMAIN. Therefore, they run the bank?

Mr. CONOVER. That is true.

Chairman ST GERMAIN. So the FDIC, the Federal Government is running that bank. Amen.

Mr. Patman.

Mr. PATMAN. The preferred stock, does it have any voting powers?

Mr. CONOVER. I don't remember.

Mr. PATMAN. Just confirm that it does not. It does not, right?

All of these money center banks, whether they are called Chase Manhattan, Citicorp, or what have you, are holding companies, are they not?

Mr. CONOVER. They all have holding companies, yes, sir.

Mr. PATMAN. And they are parts of holding companies?

Mr. CONOVER. Banks are parts of holding companies, yes.

Mr. PATMAN. The only way that you can really effectively control one of these bailouts, if you want to call it that, and I doubt that you do, would be to have some access to control over the holding company or regulatory authority over it, is that not true?

Mr. CONOVER. I am not sure what you are getting at. We were dealing with the bank and not with the holding company.

The fact that the holding company owned the bank wasn't a problem except to the degree that there were some restrictive covenants in the indentures on some of the holding company bonds. We knew that was a problem, and, as I have indicated earlier, we know how to correct it so that it won't be a problem in the future.

Mr. PATMAN. The assets of the holding company are not subject to the debts of the bank, is that true?

Mr. CONOVER. The assets of the holding company? That is correct.

Mr. BARNARD. Mr. Patman, would you yield?

Mr. PATMAN. Yes, sir.

Mr. BARNARD. This is not the first time that the FDIC has taken stock in a bank, is it?

Mr. CONOVER. No, it is not.

Mr. BARNARD. In other words, there is a precedent for this type of settlement as far as a bank is concerned as opposed to a holding company.

Mr. CONOVER. I believe that is correct. I think it has been done two, possibly three times. One was in the case of the First National Bank of Midland, TX and one in the case of a New York savings bank.

Mr. BARNARD. In the Pennsylvania bank though they took warrants, I believe.

Mr. CONOVER. That is correct.

Mr. BARNARD. And they still own those warrants.

Mr. CONOVER. They own a portion of the original warrants that they took, yes.

Mr. PATMAN. As a part of this bailout procedure, do you enter into a contract with the holding company whereby the holding company permits you to enter into the management of the holding company or influence decisions by the holding company on its management? Or did you simply buy preferred stock?

Mr. CONOVER. You don't enter into a contract with the holding company whereby you influence the management decisions of the holding company. But, as the chairman has pointed out, the FDIC has the authority to eliminate the top management of the holding company any time it wants to, and it happens to have the signed resignations of each member of the board of directors, which can be executed at any time.

Mr. PATMAN. Let me ask you—we know that the depositors of over $100,000 were protected under the arrangement that was made. How about the bondholders and the short-term paperholders; were they protected also, in both the holding company and the bank?

Mr. CONOVER. All the creditors of the bank were protected. The bondholders and the other creditors of the holding company ended up being protected by virtue of the way the transaction was structured, and that is the one thing we have all agreed is an undesirable outcome and ought to be corrected so it can't happen again.

Mr. PATMAN. And if there is a loss taken by the Federal Government because it is up to $3 billion, because of this potential of credit of $15 billion or so, will some of those bondholders be able to come out whole and not suffer a penalty, conceivably?

Mr. CONOVER. That is possible in the holding company——

Mr. PATMAN. Is it possible that the taxpayers take the hit and not any bondholder?

Mr. CONOVER. That the taxpayers take the hit? I am not sure.

Chairman ST GERMAIN. Could we ask it another way. If, God forbid, the FDIC's plan that has been agreed to by the Comptroller and the Fed were to fail, and despite all efforts Continental still failed, then there would be a loss to the FDIC, and then a potential loss to the taxpayers, but the bondholders of the holding company would be protected? In other words, they would not lose anything. Isn't that the problem with this? They get preferred treatment?

Mr. CONOVER. They get preferred treatment, but if the bank were to fail thereby wiping out the investment of the holding company in the bank, chances are that the holding company would have to declare bankruptcy anyway. At that point, whether the bondholders got out scot free would depend on the value of the other assets in the holding company.

Chairman ST GERMAIN. But you did tell us earlier this morning—it has been a delightful sojourn here—that even if you hadn't nationalized Continental Illinois National Bank, that the bondholders were in good shape anyway, so that we didn't do them that much of a favor. I am at a loss to understand this now.

Mr. CONOVER. The distinction is that with the way the transaction was done, the preferred stock is directly junior within the holding company to the bondholders. If we had been able to buy preferred stock in the bank, the holding company by definition would have been strengthened because its primary asset would have been strengthened. So it is a question of whether you have a direct or an indirect benefit to the holding company bondholders. Clearly, in my mind, the indirect benefit was better than the direct benefit from a public policy point of view.

Mr. PATMAN. Are you aware that Continental Illinois, the bank, guaranteed the repayment of certain bonds issued by what has been called WPPSS, Washington——

Mr. CONOVER. No, I am not aware of that.

Mr. PATMAN [continuing]. Power companies?

Mr. CONOVER. No, I am not aware of that.

Mr. PATMAN. How about asking your staff if they are aware of that?

Mr. CONOVER. No, they are not.

Mr. PATMAN. I understand they did, and in large measure——

Mr. CONOVER. That is probably why you asked the question.

Mr. PATMAN [continuing]. Approximately three-eighths of 1 percent of, perhaps, indebtedness. Would you check into that?

Mr. CONOVER. Yes, I certainly will.

Mr. PATMAN. And report back to us.

Are you aware of any other large bank——

Mr. CONOVER. What was guaranteed?

Mr. PATMAN. Guarantee the repayment of certain bond issues by what is commonly called WPPSS.

Mr. CONOVER. Yes.

Mr. PATMAN. And some of those different subdivisions of WPPSS, whether they be one, two, three, four, five.

Mr. CONOVER. OK.

Mr. PATMAN. And so you will check on that, and also do you know of other banks that have guaranteed the obligation of municipalities or other bond-issuing agencies, whether they are public or private? Are you concerned about that type of exposure of risk, and do you ask the banks to report such exposures in your periodic reports that you require?

Mr. CONOVER. It is a fairly common practice for banks to issue standby letters of credit in certain municipal financing transactions. Those are treated just like any other credit during an examination and are classified as nonperforming or nonaccrual, or whatever the case may be. If you are asking me whether I see that as being a significant problem in bank loan portfolios throughout the country, I don't.

Mr. PATMAN. Fine. But you will check into this?

Mr. CONOVER. On the WPPSS question, we will look into that and get back to you with an answer.

Mr. PATMAN. As to the nature and extent.

Mr. CONOVER. Yes.

Mr. PATMAN. Amount and quantity.

Mr. CONOVER. Yes.

Mr. PATMAN. Did you attempt to get others to make statements favorable to Continental?

Mr. CONOVER. No, I didn't.

Mr. PATMAN. You didn't ask Paul Volcker to make a statement favorable to the condition of the bank?

Mr. CONOVER. I talked with Paul Volcker about whether he would make a statement, and I discussed with him the statement that I made. He indicated that he would not make a statement regarding the condition of the bank.

Mr. PATMAN. Was he more doubtful about the bank than you were?

Mr. CONOVER. No. You will have to ask him that. I think that——

Mr. PATMAN. What did he tell you?

Mr. CONOVER. He told me that he didn't want to make a statement.

Chairman ST GERMAIN. How about Bill Isaac; the same thing?

Mr. CONOVER. At that time, Bill Isaac was not in an official position to make a statement regarding the bank, so the issue never came up.

Chairman ST GERMAIN. Mr. Barnard suggested we rename the bank Continental National National Bank.

I am a little intrigued here. You say everybody was on the same wavelength here about what you did? Those aren't the stories that I was getting, and I know they might have been rumors. It seems to me—didn't Secretary Regan, who I think under whom you serve, have a legal opinion prepared as to whether or not 13(c) or 13(c)(1) was applicable?

Mr. CONOVER. Yes, he did.

Chairman ST GERMAIN. And didn't he have that done because he was upset about what was happening, and he didn't want this course of action to be taken?

Mr. CONOVER. He had a legal opinion prepared by the Office of Legal Counsel in the Justice Department.

Chairman ST GERMAIN. No, he had one out of his own office. You see, I have read them all.

Mr. CONOVER. He also had one done by his own office.

Chairman ST GERMAIN. Yes, sir.

Mr. CONOVER. But if you get to the underlying reason for that, it all had to do with the technical structure of the transaction that we have already discussed.

Chairman ST GERMAIN. He was concerned about whether or not it could be done at all under 13(c) and 13(c)(1).

Mr. CONOVER. But, Mr. Chairman, the underlying reason for the preparation of those opinions was that the Treasury Department did not like the technical structure of the transaction in which preferred stock was going to be taken in the holding company. They were doing everything they could at that particular time to express that point of view as forcefully as they could, to get it structured in a different way.

Chairman ST GERMAIN. And Mr. Volcker, as I understand it—I am going to ask him the same; but you were there so I am sure you had discussions. Wasn't Paul Volcker concerned primarily with the holding company aspect and the effect of allowing the bank to fail and therefore the holding company to go bankrupt on all other holding companies around the country?

Mr. CONOVER. He was.

Chairman ST GERMAIN. Indeed he was. And now Mr. Conover, are you telling me it is ab initio, that Mr. Isaac was all excited and enthused about the course of action that eventually was taken, after having bitten the bullet in Penn Square?

Mr. CONOVER. I am sorry, I didn't understand your point.

Chairman ST GERMAIN. Bill Isaac, ab initio—that means from the very beginning—was he all excited about taking the course of action that was eventually taken, in view of the fact that he had bitten the bullet hard on Penn Square and delivered a message to this banking world: If you don't manage properly we are going to shut you down, stockholders and others are going to take the losses.

Mr. CONOVER. If your question is whether Bill Isaac was in favor of doing a payoff of the bank, certainly not to my recollection. Never in the course of the discussions, that I can recall, did he express an opinion that——

Chairman ST GERMAIN. Right from the beginning he felt that Continental should be kept open at all costs?

Mr. CONOVER. As I indicated earlier, we evaluated the pros and cons of an open bank versus a closed bank transaction, as anyone would expect us to.

Chairman ST GERMAIN. Now, how did you evaluate that?

Mr. CONOVER. By sitting down and literally preparing a list of the advantages and disadvantages of each course of action.

Chairman ST GERMAIN. Bill Isaac and who else sat down?

Mr. CONOVER. We prepared such a list in our office, and discussed it with people from the FDIC.

Chairman ST GERMAIN. But I thought you said you sat down and looked over the alternatives?

Mr. CONOVER. Well, if you——

Chairman ST GERMAIN. Did you sit down with Bill Isaac?

Mr. CONOVER. Yes.

Chairman ST GERMAIN. And who else? Was Paul Volcker there?

Mr. CONOVER. There were meetings——

Chairman ST GERMAIN. Excuse me, was Paul Volcker there when you had this discussion?

Mr. CONOVER. No, I don't believe he was.

Chairman ST GERMAIN. Just you and Bill——

Mr. CONOVER. No.

Chairman ST GERMAIN [continuing]. As principals?

Mr. CONOVER. No.

Chairman ST GERMAIN. Well, who was the other principal involved?

Mr. CONOVER. Sprague, as the other FDIC Director.

Chairman ST GERMAIN. OK.

Mr. CONOVER. And staff from the Comptroller's Office and the FDIC.

Chairman ST GERMAIN. Do you know which staff from the FDIC was there?

Mr. CONOVER. No; I don't. Those meetings tended to take place with a horde of people present.

Chairman ST GERMAIN. All right, because I have staff from the FDIC on their way up here right now, so we can find out.

Are you now telling me that it wasn't a computer one, it wasn't only the ordinary analyses done for the small banks, but rather just sitting down and writing down on a memo pad what you thought the costs would be?

Mr. CONOVER. We are shifting gears now, right?

Chairman ST GERMAIN. I don't know who is shifting the gears. You are the one that just told me.

Mr. CONOVER. I think you just shifted the gears from a discussion of whether it would be an open bank versus a closed bank transaction.

Chairman ST GERMAIN. Correct.

Mr. CONOVER. To what the costs of the various alternative ways of handling the bank might be.

Chairman ST GERMAIN. Doesn't that come into the decisionmaking process?

Mr. CONOVER. Yes; that is part of it, but there are other considerations besides the pure numbers.

Chairman ST GERMAIN. The FDIC Act requires that the least costly method be utilized, does it not?

Mr. CONOVER. Yes; it does.

Chairman ST GERMAIN. What is the citation here? Section 13(c)(4)(a) says the least costly method should be utilized. Now, how can you know what the least costly method is that is being utilized unless you perform the actual analyses, rather than just sitting down with a memo pad?

Mr. CONOVER. I agree with that.

Chairman ST GERMAIN. OK. Was that done?

Mr. CONOVER. There were cost analyses that were performed, and they were looked at.

Chairman ST GERMAIN. Cost analyses were performed by the FDIC?

Mr. CONOVER. Yes; by the FDIC.

Chairman ST GERMAIN. Because you said you didn't have them in your shop.

Mr. CONOVER. That is correct.

Chairman ST GERMAIN. Mr. Unthank and Mr. Graham Northup are on their way. Maybe we can tell them what we are looking for and seeking.

Mr. PATMAN. Mr. Chairman, may we ask for the record that he present such memorandums as he does have in his possession?

Chairman ST GERMAIN. We have those people coming here. Mr. Wortley.

Mr. WORTLEY. Thank you, Mr. Chairman.

We are coming into the grand finale here, Mr. Conover. I am worn out listening. I would just like to follow up on my line of questioning from yesterday regarding the transmittal of the examination findings. It is my understanding that the national bank examination reports are transmitted to the bank's board of directors with a cover letter from the Deputy Comptroller of Multinational Banking which sets forth those matters upon which the board is expected to act.

It is my understanding that the board is supposed to review the transmittal letter and the examination report and reply in a rather timely fashion to the items noted in that letter. Continental Bank took 8 months to reply to Deputy Comptroller Billy Wood's 1979 transmittal letter. It took 7 months to reply to his 1980 letter, and it took 5 months to respond to his 1981 letter.

Are these time periods comparable to the length of time that other large multinational banks would take or consume?

Mr. CONOVER. No; they are not. They are too long.

Mr. WORTLEY. Did you do anything to prompt them along? What is the normal period of time a multinational bank would take to respond?

Mr. CONOVER. It depends a little bit on the date you begin measuring from. The report is normally submitted to the board, then there is a board meeting held at which representatives from the Comptroller's Office—that includes me—present the examination findings and discuss them with management and the board. It is unlikely that the bank would respond prior to that meeting. If you measure the lapsed time from the date on the letter signed by the Deputy Comptroller for Multinational Banking to the date on the letter in which the bank responded, you get a distorted picture because sometime after the report is given to the board, anywhere from 4 to 6 weeks later, we would have this face-to-face meeting.

Mr. WORTLEY. Does the board have two meetings on this letter? In other words, they receive it at one board meeting. They talk about it, and then at a subsequent board meeting a representative of the Comptroller's Office sits down and reviews it with them, and they respond to some of these critical——

Mr. CONOVER. The report is distributed to them, and they read it. Whether they choose to discuss it among themselves prior to our meeting is up to them. So they may very well end up having a discussion on the subject at the board level on two different occasions. In any event, after they have received it, have read it, and have had a chance to digest it, we have a meeting with them in which usually a slide presentation is given by the examiner in charge. In the most recent case of Continental that would have been Mr. Kovarik.

Mr. WORTLEY. This was 7 to 8 months we are talking of?

Mr. CONOVER. I understand what you are saying, and I said that that was too long, and I am just indicating that there is——

Mr. WORTLEY. What is the normal timespan?

Mr. CONOVER. A more normal timespan would be about 2 months.

Mr. WORTLEY. About 2 months?

Mr. CONOVER. Yes.

Mr. WORTLEY. Mr. Woods' October 25 examination report transmittal letter puts Continental board of directors on notice regarding significant problems in the bank system of identifying and rating problem loans. I quote him: "The importance of the liability of the internal loan evaluation procedures as an early warning mechanism to control credit quality in a growth environment cannot be overemphasized."

It took Mr. Miller of Continental Bank 8 months to reply to that letter, and in his reply he downplayed the significance of Mr. Woods' comments.

Mr. Woods' 1981 transmittal letter contained a variety of comments to Continental's board regarding such matters as the 82 percent ratio of criticized assets-to-growth capital funds, and the fact that capital had not kept pace with the asset growth. An internal Comptroller memorandum of July 22, 1981, said regarding Continental's response 7 months later, and I quote:

> The recently received response to the June 30, 1980, examination does not address all matters highlighted either in the transmittal letter or in Mr. McCarte's letter to the board. The letter appears to have been put together hastily. Bank personnel apparently were embarrassed when it was realized a response had not been prepared.

Now, is a 7 months' delay in a cursory written response the normal pattern for money center banks?

Mr. CONOVER. No, it is not the normal pattern. Responses need to be made in a more timely fashion by all money center banks. Certainly the particular case you cite is unacceptable.

Mr. WORTLEY. Would it be advisable to give institutions a specific period of time in which to respond, so situations like this do not drag on?

Mr. CONOVER. Yes, it would. Yes, it will.

Mr. WORTLEY. You will, thank you.

I think these letters and responses of Continental Bank and the Comptroller's assessment of those responses ought to be made a part of the hearing record, and I would ask unanimous consent that the 1977 and 1982 letters and responses be placed in the record at the proper place.

Chairman ST GERMAIN. Along with the others that have already been entered.

Mr. WORTLEY. With 1979, 1980, and 1981.

Chairman ST GERMAIN. Is there objection?

The Chair hears none. It is so ordered.

[In response to the request of Congressman Wortley, the transmittal letters pertaining to OCC examinations dated 1977 and 1982 were submitted for the record by Mr. Conover:]

PERTAINING TO OCC EXAMINATION
COMMENCED: April 25, 1977
CLOSED: March 31, 1977

LETTER TO THE BOARD OF DIRECTORS

A general examination of your bank commenced April 25, 1977 using financial information as of March 31, 1977. The examination was conducted in accordance with standard examination procedures of the Office of the Comptroller of the Currency. This report consolidates information from the International Report of Examination, which should also be reviewed and referred to for more detailed information concerning your International activities.

The level of criticized assets continues to be of concern, even though a reduction is shown. $1,459 million or 122% of gross capital funds are subject to criticism at this examination compared to $1,546 million or 151% at the Februaary 1976 examination. Meaningful reductions are noted in the level of the most severely classified assets, with the doubtful and loss categories comprising $224 million compared to $391 million at the previous examination. These reductions are a result of an improving economy and the positive steps taken by management to reduce exposures. The majority of your problem assets remain centered in the real estate area where continued emphasis must be placed on seeking final resolution to the numerous workout arrangements already begun. Your management team has taken an aggressive stance in its attempts to reduce the bank's exposure to loss in this area, and, given the proper environment, should be able to reduce these problem assets to more reasonable proportions.

Your recent capital augmentation and continued earnings retention have allowed the equity accounts to increase to a level more in keeping with the growth attained in recent years. The capital plan set forth through 1979 should provide sufficient amounts to sustain your projected growth over the period; however, continued monitoring of the relationship between capital and other balance sheet categories is necessary.

The violations of regulations revealed by this examination have been discussed with management and corrective action has been promised in each instance.

The examination disclosed on other matters worthy of comment which were not satisfactorily remedied during the examination. The comments and criticisms included in the comment section of this report should receive the attention of the board as considered appropriate in the circumstances.

RICHARD M. KOVARIK,
Examiner-in-Charge.
(By) BILLY C. WOOD,
Regional Administrator.

PERTAINING TO OCC EXAMINATION
COMMENCED: April 30, 1982
CLOSED: November 19, 1982

COMPTROLLER OF THE CURRENCY,
ADMINISTRATOR OF NATIONAL BANKS,
Washington, DC, December 6, 1982.

BOARD OF DIRECTORS,
Continental Illinois National Bank and Trust Company of Chicago,
231 South LaSalle Street,
Chicago, IL.

MEMBERS OF THE BOARD: The purpose of this letter is to highlight conditions noted in the accompanying combined report of examination completed November 19, 1982, under the supervision of Senior National Bank Examiner Richard M. Kovarik. This letter is considered a part of the examination report and is to be treated with the same degree of confidentiality.

Examination results show the condition of the institution to be seriously deteriorated. While the bank enjoyed a large degree of success during the past five years through a policy of aggressive pursuit of dominance in domestic corporate lending, the portfolio generated during that period is failing to weather the test of a severe and prolonged recession. This has produced unsatisfactory performance and a weakened condition which adversely reflects on, and is the responsibility of both management and the board. While we are confident the institution possesses sufficient management expertise to lead the bank through this current period of difficulty, a comprehensive reassessment of corporate objectives, style, and philosophy is required. Management's and the directorate's expressed willingness and apparent ability to initiate appropriate corrective measures are viewed favorably.

Current problems can be largely attributed to decentralization of authority without adequate policies, procedures and quality control systems, combined with a management direction that encouraged aggressive growth but failed to hold managers accountable. Several large lending relationships raise prudency questions given that one of the most basic fundamentals of banking is the diversification of risk. The magnitude and severity of existing deficiencies do not lend themselves to short-term resolution. And given the current economic outlook, there remains concern that Continental's problems have not yet peaked which creates uncertainty regarding even further impact on the institution.

A program of enhanced supervisory oversight is being implemented by the Office of the Comptroller of the Currency. It will address matters detailed by Examiner Kovarik throughout the report of examination. Matters of serious concern include but are not limited to: inordinately high level of classified and criticized assets (172% and 262% of Gross Capital Funds, respectively); unprecedented volume of nonperforming loans ($2 billion at 9/30/82); seriously elevated loan losses; doubtful assets approximating one-fourth of primary capital; inadequate loan support systems, including internal credit review; the need for a separate loan workout department; diminished earnings with mediocre prospects for near term recovery; inability to attract market rate funding from traditional sources: liability structure and balance sheet mix; the serious strain placed on capital and the loan loss reserve by deteriorating asset quality; acute need to reassess and revise, as necessary, corporate goals and objectives and internal policies and procedures especially as they apply to lending, internal controls, and certain internal audit procedures; CINB's tarnished reputation in the global marketplace resulting primarily from asset problems and the bank's relationship with the defunct Penn Square Bank, N.A.

Violations of law listed in the report of examination should receive immediate attention. Of specific concern are possible violations of 12 U.S.C. 84 (lending limits) and 12 C.F.R. 9.10 (investment of income cash generated by fiduciary relationships). You should be aware that resolution of this latter item could possibly involve disclosure, and/or restitution, to affected beneficiaries. The bank's legal staff has provided responses to the above matters and both are currently under review by this Office.

While the overall assessment of the bank's data processing function was favorable, the inadequacy of hardware back-up and contingency planning in key areas was noted. Further, there is a continuing need to clarify corporate policy regarding data file retention.

The results of the Consumer Affairs examination indicate a high level of compliance in most operating areas of the bank, including a favorable CRA assessment. However, cited violation of Federal Reserve Regulations B and Z point up a need to further improve the internal compliance system.

Please direct your response to matters cited in the examination report to the Comptroller of the Currency, Administrator of National Banks, Attention: Duputy Comptroller for Multinational Banking, Washington, D.C. 20219 with a copy to the Regional Administrator of National Banks, Seventh National Bank Region, Sears Tower, Suite 5750, 233 South Wacker Drive, Chicago, Illinois 60606.

Sincerely,

William E. Martin,
Deputy Comptroller for Multinational Banking.

Enclosures.

Letter to the Board of Directors

A consolidated examination commenced May 24, 1982 using financial information as of April 30, 1982. In order to reduce duplication of efforts and to facilitate a more intense review of specific areas, a portion of our work was limited to a review of internal audit reports and work papers. Where significant exceptions were noted in these audits, additional reviews were made to insure that proper corrective actions were being taken. Areas of interest such as Commercial Lending, Funding, Earnings, Capital, Reserve for Possible Loan Losses and International/External Audit received examination in accordance with the General Examination procedures prescribed by the Comptroller of the Currency.

The examination reveals the bank to be in serious difficulty. Experiencing an inordinately high level of problem assets and a significant volume or adverse publicity occasioned by problem loans (more specifically, the relationship with the defunct Penn Square Bank, N.A.), the bank's image in the financial community has fallen precipitously.

Criticized assets have increased substantially to $5.6 billion and now represent 262% of Gross Capital Funds (GCF), compared to 99% ($1.8 billion) at our previous examination. Even absent the significant portion of criticized assets related to participations purchased from Penn Square ($821 million), criticisms still equal 223% of GCF. Either of these levels is much higher than any of your peers, and the highest level ever witnessed by the bank.

Even more important is the increased volume of more troublesome assets (Doubtful and Loans) which amount to $778 million, compared to $209 million at April 30, 1981. All losses listed in this report have been charged-off as of September 30, 1982. Those assets classified doubtful ($548 million) carry significant potential for future loss. The Reserve for Possible Loan Losses, considered adequate at September 30, 1982, must continue to receive close scrutiny to insure its continued adequacy. The increased provision taken in the third quarter, together with management's commitment to closely monitor the reserve, should aid in restoring a cushion to absorb unforeseen problems.

Beginning with the effects of the failure of the Penn Square Bank in July, significant change in the Corporation's funding profile has taken place. The effects of the bank's relationship with Penn Square on second and third quarter earnings, together with heightened adverse publicity concerning Continental Illinois Corporation, have added to the ongoing change in the funding profile. Because domestic investors are reluctant to purchase long term instruments, the Euro markets are being heavily tapped in order to maintain a relatively stable mix between long and short term funding. At this time, the funding situation has stabilized and, absent any growth (presently undersirable) or further adverse occurrences, the Corporation should continue to be able to fund itself without significant discount window borrowings. A return to more normal earnings, reductions in the level of problem assets, and a more conservative growth objective for the Corporation, will be necessary to regain investor confidence.

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. This occurred primarily in the Oil and Gas Department of the Special Industries Group, which accounted for the majority of total loan growth over the past year and is the major contributor to the increased problem assets noted at this examination. Certainly, many bank units have operated effectively and have been able to maintain satisfactory asset quality. This is a reflection on the many good managers in place. There are, however, certain bank units

(Oil and Gas and Real Estate Services) where this is not the case. The system of "checks and balances" must be predicated on increased levels of responsibility. Since the responsibility was percieved in some cases to rest solely at the orginating unit, the system was compromised. Internal reports reflected growing problems with respect to the Penn Square participations, but these signals were not heeded by management personnel who were responsible for overseeing lending activities.

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 volume involved.

The lack of adequate support has resulted in increased exceptions to proper credit and collateral documentation, most particularly in the Mid-Continent Division of the Oil and Gas Department, which housed the Penn Square participations. Without complete and proper documentation, quality is difficult to judge, and more importantly nearly impossible to maintain.

The system of monitoring credit quality also suffered as numerous problem loans were not brought to management's attention. This was witnessed by the increased disparity between both internal ratings and Watch Loan Reported loans, and CCC criticized loans. The need for an improved system to monitor loan quality has been discussed in prior examination reports, and is even more apparent now. Management has now recognized the need for a strong, independent internal review process to augment the officer-initiated Watch Loan Reporting System and serve as the "check" for Senior Management and the Board.

As stated previously, the bank's image has suffered greatly. As steps are taken to restore that image, it is essential that a rethinking include reviews of the proper type and mix of assets; funding sources available and/or desirable to compliment the asset portfolio; and adequate capital requirements for the furture. Then, actions must be taken to insure that everyone is working in a way which will achieve the position desired with the least degree of risk, and efforts can be intensified to strive for regaining the image which is so important to a money center bank. Because much of that image is dependent upon a consistent, quality earnings stream, a major factor in future strategy will have to be restoring overall asset quality.

Leverage ratios compare favorably with your competitors; however, as the problem asset levels far exceed the norm, the capital base is under increased pressure. Presently capital is considered adequate to support operations but is not sufficient to provide for further growth. As noted above, needs and sources of additional capital should be considered in the assessment of the future of the bank.

The examination of the Trust, Electronic Data Processing (EDP) and Consumer Compliance areas generally reflect satisfactory conditions. In the Trust area, the major item of contention is the ongoing failure to invest income cash as prescribed by OCC regulations. A formal interpretation of this matter is expected shortly. Progress has been made in upgrading disaster/recovery contingency plans for EDP operations; however, continued emphasis on this endeavor is needed to insure that all processing areas can deal effectively with disruptions.

The Consumer Compliance examination revealed violations of Regulations B and Z of the Federal Reserve Board. Although the violations of Regulation Z did not result in reimbursement being required, the violations of Regulation B do require the bank to notify affected customers. Steps should be taken to prevent the occurrence of consumer violations, as the effect on the bank could be both embarrassing and costly.

Other violations of Law, Regulation and Ruling are listed in the Commercial section of the report. Action should be taken to correct those violations, and the Deputy Comptroller for Multinational Banking should be notified when corrections have been affected. A potential violation of the legal lending limit (12 U.S.C. 84) was discovered during the examination. A formal ruling on this matter has been requested.

The bank is facing a most challenging period in its history. Management is considered sufficiently talented to deal effectively with the problems at hand. Senior Management and the Board of Directors have reacted appropriately to identify, isolate and deal with the shortcomings of the past. The improvements recommended in this report, and those contained in management's internal review, should aid in returning the bank to a sound condition.

RICHARD M. KOVARIK,
Senior National Bank Examiner.
WILLIAM E. MARTIN,
Deputy Comptroller for Multinational Banking.

Mr. WORTLEY. I yield back the balance of my time.

Chairman ST GERMAIN. The subcommittee will be in recess for 3 minutes.

[Recess.]

Chairman ST GERMAIN. The subcommittee will come to order.

Mr. Conover, as you have heard in our discussion, the FDIC officialdom is going to provide me with an analyses personally.

I can then determine whether the requirements of 13(c)(4)(a) were met. Remember, I asked you a question, you said you would submit for the record about how many loans were made by Continental within the city limits of the city of Chicago.

Mr. CONOVER. Yes.

Chairman ST GERMAIN. You said you would be submitting it for the record. That is going to be most interesting to me, because the requirements of 13(c)(4)(a) states, "* * * no assistance shall be provided in accordance with this section."

If the analysis was made, how could anyone say they complied with that first part of 13(c)(4)(a)? Then we go to the next phrase. "Except that such restrictions shall not apply in any case in which the corporation determines that the continued operation of such bank is essential to provide adequate bank services to its community.

We did indeed amend that a little bit because of the savings bank situation in New York, stating it would be hard to say that without a particular savings bank—New York City would go down the tube. So we amended it slightly, but still said the community.

Since I wrote this, it is my bill, the community I thought about was not—I was thinking about Chicago Bank, Chicago; Woonsocket Bank, Woonsocket, and Providence Bank, Providence. But the community did not extend to the whole Continental United States of America as well as all of its possessions and territories. So that is why I think that that should have been met, that requirement, the analyses should have been done.

Mr. Barnard has a question, then I will go to Mr. Leach.

Mr. BARNARD. On that particular question, Mr. Chairman, Mr. Conover, what in the Community Reinvestment Act reports identify the loans being made to the local community? Every bank is supposed to file a community——

Mr. CONOVER. Yes, they would.

Mr. BARNARD. Would those reports be available for the file?

Mr. CONOVER. Yes, we will answer the question, so that you will know what volume of loans was made within Chicago, assuming the data are available to do so, and I believe they are.

Chairman ST GERMAIN. If you would yield, staff informs me that the examination reports state they were in full compliance with the Community Reinvestment Act. However, I guess we don't have the material on which they based that conclusion. So I know, if the gentleman will yield, we are going to want that.

Mr. BARNARD. On a separate examination, if I could get the attention of the staff, it seems at the regular examination, or special examination, the Community Reinvestment Act files are examined, and report filed. Am I wrong there, Mr. Comptroller?

Mr. CONOVER. No, that is correct.

Mr. BARNARD. That might be helpful in answering the chairman's——

Chairman ST GERMAIN. In my letter of September 11, you have been most cooperative, really and truly, in assisting us, as has been the FDIC, but in the letter of September 11, I did ask for the provision of a tabulation of the annual rates of asset growth, the ratio of primary capital—or comparable measures in earlier years—to total assets, the ratio of classified assets to gross capital funds, the ratio of purchased funds to total deposits, the ratio of rate sensitive deposits plus purchased funds to total deposits, the ratio of reserve for possible loan losses to total loans, and the return on average assets, since 1970 for CINB, for its peer money center banks as a group, and for all national banks as a group.

I am sure it was an oversight. We would appreciate your supplying that for the record.

Mr. CONOVER. If there are any questions that we haven't answered today——

Chairman ST GERMAIN. That is what we are aware of.

[In response to the request of Chairman St Germain, the following information was submitted for the record by Mr. Conover and may be found on page 369.]

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

October 5, 1984

The Honorable Fernand J. St Germain
Chairman
Committee on Banking, Finance
and Urban Affairs
U. S. House of Representatives
Washington, D. C. 20515

Dear Mr. Chairman:

At the September 19, 1984 hearing on Continental Illinois National Bank, I was asked to provide certain information for the record. That information is as follows:

Question 1: Tabulation of the time it takes national banks with the lowest ratings (i.e., CAMEL ratings of 3, 4, and 5) to become sound.

The following is a tabulation of the average number of months it has taken to rehabilitate and restore to a sound condition those banks that were under special supervisory attention. The data encompass all those banks that were removed from "problem status" for the period covering 12/31/81 through 7/31/84.

Total Assets	Number of Banks	Average Number of Months to Rehabilitate
$100MM and under	146	30.3
$100MM to $300MM	14	39.7
$300MM and over	7	57.3
Overall average		32.2

Question 2: The extent of Continental Illinois' foreign exposure.

	12-31-83		3-31-84	
Average foreign loans as a % of average total loans	($10,258MM)	34.1%	($10,433MM)	34.7%
Average foreign deposits as a % of average total deposits	($15,288MM)	47.9%	($16,378MM)	49.5%

Average number of foreign banks with deposits in Continental, May 1984 = 461

Question 3: Dollar loss to individuals, corporations, etc., if Continental Illinois had been paid out.

It is not possible to quantify all of the losses that a payout of Continental Illinois would have caused. The most direct and immediate losses would be those incurred by creditors of the bank and the holding company -- i.e., the bond holders and uninsured depositors. However, some of these funds would be recovered as the FDIC liquidated the bank.

A large number of banks had uninsured deposits at Continental Illinois. Had the bank been paid out, some portion of those funds would have been lost, and some of the small banks with a sizable percentage of their equity capital on deposit would have failed.

Other possible losses include the ripple effect of bankruptcies that might have resulted from losses borne by uninsured commercial depositors at Continental and the other failed banks.

Finally, the pay-off of Continental Illinois could have sent shock-waves through the international money markets if holders of jumbo CDs decided not to renew their deposits at other U.S. money center banks. Again, no ready estimate of the losses such a reaction might cause can be made, but the danger to the U.S. banking system could have been sizeable.

Question 4: The number of national banks chartered since 1982.

The number of national banks chartered between January 1, 1982 and June 30, 1984 is 561.

Question 5: A breakdown of Continental Illinois' oil and gas portfolio by type and collateral.

Type	($MM's)	Collateral
Rigs	454	secured by rigs
Undeveloped Leases	90	secured by leases
Refineries	866	secured by refineries, receivables, etc.
Service & Supply	362	various collateral
Oil & Gas Reserves	3,160	secured by reserves
Integrated Companies	438	generally unsecured to the "majors"
Transmission & Miscellaneous	549	secured and unsecured
	5,919	

(Figures are as of year end 1983 and include letters of credit.)

Question 6: The amount of the loan portfolio within the city limits of Chicago.

	($000's)
Consumer loans in Chicago	136,943
Commercial loans in Chicago	4,916,513
Total	5,053,456
Savings deposits from Chicago	642,079
Checking deposits from Chicago	942,903
Total	1,584,982

(From information obtained during the 1983 Consumer Examination.)

Question 7: The amount of the shortfall to corporate bondholders if the holding company had been liquidated.

This question is best answered by the Federal Reserve Board since they are most knowledgeable about the assets of the holding company, including its real property assets.

Question 8: Of the 61% of banks rated "3" in 1980 that have returned to health since then, the number which were among the top fifty banks.

Of the 61% of banks rated "3" in 1980 that have returned to health since then, five were institutions having assets of $1 billion or more.

Question 9: Whether Continental Illinois guaranteed WPPSS bonds.

Our examiners could find no evidence that Continental Illinois guaranteed, i.e., issued standby letters of credit for, WPPSS bonds.

Question 10: The statistical information you requested in your September 11, 1984 letter.

See Attachment.

Question 11: Considerations that enter into making a decision to save a bank.

There are many ways to handle a failing bank. The most common method is through a purchase and assumption by another bank. Second is liquidation, which involves a payout to the insured depositors.

Although Continental was not handled using either of these methods, the solution had virtually the same effect on depositors, shareholders, and management as a purchase and assumption.

A number of factors were weighed in making the decision regarding Continental Illinois. Each was considered in conjunction with all the others since they are clearly interrelated. These factors included: overall cost to the FDIC, impact on financial markets and on confidence in the U.S. banking system, legal impediments, impact on borrowers who need further funding to continue their business activities and impact on other depository institutions with deposits in the failing institution.

Similar considerations would prevail in dealing with the failure or near-failure of any large bank.

Question 12: The statistical information requested by Congressman Barnard.

See Attachment.

Question 13: The date the last Penn Square Bank loan was sold to Continental Illinois.

The last Penn Square Bank loan was purchased by Continental Illinois on June 18, 1982.

I hope this information is helpful to the Subcommittee.

Sincerely,

C. T. Conover
Comptroller of the Currency

ATTACHMENT

C O N T I N E N T A L   I L L I N O I S   N A T I O N A L   B A N K

Comparative Data*

	ASSETS ($ BILLIONS)			GROWTH RATE		
	CINB	Peer Group	National Banks	CINB	Peer Group	National Banks
1970	$8.8	$101.7	$371.7	15.8%	8.0%	11.5%
1971	10.0	110.4	418.2	13.6	8.6	12.5
1972	12.3	133.1	489.4	23.0	20.6	17.0
1973	16.4	166.4	569.5	33.3	25.0	16.4
1974	19.1	202.9	629.5	16.5	21.9	10.5
1975	19.8	203.0	653.7	3.7	0.0	3.8
1976	21.4	221.8	704.3	8.1	9.3	7.7
1977	25.0	256.8	796.8	16.8	15.8	13.1
1978	29.9	289.4	892.2	19.6	12.7	12.0
1979	34.3	334.0	996.2	14.7	15.4	11.7
1980	40.3	371.1	1,095.1	17.5	11.1	9.9
1981	45.1	387.2	1,200.9	11.9	4.3	9.7
1982	41.3	415.0	1,297.2	-8.4	7.2	8.0
1983	40.7	417.3	1,392.8	-1.5	0.6	7.4

*The eight wholesale money center banks included in the peer group are Bankers Trust, Chase Manhattan Bank, Citibank, First National Bank of Boston, First National Bank of Chicago, Irving Trust Co., Manufacturers Hanover Trust Co., and Morgan Guaranty Trust Co.

CONTINENTAL ILLINOIS NATIONAL BANK

Comparative Data

	PRIMARY CAPITAL / ASSETS 1/			CLASSIFIED ASSETS / GCF	
	CINB	Peer Group 2/	National Banks 2/	CINB	National Banks 3/
1970	7.45%	6.85%	8.80%	21%	12%
1971	6.93	6.65	8.55	22	12
1972	6.75	5.99	8.29	17	11
1973	5.45	5.18	8.49	21	11
1974	5.09	4.81	8.93	65	16
1975	5.22	5.20	8.86	109	18
1976	5.44	5.17	8.80	121	19
1977	5.03	4.82	8.55	86	19
1978	4.67	4.65	8.70	86	19
1979	4.52	4.41	8.92	80	18
1980	4.39	4.38	9.14	61	21
1981	4.52	4.61	9.37	67	26
1982	5.19	4.69	9.70	172	38
1983	5.41	5.19	9.61	219	52

Primary Capital = Equity Capital + Allowance for Possible Loan Losses.

1/ In 1976 the definition of the allowance for possible loan losses, a component of primary capital, was changed. Data prior to that year may not be comparable with later data.

2/ Unweighted average of individual bank ratios.

3/ Unweighted average data from individual bank examinations.

C O N T I N E N T A L I L L I N O I S N A T I O N A L B A N K

Comparative Data

	PURCHASED FUNDS / ASSETS			RATE SENSITIVE / DEPOSITS		
	CINB	Peer Group	National Banks	CINB	Peer Group	National Banks
1970	N.A.	N.A.	N.A.	52.5%	44.5%	30.3%
1971	N.A.	N.A.	N.A.	56.9	47.7	32.6
1972	N.A.	N.A.	N.A.	60.4	52.1	33.2
1973	N.A.	N.A.	N.A.	67.1	61.7	35.0
1974	67.4%	61.1%	9.2%	73.0	66.3	36.6
1975	68.1	61.1	8.5	72.1	66.1	36.8
1976	68.8	62.0	9.0	73.0	63.8	36.4
1977	70.1	62.1	9.4	72.5	64.3	36.4
1978	70.7	64.3	11.2	74.0	67.3	38.4
1979	71.9	64.5	11.8	76.1	67.5	43.5
1980	73.4	66.0	12.6	79.1	71.7	48.6
1981	75.0	70.1	14.1	82.5	79.6	52.6
1982	76.2	69.3	14.7	83.2	80.0	52.2
1983	74.6	65.0	14.0	81.1	76.7	46.5

Purchase Funds = Large CDs + Federal Funds and Repurchase Agreements + Foreign Office Deposits + Other Liabilities for Borrowed Money.

Rate Sensitive = Total Deposits - Demand Deposits - Savings Deposits.

CONTINENTAL ILLINOIS NATIONAL BANK

Comparative Data

	APLL / TOTAL LOANS			RETURN ON AVERAGE ASSETS		
	CINB	Peer Group	National Banks	CINB	Peer Group	National Banks
1970	2.77%	2.16%	1.58%	1.10%	1.00%	1.18%
1971	2.14	1.89	1.51	0.97	0.93	0.98
1972	1.81	1.73	1.45	0.90	0.87	0.93
1973	1.69	1.42	1.41	0.74	0.88	0.93
1974	1.64	1.26	1.42	0.63	0.60	0.86
1975	1.73	1.32	1.42	0.65	0.55	0.82
1976	1.20	0.85	0.97	0.65	0.52	0.87
1977	1.06	0.79	0.92	0.61	0.47	0.92
1978	0.99	0.84	0.96	0.58	0.53	1.06
1979	0.88	0.88	1.00	0.57	0.56	1.09
1980	0.88	0.87	1.06	0.59	0.58	1.03
1981	0.86	0.92	1.08	0.55	0.60	0.98
1982	1.14	0.94	1.13	0.17	0.60	0.83
1983	1.23	1.02	1.18	0.25	0.59	0.75

APLL = Allowance for Possible Loan Losses.

Chairman St Germain. Mr. Leach.

Mr. Leach. I would just like to probe, if I could, for a minute one further factor I have heard no discussion of today, but there were some hints of in earlier press releases about the issue. That is when you were considering your various options with regard to Continental, did the factor of concentration or antitrust enter into your thinking?

That is, was there a desire to save the bank in order to have greater competition in banking within the city of Chicago?

Mr. Conover. Discussion arose as to whether it would be appropriate for the bank to merge with the First National Bank of Chicago, for example. And in any consideration of that issue, the subject of competition and antitrust would naturally have been raised. But it never became a live issue.

Mr. Leach. It never was a reason for saving Continental in the first place?

Mr. Conover. No. It really never was a reason for saving Continental in the first place.

Mr. Leach. In terms of American banking and Chicago banking, is there any reason for the existence of Continental?

Mr. Conover. In what sense do you mean that?

Mr. Leach. Let's say Continental could be liquidated at no cost to anyone. Is there a loss to society?

Mr. Conover. If Continental could be liquidated? Maybe that is not the right word, but we will use it anyway for purposes of discussion. If liquidated in a way in which there was no cost to anyone means that all existing customers have a satisfactory alternative way of being served and so forth, then there isn't a reason for Continental. But you can also say there is no reason for any other bank.

Mr. Leach. The point I am making is that sometimes there is an argument on size grounds to save something that is truly important, a national resource. You wouldn't argue that Continental is of that standard?

Mr. Conover. No, we never thought Continental was important as a national resource. We were concerned about the impact that a failed Continental would have on the Nation's financial system. But no one ever said there needs to be this thing called Continental Illinois because it is an old, treasured building and has a long history to it and the world would be terrible without it.

Mr. Leach. So, it wouldn't be analogous, for example, to losing this committee. I mean, if the Banking Committee went out of existence, I mean there would be a great national calamity. But you wouldn't say that would be the case with Continental. No.

Mr. Chairman, I yield back the balance of my time.

Chairman St Germain. Mr. Patman for 5 minutes.

Mr. Patman. Mr. Chairman, I just want to ask Mr. Conover if he would help us in outlining the guidelines, rules or other considerations that show which other banks or holding companies would or likely would receive the same treatment as Continental Illinois and its holding company. Is it size, purely?

Mr. Conover. The presumption is that we have established a precedent that all banks or bank holding companies of a particular size or particular nature are going to be treated this way in the future. I don't buy the fundamental premise.

This case was handled in the way it was because of the peculiarities of this particular situation. The bank got to where it was because of its peculiarities as a bank, and we have traced through all the forces that came together to cause the bank to be in the nearly failed condition that it was.

Mr. PATMAN. What, in other banks, is similar in the way of particular peculiarities, perhaps? Or financial institutions.

Mr. CONOVER. There are other banks which, in terms of size or type of lending, or number of offices or number of employees, or any number of things, have some similar characteristics to Continental. But——

Mr. PATMAN. What would impel you as an individual to ask for consideration to be given to other large financial institutions of any kind in America similar to this?

Mr. CONOVER. What would impel me?

Mr. PATMAN. Yes. What, in your judgment, would warrant doing the same thing for another institution?

Mr. CONOVER. Under the present set of laws and the present deposit insurance scheme, I think if we found a situation similar in characteristics to this one, in which we could find no buyer, and the only alternative was to provide direct Federal assistance through the FDIC and the Fed or pay off the bank and run the risk of jeopardizing in a very serious way the Nation's entire banking and financial system, we might——

Mr. PATMAN. If any of the banks got themselves in the same predicament as Continental Illinois, you would anticipate we would do the same thing for them, wouldn't you?

Mr. CONOVER. I didn't say it precisely that way.

Mr. PATMAN. Is there any one of them that you would not do it for?

Mr. CONOVER. I certainly wouldn't answer by identifying one. If conditions existed as in this case, since I think this was a good, sensible solution to the problem at hand, it would make sense to deal with it in the same way.

Mr. PATMAN. For any of the other large money center banks?

Mr. CONOVER. For any whose failure might have the same impact on the Nation's financial system as we thought this one could have.

Mr. PATMAN. To your way of thinking, wouldn't you say that any of the others, upon failing, would have the same impact?

Mr. CONOVER. That is probably true.

Mr. LEACH. Would the gentleman yield?

Mr. PATMAN. What about the next tier down?

Chairman ST GERMAIN. Bill, we have "Alive at Five" going. I think you have made your point.

Mr. PATMAN. May I ask for the record he submit to the committee the factors that enter into his judgment on cases of this nature?

Chairman ST GERMAIN. As to how far down they go?

Mr. PATMAN. That is right, and what guidelines——

Mr. CONOVER. No, I can't submit a list of banks. I certainly don't want to do that.

Chairman ST GERMAIN. Not the banks.

Mr. PATMAN. No. The considerations.

Mr. CONOVER. The considerations that went into this deal?

Mr. PATMAN. Just give me 25 considerations that should go into any sort of consideration of this type. Or 10, or whatever you think would adequately cover what you think of when you make your dicision.

Mr. CONOVER. All right.

Mr. PATMAN. Thank you very much.

[In response to the request of Congressman Patman, the following information was submitted for the record by Mr. Conover and may be on page 367.]

Chairman ST GERMAIN. Mr. Conover, as a matter of fact, the answer to the question, absent anything occurring statutorily or any other way, were there within the next month, 2 months, 6 months or 1 year to occur another situation such as you faced at Continental, you would not have any alternative——

Mr. CONOVER. You would have to deal with it in the same way. Given the current laws——

Mr. LEACH. May I ask one followup? There is one thing to say, that one might have to save a particular banking operation. But one of the issues this committee has raised and has been raised in other ways by members of the administration is how you handle every part of the package. For example, would you tell the committee that you must protect bondholders of all types, whether they be of the bank or of the——

Mr. CONOVER. Absolutely not. I mean, I would not do that. That is what——

Mr. LEACH. So you might, in reviewing the situation, you might well take a little bit different approach.

Mr. CONOVER. Well, if——

Mr. LEACH. You are not saying that you did everything right. Would you want to suggest to the committee maybe if you did it over, you would do it a little differently?

Mr. CONOVER. No; I am not suggesting that, Mr. Leach. I am saying that there were some outcomes of the way we did it that were undesirable. But by virtue of the structure of the beast we were dealing with, they were unavoidable under the circumstances, such as propping up of the bondholders in the holding company.

Mr. LEACH. That was unavoidable?

Mr. CONOVER. Unavoidable and clearly undesirable as far as I am concerned.

Mr. LEACH. Thank you, Mr. Chairman.

Chairman ST GERMAIN. Mr. Conover, are you familiar with the Committee on Banking Regulations and Supervisory Practices an international body known as the Cooke Committee?

Mr. CONOVER. Yes; I am.

Chairman ST GERMAIN. Are you familiar with its functions?

Mr. CONOVER. Yes.

Chairman ST GERMAIN. Are any American regulators members of that committee?

Mr. CONOVER. Yes.

Chairman ST GERMAIN. Which are?

Mr. CONOVER. The FDIC, the Comptroller's Office, and the Fed.

Chairman ST GERMAIN. For how long? Are they recent members?

Mr. CONOVER. The FDIC is a recent member. The Comptroller's Office and the Fed go back 6 or 7 years.

Chairman ST GERMAIN. With respect to Continental, did you or anyone in your office have any contact with the Cooke committee relative to the Continental situation?

Mr. CONOVER. No; we didn't have any contact with the Cooke committee. Prior to the consummation or announcement of the deal, we advised the Bank of England as to what was about to transpire. And after the fact, we had two representatives go to London and meet with a group of British bankers and people in the London market——

Chairman ST GERMAIN. Was one Joe Selby?

Mr. CONOVER. Yes.

Chairman ST GERMAIN. You are aware of his statement that the Cooke committee had a better insight into what was happening than we did here in Washington in relation to Continental? Selby was referring to Continental. Do you agree with Mr. Selby's statement?

Mr. CONOVER. I wasn't aware of Mr. Selby's statement until you just read it.

Chairman ST GERMAIN. Is that Mr. Selby?

Mr. CONOVER. Mr. Selby tells me he thinks that is a misquote, that what he did was call Peter Cooke to find out what the reaction of the London marketplace was to the Continental deal. Since Continental had been funding itself in Europe and, more specifically, in the London markets for some time, and since that was where the crisis in confidence occurred, it was of natural interest to us to find out the reaction of that marketplace to the deal after it was announced. So Mr. Selby talked to Peter Cooke and asked him that question.

Chairman ST GERMAIN. Maybe Mr. Selby could correct the Fortune magazine article where he contends they misquoted him. I mean Fortune——

Mr. SELBY. The Fortune article did not say that I talked to the Cooke committee. It said that I talked to Peter Cooke and the Bank of England.

Chairman ST GERMAIN. If that be the case, we will correct our record.

[The following quotation is taken from the Fortune magazine article referred to:]

[From Fortune magazine, Oct. 1, 1984]

As concern mounted last spring about Continental Illinois's problems, Joe Selby in Washington was on the telephone to Cooke at the Bank of England to find out what was being said on Threadneedle Street. "They had a better insight into what was happening than we did here in Washington," Selby remarks. At the Federal Deposit Insurance Corporation, Robert Shumway, director of the division of bank supervision, fielded questions from Cooke Committee members in Ottawa, Brussels, and London, cities in which the Chicago bank had offices. The conversations was frank and functional, participants say, and the callers trusted one another with their deepest secrets because they had come to know one another through the Cooke Committee. Once again the U.S. government passed word via the Cooke Committee that it intended to bail out a bank. The result in effect was a nonevent: bankers shook their heads over Continental Illinois, but the international banking system took it pretty much in stride.

Chairman St Germain. On page 7 of your statement, you say, "This is easy, Continental management announced its decision in 1976 to become one of the top three banks lending to corporate America."

For the record, I wish you would tell me what motivates these people to want to be the top 10 or top 5 or top 3? You know, go, go, go. Is there something hyper about these people that they want to be the biggest?

I talked to some of the English bankers. The fellow who heads up Barkleys, a big institution, he makes I think maybe $80,000 a year. He is underpaid, like you. The fellow at Continental, he is making a half million. Maybe that is one of the motivations.

I believe you have a golden parachute question, Mr. Barnard?

Mr. Barnard. Mr. Comptroller, I wanted to congratulate you and your staff on a very excellent brief on the question of the golden parachute in this particular situation. And I know that the decision not to void this came about because it said that, given the—industrywide practice with respect to such termination agreements, it will be difficult to establish a violation of either paragraph 18 of our interpretive ruling on the subject contained in 12 CFR. It would be interesting to me to know how much you feel would have been excessive in that situation.

At the same time, the last and real conclusion, said it is unlikely the Comptroller would be successful in an enforcement action against Continental and/or Anderson, Miller and Perkins given the nature of their contracts. The bank size, financial condition and industry practice—memo to Robert Serino, it might be advisable for the FDIC, considering the leverage it now has over Continental, to suggest that these contracts should be rescinded as they are not in the bank's best interest. Is that your recommendation?

Mr. Conover. I think we have to break the compensation provided to the individuals into two parts. One is normal retirement; the other is the 2- or 3-year consulting contracts. I have talked both to the subsequent management of the bank and the FDIC, about this subject. I believe the FDIC is at least considering taking, and probably will take, some action regarding those contracts.

Mr. Barnard. In the event these contracts were in the vicinty of, say, $1 or $2 million in separation, what do you think your decision would have been in that instance?

Mr. Conover. I don't think the decision is really any different whatever the amounts are. I think the important point is that either the bank, itself, or the FDIC is in a better position to do something about this problem than we are. I think they ought to go ahead and do it.

Mr. Barnard. Of course, the safety and soundness of the bank is the main issue of whether or not these parachutes threaten—I think that is one of the criteria.

Mr. Comptroller, I don't expect an answer here now. But we need to put this Continental situation in perspective to the total banking system. One of the questions that the committee has asked of you, which I hope that you will reconsider and try to furnish us, is if you can provide us information which would aid this committee in assessing the overall financial strength of the financial institutions over which you have regulatory responsibility. And if you could do that, I think it would help us in evaluating the total financial system, and not just get an impression of what it is, compared to the condition of one's institution.

Mr. CONOVER. I think that is appropriate.

Mr. BARNARD. In that I would like for you to include the current trends among national banks with regard to the following financial measures: ratio of primary capital to total assets, ratio of classified assets to gross capital funds and ratio of purchased funds to total deposits, and what is the current overall condition of the banking industry which your office is responsible.

I will be glad to give you that in writing.

Mr. CONOVER. Fine.

[In response to the request of Congressman Barnard, the following information was submitted for the record by Mr. Conover:]

Chairman ST GERMAIN. The time of the gentleman has expired.

Mr. Conover, we want to thank you for a sterling appearance and I will bet while you were at Yale 2 years behind Stu McKinney, you never in your fondest dreams would have thought that you would spend a day with such congenial company as you have here today.

Mr. CONOVER. You are absolutely right, Mr. Chairman.

Chairman ST GERMAIN. We want to thank you for your assistance and cooperation, not only today but in preparing for these hearings, and we hope we can continue to have the same spirit of cooperation.

The subcommittee is in recess subject to the call of the Chair.

[Whereupon, at 3:10, the subcommittee was recessed subject to the call of the Chair.]

[The following additional information: an article entitled "Central Bankers Have a Hot Line, Too" from Fortune magazine of October 1, 1984; an except from the Federal Register regarding the Comptroller of the Currency's proposed rule on "Minimum Capital Ratios; Insurance of Directives"; and the subcommittee's letter of invitation to the witness Comptroller of the Currency the Honorable C. Todd Conover to testify follow:]

MONEY & MARKETS

CENTRAL BANKERS HAVE A HOT LINE TOO

It connects a worldwide old-boy network of banking regulators known as the Cooke Committee. So far, however, this secretive group has been considerably better at crisis management than at crisis prevention. ■ *by Stephen Fay*

EVERY SO OFTEN Fernand St Germain, the powerful chairman of the House Banking Committee, publicly denounces a mystery-cloaked international body, the Committee on Banking Regulations and Supervisory Practices. Since no snappy acronym can be formed from those initials, almost everyone knows it as the Cooke Committee, after its chairman, Peter Cooke, a Bank of England official. Among the things that arouse St Germain's ire about the Cooke Committee, an arm of the Bank for International Settlements in the prosperous and discreet Swiss city of Basel, is the secrecy with which it operates. "I'm not telling you a goddamn thing about the Cooke Committee," a Washington member of the group barked at a reporter this summer.

The mystery surrounding the committee is diminishing somewhat, but Peter Cooke says: "I will defend to the death keeping a very large part of what we discuss secret." His committee is one of the few international organizations that produces no annual report. The document describing the committee's working arrangements and responsibilities, known as the Basel Concordat, was not published until 1981, six years after it took effect.

Even more than the Cooke Committee's secrecy, St Germain resents its lack of accountability to the U.S. Congress and his House Banking Committee, along with what he regards as its failure to do anything constructive about the reckless expansion of international bank lending, especially to Latin American nations that have proved reluctant or unable to pay off monumental debts.

RESEARCH ASSOCIATE *Susan Caminiti*

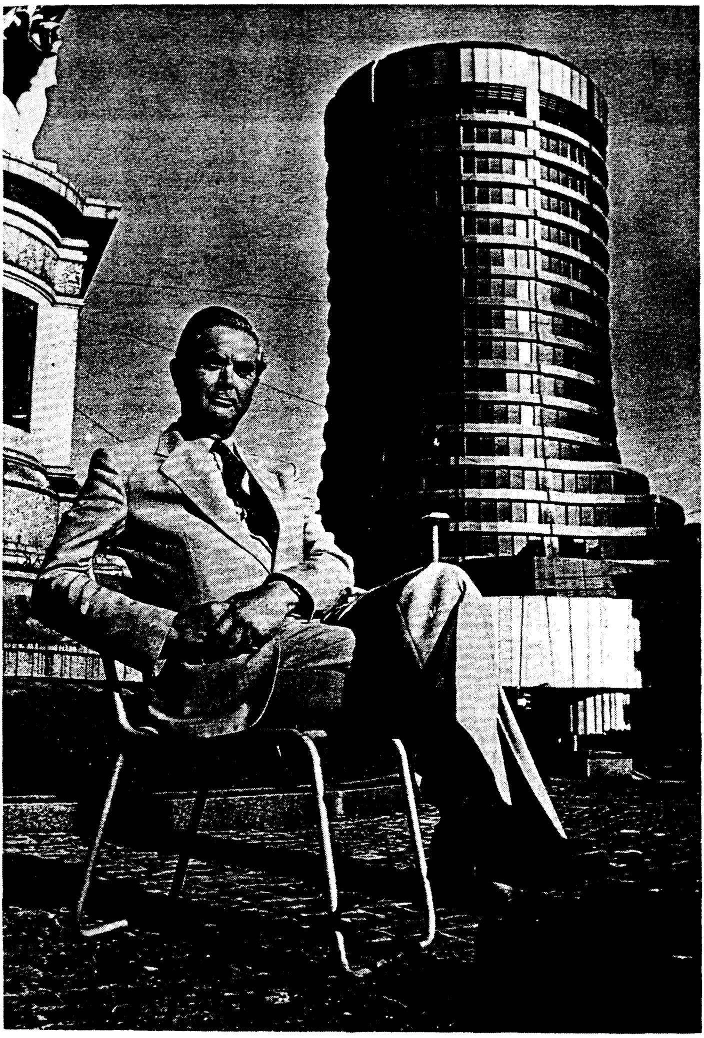
St Germain talks about the Cooke Committee in terms of an international banking conspiracy, a bankers' plot to obscure the need for proper regulation of international banking. He has held congressional hearings on the Cooke Committee, and at his order the General Accounting Office is even now investigating the group. Last year the staff of St Germain's House Banking Committee wanted to haul Peter Cooke in to explain himself and his committee—a proposal that central bankers, proud of their freedom from political oversight, found abhorrent.

A compromise was arrived at: the next time he was in Washington, Cooke would pay a courtesy call on St Germain. The meeting took place in the spring of 1983. St Germain described it: "When Cooke stopped by to chat with us he pointed out that Bank for International Settlements data indicated in advance the growing debt situation in developing countries. I asked him what international banking regulators did to slow the growth rate revealed by BIS data. Very frankly, he said [they did] really nothing or very little, except to discuss it."

Reading this in the published hearings of the Banking Committee, Cooke's upper lip unstiffened. "I would not accept that as a statement of what I actually said," he commented tartly. Cooke says his committee sent a paper to commercial banks in March 1982 on managing international lending. Obviously, many banks ignored the sensible advice it contained, such as the suggestion that small banks taking part in a syndicated overseas loan should make their own assessments of risk and not just accept the lead bank's criteria.

Cooke is unequivocal: the committee could do no more. The committee cannot say to banks, "Thou shalt not lend to this country or that," he explains, "because that introduces political judgment and it sets up all sorts of shocks and tremors. Who am I to say whether the judgment is right or wrong politically? Supervisors don't want to get into the business of running banks for bankers."

What then is the Cooke Committee—St Germain's sinister agglomeration of faceless bankers or, as Peter Cooke and his colleagues would have it, a useful bureaucratic tool? Organized in 1975 by central bankers, the Cooke Committee is made up of bank regulators and supervisors from around the world, who use it as a sort of hot line for reliable information to help them deal with banking problems and troublesome rumors of problems. "It serves to make the world a little



Beyond Peter Cooke, *chairman of the Cooke Committee, looms the round tower of the Bank for International Settlements in Basel.*

PHOTOGRAPHS BY RALPH CRANE

MONEY & MARKETS

Central bankers *relax in Basel on a warm summer Sunday. From left: Gerald Bouey of the Bank of Canada; Erik Hoffmeyer of the Danish National Bank; Henry Wallich of the U.S. Federal Reserve Board; and Lord Richardson, former Governor of the Bank of England and the man responsible for the founding of the Cooke Committee.*

smaller," says an American member, H. Joe Selby, senior deputy comptroller for bank supervision in the Comptroller of the Currency's office.

Making the world smaller means, in banking, making it safer. In March 1980, American regulators used the Cooke Committee to spread the confidential word to central banks abroad that the comptroller had determined to save First Pennsylvania Bank of Philadelphia. After this word was spread, the outflow of foreign funds from the bank diminished, giving the rescuers time to restructure the bank. Similarly, when the U.S. froze Iranian assets during the hostage crisis that same year, the Cooke Committee was able to flash the reassuring message that the U.S. was determined, despite its action, not to disrupt the system of international settlements.

As concern mounted last spring about Continental Illinois's problems, Joe Selby in Washington was on the telephone to Cooke at the Bank of England to find out what was being said on Threadneedle Street. "They had a better insight into what was happening than we did here in Washington," Selby remarks. At the Federal Deposit Insurance Corporation, Robert Shumway, director of the division of bank supervision, fielded questions from Cooke Committee members in Ottawa, Brussels, and London, cities in which the Chicago bank had offices. The conversations were frank and functional, participants say, and the callers trusted one another with their deepest secrets because they had come to know one another through the Cooke Committee. Once again the U.S. government passed word via the Cooke Committee that it intended to bail out a bank. The result in effect was a nonevent: bankers shook their heads over Continental Illinois, but the international banking system took it pretty much in stride.

PETER COOKE, at least, is not a secret. He is 52 and an associate director of the Bank of England, where he is in charge of banking supervision. He works overlooking the bank's garden court in an office with a fine molded ceiling over the fireplace and landscapes on the walls. His red leather desk is scrupulously tidy. A history major at Oxford, Cooke was hired by the Bank of England some 30 years ago and developed a taste for international economic administration, working first at the BIS and then in Washington at the International Monetary Fund. Eventually, he became a banking supervisor—a specialist occupation, the delicacy of which is illustrated by the legendary bank supervisor's prayer: "Oh Lord, let there be failures, but let them be small ones." Small failures are instructive; large ones are embarrassing.

It was a big failure that led to the establishment of the Cooke Committee: the 1974 collapse of the Herstatt Bank, which threatened to spill over not just into the rest of the West German banking system but across national frontiers. That, coupled with frequent disruptions in international markets in the new era of floating exchange rates, led the Governor of the Bank of England, Gordon (now Lord) Richardson, to expound the doctrine that even good supervisory systems in individual countries are not enough to regulate international banking.

The first meeting was held in January 1975 with members drawn from the inner circle of BIS members known as the Group of Ten—the U.S., the United Kingdom, France, Germany, Italy, the Netherlands, Belgium, Sweden, Canada, and Japan. Switzerland and Luxembourg were also present, since they are important centers of international banking.

The U.S. was represented at that first meeting by the Federal Reserve Board, though the U.S. is not exactly a member of the BIS. It has no voting rights and no members on the board, but when the central bank governors meet in Basel each month to mull over the state of the world's economies, the Federal Reserve Board's representative, Henry Wallich, has his feet under the table. The regulators and supervisors from Washington are accommodated on the Cooke Committee in the same informal way. The Federal Reserve Bank of New York joined shortly after the committee was organized in 1975. The Comptroller of the Currency's office came aboard in 1978, the FDIC in 1984. The U.S. now has more representatives than any other country on a subcommittee of an organization of which it is not a member.

In the few months between Richardson's getting the idea and the committee's first meeting, the Franklin National Bank collapsed in New York, emphasizing the need for an international banking intelligence network that might try to spot and correct bad banking behavior.

The first task, Cooke recalls, was for the supervisors to get to know one another's systems; the next was to get to know one another. Once they did so, it was clear that the formal meetings were less productive than telephone conversations between supervi-

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sors who had already met in Basel. "Banking supervision is often very sensitive, very confidential, often involving secrecy laws. Personal trust is very important in getting the dialogue going," says Cooke.

John Heimann was the first Comptroller of the Currency to take part in the Cooke Committee's informal international network. Now deputy chairman in New York of Becker Paribas, an investment banking firm, which is being sold to Merrill Lynch, he remembers: "The meetings were on a totally apolitical basis, and they created an ambiance of trust and understanding so that any one of us could pick up the phone at any time. I might say to a colleague, 'Look, no memos, no attribution, but I'm scared to death of this position. What have you heard?' "

"I might say to a colleague, 'Look, no memos, no attribution, but I'm scared to death of this position. What have you heard?'"

One of the Cooke Committee's darker secrets was discovered by Richard S. Dale, an English banker who turned academic for a time. Leafing through documents he obtained from the Federal Reserve Board in 1982 under the Freedom of Information Act, Dale found that the committee's members were confused about the division of responsibility in international banking supervision. He unearthed four different analyses of where primary responsibility lay for bank activities outside a bank's own country—an ambiguity that suggested the Cooke Committee was more a network than a safety net. This conclusion was reinforced by the 1982 failure of Milan's Banco Ambrosiano, which had connections with the Vatican bank.

Most public speculation about the case concentrated on the bank's president, Roberto Calvi, who was found hanging from Blackfriars Bridge on the River Thames in London. But the Cooke Committee's private damage report revealed that whatever wickedness Calvi might have contrived, bank supervisors had done nothing to prevent default on loans of $400 million by a Luxembourg subsidiary of Banco Ambrosiano. Luxembourg's bank supervisors thought Italy bore responsibility, while the Italians denied accountability. That was embarrassing. What was worse for creditors was that no central bank was willing to act as lender of last resort, and there was no institution capable of bailing out the bank and protecting victims. (The Vatican eventually did the decent thing, partially satisfying claims from more than 100 banks in July 1984; after all, Calvi was known as God's banker.)

Last year the committee's members agreed on a principle called consolidated supervision, which amounts to this: foreign offices of an American bank ought to be supervised by Washington, a British bank's offices by the Bank of England, and so on. Naturally, supervisors keep an eye on foreign banks operating in their territory, reporting any bad news.

THIS PRINCIPLE is expected to bring a change in West German banking laws. West German banks have been able to use Luxembourg as their base for "offshore" business, effectively avoiding supervision of their international activities by regulators at home. The Cooke Committee, says one member, "has pushed the Germans along" toward embracing consolidated supervision by making banks register their offshore offices with West Germany's Federal Banking Supervisory Office.

The Cooke Committee also stated that regulators can forbid a foreign bank to open an office in their countries if they are not satisfied with the quality of supervision in the bank's home capital. Britain has already made use of consolidated supervision. South Korean banks reportedly were told that they would not be allowed to operate in London unless Korea's domestic regulators in Seoul pulled up their socks—which presumably happened: the Bank of Seoul & Trust still has an office in London.

The concordat fixing supervisory responsibility is "a guideline and an understanding," says Cooke, who is trying to make sure that it is understood in places like Southeast Asia, the Caribbean, and South America. Since Cooke is anxious not to enlarge the committee, the message is preached at conferences for nonmember regulators and supervisors, such as one in Rome in September.

New banking centers like Hong Kong and Singapore have been cooperative in following the principle of consolidated supervision, but problems in the Caribbean persist. Frederick Dahl, the Federal Reserve Board's representative on the Cooke Committee, notes: "When one island tightens up, there's always another to go to." If awkward questions are asked about accounts opened by drug traffickers on one island, they can move on to another water-locked haven.

But committee members are also concerned about some big recent decisions by U.S. bank regulators. The worries center on an intriguing philosophical principle established in the insurance industry known as moral hazard. This principle states that increasing insurance serves to heighten chances of loss because the players feel they can afford to take imprudent risks. In banking this means that if commercial bankers believe they will eventually be bailed out by the lender of last resort—a central bank or a body like the FDIC—they will be led to behave less prudently.

Because of moral hazard, a central banker who privately admits that a bank as large as Continental Illinois cannot be allowed to fail will publicly reject the logical conclusion that the role of the lender of last resort is to dig up cash to prevent all big failures. "Our message is, 'You can't rely on us,' " says one of Europe's senior central bankers. "We have to leave the banks in the optimum degree of doubt about how or when or to what extent we'll bail them out."

On the day late in July that the FDIC announced in Washington its plans to become the custodian of Continental Illinois, Joe Selby of the comptroller's office was in London talking to supervisors and regulators from the world over. Having listened to Selby, one member of the Cooke Committee concluded that because Continental Illinois had been bailed out, it does not follow that the next big American bank to be threatened by collapse will be bailed out too.

But is that conclusion really true? If one large, troubled financial institution after another wobbles into the emergency room—Financial Corp. of America, owner of the U.S.'s biggest thrift, was the latest—and none is turned away, it will get harder to keep 'em guessing, as the Cooke Committee likes to do.

redemption charges which are applicable in accordance with § 1421.733 and § 1421.753. Except for wheat, barley, sorghum, or rye, commodities which are reconcentrated shall be transported without cost to CCC. CCC shall increase or decrease the loan to the producer by the amount by which the loan value of the commodity stored in the subsequent warehouse is greater than or less than the value of the original warehouse storage loan. The maturity date of the new warehouse storage loan shall be the maturity date applicable to the original warehouse storage loan.

* * * * *

8. In § 1421.19, paragraph (a) is revised to read as follows:

§ 1421.19 Liquidation of farm storage loans.

(a) *General.* In the case of farm storage loans, the producer is required to repay the loan or deliver to CCC a sufficient quantity of the eligible commodity having a price support value equal to or greater than the outstanding balance of the loan. Deliveries may be either of the identical commodity which is subject to the note and security agreement or of other eligible commodities of the same kind. Deliveries shall be made in accordance with written instructions issued by the county ASCS office which shall set forth the time and place of delivery. CCC will not accept delivery of any quantity in excess of the larger of: (1) 110 percent of the measured or certified quantity, or (2) a sufficient quantity of the commodity having a settlement value equal to 110 percent of the loan value being settled. Settlement of the quantity delivered shall be made as provided in § 1421.22. If the producer fails to deliver to CCC the commodity pledged as price support loan collateral by the date specified by CCC on Form CCC-691, Commodity Delivery Notice, and if the producer subsequently redeems the collateral by repaying the loan before delivery is accomplished, liquidated damages shall be assessed, in addition to any applicable interest due on the loan, on the quantity of the commodity redeemed. Such liquidated damages shall be assessed beginning on the date following the required delivery date and shall continue until the loan is repaid. Liquidated damages shall be computed by multiplying the loan principal on the repaid quantity by 50 percent of the rate of interest charged by CCC with respect to delinquent debts on the date the failure to deliver occurred.

* * * * *

9. In § 1421.22, paragraph (a) is revised to read as follows:

§ 1421.22 Settlement.

(a) *General.* Settlement with producers for commodities acquired by CCC as a result of loans made or under purchase agreements entered into under this subpart shall be made as provided in this section and in the applicable commodity regulation. The price support rate at which settlement shall be made shall be determined in accordance with the provisions of the applicable commodity regulations. Settlement shall be made on the basis of the grade, quality, and quantity of the commodity delivered by the producer. In the case of farm-stored peanuts and farm-stored tobacco, paragraphs (b), (c), and (e) of this section shall not apply. In the case of farm-stored rice, paragraphs (b) and (c) of this section shall not apply.

* * * * *

10. A new § 1421.29 is added to read as follows:

§ 1421.29 Paperwork Reduction Act assigned numbers.

The Office of Management and Budget has approved the information collection requirements contained in these regulations in accordance with 44 U.S.C. Chapter 35 and OMB Numbers 0560-0087 and 0560-0040 have been assigned.

Signed at Washington, D.C., on August 28, 1984.

Everett Rank,

Executive Vice President, Commodity Credit Corporation.

[FR Doc. 84-23317 Filed 8-31-84; 8:45 am]

BILLING CODE 3410-05-M

DEPARTMENT OF THE TREASURY

Comptroller of The Currency

12 CFR Part 3

[Docket No. 84-29]

Minimum Capital Ratios; Issuance of Directives

AGENCY: Comptroller of the Currency, Treasury.

ACTION: Proposed rule.

SUMMARY: Section 980 of the International Lending Supervision Act of 1983 (Pub. L. 98-181, Title IX, 97 Stat. 1153) condified at 12 U.S.C. 3907, directs the Comptroller of the Currency to establish minimum levels of capital for national banks and to require them to achieve and maintain adequate capital. The Office also is required to analyze capital adequacy in taking action on various types of applications such as mergers and branches and in conducting the Office's supervisory activities related to the safety and soundness of individual banks and the banking system. This proposal: (a) Defines capital; (b) establishes required minimum capital ratios; (c) establishes procedures to set higher required minimum capital ratios for an individual bank; and (d) establishes procedures for issuing a directive to require a national bank to achieve and maintain the minimum capital ratios applicable to it.

DATE: Comments must be received by November 5, 1984.

ADDRESSES: Comments should be sent to Docket No. 84-29, Communications Division, Office of the Comptroller of the Currency, 490 L'Enfant Plaza, S.W., Washington, D.C. 20219, Attention: Lynnette Carter. Comments will be available for inspection and photocopying.

Comments specifically addressing the information collection requirements in §§ 3.7 and 3.12 should be submitted to: Office of Management and Budget, 726 Jackson Place, N.W., Washington, D.G. 20500, Attention: Desk Officer for the Office of the Comptroller of the Currency. Those comments also should be directed to the Comptroller's Office at the above address.

FOR FURTHER INFORMATION CONTACT: Susan K. Fetner, National Bank Examiner, or John H. Noonan, Director, Commercial Examinations Division (202 447-1164), or Dorthy A. Sable, Senior Attorney (202 447-1880).

SUPPLEMENTARY INFORMATION:

Background

Capital performs several very important functions in banking institutions. It absorbs losses; helps to maintain confidence in individual banks and the banking system as a whole; and supports growth. Capital also provides protection to depositors in the event of a threatened insolvency.

The Office of the Comptroller of the Currency (Office) has always had a strong concern for the maintenance of adequate capital in individual banks and in the banking system. The protection of depositors and fostering of stability in the financial system are critical to the mission of the Office and capital adequacy plays a key role in the policies and programs used in performing the Office's supervisory functions. A determination of capital adequacy in one of the major objectives of a bank examination and is one of the five components which form the basis of the Uniform Financial Institution Rating System used by the Office in determining the condition of individual banking institutions. Additionally, by enacting the International Lending

Supervision Act of 1983 (12 U.S.C. 3901 *et seq.*) (ILSA) Congress has explicitly recognized the importance capital adequacy assumes in the safe and sound operation of the nation's banking system.

Although there is widespread agreement as to the importance of adequate capital, there has been vigorous debate over the years among regulatory authorities, bankers, industry analysts and other regarding what constitutes and adequate level of capital. There is general agreement that the capital of any given bank should be sufficient to maintain public confidence in the institution; support the volume, type and character of the business conducted; provide for the possibilities of loss inherent therein; and permit the bank to continue to meet the reasonable credit requirements of the area served. The quantification of this into an appropriate capital ratio has, however, been the subject of much controversy.

Bank capital ratios, relating the amount of bank capital to bank assets, vary in response to differential growth rates in the numerator—bank capital, and the denominator—bank assets. The growth rate of bank assets is affected by the rate of inflation, credit demand, innovations in bank asset and liability management, and the real rate of growth in the economy. The growth rate of bank capital is a function of the rate of return on assets, the retention rate of earnings, and net new issues of capital securities. The "adequacy" of these bank capital ratios is affected by the economic environment in which banks operate and the magnitude of risk inherent in the structure and operating characteristics of individual institutions.

Several factors have emerged over the past few years which are accentuating the potential demands on bank capital. The decrease in banks' net interest margins, together with a weakening of loan portfolios brought about by shocks in the domestic and world economy have caused a decline in bank profitability and increased levels of risk within the system. The competition for financial services has intensified on both an intraindustry and interindustry basis, placing additional pressures on bank profitability. Further, because of the growing interdependency within the system, problems in one institution can have repercussions on other institutions, arguing for stronger capital levels in both individual banks and the system as a whole. Increasing levels of off-balance sheet risks are also a factor in the need for higher capital.

The Comptroller, the Board of Governors of the Federal Reserve System (FRB) and the Federal Deposit Insurance Corporation (FDIC) have previously adopted and published capital guidelines which, together with the efforts of banks to achieve them, have been successful recently in preventing a decline in bank capital ratios. These policies, while similar, have not been completely uniform and have allowed for some disparity in the treatment of federally regulated banks. Section 908 of ILSA (12 U.S.C. 3907) directs the federal banking agencies to "* * * cause banking institutions to achieve and maintain adequate capital by establishing minimum levels of capital for such banking institutions and by such other methods as the appropriate Federal banking agency deems appropriate." ILSA also encourages uniformity among the agencies in imposing requirements under the Act. Therefore, pursuant to the Office's authority under ILSA and the authority contained in the National Banking Act, the Office is proposing a regulation on capital requirements. The FRB and the FDIC also have issued similar capital proposals for comment. The proposed regulation is intended to implement the provisions of the ILSA, foster further improvement in bank capital ratios, and eliminate the disparities in treatment of federally regulated banks with respect to capital adequacy. The proposed regulation also sets forth the procedures, pursuant to the authority contained in ILSA, for issuing directives to require banks to achieve and maintain adequate capital.

The proposed regulation will supplement, rather than replace, the Office's supervisory evaluations of capital adequacy. The process of determinig the adequacy of a bank's capital on an ongoing basis begins with a qualitative evaluation of the critical variables that directly bear on the institution's overall financial condition. These variables include the quality, present value, type and diversification of assets; historical and prospective earnings; liquidity (with emphasis on asset/liability management); the quality of management; and the existence of other activities which may expose the bank to risks, including off-balance sheet items, the degree of leverage and risks undertaken by the parent company or other affiliates. Banks with significant weaknesses in one or more of these areas will be expected to maintain higher capital levels than the minimums set forth in the regulation. In addition, the OCC stresses that the capital requirements set forth in this proposed regulation are minimums and that all banks are encouraged to maintain higher levels of capital in order to provide protection against unforeseen adversities.

The Proposal

The regulation would apply to national banks and banks located in the District of Columbia. The regulation would not apply to bank holding companies; however, when considering the condition of or an application from banks which are subsidiaries of holding companies, the activities and condition (including capital adequacy) of the bank holding company will be considered by the Office. Although the proposed regulation would not apply to federal branches and agencies, the Office is considering imposition of a comparable capital equivalency deposit requirement for federal branches and agencies (see Issues for Comment, No. 10).

Under the proposed regulation, the minimum acceptable ratio of total capital to total assets would be established at six (6) percent (%) and the minimum ratio of "primary " capital to adjusted total assets would be established at five and one-half (5 ½) percent (%). These ratios would apply to well-managed banks of all sizes which have no material weaknesses. Based on the December 31, 1983 Call Reports, approximately 95% of all national banks had a primary capital ratio in excess of 6%, a level which would exceed the primary capital requirement established by this regulation. In addition, most of the larger multinational and regional banks (which generally have lower capital ratios than smaller banks) had primary and total capital ratios which would exceed the minimum requirements. A few large banks will be faced with a relatively large dollar shortfall in their capital accounts. While the OCC expects that all banks will make every effort to achieve compliance as rapidly as possible, the Office will consider the individual circumstances and the ability of each bank to achieve compliance.

The proposed regulation represents a change from the interagency guidelines issued by the OCC and the FRB in December 1981 and amended in June of 1983. Regional and multinational banks would be subject to an increase in the primary capital ratio from 5% ot 5½% while community banks would have their minimum primary capital ratio lowered from 6% to 5½%. The new total capital ratio, as proposed, would be 6%. Previously, the guidelines had used a zone concept, based on asset size, to determine the nature and intensity of supervisory action for a particular institution. Multinational and regional banks were presumed to have inadequate total capital if below a 5½% ratio, and community banks were presumed under capitalized if below 6% total capital. The zone concept provided some guidance for bankers and regulators in monitoring total capital levels and consideration is being given to continuing use of the zones in conjunction with a minimum capital requirement. (See Issues for Comment, No. 9).

Primary Capital Definition

Primary capital in the proposed regulation is defined as the total of common and perpetual preferred stock, capital surplus, undivided profits, contingency and other capital reserves, a limited amount of mandatory convertible debt (as defined), minority interests in consolidated subsidiaries, net worth certificates and the allowance for loan and lease losses; minus intangible assets. The term mandatory convertible debt is defined to include only those subordinated debt instruments that mandatorily convert into the issuing bank's common or perpetual preferred stock. The definition intentionally does not include subordinated debt that merely requires the issuer to sell stock in sufficient amounts to replace the debt obligation, even though these instruments are considered as primary capital under OCC's present guidelines. Furthermore, for purposes of meeting the minimum primary capital requirements of this proposed regulation, mandatory convertible debt would be included only to the extent of 20% of primary capital exclusive of such debt. The proposed regulation limits the amount of mandatory convertible debt that would be included in measuring primary capital because, while these instruments contain many of the features of equity capital, they do not represent equity until actually converted.

The proposed definition of primary capital thus also differs from that contained in 12 CFR 7.1100 which defines capital for statutory and supervisory purposes. The Office will amend that interpretive ruling upon adoption of a final regulation under this proposal (see Issues for Comment, No. 1).

Secondary Capital Definition

The definition of secondary capital would include mandatory convertible debt that is not included in primary capital (in excess of 20%), intangible assets, and, subject to certain restrictions in 12 CFR 7.1100, limited life preferred stock and subordinated notes and debentures. As in the case of primary capital, the definition of secondary capital differs from that contained in 12 CFR 7.1100 (See Issues for Comment, No. 1).

Minimum Capital Ratios

The proposal would require banks to have and maintain a ratio of total capital to total assets (as defined) of at least 6% and a ratio of primary capital to adjusted total assets of at least 5½%. These ratios would apply to all national banks, regardless of size. However, the Office would retain the right to establish higher ratios for individual banks whose circumstances warrant a stronger capital base. In addition, banks which have entered into, or subsequently enter into a written agreement or which are or become subject to a cease and desist order under 12 U.S.C. 1818 (b) or (c) requiring higher minimum capital ratios for the bank, must achieve and maintain those higher ratios. Similarly, if higher minimum capital ratios have been or are required as a condition for approval of an application, the bank will be governed by those ratios.

The ratios must be achieved as of each Call Report date and will be calculated in terms of the bank's reported total capital to its reported average total assets and its primary capital to average total assets as adjusted. During the following quarter, the bank must maintain this ratio. If total assets increase, on average, during the quarter, the bank must increase its capital (unless it is already above the minimum) before the upcoming Call Report date, in order to be in compliance with the required ratios as of the Call Report date for that quarter.

Banks which are not able to achieve the ratios by the effective date of the final rule will be required to submit to the Office an acceptable plan to achieve the minimum capital ratios within a reasonable time. The plan itself must be submitted within 60 days after the effective date of the final rule and must set forth the means and time frames in which the bank will achieve the minimum ratios. The Office understands that banks that will need to raise or generate a substantial amount of capital to achieve the ratios will require a reasonable period of time in which to do so and the Office will take this into account in reviewing individual bank plans. Rather than a formal approval or acceptance process, the proposed rule provides that the bank may consider its plan acceptable to the Office unless it is notified to the contrary. It should be noted, however, that under this provision, the Office may subsequently require changes in a bank's plan, such as an acceleration of the time schedule, in the event of changed circumstances. Because not all banks will have the required ratios at the time the final rule becomes effective, or be able to achieve the ratios quickly thereafter, the rule provides that a bank in compliance with an acceptable plan to achieve the ratios will not be considered to be in violation of the regulation.

Finally, the Office has reserved the authority to permit a bank to operate with capital ratios below the minimums when, in the opinion of the Office, the circumstances justify such action. This provision might apply for example, to a situation in which a bank in compliance with the minimum ratios would not be in compliance if it undertook a proposed acquisition which would dilute its capital or increase its assets. Such an acquisition, however, may be necessary or desirable to alleviate a troubled or emergency situation involving another bank. In such circumstances, when the Office believes that the acquisition should be approved, it may specifically authorize the acquiring bank to have capital ratios below the minimums during a specified period of time, *i.e.*, the time necessary for the bank to absorb the acquisition and increase its capital to again meet the minimums specified in the regulation. This provision is not intended to authorize banks below the required minimums to continue to operate with lower capital ratios or to authorize banks to reduce their capital.

Minimum Capital Ratios for an Individual Bank

As noted above, the general minimum captial ratios are intended to apply to sound banks without any significant risks or problems. Higher minimum captial ratios may be appropriate or necessary for individual banks depending upon their circumstances. The International Lending Supervision Act specifically provides the Comptroller with the authority "to establish such minimum level of capital for a banking institution as the [Office], in its discretion, deems to be necessary or appropriate in light of the particular circumstances of the banking institution." 12 U.S.C. 3907(a)(2). Higher minimum ratios may be estabished for a bank and required as a part of a written agreement or a cease and desist order under 12 U.S.C. 1818 (b) or (c), or as a condition for approval of an application. In addition, the proposed rule establishes a procedure for setting higher required minimum capital ratios for an individual bank. This part of the rule sets out examples of situations when higher minimum capital ratios may be necessary or appropriate and examples of the factors which the Office may consider in deciding what a bank's minimum capital ratios should be. These examples are not intended to be exclusive because it is not possible to predict in advance each situation in which higher capital ratios may be necessary or every factor which should be considered in a particular situation.

The procedure provides for written notice from the Office to the bank indicating the capital ratios which the Office believes are appropriate for the bank, the date when they should be achieved, and an explanation of why those ratios are considered appropriate. The bank will have thirty days in which it may respond to the Office in writing. After the close of the bank's response period, or after the bank's response is received, if sooner, the Office will consider any response from the bank. Unless further information or clarification of the bank's response is required, or the time periods are extended for good cause, the Office will reach a decision within thirty days after the close of the response period and will advise the bank in writing whether higher capital ratios will be required for it and, if so, what those ratios are and when they must be achieved. The Office also may require the bank to submit an acceptable plan to achieve the required ratios established for it. This procedure is intended to provide an informative and fair, but relatively uncomplicated and prompt method of addressing an individual bank's need for higher capital levels.

Directives

A directive is a form of order specifically authorized under the International Lending Supervision Act, 12 U.S.C. 3907(b)(2). Issuance of a directive of discretionary when a bank does not have or maintain capital at or above the level required for it, whether under the general minimum capital ratios set forth in the rule, under a decision establishing higher minimum capital ratios for the bank, under the terms of a written agreement under 12 U.S.C. 1818(b), or as a condition for approval of an application. A directive also may be issued when a bank has failed to submit or is not in compliance with an acceptable plan to achieve its required minimum capital ratios.

Under the proposal, the Office will notify a bank in writing of the Office's intention to issue a directive to the bank. The notice will include reasons for the action and the contents of the proposed directive. The bank will have thirty days in which to respond in writing to the notice. The response may state why a directive should not be issued; may propose alternative provisions for the directive; and/or may include a plan to achieve the bank's required minimum captial ratios. The response should include any information which the bank would have the Office consider in deciding whether to issue a directive or what the provisions of the directive should be. Failure to respond within the allotted time period will be deemed to be a waiver of any objections to the proposed directive. After the close of the bank's response period, or after receipt of the bank's response, if sooner, the Office will consider the bank's response and will decide whether to issue the directive as originally proposed or in modified form. Unless the time periods are extended by the Office, for example, in cases where additional information or a clarification of the bank's response is needed, the Office will issue the directive, or notify the bank that a directive will not be issued, within thirty days after the close of the bank's response period.

The terms of the directive will vary in each individual case. The directive may order the bank to achieve and maintain its required minimum capital ratios by a specified date; comply with a previously submitted plan to achieve those ratios; submit and comply with an acceptable plan to achieve the ratios; reduce assets or the rate of growth of assets, or restrict dividends in order to achieve its required capital ratios; or a combination of any of the above or similar actions.

A directive, or any plan submitted pursuant to a directive, is enforceable to the same extent as an effective and outstanding order issued pursuant to 12 U.S.C. 1818(b) which has become final. In addition, violation of a directive may result in civil money penalties against the bank or its officers, directors, employees, or other persons participating in the conduct of its affairs.

Because of the critical importance of adequate capital to the soundness of a bank's operations, the procedure for issuance of a directive has been designed to reach a resolution in a prompt, but fair manner and the Office intends to actively seek enforcement of directives in the event of noncompliance.

Issues for Comment

Comments are requested on the proposal and specifically on the following issues:

(1) Whether the definitions of capital and its components should be the same for the purposes of determining capital adequacy and for statutory purposes, such as the lending limits in 12 U.S.C. 84. The Office adopted one definition for both purposes in Interpretive Ruling 12 CFR 7.1100 and believes that the definitions in this proposed regulation also should govern the determination of capital for both supervisory and statutory purposes since a common definition would avoid complexity and confusion.

(2) Whether higher minimum capital ratios are appropriate or feasible. The Office believes that the minimum capital ratios proposed are appropriate for the banking industry in general and are feasible to achieve and maintain. However, the Office solicits comment on whether higher minimum ratios than those proposed should be required now or required in the next year or two, and whether and when it would be feasible for banks to achieve such higher capital levels.

(3) Whether the proposed regulation should "grandfather" capital components now considered primary capital but which would not be included in primary capital under the proposed regulation. The proposed regulation would not change a bank's total capital. However, some items currently included in primary capital—by Interpretive Ruling 12 CFR 7.1100 or bank practice—would instead be included in secondary capital. One such item is mandatory convertible debt which must be repaid through the sale of common or perpetual preferred stock. This type of mandatory convertible debt, commonly referred to as "equity commitment notes" has been issued by some national banks with the Office's approval. Under the proposed regulation, this type of debt would continue to be counted as capital but it would be considered secondary capital. The Office believes that banks should be able to continue to include in their primary capital, previously approved and issued equity commitment notes or other similar instruments. Therefore, as a transitional rule, such instruments would be included in primary capital to the extent previously authorized, during the original effective term of the instruments.

The other item included in secondary capital in the proposed regulation is intangible assets. While the Office has not ruled previously that this item is included in primary capital, the Office is aware that banks commonly do not exclude intangible assets in calculating primary capital. Comment is requested on the effect on individual banks if intangible assets are excluded from primary capital and, alternatively, the extent to which intangible assets should be includable in primary capital.

(4) Whether the reserves for loan and lease losses should be excluded from capital. Since the amount of a bank's reserve for loan and lease losses is

specifically tailored to its loss experience as well as estimated potential losses on particular assets, it can be argued that all or at least a portion of the reserve should not be considered as capital because it will be depleted. Traditionally, however, these reserves have been considered as capital since they perform one of capital's primary functions, *i.e.*, to serve as a cushion against losses. The Office requests comment on whether all or any portions of loan and lease reserves should be excluded from the definition of capital.

(5) Whether limits should be placed on the amount of subordinated notes and debentures and limited life preferred stock that is included in secondary capital. Limits may include such factors as requiring a minimum original maturity, discounting the amount that is included in secondary capital based on the remaining maturity, and a percentage limit on the aggregate amount that can be included in secondary capital. Certain limits now are imposed in 12 CFR 7.1100 and the Office believes that those or similar restrictions should be placed on these types of instruments when they are included in a bank's capital.

(6) Whether limits should be placed on the amount of secondary capital that can be included in total capital. For example, should secondary capital be limited to an amount equal to 50 percent of primary capital as is now the case under 12 CFR 7.1100? Because the components of secondary capital do not provide the same degree of protection obtained through primary capital, the Office believes that a limit on secondary capital is warranted, at least when determining total capital (capital and surplus) for statutory purposes. (See Issue no. 1). The Office requests comment on the effects such a limit would have, given the proposed definitions of primary and secondary capital.

(7) Whether the minimum capital requirements should be tailored to the risk composition and liquidity of assets. The proposed minimum capital requirements are neutral with respect to the composition of a bank's assets, *i.e.*, the same capital ratio is required for both liquid and illiquid assets and for both high and low risk assets. The Office is concerned that this neutrality may not provide an incentive for banks to enhance or maintain the liquidity or quality of their assets. Asset liquidity is important since it offers banks an alternative to reliance on short term funding, with its inherently volatile conditions, to meet liquidity needs. While asset composition, including risk and liquidity, will be considered in an Office decision to require capital ratios above the minimums for an individual bank, the Office solicits suggestions on ways in which the general minimum requirements or other regulatory requirements could encourage high quality, liquid bank assets. For example, should relatively risk free or liquid assets be excluded or discounted in computing total assets, with higher minimum capital ratios required for the remaining risk assets?

(8) Whether the capital ratios should be calculated on the basis of average or actual total assets. The proposed ratios are minimums and banks are encouraged to maintain higher levels of capital. However, the Office does not want to require banks at the margin to make calculations prior to each increase in their asset portfolios. Similarly, the Office wishes to minimize the likelihood of inadvertent or technical violations. Therefore, in order to avoid these problems, yet assure that the ratios are maintained on a relatively constant basis, total and primary capital would be computed as of each Call Report date and the capital ratios calculated based on average total assets (or average total assets less intangible assets) for that Call Report period. Capital and average total assets already are required to be stated in Call Reports, however, the capital ratios would not need to be stated.

During the following quarter, to comply with the regulation, the bank need only maintain its capital at the levels necaessary to meet the minimum ratios based on the average total-assets figure in its most recent Call Report. However, if the bank's assets, on average, increase during the quarter, it must correspondingly increase its capital (if at the minimum level) before the end of the quarter so that it will be in compliance with the required minimum ratios as of the Call Report date for that quarter. Use of the average total assets figure therefore, should eliminate the potential for inadvertant violations and simplify banks' internal procedures for compliance.

The Office is concerned, however, that some banks may have total assets as of the Call Report dates or otherwise that are substantially higher than their average total assets so that the bank, while technically in compliance with the regulation, actually is defeating its purpose, *i.e.*, to assure that banks have the minimum adequate level of capital to support their operations. Therefore, Call Report and examination data on total assets will be reviewed and compared with the reported average total assets figure. where there is significant disparity between these figures on a repeated basis, the bank may be required to maintain its minimum capital ratios on a constant basis in relation to its actual total assets. The Office seeks comment on the average total asset method or alternative methods to achieve compliance with the regulation.

(9) Whether the zone concept provides useful guidance to banks. The Office is considering whether to issue guidelines in conjuction with the final version of the regulation concerning the degree and type of administrative action which would correspond to particular capital ratio zones. Although these guidelines would be primarily for internal agency purposes, they would be published for the information of bank management. Under the zone concept, the Office would consider banks having a total capital ratio in excess of 7% to be adequately capitalized, absent special circumstances. Banks having a total capital ratio between 6–7% would be monitored to determine whether their capital is adequate in light of the quality of assets, management strength, and other factors. Banks having a total capital ratio of less than 6% (the minimum required in the regulation) would be presumed to be undercapitalized and would be subject to appropriate supervision and administrative action.

The proposed regulation itself indicates the range of adminsitrative or supervisory actions which the Office may take if a bank does not have the minimum capital ratios required for it or has not submitted or complied with an acceptable plan to achieve those ratios. Since the appropriate supervisory action necessarily must be determined on a case-by-case basis, the zone concept as a guide for adminstrative actions may not be particularly useful. However, comment on the past or possible future usefulness to the banking industry of the zone would be of assistance to the Office.

(10) Whether the minimum capital requirement should apply to federal branches and agencies. Under 12 U.S.C. 3102(g), federal branches and agencies are required to maintain capital equivalency deposits which, at a minimum, equal 5% of liabilities. The statutory minimum is roughly equivalent to the 5% minimum primary capital requirement for regional and multinational banks in the Office's current guidelines. However, the International Banking Act of 1978 (IBA) also mandates competitive equality

between national banks and federal branches and agencies. Because the operations of federal branches and agencies are not inherently either more or less risky than those of national banks, the Office believes that federal branches and agencies should be subject to comparable capital adequacy requirements. However, since the IBA requires that the capital equivalency deposit consist of cash or investment securities and be computed as a percent of liabilities, a capital-to-assets ratio would be difficult to implement. Alternatively, comparability could be attained by requiring capital equivalency deposits for federal branches and agencies equal to at least 5½% of liabilities, rather than the current 5%. The Office requests comments on this and other means of establishing relatively comparable capital requirements for federal branches and agencies.

Regulatory Flexibility Act

Pursuant to section 605(b) of the Regulatory Flexibility Act (Pub. L. 96-354, 5 U.S.C. 601 *et seq.*) the Comptroller of the Currency has certified that the proposed regulation, if adopted, will not have a significant economic impact on a substantial number of small entities since nearly all small banks (those with total assets of less than $1 billion) already meet or exceed the primary and total capital ratios proposed in the regulation.

Executive Order 12291

The Comptroller of the Currency has determined that the proposed regulation is a "major rule" and a regulatory impact analysis has been performed in connection with the Office's consideration of this rule. In reviewing the impact of the proposal, the analysis considered that:

(1) 151 national banks have a shortfall, at a minimum, of $3.3 billion in primary capital;

(2) 89 of those banks, plus an additional 111, have a shortfall, at a minimum, of $2.4 billion in secondary capital;

(3) 266 national banks meet both minimums, but face credit and other risks that warrant higher capital ratios (the amount of capital they must raise cannot be easily estimated);

(4) Underwriting costs associated with raising needed capital could approach $200 million, the precise amount depending on the volume of funds raised in capital markets as opposed to the use of retained earnings; and

(5) Until capital ratios are met, dividend payouts could be lower than historical averages.

However, OCC believes the costs of the proposed mandatory minimum capital ratios are outweighed by the benefits. These benefits cannot be easily quantified, but include:

(1) An increased capacity, especially among large banks, to withstand losses associated with credit and other risks that are a normal part of banking;

(2) Increased stability in our financial system; and

(3) Increased capacity to fund economic growth.

The Office is especially interested in receiving additional information bearing on the benefits and costs of this proposal. A copy of the regulatory impact analysis may be obtained from the Office's Communications Division under procedures set forth in 12 CFR 4.17 and 4.17a.

Paperwork Reduction Act

The potential paperwork burdens contained in this rule pertaining to: (1) The preparation of a written plan to increase capital by a national bank that does not have the minimum capital ratios specified in the regulation or individually required for it; and (2) the written response which a bank may make to the Office when notified that higher minimum capital ratios may be required for it; have been submitted to the Office of Management and Budget for review pursuant to 44 U.S.C. 3504(h).

List of Subjects in 12 CFR Part 3

Banks, Banking, Primary, Secondary and total capital, Minimum capital ratios, Procedures for establishing higher minimum capital ratios for an individual bank, Enforcement of minimum capital ratios, Issuance of directives.

This proposal does not duplicate, overlap, or conflict with any existing federal laws and regulations governing national banks with the exception of Interpretive Ruling 12 CFR 7.1100 which will be amended accordingly following adoption of the final version of this proposed regulation.

Authority and Issuance

Accordingly, pursuant to authority under 12 U.S.C. 93a, 3907, and 3909, the Comptroller of the Currency proposes to add a new Part 3 to Title 12 of the Code of Federal Regulations, as follows:

PART 3—MINIMUM CAPITAL RATIOS; ISSUANCE OF DIRECTIVES

Authority: 12 U.S.C. 1 *et seq.*; 12 U.S.C. 93a, 161 and 1818; and 12 U.S.C. 3907 and 3909.

Subpart A—Authority and Definitions

§ 3.1 Authority.

This part is issued under the authority of 12 U.S.C 1 *et. seq.*, 93a, 161 and 1818; and the International Lending Supervision Act of 1983 (Pub. L. 98-181, Title IX, 97 Stat. 1153), 12 U.S.C. 3907 and 3909.

§ 3.2 Definitions.

For the purposes of this Part:

(a) "Bank" means a national banking association or a District of Columbia bank.

(b) "Intangible assets" means those assets within the definition of this term in the "Instructions—Consolidated Reports of Condition and Income" (Call Report).

(c) "Mandatory convertible debt" means subordinated debt instruments which require the issuer to convert such offerings into either common or perpetual preferred stock by a date at or before the maturity of the instrument. The maturity of these instruments must be 12 years or less.

(d) "Primary capital" means the sum of (1) and (2) below, minus intangible assets:

(1) Common stock, perpetual preferred stock, capital surplus, undivided profits, reserves for contingencies and other capital reserves, net worth certificates issued by the Federal Deposit Insurance Corporation, minority interests in consolidated subsidiaries, and

allowances for possible loan and lease losses; and

(2) Mandatory convertible debt to the extent of 20% of the sum of (1);

(e) "Secondary capital" means the sum of: mandatory convertible debt that is not included in primary capital, intangible assets, and limited life preferred stock and subordinated notes and debentures having an original weighted average maturity of at least seven (7) years, subject to the amortization schedule set forth in 12 CFR 7.1100(f)(2).

(f) "Total assets" means the average total assets figure required to be computed for and stated in a bank's most recent quarterly "Consolidated Report of Condition and Income" (Call Report), plus the allowance for possible loan and lease losses. "Adjusted total assets" means total assets minus intangible assets.

(g) "Total capital" means the sum of primary capital and secondary capital.

§ 3.3 Transitional Rule.

Funding instruments approved by the Office as primary of secondary capital and issued prior to the effective date of this regulation may continue to be included, to the extent previously authorized, in a bank's primary or secondary capital as the case may be, during the original effective term of the instrument.

§ 3.4 Reservation of Authority.

Notwithstanding the definitions of "primary capital" and "secondary capital" in § 3.2 (d) and (e), the Office may find that a newly developed or modified funding instrument constitutes or may constitute "primary capital" or secondary capital," and the Office may permit one or more banks to include funds obtained through such instrument as primary or secondary capital, permanently or on a temporary basis, for the purposes of compliance with this Part or for other purposes.

Subpart B—Minimum Capital Ratios

§ 3.5 Applicability.

This subpart is applicable to all banks unless the Office determines, pursuant to the procedures set forth in Subpart C, that different minimum capital ratios are appropriate for an individual bank based upon its particular circumstances, or unless different minimum capital ratios have been established or are established for an individual bank in a written agreement or a temporary or final order pursuant to 12 U.S.C. 1818 (b) or (c), or as a condition for approval of an application.

§ 3.6 Minimum Capital Ratios.

A bank must have an maintain total capital equal to at least 6 percent of total assets and primary capital equal to at least 5½ percent of adjusted total assets.

§ 3.7 Plan to Achieve Minimum Capital ratios.

Any bank having total or primary capital ratios less than the minimums set forth in § 3.6 shall, within 60 days of the effective date of this regulation, submit to the Office a plan describing the means and schedule by which the bank shall achieve the minimum capital ratios. The plan may be considered acceptable unless the bank is notified to the contrary by the Office. A bank in compliance with an acceptable plan to achieve the minimum capital ratios will not be deemed to be in violation of § 3.6.

§ 3.8 Reservation of Authority.

When, in the opinion of the Office the circumstances so require, a bank may be authorized to have less than the minimum capital ratios in § 3.6 during a time period specified by the Office.

Subpart C—Establishment of Minimum Capital Ratios for an Individual Bank

§ 3.9 Purpose and Scope.

The rules and procedures specified in this subpart are applicable to a proceeding to establish required minimum capital ratios for an individual bank above the ratios that would otherwise be applicable to the bank under § 3.6. The Comptroller is authorized under 12 U.S.C. 3907(a)(2) to establish such minimum capital requirements for a bank as the Office, in its descretion, deems necessary or appropriate in light of the particular circumstances of that bank. Proceedings under this subpart may be initiated to require a bank to maintain existing capital ratios which are above those set forth in § 3.6 or other legal authority, as well as to require a bank to reach higher minimum capital ratios.

§ 3.10 Applicability.

Higher minimum capital ratios may be required for an individual bank when the Office believes that the bank's capital is or may become inadequate in view of its circumstances. For example, higher capital ratios than those required in § 3.6 may be appropriate for:

(a) A newly chartered bank;

(b) A bank in need of special supervisory attention;

(c) A bank which has or is expected to have losses resulting in capital inadequacy;

(d) A bank having a high proportion of off-balance sheet risk in relation to other assets and liabilities or a low proportion of liquid assets;

(e) A bank undergoing expansion, either internally or through acquisitions; or

(f) A bank which may be adversely affected by the activities or condition of its holding company, affiliate(s), or other persons or institution which which it has significant business relationships.

§ 3.11 Standards for Determination of Appropriate Individual Minimum Capital Ratios.

The appropriate minimum capital ratios for an individual bank cannot be determined solely through the application of a rigid mathematical formula or wholly objective criteria. The decision is necessarily based in part on subjective judgment grounded in agency expertise. The factors to be considered in the determination will vary in each case and may include, for example:

(a) The conditions or circumstances leading to the Office determination that higher mimimum capital ratios are appropriate or necessary for the bank;

(b) The exigency of those circumstances or potential problems;

(c) The overall condition, management strength, and future prospects of the bank and, if applicable, its holding company and/or affiliate(s);

(d) The bank's liquidity, capital and other ratios compared to the ratios of its peer group; and

(e) The views of the bank's directors and senior management.

§ 3.12 Procedures.

(a) *Notice.* When the Office determines that minimum capital ratios above those set forth in § 3.6 are necessary or appropriate for a particular bank, the Office will notify the bank in writing of the proposed minimum capital ratios and the date by which they should be reached (if applicable), and will provide an explanation why the ratios proposed are considered necessary or appropriate for the bank.

(b) *Response.* (1) The bank may respond to any or all of the items in the notice. The response should include any matters which the bank would have the Office consider in deciding whether individual minimum capital ratios should be established for the bank, what those capital ratios should be, and, if applicable, when they should be achieved. The response must be in writing and delivered to the designated OCC official within 30 days after the date on which the bank received the notice.

(2) Failure to respond within thetime period specified in paragraph (b)(1) of

this section shall constitute a waiver of any objections to the proposed minimum capital ratios or the deadline for their achievement.

(c) *Decision.* Within 30 days after the close of the bank's response period, the Office will decide, based on a review of the bank's response and other information concerning the bank, whether individual minimum capital ratios should be established for the bank and, if so, the ratios and the date the requirements will become effective. The bank will be notified of the decision in writing. The notice will include an explanation of the decision, except for a decision not to establish individual minimum capital requirements for the bank.

(d) *Submission of plan.* The decision may require the bank to develop and submit to the Office, within a time period specified, an acceptable plan to reach the minimum capital ratios established for the bank by the date required.

(e) *Amendment of time periods.* The Office may shorten the time periods specified in this subpart: (1) When, in the opinion of the Office, the condition of the bank so requires, provided that the bank is informed promptly of the new time periods; or (2) with the consent of the bank. In its discretion, the Office may extend the time periods for good cause. In particular, the time period for the Office's decision may be extended if, after receipt of the bank's response, further clarification or information is required, or there is a material change in the circumstances affecting either the bank's capital adequacy or its ability to achieve the proposed minimum capital ratios by the proposed date.

(f) *Change in circumstances.* If, after the Office's decision in paragraph (c) of this section, there is a change in the circumstances affecting the bank's capital adequacy or its ability to reach the required minimum capital ratios by the specified date, either the bank or the Office may propose to the other a change in the minimum capital ratios for the bank, the date when the minimums must be achieved, or the bank's plan (if applicable). The Office may decline to consider proposals that are not based on a significant change in circumstances or are repetitive or frivolous. Pending a decision on reconsideration, the Office's original decision and any plan required under that decision shall continue in full force and effect.

§ 3.13 Relation to other actions.

In lieu of, or in addition to, the procedures in this subpart, the required minimum capital ratios for a bank may be established or revised through a written agreement or crease and desist proceedings under 12 U.S.C. 1818(b) or (c) (12 CFR 19.0–18.21), or as a condition for approval of an application.

Subpart D—Enforcement

§ 3.14 Remedies.

A bank that does not have or maintain the minimum capital ratios applicable to it, whether established in Subpart B of this regulation, in a decision pursuant to Subpart C, in a written agreement or temporary or final order under 12 U.S.C. 1818 (b) or (c), or in a condition for approval of an application, or a bank that has failed to submit or comply with an acceptable plan to attain those ratios will be subject to such administrative action or sanctions as the Office considers appropriate, including issuance of a Directive pursuant to Subpart E, other enforcement action, assessment of civil money penalties, and/or the denial, conditioning, or revocation of applications. Failure to achieve or maintain the minimum primary capital ratio also may be the basis for an FDIC action to terminate federal deposit insurance. See 12 CFR 325.4(c).

Subpart E—Issuance of a Directive

§ 3.15 Purpose and Scope.

This subpart is applicable to proceedings by the Office to issue a directive under 12 U.S.C. 3907(b)(2). A directive is an order issued to a bank that does not have or maintain capital at or above the minimum ratios set forth in § 3.6, or established for the bank under subpart C, by a written agreement under 12 U.S.C. 1818(b), or as a condition for approval of an application. A directive may order the bank to (a) achieve the minimum capital ratios applicable to it by a specified date; (b) adhere to a previously submitted plan to achieve the applicable capital ratios; (c) submit and adhere to a plan acceptable to the Office describing the means and time schedule by which the bank shall achieve the applicable capital ratios; (d) take other action, such as reduction of assets or the rate of growth of assets, or restrictions on the payment of dividends, to achieve the applicable capital ratios; or (e) a combination of any of these or similar actions. A directive issued under this rule, including a plan submitted under a directive, is enforceable in the same manner and to the same extent as an effective and outstanding cease and desist order which has become final as defined in 12 U.S.C. 1818(k). Violation of a directive may result in assessment of civil money penalties in accordance with 12 U.S.C. 3909(d).

§ 3.16 Notice of intent to issue a directive.

The Office will notify a bank in writing of its intention to issue a directive. The notice will state:

(a) Reasons for issuance of the directive; and

(b) The proposed contents of the directive.

§ 3.17 Response to notice.

(a) A bank may respond to the notice by stating why a directive should not be issued and/or by proposing alternative contents for the directive. The response should include any matters which the bank would have the Office consider in deciding whether to issue a directive and/or what the contents of the directive should be. The response may include a plan for achieving the minimum capital ratios applicable to the bank. The response must be in writing and delivered to the designated OCC official within 30 days after the date on which the bank received the notice.

(b) Failure to respond within the time period specified in paragraph (a) of this section shall constitute a waiver of any objections to the proposed directive.

§ 3.18 Decision.

After the closing date of the bank's response period, or receipt of the bank's response, if earlier, the Office will consider the bank's response, and may seek additional information or clarification of the response. Thereafter, the Office will determine whether to issue the directive as originally proposed or in modified form. A directive will be issued, or the bank advised that the Office has decided not to issue a directive, within 30 days after the closing date of the bank's response period as set forth in § 3.17 unless the response period, or the time for the Office's decision, is extended under § 3.20.

§ 3.19 Issuance of a directive.

(a) A directive will be served by delivery to the bank. It will include or be accompanied by a statement of reasons for its issuance.

(b) A directive is effective immediately upon its receipt by the bank, or upon such later date as may be specified therein, and shall remain effective and enforceable until it is stayed, modified, or terminated by the Office.

§ 3.20 Amendment of time periods.

(a) The Office may shorten the time periods specified in this subpart:

(1) When, in the opinion of the Office, the condition of the bank so requires, provided that the bank shall be

informed promptly of the new time periods;

(2) With the consent of the bank; or

(3) When the bank already has advised the Office that it cannot or will not achieve its applicable minimum capital ratios.

(b) In its discretion, the Office may extend the time periods for good cause. In particular, the time period for the Office's decision may be extended if, after receipt of the bank's response, further clarification or information is required, or there is a material change in the circumstances affecting either the bank's capital adequacy or its ability to achieve the minimum capital ratios applicable to it by the specified date.

§ 3.21 Change in Circumstances.

Upon a change in circumstances, a bank may request the Office to reconsider the terms of its directive or may propose changes in the plan to achieve the bank's applicable minimum capital ratios. The Office also may take such action on its own motion. The Office may decline to consider requests or proposals that are not based on a significant change in circumstances or are repetitive or frivolous. Pending a decision on reconsideration, the directive and plan shall continue in full force and effect.

§ 3.22 Relation to Other Administrative Actions.

A directive may be issued in addition to, or in lieu of, any other action authorized by law, including cease and desist proceedings, civil money penalties, or the conditioning or denial of applications. The Office also may, in its discretion, take any action authorized by law, in lieu of a directive, in response to a bank's failure to achieve or maintain the applicable minimum capital ratios.

Dated: August 29, 1984.

C. T. Conover,

Comptroller of the Currency.

[FR Doc. 84-23313 Filed 8-31-84; 8:45 am]

BILLING CODE 4810-33-M

DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

14 CFR Part 71

[Airspace Docket No. 84-AGL-7]

Proposed Alteration of Transition Area

AGENCY: Federal Aviation Administration (FAA), DOT.

ACTION: Notice of proposed rulemaking.

SUMMARY: This notice proposes to alter the Monroe, Michigan, transition area to accommodate a new RNAV Runway 20 instrument approach to Custer Airport.

The intended effect of this action is to insure segregation of the aircraft using these approach procedures in instrument weather conditions from other aircraft operating under visual weather conditions in controlled airspace.

DATE: Comments must be received on or before October 4, 1984.

ADDRESS: Send comments on the proposal in triplicate to FAA Office of Regional Counsel, AGL-7, Attention: Rules Docket Clerk, Docket No. 84-AGL-7, 2300 East Devon Avenue, Des Plaines, Illinois 60018.

The official docket will be available for examination by interested persons in the office of the Regional Counsel, Federal Aviation Administration, 2300 East Devon Avenue, Des Plaines, Illinois 60018.

An informal docket will also be available for examination during normal business hours in the Airspace, Procedures, and Automation Branch, Air Traffic Division, Federal Aviation Administration, 2300 East Devon Avenue, Des Plaines, Illinois 60018.

FOR FURTHER INFORMATION CONTACT: Edward R. Heaps, Airspace, Procedures, and Automation Branch, Air Traffic Division, AGL-530, FAA, Great Lakes Region, 2300 East Devon Avenue, Des Plaines, Illinois 60018, telephone (312) 694-7360.

SUPPLEMENTARY INFORMATION: The development of a new RNAV instrument approach procedure requires that the FAA alter the designated airspace to ensure that the procedure will be contained within controlled airspace. The additional airspace designated will be approximately a 1.5 mile expansion to the existing transition area excluding that portion which overlies the Detroit, Michigan, 700-foot transition area.

The minimum descent altitudes for this procedure may be established below the floor of the 700-foot controlled airspace.

Aeronautical maps and charts will reflect the defined areas which will enable other aircraft to circumnavigate the area in order to comply with applicable visual flight rule requirements.

Comments Invited

Interested parties are invited to participate in this proposed rulemaking by submitting such written data, views, or arguments as they may desire. Comments that provide the factual basis supporting the views and suggestions presented are particularly helpful in developing reasoned regulatory decisions on the proposal. Comments are specifically invited on the overall regulatory, economic, environmental, and energy aspects of the proposal. Communications should identify the airspace docket and be submitted in triplicate to the address listed above. Commenters wishing the FAA to acknowledge receipt of their comments on this notice must submit with those comments a self-addressed, stamped postcard on which the following statement is made: "Comments to Airspace Docket No. 84-AGL-7." The postcard will be date/time stamped and returned to the commenter. All communications received before the specified closing date for comments will be considered before taking action on the proposed rule. The proposal contained in this notice may be changed in the light of comments received. All comments submitted will be available for examination in the Rules Docket both before and after the closing date for comments. A report summarizing each substantive public contact with FAA personnel concerned with the rulemaking will be filed in the docket.

Availability of NPRM

Any person may obtain a copy of this notice of proposed rulemaking (NPRM) by submitting a request to the Federal Aviation Administration, Office of Public Affairs, Attention: Public Information Center, APA-430, 800 Independence Avenue, SW., Washington, D.C. 20591, or by calling (202) 426-8058. Communications must identify the notice number of this NPRM. Persons interested in being placed on a mailing list for future NPRM's should also request a copy of Advisory Circular No. 11-2, which describes the application procedures.

The Proposal

The FAA is considering an amendment to § 71.181 of Part 71 of the Federal Aviation Regulations (14 CFR Part 71) to alter the transition area airspace near Monroe, Michigan.

Sections 71.171 and 71.181 of Part 71 of the Federal Aviation Regulations were published in FAA Order 7400.6, Part 1 dated January 3, 1984.

List of Subjects in 14 CFR Part 71

Transition areas, Aviation safety.

The Proposed Amendment

PART 71—[AMENDED]

Accordingly, pursuant to the authority delegated to me, the Federal Aviation Administration proposes to amend

U.S. HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION AND INSURANCE
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
NINETY-EIGHTH CONGRESS
WASHINGTON, D.C. 20515

September 11, 1984

Honorable C. Todd Conover
Comptroller of the Currency
490 L'Enfant Plaza, S.W.
Washington, D.C. 20219

Dear Mr. Conover:

To assist this Subcommittee in its inquiry into the circumstances that made it necessary to provide federal assistance to Continental Illinois Corporation (CIC) and Continental Illinois National Bank (CINB), you are asked to appear before the Subcommittee on Financial Institutions Supervision, Regulation and Insurance on September 19, 1984, at 10:00 am, in Room 2128 of the Rayburn House Office Building.

In your testimony, you are requested to provide the information and respond to the questions enumerated below:

(1) Provide a tabulation of the annual rates of asset growth, the ratio of primary capital (or comparable measures in earlier years) to total assets, the ratio of classified assets to gross capital funds, the ratio of purchased funds to total deposits, the ratio of rate sensitive deposits plus purchased funds to total deposits, the ratio of reserve for possible loan losses to total loans, and the return on average assets, since 1970 for CINB, for its peer money center banks as a group, and for all national banks as a group.

(2) What is the current condition of the portion of the banking industry for which you, as Comptroller of the Currency, are responsible?

(3) After the failure of Franklin National Bank, the Office of the Comptroller of the Currency undertook an extensive internal review of its examination and supervision practices and procedures. One of the principal recommendations of the Haskins and Sells study was the establishment of the National Bank Surveillance System. How was this system applied in the examination and supervision of CINB? Do you intend to modify the NBS System as a result of the CINB experience? What modifications do you anticipate will be made?

(4) As required by the provisions of the International Lending Supervision Act of 1983, the OCC has recently announced a proposed rule addressing the capitalization of national banks. Under the proposed rule, what amounts of capital would be regarded as adequate, marginal, or inadequate?

(5) With respect to each examination of CINB since 1977, how was CINB's high growth corporate plan announced in 1976, its growing dependence on purchased funds, and its high level of criticized and classified assets incorporated in evaluating its capital adequacy both in absolute terms and with respect to its peer money center institutions? Do you intend to modify OCC capital adequacy evaluation standards as a result of the CINB experience? If so, what modifications do you expect will be made?

(6) The management practices and financial soundness of Penn Square National Bank had a significant effect on the well-being of CINB. The problems in Penn Square were well known to OCC supervisory officials two full years before it failed. Explain in detail the examination findings and supervisory actions taken to correct Penn Square's problems in the three years preceding its failure and what actions OCC took to isolate Penn Square's problems from other commercial banks. What actions, for example, did your office take to notify OCC examiners working in banks with close ties with Penn Square of the loan management and soundness problems in that bank?

(7) Possibly the most knowledgeable individual in the OCC concerning CINB is Senior National Bank Examiner, Richard Kovarick. He was Examiner-in-Charge of the 1977 and 1982 examinations and participated in the 1979 and 1981 examinations. In his 1982 Letter to the Board of Directors, he wrote:

> "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 problems referred to by Mr. Kovarick were noted repeatedly by earlier examiners but were not viewed as being significant. What actions are being taken within OCC to assure that such management practices are effectively addressed before they become safety and soundness problems?

(8) What role did the OCC have in the development of the CIC/CINB Assistance Program? Review the chronology of the Assistance Program's development.

(9) Were all public statements made by you or your agency regarding the soundness of CINB consistent with the information you or your agency had at the time the statement was made?

(10) The cost of funds in open financial markets is closely related to the risk of nonpayment. Other things being equal, the cost of funds for those financial institutions the public views as being so large the government cannot allow them to fail will decline relative to the cost of funds for institutions not so viewed. In this respect, what are the long term implications of the Assistance Program for the competitive relationship between large and small banks and between bank holding company affiliated and non-affiliated businesses?

In accordance with Committee rules, please deliver 175 copies of each prepared statement to Room B303 Rayburn before 12:00 p.m. on September 17, 1984. Your prepared statement will be distributed to all Members of the Subcommittee in advance of the hearing and will be included in its entirety in the hearing record.

Sincerely,

Fernand J. St Germain
Chairman

FJStG:jDc

INQUIRY INTO CONTINENTAL ILLINOIS CORP. AND CONTINENTAL ILLINOIS NATIONAL BANK

THURSDAY, OCTOBER 4, 1984

House of Representatives, Subcommittee on Financial Institutions Supervision, Regulation and Insurance, Committee on Banking, Finance and Urban Affairs,

Washington, DC.

The subcommittee met, pursuant to call, at 10:25 a.m., in room 2128, Rayburn House Office Building, Hon. Fernand J. St Germain (chairman of the subcommittee) presiding.

Present: Representatives St Germain, Annunzio, Hubbard, Barnard, Vento, Patman, Lehman, Carper, Wylie, Hansen, Leach, McKinney, McCollum, and Wortley.

Also present: Representative Thomas J. Ridge of the full committee.

Chairman St Germain. The subcommittee will come to order.

We resume hearings this morning on Continental Illinois National Bank with testimony from its largest single stockholder, the Federal Deposit Insurance Corporation.

It may not have filtered through the ranks of the bureaucracy yet, but the Continental Illinois failure will have a lasting and heavy impact on the entire Federal financial regulatory system—and the public's acceptance of its role.

It raises fundamental questions about the fairness, cost and, most of all, the efficacy of a regulatory system built on the quicksand of secrecy, procrastination and expediency.

The Federal Deposit Insurance Corporation is revealed not as the solid cornerstone of confidence, but as the linchpin in the Federal Government's most costly and grandiose corporate welfare program. The FDIC finds itself not in its traditional role as champion of the small independent banks, but as the cashier in a fail-safe program for the biggest of our big banks—direct Government intervention that is certain to distort the marketplace in favor of the big and against the small.

Perhaps FDIC looks on itself as an unwilling partner forced to accept and pay the bills of its profligate fellow regulators. If that is the case, this hearing provides an excellent opportunity to set the record straight.

FDIC did have its moments of glory as the regulators sat around in those long agonizing, hand wringing sessions about their problem in Chicago.

Reading the examination reports, FDIC's supervisory personnel did spot the severity of the problems. In May 1983, ignoring the Comptroller of the Currency's lukewarm rating of a "3," (risks above normal) the FDIC declared the bank a full scale "4" (serious financial weakness) and threw the illustrious name of Continental on the agency's infamous list of problem banks.

At this point, FDIC looked like the star performer among the regulators. But, what did FDIC do with the information? Our investigators cannot find any alarms, red flags, or other signals that warned anyone that FDIC had found a rotten apple—a large rotten apple. Apparently, even the State banks—for which FDIC has a primary regulatory role—didn't get any signals, and the examiners appeared to have stood silently while they continued to move deposits into Continental—increasing FDIC liability in an institution they knew was a problem bank. In the final analysis, the supervisory personnel who insisted on the "4" rating might as well have stayed in bed for all the good their findings did.

A bailout of this magnitude raises monumental questions of public policy. Many of these questions, unfortunately, have been shrouded in the secrecy of the regulatory agencies and the seeming willingness of so many to accept at face value the ex post facto rationalizations that pour so freely in the background briefings and mimeographed handouts.

Even if one believes—and this takes some believing—that the regulators performed brilliantly, one surely must still question the power, the inordinate power, that is assumed by these agencies. Billions of dollars are committed, banking policy is changed, the marketplace redefined, without public hearings, without votes, without any of the checks and balances that we accept in our system. Perhaps all these gentlemen are the wisest of the wise and above reproach, but even such personal credentials would be a frail peg on which to hang such massive governmental power in a democracy.

The only thing that appears to top the magnitude of the outlays to save Continental is the mountain of misinformation, distortions, and half-truths that seem to surround every aspect of this case.

At times, the multibillion dollar bailout has been described as virtually cost-free. Even more frequently, the domino theory has been floated, suggesting that 75 or more banks would have failed had the regulators not staffed the bucket brigade. In fact, the regulators briefed Members of both the House and Senate in July and used the domino theory as the centerpiece of their contention that "we had no choice." Variations on the theme have been repeated time and again in major publications.

Unless one assumes that all the assets of Continental—and they were considerable—would have been vaporized overnight and that the entire support mechanisms of the regulatory system would have disappeared, the numbers are nothing less than absurd.

Unless they are more incompetent than we suspect, the agencies knew full well that the domino theory was concocted. At most—and this stretches a pessimistic scenario pretty far—may be a half dozen institutions would have been on the edge of a failure line. A more reasonable analysis suggests that these troubles could have been handled by the emergency mechanisms of the Federal regulatory system—incidentally at a fraction of the bailout costs of Continental. The number of dominoes is probably close to zero. At least one publication, I am happy to note, did question the domino theory. Associate Editor Sanford Rose wrote in Tuesday's edition of the American Banker: "It now appears that top bank regulators were something less than candid when they said that a significant number of small U.S. banks would fail unless Continental Illinois was bailed out." And Mr. Rose concludes: * * * the American public has the right to a little more honesty from its public officials than it apparently got in this sordid episode."

We have been analyzing the regulators' domino theory and will be developing these facts fully during the hearing. We can assure the American Banker that there is plenty of evidence to support Sanford Rose's conclusion.

The idea that the bailout is a painless cost-free exercise should be thrown in the same pile with other unsupported rationalizations. Yes, Continental could have a substantial budget impact—conceivably amounting to as much as $3.8 billion according to the Congressional Budget Office.

Unfortunately, FDIC's liquidation and bailout estimates often have a way of growing after the initial optimistic projections. When United American Bank and the other Butcher banks failed in Tennessee in 1983, the forecasts were that the FDIC would get out of that mess with costs of $400 million or less. Just last week, banking publications carried reports of estimates that FDIC's actual cost could probably top $1 billion—more than 100 percent above those well publicized and rosy predictions of 1983. The same people who came up with the United American projections programmed the same computer in calculating the costs of the Continental collapse.

In hopes of dampening the public's concerns over cost, the regulators have suggested that all this was being paid for with "play" money out of someone's Monopoly game. The insurance premiums which support, in part, the Government's guarantees to banks are paid ultimately by the customers of those institutions in the form of higher fees and interest rates. More important, it is absurd to think that the premiums begin to pay the value of the full faith and credit of the Federal Government which stands behind—and provides the real strength for the insurance funds.

The FDIC has a direct draw on the Treasury of $3 billion and when that is exhausted additional sums will have to be appropriated out of tax moneys.

This idea that somehow the FDIC's funds are bankers' money is disturbing. Taking some of these statements literally, there is a clear suggestion that the FDIC and the bankers have a perfect right to go off in the corner and divvy up the insurance fund in any manner that appears expedient. Such a mind-set, I fear, pervades the Federal bank regulatory system—a feeling that everything operates on an agency-constituency relationship—the rest of the Federal Government and the public notwithstanding.

Uncalculated in the cost figures of Continental is the liability incurred by the Federal Government in a fail-safe program for big banks as described by the Comptroller before this committee 2 weeks ago. Uncalculated also are the costs to smaller- and mediumsized banks and their communities which must face the distinct competitive disadvantages of a federally inspired fail-safe program for the big banks. That famous level playing field was stood on its end by the Continental bailout.

Support for Government programs depend in large part on the public's perception of how equitably those outlays are made in the economy. Clearly, fail-safe bailout policy for one class of banks and a hit and miss policy for the remainder of the industry is the very epitomy of unfairness and unequal treatment.

But, the double standard does not apply simply to small banks. From 1981 through 1983 we had between 70,000 and 80,000 business failures, the highest rate in 50 years. Where were the Continental-style Government bailouts for all the small business people who saw their doors padlocked for the last time?

All of us, I believe, would feel better if there was any strong evidence that the regulators approached the Continental problems in a concerted, businesslike manner and based their decision on hard-nosed data.

In truth and in fact, it appears that the three regulators made their initial decision to assist Continental with little in hand but the broad concept that the bank was "essential" in a global sense. At this point, not even a contrived list of dominoes was in hand and apparently no cost analysis which would have given the regulators a clue as to what route might save the Federal Government money. It appears that the decision to bailout was made on high in the early hours without any hard facts or empirical evidence. After that apparently the word went out to the bureaucracy to come up with numbers to rationalize the action for public consumption.

Again, this entire process calls for greater openness. It cries out for a greater degree of truthfulness. It does not enhance the confidence of the American people in the Federal regulatory structure to have one of its officials issue misleading statements about the condition of the bank as the Comptroller did during the early stages of the rescue effort. It does not enhance the credibility of the agencies to float distorted or manufactured numbers suggesting that the banking system would collapse like so many dominoes unless the money gates were opened wide.

The Continental failure doesn't have many bright spots, but it does explode some myths. It certainly disabuses any thought that the regulators—faced with the debris of Penn Square—got their act together. It's the same timid, uncoordinated, secretive regulatory system. It certainly suggests that one must take great care in accepting—on face value—stock tips coming out of the banking agencies or buying the sky-is-falling approach to public policy and outlays of Federal moneys. It ends the myth that there is a solid wall between the holding companies and their subsidiary banks. When the rescue squad raced into Chicago, it headed straight for the holding company and installed the life lines to the bank through that structure. Ever since, the poor fellows at Treasury have been shredding old copies of speeches and testimony which assured the world that there was a full and definitive separability between the holding company and the bank subsidiary.

Let's hope that a few other banking myths disappear before we end these hearings so that we can move the regulators back to the real world in which the American people reside.

At this point, I would ask unanimous consent to place the report from the Congressional Budget Office at the conclusion of my statement, without objection.

[The Congressional Budget Office report follows:]

CONGRESSIONAL BUDGET OFFICE
U.S. CONGRESS
WASHINGTON, D.C. 20515

Rudolph G. Penner
Director

October 3, 1984

Honorable Fernand J. St Germain
Chairman
Committee on Banking, Finance and
Urban Affairs
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

As you requested, the Congressional Budget Office has prepared an analysis of the estimated federal budget impact of the financial assistance provided to Continental Illinois National Bank and Trust Company.

There is much uncertainty about key factors in the analysis--especially the value of loans transferred to the FDIC and the future value of CI stock. Consequently, a single point estimate of the budgetary effects of the assistance plan is not feasible. Based on an assessment of various possible outcomes, CBO estimates that net federal outlays over the 1984-1990 period are likely to fall between -\$0.2 billion and \$3.8 billion. The outlays will be incurred by the FDIC and will appear on the unified budget.

If you wish further details on this estimate, we will be pleased to provide them.

Sincerely,

Eric Hanushek

for Rudolph G. Penner

October 3, 1984

CONGRESSIONAL BUDGET OFFICE

ANALYSIS OF THE FEDERAL BUDGET IMPACT OF ASSISTANCE TO THE CONTINENTAL ILLINOIS NATIONAL BANK AND TRUST COMPANY

INTRODUCTION

Over the past several months, agencies of the federal government have participated in efforts to maintain the viability of the Continental Illinois National Bank and Trust Company (CI). The assistance began with Federal Reserve loans to maintain the bank's liquidity and culminated in a long-term assistance plan announced on July 26, 1984 by the Federal Deposit Insurance Corporation (FDIC), the Comptroller of the Currency, and the Federal Reserve. CI stockholders approved that plan on September 26. At the request of Chairman St Germain of the House Committee on Banking, Finance and Urban Affairs, the Congressional Budget Office (CBO) has analyzed the rescue plan and has assessed its budget impact.

There is much uncertainty about key factors in the analysis--especially the value of loans transferred to the FDIC and the future value of CI stock. Consequently, a single point estimate of the budgetary effects of the assistance plan is not feasible. Based on an assessment of various possible outcomes, CBO estimates that net federal outlays over the 1984-1990 period are likely to fall between -$0.2 billion and $3.8 billion. The outlays will be incurred by the FDIC and will appear on the unified budget.

FDIC expenditures are not funded from general tax revenues, however. They are derived from a trust fund financed by insurance assessments paid by member banks. As a result, the cost of FDIC assistance will ultimately be borne by the banking system's depositors, borrowers, and/or stockholders.

The loan activity of the Federal Reserve and the administrative expenses of both the Fed and the Comptroller of the Currency will not have any significant budgetary effects. The Fed loans are at rates approximating its normal earnings, while the administrative activities are estimated to cost less than $1 million in 1984 and to fall within the normal scope of agency activities thereafter. There are no off-budget expenses associated with the assistance plan.

THE ASSISTANCE PLAN

The financial portion of the permanent assistance program for Continental Illinois (CI) consists of a purchase of CI loans and equity by the FDIC, for a total of $4.5 billion. In addition, the Federal Reserve is continuing its lending to Continental to help maintain the bank's liquidity.

Loan Purchases

The FDIC will purchase, for $3.5 billion, loans from CI with a face value of $5.7 billion. The loans will be transferred in two parts: the first group, with a face value of about $4.2 billion, was sold to the FDIC for $2.0 billion. The second group, with a face value of $1.5 billion, will be sold to the FDIC over the next three years for $1.5 billion. 1/ CI's selection of loans to be transferred is restricted in that: (a) loans must have been originated or committed prior to May 31, 1984, and (b) no loan to or guaranteed by a foreign government shall be transferred, except as agreed by the FDIC.

The FDIC will pay the $3.5 billion purchase price by assuming $3.5 billion of CI debt to the Federal Reserve. The FDIC will pay interest to the Fed quarterly, and will also pass through as principal payments to the Fed any collections, over and above interest and other expenses, on the $3.5 billion portfolio of troubled loans, until the Fed loan is repaid. Five years after the agreement is implemented, the FDIC will be required to pay off any remaining principal on the $3.5 billion in Fed loans. At that time, the FDIC will be compensated for any losses incurred on the loans by receiving an option to acquire, at $.00001 per share, a portion of the 40 million shares of CI currently outstanding. If the losses are $800 million or more, the FDIC will acquire all 40 million shares.

Equity Purchase

The FDIC purchased $1.0 billion in preferred stock in CI, divided into two non-voting issues. One issue, of $720 million, is convertible (upon sale to a third party) into 160 million shares of newly authorized common stock. This preferred stock will be entitled to dividends equivalent to those paid on common stock (though none are anticipated for at least a year). The second issue, of $280 million, will pay dividends at an adjustable rate based on current rates for certain U.S. Treasury securities. This issue is callable at the option of CI and, for the first three years, the dividend is payable in cash or in additional adjustable rate preferred stock.

THE BUDGET IMPACT

While a number of federal agencies have played a role in developing the assistance plan, the direct budget impact derives from the actions of the FDIC. The Federal Reserve Board and the Comptroller of the Currency are also involved in the plan, but their activities will not have any significant budget effects. The rescue plan may also affect the American and international financial systems and the U.S. economy, which could, in turn, affect the federal budget. The direct budgetary effects are highly uncertain, and there is no reliable way to predict the nature or magnitude of possible secondary effects.

1/ Instead of transferring loans, the bank has the option of paying all or part of the $1.5 billion in cash, but it is unlikely that this option will be exercised. This analysis assumes that the maximum amount of loans is sold.

The FDIC

All of the significant budgetary consequences of the plan are related to the activities of the FDIC. Assistance to banks and administrative expenses paid from the FDIC trust fund appear as outlays in the federal budget when they are disbursed. On the other hand, earnings on the trust fund portfolio, recoveries on previous investments, and insurance assessments paid by insured banks reduce budget outlays when they are received. Each of the FDIC transactions in this plan has a direct impact on the unified budget.

Fiscal Year 1984 Budget Impact. In May 1984, the FDIC provided $1.5 billion of a $2.0 billion loan to CI as part of a temporary assistance plan. 2/ This loan resulted in an initial $1.5 billion federal budget outlay. FDIC interest receipts were not significantly affected by this interim loan, because the interest payment by CI to the FDIC is approximately equivalent to the earnings the FDIC would have received on Treasury investments.

The permanent assistance plan became effective after approval by the CI stockholders on September 26, 1984. Under that plan, the interim loan was repaid, and the FDIC completed the $1.0 billion equity purchase, resulting in net federal outlays of $1.0 billion in fiscal year 1984. 3/

Loan Purchases. By acquiring the CI loans (having a face value of $5.7 billion), the FDIC will receive any principal and interest payments made by the borrowers, and these receipts will reduce net outlays. On the other hand, the FDIC's payments to the Fed to cover interest and principal on the $3.5 billion loan assumed from CI will increase FDIC outlays over the 1985-1989 period. It is likely that the receipts from the transferred loans will be less than the payments due to the Fed, and the difference between the two will be net additional outlays to the FDIC.

The plan also requires the FDIC to pay CI the amount by which interest the bank paid to the Fed on $2.0 billion of its borrowings exceeds collections on the initial $2.0 billion in transferred loans from July 26, 1984 to the implementation date of the plan. 4/ This amount is expected to be about $24 million, and will be paid in fiscal year 1985.

2/ Another $0.5 billion was provided by a group of U.S. banks.

3/ This analysis is consistent with the budgetary treatment projected by the FDIC and used in the Administration's mid-session budget estimates released in August. Alternatively, it is possible to view the assistance plan as a $3.5 billion loan from the Fed to the FDIC, and $4.5 billion in direct assistance from the FDIC to CI. Under such an interpretation, the entire $4.5 billion would be recorded as an outlay in 1984, rather than being spread out over a five-year period, and the FDIC's subsequent principal payments to the Fed would not be regarded as budget outlays. Total FDIC outlays over the 1984-1990 period would be the same with either treatment.

4/ This provision has an effect similar to that of transferring the first $2.0 billion in loans to the FDIC as of July 26, with the FDIC assuming $2.0 billion in CI loans to the Fed at the same time.

The value of the troubled loans acquired by the FDIC is the major uncertainty in the cost of the plan to the FDIC. CI has indicated that many of the loans will be for energy exploration and development activities, which have little prospect of success unless energy prices increase sharply. The transferred loans will also include real estate, shipping, and foreign private sector loans. All of the loans will be of poor quality on the date on which they are sold. According to the CI proxy statement, the loans will be administered to maximize recoveries to the FDIC over the five years prior to the valuation date.

To reflect the uncertainty as to the amount of likely loan collections, the CBO analysis is based on three alternative scenarios:

- an optimistic assumption--that the FDIC will collect $4.0 billion of principal and interest on the $3.5 billion in transferred loans.

- a pessimistic assumption--that collections of principal and interest will total about $2.0 billion on the $3.5 billion in transferred loans.

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

The estimated range of $2 billion to $4 billion in collections is based on FDIC's historical rate of recovery on assets obtained from failed institutions and on information from knowledgeable individuals in government agencies and in the financial community. Because a significant portion of the loans are related to energy development activities, the collections are very sensitive to oil prices. This analysis assumes relatively stable oil prices over the next five years (consistent with CBO's baseline projections). Loan recoveries could be greater or less than projected if oil prices were to dramatically increase or decrease.

A number of other factors affect the estimate of loan collections. On the pessimistic side, the loans are being specifically selected because of their expected poor performance; they include loans obtained from the Penn Square Bank and some foreign loans, which may be particularly difficult to collect. In addition, only the collections obtained in the first five years are applicable to the valuation date transactions. On the other hand, the FDIC is assuming these loans at a discount of close to 40 percent from the $5.7 billion face value. It is possible, therefore, that the rate of collections on the $3.5 billion could exceed the 70-75 percent of book value the FDIC estimates to be its average historical rate.

The analysis also assumes a relatively steady stream of FDIC loan collections and FDIC repayments to the Fed over the five-year period. It is possible that these flows could be uneven. For example, the FDIC could sell some of the transferred loans and/or pay off the Fed loan early, resulting in large cash flows in a particular year.

Table 1 shows the budget effects of the loan purchase transaction under each of the above assumptions. It is displayed in two components, with outlays occurring at the end of the five-year period (the "valuation date") shown separately from those occurring at other times during the 1985-1989 period. Under the optimistic assumption, the FDIC would be able to pay back about $2.7 billion in principal of the $3.5 billion Fed loan from its loan collections before the valuation date, and net FDIC outlays over the five-year period would be about $0.6 billion. Under the pessimistic assumption, $3.2 billion in principal would remain unpaid until the valuation date, and net outlays associated with the loan purchase transactions over the five-year period would be $3.1 billion. Under the midpoint assumption, the FDIC would repay $1.5 billion in principal from its loan collections before the valuation date, and net FDIC outlays from the loan transactions would be $1.9 billion from 1985 through 1989. In all cases, some additional loan collections may occur after 1989, but the amounts are not likely to be substantial.

TABLE 1. EFFECT OF LOAN PURCHASES ON FDIC OUTLAYS
(By fiscal year, in billions of dollars)

	1985-1989 Excluding Valuation Date Transactions	Valuation Date Transactions	Total 1985-1989
Optimistic:			
FDIC payments to Fed:			
Principal	2.7	0.8	3.5
Interest	1.1	*	1.1
FDIC loan receipts (net of expenses)	-4.0	---	-4.0
Net FDIC outlays	-0.3	0.9	0.6
Pessimistic:			
FDIC payments to Fed:			
Principal	0.3	3.2	3.5
Interest	1.5	0.1	1.6
FDIC loan receipts (net of expenses)	-2.0	---	-2.0
Net FDIC outlays	-0.2	3.3	3.1
Midpoint:			
FDIC payments to Fed:			
Principal	1.5	2.0	3.5
Interest	1.3	*	1.4
FDIC loan receipts (net of expenses)	-3.0	---	-3.0
Net FDIC outlays	-0.2	2.1	1.9

* Less than $50 million.

NOTE: Details may not add to totals because of rounding.

Equity Purchases. The FDIC paid $1 billion for preferred stock--$720 million for preferred convertible into 160 million shares of common, and $280 million for floating rate preferred. Under the pessimistic and midpoint assumptions used in this analysis, the FDIC would acquire an additional 40 million shares of common stock at a total cost of $400, as a result of losses incurred on the acquired loans. (There could be a maximum of 240 million shares of common stock outstanding, which would occur if present shareholders exercise their right to acquire up to 40 million additional shares of CI.) In the optimistic case, the FDIC would acquire about 28 million shares.

For the purpose of this analysis, CBO has assumed that the floating rate preferred stock would be sold in about three years, after accumulating dividends over that period in the form of additional stock. It is likely that such stock could be sold at a negligible discount, because it will be earning rates equivalent to those of Treasury securities. On this basis, FDIC receipts from the sale are projected to be about $0.4 billion.

The value of the remaining stock--the preferred stock convertible into 160 million shares of common, plus up to 40 million additional shares of common--will depend on the market price of CI common stock, which in turn depends on the success of the "new" CI and the market's assessment of its prospects. For the purpose of this analysis, CBO has assumed that the FDIC would sell its rights to 160 million shares in 2-3 years. 5/ (The additional shares would be obtained on the valuation date, and would probably be sold shortly thereafter.) The budget impact is estimated using optimistic, pessimistic, and midpoint assumptions, with prices of $7.00, $1.00, and $4.00, respectively, per share of common stock.

Each stock price assumption represents a number of different possible combinations of the key factors that determine prices. As an example, the $4.00 price could be considered to represent a return on total assets of 0.6 percent, about what CI earned in 1979-1981 and typical for large banks over the past several years, applied to a projected asset base of about $27 billion and valued at six times earnings, currently typical for a large bank. The $7.00 price would represent assumptions on the high end of the industry's recent experience--for example, a return on assets of 0.7 percent and a price-earnings ratio of 8:1--applied to a larger asset base of $30 billion. The $1.00 price would represent assumptions on the low end of recent industry experience--for example, a return of 0.2 percent of assets and valuation at four times earnings--applied to $25 billion in assets.

On this basis, the FDIC's receipts from the sale of the convertible preferred and common stock would range from $0.2 billion (pessimistic) to $1.3 billion (optimistic), with a midpoint of $0.8 billion--in addition to the $0.4 billion from the floating rate preferred stock. The budget impact of all the equity transactions, net of the $1.0 billion purchase price, is projected to range from a net outlay of $0.4 billion to a net receipt of $0.7 billion, excluding interest costs. These estimates are summarized in Table 2.

5/ The FDIC has indicated that it would sell the stock "as soon as practicable." It is likely to wait, however, until CI's financial situation is stabilized in the hope of obtaining a high sale price.

TABLE 2. EFFECT OF EQUITY PURCHASES ON FDIC OUTLAYS

	Assumed market price per share of common stock (in dollars)	Receipts from stock sales (in billions of dollars)	Net gain (+) or loss (-) on equity purchases (in billions of dollars)
Optimistic	7.00	1.7	0.7
Pessimistic	1.00	0.6	-0.4
Midpoint	4.00	1.2	0.2

Net Effect on FDIC Outlays. The overall budget impact on the FDIC is summarized in Table 3. It includes the results of the loan and equity purchases, as well as dividend income 6/ and the loss of interest on the FDIC portfolio as a result of the outlays for CI assistance. Net outlays over the 1985-1990 period are projected to range from -$0.2 billion (using optimistic stock price and loan collection assumptions) to $3.8 billion (using pessimistic assumptions), with a midpoint estimate of $1.8 billion.

These estimates do not include any change in the insurance assessments paid by member banks and retained by the FDIC. The assessment rate is set by statute, at 1/12 of 1 percent of total domestic deposits (after adjustment for deposits in transit), and it cannot be changed by the FDIC. If assessment income exceeds the amounts required to meet the FDIC's expenses and insurance losses and to maintain the trust fund at an appropriate level, banks generally receive a credit against their next year's assessments. While historically the rebate has been about 50 percent, the record number of recent bank failures has been reducing this percentage annually, so that a rebate toward the 1985 assessments is not expected, even without the CI transactions. Thus, FDIC expenses related to bank failures reduce potential credits toward FDIC's insurance assessments and lead to higher bank costs. These costs are passed on to depositors, borrowers, and/or stockholders.

If the FDIC incurs losses in future years as a result of CI, as in the pessimistic and midpoint cases, it would reduce or eliminate insurance rebates that might otherwise be made. If losses exceed FDIC income, equity in the trust fund would be reduced. Over time, the FDIC recovers a majority of its losses through the bank assessments. There is no reliable basis for projecting when the FDIC would be able to replenish its trust fund from such assessments.

6/ Dividends are assumed to be paid starting in fiscal year 1986, at an annual rate of about 40 cents per share in the optimistic case and 20 cents per share in the midpoint case. No dividends are assumed in the pessimistic case.

TABLE 3. NET BUDGET IMPACT OF FDIC TRANSACTIONS
(Outlays, by fiscal year, in billions of dollars)

	1984	1985-1989 Excluding Valuation Date Transactions	Transactions on Valuation Date or Shortly Thereafter	Total 1984-1990
Optimistic:				
Equity purchases (+) and sales (-)	1.0	-1.5	-0.2	-0.7
Net collections on transferred loans	---	-4.0	---	-4.0
Interest and principal paid to Fed and CI	---	3.7	0.9	4.6
Loss of interest on portfolio less cash dividends received	---	-0.1	---	-0.1
NET OUTLAYS	1.0	-1.9	0.7	-0.2
Pessimistic:				
Equity purchases (+) and sales (-)	1.0	-0.5	*	0.4
Net collections on transferred loans	---	-2.0	---	-2.0
Interest and principal paid to Fed and CI	---	1.8	3.3	5.1
Loss of interest on portfolio less cash dividends received	---	0.3	---	0.3
NET OUTLAYS	1.0	-0.4	3.2	3.8
Midpoint:				
Equity purchases (+) and sales (-)	1.0	-1.0	-0.2	-0.2
Net collections on transferred loans	---	-3.0	---	-3.0
Interest and principal paid to Fed and CI	---	2.8	2.1	4.9
Loss of interest on portfolio less cash dividends received	---	0.1	---	0.1
NET OUTLAYS	1.0	-1.1	1.9	1.8

* Less than $50 million.

NOTE: Details may not add to totals because of rounding.

What is even harder to assess is the potential budget impact of the alternatives that were available to the FDIC. For example, in many similar situations involving smaller banks, the FDIC has closed the bank and merged it with an existing institution or created a new bank. The FDIC sought to make similar arrangements for Continental Illinois, but the bank size, the volatility of its funding sources, and the composition of its assets made finding a suitor difficult. The FDIC received one tentative offer to take ownership of the bank, but rejected it as too costly.

Alternatively, the bank could have been closed and depositors paid off to the statutory limit. The FDIC would have been named receiver of the bank's assets, would have paid off depositors and creditors as necessary, and would have recovered as much of such payments as possible by liquidating the bank's assets. Insured deposits at that time were only $3 billion to $4 billion, and creditors (including the Federal Reserve) were owed in excess of $3 billion. The FDIC, along with financial institutions and other depositors with holdings in excess of $100,000, would have shared in any losses, which might have threatened the financial viability of some of the affected institutions. Once the FDIC had agreed to guarantee all deposits and general creditors, its direct liability in the event of a CI failure would have been about $38 billion, though its net liability after recoveries would have been considerably less. In either case, the failure of a bank of CI's magnitude might have caused a general loss of confidence in American banking institutions, and the long-term budgetary and economic impact, although impossible to measure, could have been enormous.

The Federal Reserve Board

While the Federal Reserve System is off-budget, the bulk of Federal Reserve earnings are returned to the Treasury and counted as miscellaneous receipts in the unified budget. Therefore, any activity which changes Federal Reserve earnings can be considered to have a revenue effect. The Federal Reserve's loans to Continental Illinois totaled about $7 billion in late August, and more may be made in the future. These loans do not appear to have affected the size of the Fed's portfolio. Federal Reserve earnings could be affected by any difference between the interest rate the Federal Reserve receives on the Continental loans and what it would have earned on alternative instruments. The rate paid by CI and the rate assumed by the FDIC (the three-month Treasury bill rate plus 25 basis points) are close to the rate the Fed might be expected to have earned on the mix of short-term Treasury securities it presumably gave up for the CI loans. Administrative costs associated with the rescue effort cannot be determined precisely, but they have been less than $1 million in 1984 and are not likely to be substantial in the future. Therefore, any revenue effect is expected to be negligible.

Comptroller of the Currency

The Comptroller of the Currency is the primary supervising agency of national banks, including CI. In order to monitor the financial condition of CI and assist in developing the rescue plan, the Comptroller has shifted some resources, primarily staff time, to assist with the CI effort, but does not expect total agency obligations to increase in 1984 or subsequent years because of activities related to CI. As a result, no significant budget impact is expected to result from the Comptroller's activities.

Chairman ST GERMAIN. Mr. Wylie.

Mr. WYLIE. Thank you very much, Mr. Chairman.

I have a much shorter statement with a slightly different view.

I am pleased to have the opportunity to say to Chairman Isaac publicly what I have already said to him privately: that I think his handling of the Continental situation was highly commendable given the choices that were available to you and the amount of time you had to react. It has become a cliche to say that the regulators had no choice but to act as they did in the case of Continental, and Chairman Isaac presents this argument forcefully in his statement today.

What this subcommittee and the full Banking Committee must realize is that if we want the regulators to have more choices, if we want large and small banks to be treated alike, and if we want to avoid bailouts of failed managers, it is up to us to make those options possible, and in general to enlarge the range of options available to meet unforeseeable circumstances.

Chairman Isaac makes the point very well in his statement when he says, "While a great many people in and out of government deplore the necessity of Continental-type rescue efforts, few appear to be willing to make fundamental changes in the system that gave rise to it."

The task ahead is to reform the deposit insurance system and to improve the supervision of depository institutions with special attention to internal controls and capital adequacy. Chairman Isaac has submitted a thought-provoking proposal—the Federal Deposit Insurance Improvements Act of 1984, H.R. 5738—which I have introduced at his request. Tuesday's Wall Street Journal carried an article about an FDIC proposal to raise insured banks' capital to 9 percent by allowing subordinated debt securities to be converted. Additional proposals for long overdue regulatory reforms will be forthcoming, in particular from Vice President Bush's task force group on the regulation of financial services. Our task will be complicated by the need to implement any changes gradually, so that the system can make an orderly adjustment. Ideally, the market should be on notice as to how the regulators will handle these situations which are foreseeable so that the damage done by rumors and reckless speculation can be contained.

We have an opportunity to make a significant contribution to the safety and soundness of the banking industry on which the health of the entire economy depends. Although, Mr. Chairman, I personally was disappointed by your announcement of September 21 about enacting banking legislation this year, I respect your decision as being realistic and I do find comfort in your statement that the House Banking Committee will consider these important issues in the next session.

I want to assure you that I offer you my full assistance and that of my staff to get on with early hearings, not just on the subjects of loopholes and asset deregulation, but also on reforming our deposit insurance system and our Federal examination and supervisory system to assure the kind of financial system which can meet the challenges ahead and support a growing and vibrant American economy. Thank you very, very much for this opportunity.

[The opening statement of Congressman Wylie follows:]

STATEMENT OF
REP. CHALMERS P. WYLIE, OHIO
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
HEARINGS ON CONTINENTAL ILLINOIS
OCTOBER 4, 1984

MR. CHAIRMAN:

I AM PLEASED TO HAVE THE OPPORTUNITY TO SAY TO CHAIRMAN ISAAC PUBLICLY WHAT I'VE ALREADY SAID TO HIM PRIVATELY, THAT HIS HANDLING OF THE CONTINENTAL SITUATION WAS HIGHLY COMMENDABLE, GIVEN THE CHOICES THAT WERE AVAILABLE TO YOU AND THE AMOUNT OF TIME YOU HAD TO REACT.

IT HAS BECOME A CLICHE TO SAY THAT THE REGULATORS HAD NO CHOICE BUT TO ACT AS THEY DID IN THE CASE OF CONTINENTAL, AND CHAIRMAN ISAAC PRESENTS THIS ARGUMENT FORCEFULLY IN HIS STATEMENT TODAY. WHAT THIS SUBCOMMITTEE AND THE FULL BANKING COMMITTEE MUST REALIZE IS THAT IF WE WANT THE REGULATORS TO HAVE MORE CHOICES THAN THEY HAD IN THIS INSTANCE, IF WE WANT LARGE AND SMALL BANKS TO BE TREATED ALIKE, AND IF WE WANT TO AVOID UNSEEMLY BAILOUTS OF FAILED MANAGERS, IT IS UP TO US TO MAKE THOSE OPTIONS POSSIBLE, AND IN GENERAL TO ENLARGE THE RANGE OF OPTIONS AVAILABLE TO MEET UNFORESEEABLE CIRCUMSTANCES.

CHAIRMAN ISAAC MAKES THE POINT VERY WELL IN HIS STATEMENT WHEN HE SAYS, "WHILE A GREAT MANY PEOPLE IN AND OUT OF GOVERNMENT DEPLORE THE NECESSITY OF CONTINENTAL-TYPE RESCUE EFFORTS, FEWER APPEAR TO BE WILLING TO MAKE FUNDAMENTAL CHANGES IN THE SYSTEM THAT GAVE RISE TO IT."

THE TASK AHEAD IS TO REFORM THE DEPOSIT INSURANCE SYSTEM AND TO IMPROVE THE SUPERVISION OF DEPOSITORY INSTITUTIONS, WITH SPECIAL ATTENTION TO INTERNAL CONTROLS AND CAPITAL ADEQUACY. CHAIRMAN ISAAC HAS SUBMITTED A THOUGHT PROVOKING PROPOSAL, THE FEDERAL DEPOSIT INSURANCE IMPROVEMENTS

ACT OF 1984 (H.R. 5738) WHICH I INTRODUCED AT HIS REQUEST ON MAY 24, 1984. TUESDAY'S WALL STREET JOURNAL CARRIED AN ARTICLE ABOUT AN FDIC PROPOSAL TO RAISE INSURED BANKS CAPITAL TO 9% BY ALLOWING SUBORDINATED DEBT SECURITIES TO BE CONVERTED. ADDITIONAL PROPOSALS FOR LONG OVERDUE REGULATORY REFORMS WILL BE FORTHCOMING, IN PARTICULAR FROM VICE PRESIDENT BUSH'S TASK GROUP ON THE REGULATION OF FINANCIAL SERVICES. OUR TASK WILL BE COMPLICATED BY THE NEED TO IMPLEMENT ANY CHANGES GRADUALLY, SO THAT THE SYSTEM CAN MAKE AN ORDERLY ADJUSTMENT. IDEALLY, THE MARKET SHOULD BE ON NOTICE AS TO HOW THE REGULATORS WILL HANDLE THOSE SITUATIONS WHICH ARE FORESEEABLE, SO THAT THE DAMAGE DONE BY RUMORS AND RECKLESS SPECULATION CAN BE CONTAINED.

MR. CHAIRMAN, WE HAVE AN OPPORTUNITY TO MAKE A SIGNIFICANT CONTRIBUTION TO THE SAFETY AND SOUNDNESS OF THE BANKING INDUSTRY, ON WHICH THE HEALTH OF THE ENTIRE ECONOMY DEPENDS. ALTHOUGH I PERSONALLY WAS DISAPPOINTED BY YOUR ANNOUNCEMENT OF SEPTEMBER 21ST ABOUT ENACTING BANKING LEGISLATION THIS YEAR, I RESPECT YOUR DECISION AS BEING REALISTIC, AND I DO FIND COMFORT IN YOUR STATEMENT THAT THE HOUSE BANKING COMMITTEE WILL CONSIDER THESE IMPORTANT ISSUES. I TRUST YOU WILL MAKE THESE HEARINGS ON THE FINANCIAL SERVICES INDUSTRY YOUR FIRST PRIORITY NEXT CONGRESS. I WANT TO ASSURE YOU THAT I OFFER YOU MY FULL ASSISTANCE, AND THAT OF MY STAFF, TO GET ON WITH EARLY HEARINGS, NOT JUST ON THE SUBJECTS OF LOOPHOLES AND ASSET DEREGULATION, BUT ALSO ON REFORMING OUR DEPOSIT INSURANCE SYSTEM AND OUR FEDERAL EXAMINATION AND SUPERVISORY SYSTEM TO ENSURE THE KIND OF FINANCIAL SYSTEM WHICH CAN MEET THE CHALLENGES AHEAD AND SUPPORT A GROWING AND VIBRANT AMERICAN ECONOMY.

Chairman ST GERMAIN. Thank you, Mr. Wylie.

I would announce to the members of the subcommittee that at this time we are going to ask one of our staff members, Mr. Dugger, accompanied by a gentleman who has been assigned to the committee by the GAO—along with others, GAO has provided facts and computer data, and so forth, to the committee staff that has compiled and produced the drafts that will be explained to us by Mr. Dugger.

So, prior to Mr. Isaac's testimony we wish to get this into the record so Mr. Isaac could then comment on these numbers when he testifies subsequent to our discussion with Mr. Dugger and Mr. Bowser.

I would ask the two gentlemen, Mr. Dugger and Mr. Bowser, to rise at this point.

Do you swear that the testimony you are about to give will be the truth, the whole truth and nothing but the truth?

Mr. DUGGER. I do.

Mr. BOWSER. I do.

Chairman ST GERMAIN. You may proceed, Mr. Dugger.

TESTIMONY OF ROBERT H. DUGGER, SUBCOMMITTEE DEPUTY STAFF DIRECTOR: ACCOMPANIED BY GARY BOWSER, SENIOR AUDITOR, GENERAL ACCOUNTING OFFICE

Mr. DUGGER. Mr. Chairman, and members of the subcommittee, you each have before you a copy of a committee staff report on the potential impact of a Continental bank failure on banks which had exposure in the form of deposits or Federal funds investments in that bank. This report, which I shall refer to as the staff report, attempts simply to clarify certain findings obtained last June by the FDIC staff concerning the exposure of certain banks to a Continental bank failure.

This report was prepared by the committee staff, but particular credit must go to the individual on my right, Gary Bowser, and his colleagues. Gary is a senior GAO auditor on assignment to the committee to assist us in carrying out the Continental inquiry.

He and I together will attempt to answer any questions you may have at the conclusion of my brief presentation.

Last May, Continental Bank's situation reached a point that the FDIC, Comptroller of the Currency and Federal Reserve concluded that a $2 billion temporary assistance program had to be implemented on an emergency basis. The temporary assistance program went into effect on May 17. About 20 days later, as best we can determine, FDIC Chairman Isaac asked his staff to obtain information on the deposit and investment exposure of other banks in Continental. His staff produced two memoranda which appear in the appendix of the staff report, dated June 20 and June 22, about 34 days after implementation of the temporary assistance plan.

Chairman ST GERMAIN. Is that the assistance plan of May 10 or 15?

Mr. DUGGER. May 17.

These two memoranda have been referred to in official statements on a number of occasions. This may be because the memoranda contain the only extended discussion of any of the aspects of

Continental Bank on which the FDIC's essentiality finding was based.

The information contained in the memoranda was referred to, for example, in the conference call made by Chairmen Volcker and Isaac and Comptroller Conover to the chairmen and ranking minority members of the House and Senate Banking Committees, the evening before the permanent assistance package was approved on July 26.

The information in the memoranda was referred to again most recently by Comptroller Conover when he testified before this subcommittee 2 weeks ago.

On that occasion, Mr. Conover said "If Continental Bank had failed and had been treated as a payoff, certainly those 66 banks would have failed and probably a goodly number of the other 113 would have failed; if not immediately thereafter, certainly within some timeframe afterwards. So let us say that we could have seen another 100 banking failures."

This statement and others like it which attempt to justify the Continental assistance program failed to give appropriate weight to three important limitations in the analysis contained in the two FDIC memoranda prepared last June. The limitations appear to be the result of the FDIC staff providing Mr. Isaac only what he asked for and the brief amount of time available to them to perform that very difficult task.

The limitations are, first, the benefit of $100,000 in deposit insurance coverage is not incorporated in the analysis.

Two, the benefit of the proceeds from a sale of Continental Bank's assets is also not incorporated in the analysis.

Three, the deposit and investment data used in the analysis is as of April 30, a date prior to the enormous deposit outflows and public concerns about Continental Bank.

To properly assess the impact of a Continental Bank failure on those banks with deposits in it or on the banking system generally, far more information than is contained in the two FDIC memoranda would be needed. At a minimum, the effect of deposit insurance, asset sales, and deposit shifts after Continental's troubles became well known, should be included.

To assist the subcommittee in its inquiry, the committee staff has recomputed the information in the two FDIC staff memoranda, this time to include the benefits of deposit insurance and asset sales.

We have also requested the FDIC to provide information on the level of deposits as of June 30 for those banks with significant exposures in Continental.

The analysis, incorporating deposit insurance and asset sales, is in the report in front of you and reflected in the charts along the far wall.

The June 30 deposit information will have to await an opportuity to discuss it at a later date. It is simply not available this morning.

The FDIC staff memoranda focused on the amount of demand deposits, time deposits and Federal funds invested by individual banks in Continental. The sum of these items is referred to as a bank's exposure.

The FDIC staff found that there were 113 banks with exposures in Continental amounting to between 50 and 100 percent of their equity capital. They found that 66 banks had over 100 percent of their equity capital exposed.

From these facts, it has been concluded by various agency officials, as Mr. Conover did 2 weeks ago, that if Continental had failed, 66 banks would have had 100 percent of their capital wiped out and another 113 would have had their equity capital significantly impaired. That is, if Continental Bank had failed, it would have resulted in the failure of 179 banks with total assets of $17 billion.

For this conclusion to be true, one must assume that the banks would not receive an insurance payment from the FDIC covering the first $100,000 of their deposits in Continental, and that in the subsequent liquidation of Continental Bank, there would be no recovery from the sale of Continental's assets.

Chairman ST GERMAIN. Excuse me, are you saying that according to the FDIC's data, the assumption was apparently made that Continential's loans were valueless?

Mr. DUGGER. That is correct.

Chairman ST GERMAIN. So you have to assume that out of all those assets, there would be nothing coming from them?

Mr. DUGGER. Correct. Neither of these assumptions are true. And what considerations are included in an impact analysis, the number of banks that apparently would be seriously affected by Continental failure decreases significantly.

Chris, could you bring the chart up, please? This chart and the analysis in the staff report reflect an initial subtraction of $100,000 from the insured deposits to account for FDIC deposit insurance. With this done, the number of banks with deposits exceeding 100 percent of capital drops to 65. The number of banks with deposits between 50 and 100 percent drops to 101. The number of banks in each of these categories, for various levels of recovery assumptions, is portrayed in this chart and in the report.

You may find table 4 in the report particularly useful at this point. The top line of numbers in table 4 in the report corresponding to a recovery assumption of zero is what the FDIC staff would have obtained had they been asked to net out deposit insurance.

On this chart, this is reflected as the number of banks at the zero recovery level, that is, at this point here, assumed percent of recovery, zero, the number of banks is about 65 with greater than 100 percent of assets at risk; and between 50 and 100 percent of assets, a number of 101 with deposit——

Mr. VENTO. Mr. Chairman, did you research what the cost of that would be? What would be the price to the FDIC insurance fund for that particular insurance? Do we have that information?

Mr. DUGGER. I believe we will touch on that point in a moment.

Mr. VENTO. Thank you.

Mr. PATMAN. Could I ask a question at this point?

Chairman ST GERMAIN. Could we allow him to finish. Then we will have questions and answers.

Mr. DUGGER. With deposit insurance taken care of, the question becomes how much would the banks have received from the general liquidation of Continental Bank? This is a very difficult question to answer. The only guide is the FDIC historical recovery rate from liquidating institutions much smaller than Continental.

We have been told that the FDIC historically has been able to recover from 72 to 74 cents on the dollar. You should be aware that there are strong arguments justifying both higher and lower recovery levels in the case of Continental. Therefore, in the absence of any other indicator, the subcommittee may wish to consider accepting a level of 70 percent, a level somewhat below this FDIC historical performance for the purpose of discussion today.

If this is done, the number of banks that would be seriously affected by a Continental failure is indicated in table 4 on the line corresponding to the 70-percent recovery level, and in this chart, as the point above the 70-percent recovery level, that would be right about here, at this level.

In this context, assuming the banks in both groups, that is groups between 50 and 100 and those above 100 percent of capital at risk, the number of banks with over 50 percent of capital at risk would be 28; the volume of banking assets would be $1.47 billion, or $1.5 billion. The amount of losses to those 28 banks would be $58 million.

This is a very different assessment of the impact of a Continental Bank failure from the 179 banks with $17 billion in assets, and $1 billion in losses referred to by some agency officials.

Chairman ST GERMAIN. Does that answer your question, Bruce?

Mr. DUGGER. Before concluding, I would like to direct your attention to the two other aspects of the information staff developed which bear directly on the seriousness of the impact on the depositing banks and on the time sensitivity of the information.

As you discussed on page 16 of the committee staff report, of the 179 banks with significant exposures in Continental, 58 had no uninsured deposits at all in Continental. This means that the exposure that jeopardized the solvency of these banks was due entirely to their Federal funds investment in Continental Bank.

Federal funds investments are uninsured overnight investments made by banks in other banks. They are generally made only on the basis of which bank is offering the highest overnight interest rate and are not indicative of what is generally understood as a correspondent banking relationship. Correspondent relationships involve provision of check clearing, cash handling, loan funding, and other banking services generally by a larger bank to smaller banks.

A precipitous cutoff in a correspondent relationship could cause a hardship on a smaller bank. Ending a Federal funds investing relationship would cause no such hardship to the investing bank. It would simply invest its funds elsewhere. The amount of interest sensitive deposit and Federal funds investments in Continental are likely to have been sensitive to public concerns about that bank and, therefore, the level of these exposures may have declined in May and June.

It was for this reason that the FDIC was asked to gather information concerning the June 30 level of exposure.

That completes our presentation of the staff report, Mr. Chairman. Gary and I will do our best to answer any questions you or the other members of the subcommittee may have.

[The staff report entitled "Continental Illinois National Bank Failure and Its Potential Impact on Correspondent Banks" follows:]

CONTINENTAL ILLINOIS NATIONAL BANK
FAILURE AND ITS
POTENTIAL IMPACT ON
CORRESPONDENT BANKS

STAFF REPORT

TO

SUBCOMMITTEE ON FINANCIAL INSTITUIONS SUPERVISION, REGULATION AND INSURANCE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

October 4, 1984

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

CONTENTS

Executive Summary

This report discusses the potential impact of the liquidation of Continental Illinois National Bank on banks with deposits and federal funds in Continental Bank. The report is divided into three sections.

In the first section, we present (1) three charts which provide information on the number of banks, total assets, and the amount of loss as related to various percentages of recoveries from that would have resulted from a possible Continental Illinois National Bank liquidation for those banks with an uninsured loss in excess of 50% of their equity capital, (2) a table summarizing the data values used to produce the 3 charts, (3) a series of tables providing information on banks that had at least $10 million of funds invested in Continental Illinois Bank and a percent of exposure to capital less than 50%.

The second section presents the Federal Deposit Insurance Corporation's calculation and the Committee's recalculation of the potential impact that the failure of Continental Illinois National Bank would have had on its "correspondent banks."

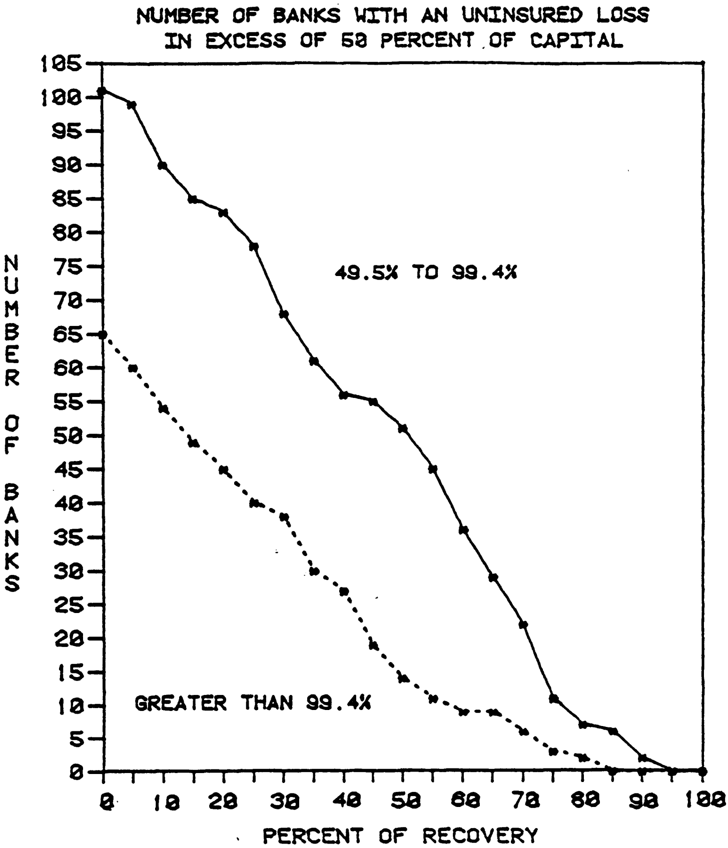
The third section discusses the cost analysis that is normally used by the Federal Deposit Insurance Corporation to determine the least costly method of assistance.

Section 1

Statistical data on the number of banks, total assets, and amount of loss for those banks with an uninsured loss in excess of 50% of capital

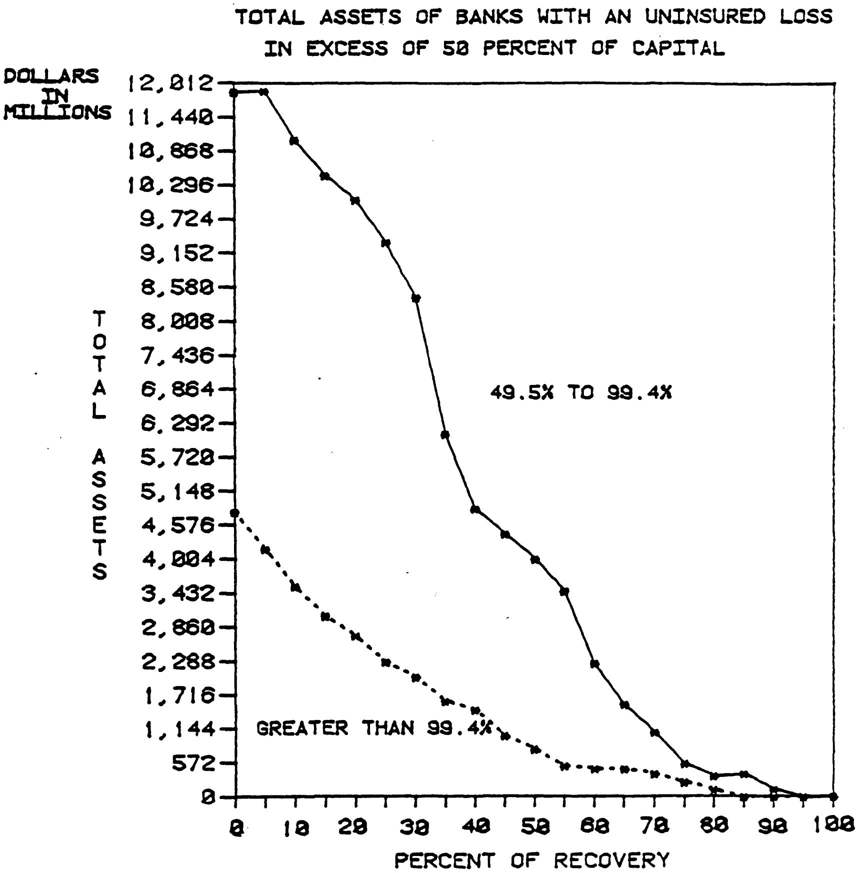
Statistical data on the number of banks with exposure to CINB greater than $10 million with an uninsured loss less than 50% of capital.

TABLE 1



Note: Ranges for points on the two lines were chosen to prevent overlap. Banks with ratios between 49.5 percent and 49.9 percent were included in the 50 percent category. Also, banks with ratios between 99.5 percent and 99.9 percent were included in the 100 percent category.

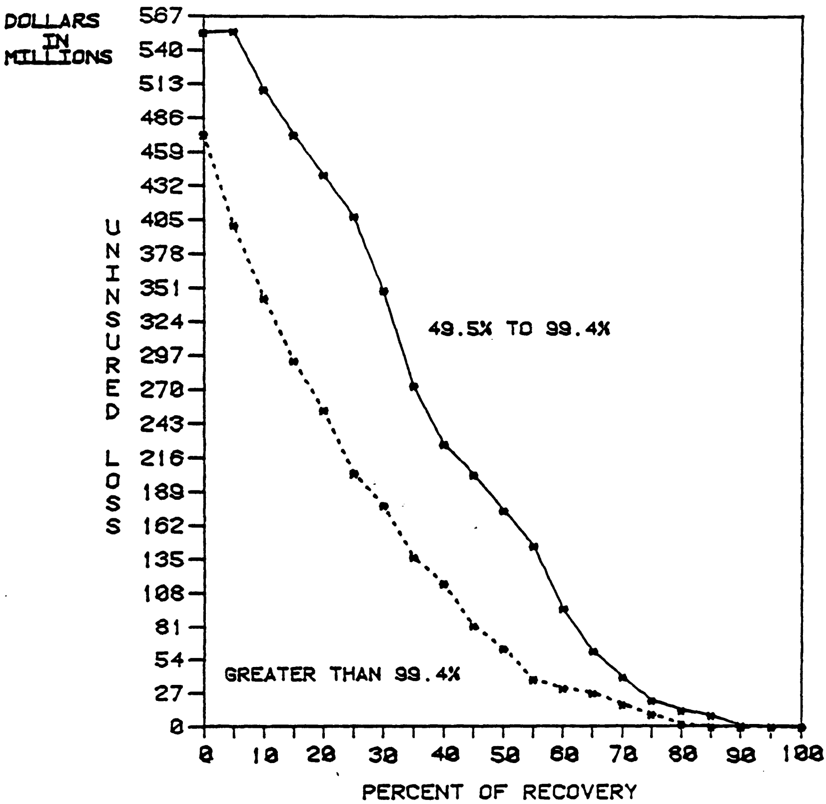
TABLE 2



Note: Ranges for points on the two lines were chosen to prevent overlap. Banks with ratios between 49.5 percent and 49.9 percent were included in the 50 percent category. Also, banks with ratios between 99.5 percent and 99.9 percent were included in the 100 percent category.

TABLE 3

THE AMOUNT OF LOSS FOR BANKS WITH AN UNINSURED LOSS IN EXCESS OF 50 PERCENT OF CAPITA



Note: Ranges for points on the two lines were chosen to prevent overlap. Banks with ratios between 49.5 percent and 49.9 percent were included in the 50 percent category. Also, banks with ratios between 99.5 percent and 99.9 percent were included in the 100 percent category.

TABLE 4

NUMBER OF BANKS, AMOUNT OF ASSETS, AND UNINSURED LOSS UNDER VARIOUS RECOVERY ASSUMPTIONS

	NUMBER OF BANKS		AMOUNT OF ASSETS (dollars in millions)		AMOUNT OF LOSS (dollars in millions)	
PERCENT OF RECOVERY	GREATER THAN 99.4%	BETWEEN 49.5% & 99.4%	GREATER THAN 99.4%	BETWEEN 49.5% & 99.4%	GREATER THAN 99.5%	BETWEEN 49.5% & 99.4%
0	65	101	$4,792	$11,857	$473	$554
5	60	99	4,170	11,875	401	555
10	54	90	3,546	11,051	343	509
15	49	85	3,046	10,460	293	473
20	45	83	2,716	10,050	254	441
25	40	78	2,281	9,335	204	408
30	38	68	2,021	8,411	178	349
35	30	61	1,612	6,105	137	273
40	27	56	1,460	4,846	116	227
45	19	55	1,024	4,419	82	203
50	14	51	796	3,997	63	174
55	11	45	513	3,465	38	146
60	9	36	465	2,251	31	96
65	9	29	465	1,556	27	61
70	6	22	385	1,085	18	40
75	3	11	240	555	10	21
80	2	7	119	346	2	13
85	0	6	0	385	0	9
90	0	2	0	119	0	1
95	0	0	0	0	0	0
100	0	0	0	0	0	0

TABLE 5

LISTING OF CORRESPONDENT BANKS
WITH EXPOSURE TO CINB OF
GREATER THAN 50 MILLION AND
PERCENT OF EXPOSURE TO CAPITAL LESS THAN 50%
(In Thousands of Dollars)

Bank No.	Assets	Demand Deposit Accounts	Time Deposits	Federal Funds Sold	Exposure	Capital	% of Exp. to Capital
1	8,096,390	2,759	146	50,000	52,906	412,957	13
2	23,001,540	408	138,975	0	139,383	1,008,532	14
3	109,668,351	17,916	213,817	300,000	531,733	4,200,083	13
4	23,855,154	97,767	0	0	97,767	1,051,730	9
5	20,848,829	55,976	5,650	0	61,626	925,552	7
6	5,954,922	0	86,579	40,000	126,579	322,891	39
7	6,973,980	41	53,322	30,000	83,364	358,620	23
8	35,539,783	0	224,569	0	224,569	1,425,664	16
9	936,822	3,533	14,000	44,500	62,033	0	0
10	17,440,544	52	74,000	0	74,052	763,226	10
11	9,138,864	69	12,100	50,000	62,169	438,313	14
12	16,897,106	923	127,416	0	128,339	776,475	17
13	40,129,581	355	226,815	0	227,171	1,636,597	14
14	22,634,707	5,841	85,000	0	90,841	878,802	10
15	12,645,530	9,297	50,000	0	59,297	632,737	9
16	49,345,727	10,639	135,938	0	146,577	1,954,240	8
17	58,059,865	27,364	6,797	150,000	184,161	2,502,005	7
18	56,204,251	972	206,250	0	207,222	2,906,265	7
19	113,474,000	558	72,000	0	72,558	5,924,000	1
20	5,799,603	6,541	20,000	50,000	76,541	528,144	14
21	8,353,574	1,471	50,000	0	51,471	422,500	12
	644,999,123	242,482	1,803,374	714,500	2,760,359	29,069,333	

TABLE 6

LISTING OF CORRESPONDENT BANKS
WITH EXPOSURE TO CINB OF
20 MILLION TO 49.9 MILLION AND
PERCENT OF EXPOSURE TO CAPITAL LESS THAN 50%
(In Thousands of Dollars)

Bank No.	Assets	Demand Deposit Accounts	Time Deposits	Federal Funds Sold	Exposure	Capital	% of Exp. to Capital
1	2,755,764	12,351	10,000	0	22,351	105,318	21
2	3,697,908	19	31,000	0	31,019	217,050	14
3	4,757,591	201	0	20,000	20,201	207,275	10
4	8,477,650	1	7,300	25,000	32,301	438,220	7
5	3,066,290	5,187	26,195	0	31,382	174,839	18
6	2,004,140	16,233	11,000	10,000	37,233	112,882	33
7	1,072,501	4,523	0	25,000	29,523	72,770	41
8	1,983,223	201	35,000	0	35,201	117,031	30
9	1,699,321	5	0	25,000	25,005	102,740	24
10	7,485,877	0	25,000	0	25,000	498,067	5
11	9,681,201	86	43,000	0	43,086	904,847	5
12	79,546,624	6,383	16,812	0	23,195	3,662,570	1
13	109,927	0	20,000	0	20,000	0	-
14	954,074	0	20,000	0	20,000	53,615	37
15	3,236,369	5,784	0	20,000	25,784	125,080	21
16	4,736,423	900	33,043	0	33,943	218,338	16
17	5,128,125	1,266	3,000	25,000	29,266	331,543	9
18	21,809,868	6,001	20,000	0	26,001	930,407	3
19	4,866,675	51	30,000	0	30,051	220,810	14
20	2,553,669	200	20,000	0	20,200	132,316	15
21	11,034,025	806	0	25,000	25,806	331,902	8
22	12,581,531	904	35,000	0	35,904	529,659	7
23	3,800,762	26	15,209	10,000	25,235	193,728	13
	197,039,548	61,128	401,559	185,000	647,687	9,681,007	

TABLE 7

LISTING OF CORRESPONDENT BANKS WITH EXPOSURE TO CINB OF 10 MILLION TO 19.9 MILLION AND PERCENT OF EXPOSURE TO CAPITAL LESS THAN 50%

(In Thousands of Dollars)

Bank No.	Assets	Demand Deposit Accounts	Time Deposits	Federal Funds Sold	Exposure	Capital	% of Exp. to Capital
1	2,712,172	0	0	15,000	15,000	164,869	9
2	502,741	14	0	12,000	12,014	27,629	43
3	1,103,252	108	0	10,000	10,108	66,578	15
4	1,270,841	0	0	10,000	10,000	58,845	17
5	852,899	0	10,250	0	10,250	50,495	20
6	3,284,833	290	0	10,000	10,290	168,024	6
7	5,270,170	1,675	10,000	0	11,675	250,253	5
8	225,650	232	3,277	8,000	11,509	23,257	49
9	481,057	102	0	15,000	15,102	42,889	35
10	624,832	265	5,300	5,500	11,065	40,519	27
11	685,544	1,192	1,000	10,000	12,192	38,307	32
12	666,533	0	0	10,000	10,000	54,082	18
13	3,035,073	13,222	573	0	13,795	171,768	8
14	622,287	28	0	10,000	10,028	41,952	24
15	2,560,703	11,512	0	0	11,512	120,102	10
16	520,946	254	0	10,000	10,254	38,534	27
17	1,761,048	150	800	15,900	16,850	82,175	21
18	7,187,746	2,179	8,250	0	10,429	321,778	3
19	1,131,864	515	12,000	0	12,515	96,863	13
20	1,525,816	152	0	10,000	10,152	81,726	12
21	3,434,076	3,643	9,000	0	12,643	218,035	6
22	853,481	55	0	13,250	13,305	59,760	22
23	2,387,348	0	0	10,000	10,000	118,821	8
24	2,676,633	37	10,535	0	10,572	147,522	7
25	800,063	0	0	10,000	10,000	47,621	21
26	1,749,477	143	16,971	0	17,114	112,783	15
27	2,298,161	16,455	0	0	16,455	159,408	10
28	4,128,905	4,680	10,000	0	14,680	201,689	7
29	4,192,667	2,172	10,000	0	12,172	264,818	5
30	5,830,419	0	10,000	0	10,000	301,695	3
31	616,343	0	0	15,000	15,000	35,575	42
32	2,387,536	0	0	10,000	10,000	147,479	7
33	4,143,764	546	10,000	0	10,546	225,174	5
34	556,075	4	0	10,000	10,004	39,277	25
35	844,791	0	10,000	0	10,000	82,383	12
36	5,715,188	2,584	10,000	0	12,584	263,349	5
37	11,863,099	850	10,000	0	10,850	496,813	2
38	3,378,051	29	0	12,120	12,149	0	-
39	316,712	14	0	10,000	10,014	23,971	42
	94,198,786	63,102	157,956	241,770	462,828	4,886,818	

TABLE 6

DATA ON BANKS
WITH FUNDS IN CONTINENTAL BANK
GREATER THAN CAPITAL 1/

(dollars in thousands)

OBS	ASSETS	DDA	TIME	FFSOLD	CAPITAL	CDATIME	EXPOS	PCT
1	50788	0	0	8500	1474	0	8500	576.662
2	98105	0	0	12500	7727	0	12500	161.770
3	28256	13	0	3280	533	13	3293	617.824
4	121251	443	2600	27000	6599	3043	30043	455.266
5	27470	844	0	5700	1760	844	6544	371.818
6	13023	525	0	2350	852	525	2875	337.441
7	41942	110	0	9350	3198	110	9460	295.810
8	25626	1	598	4140	1603	599	4739	295.633
9	27851	8	0	4000	1639	8	4008	244.539
10	15559	37	2300	980	1396	2337	3317	237.607
11	43794	202	0	5400	2709	202	5602	206.792
12	20408	259	0	2200	1193	259	2459	206.119
13	133341	36	2750	12950	7700	2786	15736	204.364
14	46149	461	0	4070	2373	461	4531	190.940
15	58886	51	0	6340	3398	51	6391	188.081
16	32281	21	0	1000	542	21	1021	188.376
17	70749	93	1000	7800	4836	1093	8893	183.892
18	42208	110	0	3800	2139	110	3910	182.796
19	10120	36	300	1370	969	336	1706	176.058
20	12608	337	0	1750	1194	337	2087	174.791
21	109682	100	0	11800	6902	100	11900	172.414
22	22879	7	0	2000	1182	7	2007	169.797
23	159103	213	10000	6500	9954	10213	16713	167.902
24	5956	4	0	1500	894	4	1504	168.233
25	63785	16	0	6500	3875	16	6516	168.155
26	44002	349	0	3620	2524	349	3969	157.250
27	57652	1219	825	2700	3123	2044	4744	151.905
28	17016	86	0	1500	1043	86	1586	152.061
29	15887	24	1055	1480	1693	1079	2559	151.152
30	42535	38	0	5370	3576	38	5408	151.230
31	119323	60	4615	4500	6127	4675	9175	149.747
32	20558	8	3200	0	2165	3208	3208	148.176
33	74360	202	0	6330	4446	202	6532	146.919
34	74125	15	1630	2620	3004	1645	4265	141.977
35	165583	3304	0	10500	10067	3304	13804	137.121
36	164473	30	13600	3930	13208	13630	17560	132.950
37	59171	2720	1800	3440	5966	4520	7960	133.423
38	153657	1050	0	14200	11618	1050	15250	131.262
39	33803	14	0	2880	2223	14	2894	130.184
40	55819	33	0	4000	3236	33	4033	124.629
41	17497	15	0	1400	1132	15	1415	125.000
42	6497	3	0	400	339	3	403	118.879
43	246550	2487	5326	13600	18178	7813	21413	117.796
44	10504	0	0	1100	957	0	1100	114.943
45	46894	780	250	2900	3460	1030	3930	113.584
46	46145	13	262	3000	2863	275	3275	114.390
47	81907	381	0	8500	7836	381	8881	113.336
48	47007	128	1000	1800	2582	1128	2928	113.400
49	368600	30	2000	21470	21188	2030	23500	110.912
50	23585	102	0	1440	1339	102	1542	115.161
51	107216	81	0	7560	7006	81	7641	109.064
52	48746	1026	0	2000	2875	1026	3026	105.252
53	146304	3328	0	19000	21318	3328	22328	104.738
54	142870	870	1000	6130	7765	1870	8000	103.026
55	21023	40	0	1200	1226	40	1240	101.142
56	214220	3120	100	10000	13156	3220	13220	100.486
57	15609	23	0	780	448	23	803	179.241
58	23810	30	500	1950	1890	530	2480	131.217
59	13836	576	100	230	734	676	906	123.433
60	58204	0	0	8700	2341	0	8700	371.636
61	314156	11	20000	0	17183	20011	20011	116.458
62	65783	0	10000	0	6935	10000	10000	144.196
63	18818	13	0	4600	1272	13	4613	362.657
64	105519	109	7700	11000	8659	7809	18809	217.219
65	63386	159	3400	1080	4108	3559	4639	112.926
66	70658	45	3500	2100	5572	3545	5645	101.310
	6161372	28445	101411	351790	313022	127860	479650	

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DATA ON BANKS
WITH FUNDS IN CONTINENTAL BANK
BETWEEN 50 and 100 PERCENT OF CAPITAL 1/

(dollars in thousands)

OBS	ASSETS	DDA	TIME	FFSOLD	CAPITAL	DDATIME	EXPOS	PCT
1	1133638	0	0	42290	53462	0	42290	79.1029
2	372798	65	0	15000	21026	65	15065	71.6494
3	14501	33	0	1500	1554	33	1533	98.6486
4	27369	24	0	1930	2079	24	1954	93.9875
5	17927	9	1500	0	1665	1509	1509	90.6306
6	9580	23	253	600	1009	276	876	86.8186
7	46514	71	1000	900	3151	1071	1971	62.5516
8	35130	22	0	2050	3397	22	2072	60.9950
9	13664	114	800	0	1533	914	914	59.6217
10	27084	10	1000	0	1703	1010	1010	59.3071
11	19276	14	1000	0	1781	1014	1014	56.9343
12	266860	47	0	10000	19870	47	10047	50.5637
13	56513	24	400	2000	4818	424	2424	50.3113
14	185981	515	5000	7000	12646	5515	12515	98.9641
15	19588	80	100	1260	1463	180	1440	98.4279
16	36572	42	600	2000	2728	642	2642	96.8475
17	171205	1183	10800	0	12523	11983	11983	95.6879
18	123963	557	0	7000	7914	557	7557	95.4890
19	46159	26	1000	2770	4052	1026	3796	93.6821
20	25157	4	0	2180	2444	4	2184	89.3617
21	73774	548	0	3570	4637	548	4118	88.8074
22	20555	66	100	1300	1645	166	1466	89.1185
23	173445	64	7400	4000	13182	7464	11464	86.9671
24	24252	5	0	1990	2359	5	1995	84.5697
25	125856	760	5224	1300	8760	5984	7284	83.1507
26	14655	16	0	1100	1378	16	1116	80.9869
27	18361	0	0	1000	1229	0	1000	81.3670
28	62444	158	1000	2800	5035	1158	3958	78.6097
29	22747	4	0	1770	2279	4	1774	77.8412
30	47894	848	0	2200	3902	848	3048	78.1138
31	104685	108	1000	3720	6217	1108	4828	77.6580
32	11861	78	0	1060	1486	78	1138	76.5814
33	37546	17	1000	900	2477	1017	1917	77.3920
34	46218	155	0	2200	3073	155	2355	76.6352
35	310506	1254	1226	5900	11173	2480	8380	75.0022
36	66075	278	0	3000	4431	278	3278	73.9788
37	1288647	4702	35952	18000	79004	40654	58654	74.2418
38	25600	333	0	1100	1938	333	1433	73.9422
39	208997	1132	5000	3500	13188	6132	9632	73.0361
40	44674	45	1000	1030	2873	1045	2075	72.2242
41	57828	650	1650	0	3227	2300	2300	71.2736
42	179396	0	3500	7900	16222	3500	11400	70.2749
43	108100	4	0	5800	8375	4	5804	69.3015
44	183131	38	10000	0	14455	10038	10038	69.4431
45	150390	260	0	7000	10514	260	7260	69.0508
46	107547	251	0	5000	7645	251	5251	68.6495
47	8346	2	0	380	552	2	382	69.2029
48	94210	492	2000	1000	5105	2492	3452	68.4035
49	146513	222	0	10000	15194	222	10222	67.2766
50	442500	941	9200	10000	30440	10141	20141	66.1662
51	28477	140	0	1700	2785	140	1840	66.0682
52	43753	222	0	2500	4138	222	2722	65.7806
53	307653	354	100	12000	19590	454	12454	63.5733
54	102115	128	1000	4100	8114	1128	5228	64.4318
55	44867	20	0	1600	2562	20	1620	63.2319
56	17604	16	0	1000	1614	16	1016	62.9492

DATA ON BANKS
WITH FUNDS IN CONTINENTAL BANK
BETWEEN 50 and 100 PERCENT OF CAPITAL 1/

(dollars in thousands)

OBS	ASSETS	DDA	TIME	FFSOLD	CAPITAL	DDATIME	EXECS	PCT
57	387981	75	5000	10000	24708	5075	15075	61.0126
58	130385	424	3000	2100	9573	3424	5524	57.7040
59	54779	12	0	2200	3814	12	2212	57.9969
60	98898	441	600	3000	7079	1041	4041	57.0843
61	149923	310	200	5550	10711	510	6060	56.5774
62	63506	147	0	2850	5272	147	2997	56.8475
63	114557	130	120	4370	8312	250	4620	55.5823
64	61554	59	0	2000	3661	59	2059	56.2415
65	15655	98	0	600	1245	98	698	56.0643
66	27629	57	1000	0	1880	1057	1057	56.2234
67	78983	138	0	3400	6298	138	3538	56.1766
68	102814	55	3000	680	6801	3055	3735	54.9184
69	248558	99	7000	1300	15472	7099	8399	54.2852
70	85587	46	0	2000	3760	46	2046	54.4149
71	121091	1782	325	2000	7563	2107	4107	54.3038
72	218754	5991	300	6000	22998	6291	12291	53.4438
73	41010	31	0	1420	2751	31	1451	52.7445
74	44218	195	0	1750	3715	195	1945	52.3553
75	37949	351	0	950	2508	351	1301	51.8740
76	78083	74	0	2500	4995	74	2574	51.5315
77	31610	288	0	1300	3040	288	1588	52.2368
78	10438	73	0	870	1838	73	943	51.3058
79	92243	176	1000	2000	6220	1176	3176	51.0611
80	33738	94	0	1800	3741	94	1894	50.6282
81	127170	20	2500	2000	8920	2520	4520	50.6726
82	24932	97	0	980	2167	97	1077	49.7000
83	42912	62	0	1400	2899	62	1462	50.4312
84	28867	626	0	1800	2676	626	2426	90.6577
85	294729	332	5875	10000	16532	6207	16207	97.4541
86	19172	389	0	500	1309	389	889	68.1900
87	42009	393	1000	550	3055	1393	1943	63.6007
88	65868	309	0	4950	8870	309	5259	59.2897
89	97610	282	0	3730	7065	282	4012	56.7870
90	90150	508	0	3000	6263	508	3508	56.0115
91	104575	51	1900	2220	7770	1951	4171	53.6808
92	32718	635	0	500	2190	635	1135	51.8265
93	16916	441	0	300	1488	441	741	49.7984
94	209169	28	0	10000	17032	28	10028	58.8773
95	132278	0	0	4000	7183	0	4000	55.6870
96	53930	6	0	3000	3960	6	3006	75.9091
97	15990	9	0	500	701	9	509	72.6106
98	79938	138	4000	0	6127	4138	4138	67.5371
99	43724	22	0	2000	3070	22	2022	65.8632
100	57923	29	0	2500	4409	29	2529	57.3599
101	245886	12	11000	0	19186	11012	11012	57.3960
102	65063	0	3000	0	5257	3000	3000	57.0668
103	23788	23	1000	100	1284	1023	1123	87.4611
104	204034	19	3000	10000	15706	3019	13019	82.8919
105	87482	42	2400	2000	5768	2442	4442	77.0111
106	15798	24	0	1000	1300	24	1024	78.7692
107	73654	626	0	4100	6603	626	4726	71.5735
108	46833	49	0	5300	7063	49	5349	71.4852
109	39322	741	0	2000	4079	741	2741	67.2143
110	21249	50	0	1000	1827	50	1050	57.4713
111	94661	280	0	5000	9521	280	5280	55.4564
112	18142	65	0	600	1319	65	665	50.4170
113	36165	0	3200	0	6269	3200	3200	51.0448
	========	=====	======	======	======	======	======	
	12347199	34601	171225	375270	851538	205826	581096	

NOTES

1/ Explanation of column headings:

--	OBS	=	Numerical count of the banks
--	DDA	=	Amount of demand deposits placed with Continental Bank
--	TIME	=	Amount of time deposits placed with Continental Bank
--	FFSOLD	=	Amount of Federal Funds sold to Continental Bank
--	Capital	=	Equity Capital
--	DDATIME	=	Sum of DDA and TIME columns
--	EXPOS	=	Sum of DDA, TIME, and FFSOLD columns
--	PCT	=	EXPOS column as a percent of capital column

Section 2

Recalculation of the effect of Continental Illinois National Bank's failure on correspondent banks.

FDIC ANALYSIS

In response to a June 6, 1984 request from Chairman Isaac, Federal Deposit Insurance Corporation staff identified 2,299 banks which had deposits or funds invested in Continental Illinois National Bank (CINB) as of April 30, 1984 (see appendix). Of these, 976 banks had an exposure in excess of $100,00 which, according to FDIC, accounted for more than 99% of the total exposure in CINB of the 2,299 banks. Some banks had a depositor relationship with CINB and had funds in demand accounts, time deposit accounts or both. Other banks sold unsecured federal funds to CINB. Many banks had both a depositor and creditor relationship with CINB. The amount of this exposure was calculated as a percent of the correspondent bank's equity capital as of December 31, 1983. FDIC staff made no adjustments for deposit insurance coverage for the deposits of these 976 banks, nor did FDIC consider the anticipated recovery based on CINB's liquidation. The result of this calculation of exposure to capital revealed that 66 banks had an exposure to CINB in excess of 100% of their capital and another 113 banks had an exposure to CINB between 50% and 100% of their capital. A summary of data on these 179 banks follows.

Funds invested in CINB in excess of capital

State	Number of Banks
Illinois	54
Nine other states	12
	66

Funds invested in CINB between 50 and 100 percent of capital

State	Number of Banks
Illinois	70
Iowa	11
Indiana	10
Wisconsin	10
Eight other states	12
Total between 50%-100%	113
GRAND TOTAL	179

These 179 banks had total assets of $17.1 billion, demand deposits with ontinental of $61 million, time deposits of $273 million, Federal funds sold of 727 million, capital of $1.16 billion, and total exposure of $1.06 billion. For a omplete listing of information by bank for these 179 institutions, see tables 8 nd 9.

:OMMITTEE ANALYSIS

We began our analysis by recalculating the potential uninsured loss of the 179 anks by adding the demand and time deposits together and substracting up to 100,000 of insured deposits. Allowing only for this $100,000 insurance adjustment, he exposure rate for 13 banks dropped below 50% and one bank dropped from the .00% category into the 50-100% category. This left 65 of the 66 banks with an ninsured exposure in excess of capital and 101 of the 113 banks with an uninsured xposure between 50 to 100 percent of capital. We proceeded to analyze the emaining 166 institutions focusing on the uninsured amounts, including federal unds sold which is an uninsured investment. Of the 65 banks with an exposure in xcess of capital, we identified only 6 banks that had demand and time deposits with CINB in excess of capital. The remaining 59 banks that had an exposure in CINB in excess of capital were in that position, in whole or in part, because of the amount of federal funds sold to CINB. Furthermore, 21 of the 65 banks had no uninsured deposits in CINB, but had federal funds sold alone in excess of capital. Likewise, 31 of the 101 banks determined to have an exposure in CINB of 50% to 100% of equity capital had no uninsured deposits. In total, 58 of the 179 banks had no uninsured deposits in CINB and their 50% or greater uninsured exposure was due solely to selling unsecured federal funds.

We proceeded to recalculate the number of banks, total assets, and amount of loss for the 179 banks that FDIC identified as having greater than 50% of equity capital invested in CINB using recovery from liquidation values of 0% to 100% in 5% increments. The analysis shows that as the rate of recovery increased, the number of banks in both categories (from 50 - 100 percent and over 100 percent of capital), the total assets, and the total loss all declined sharply. This analysis revealed, for example, that at a recovery rate of 40%, there would be only 27 banks with a loss in excess of capital, these banks had total assets of $4.85 billion and would have a total loss of $137 million. Only 56 banks would have had a loss of between 50% to 100% of capital; these banks had total assets of $1.46 billion and would have a loss amount of $273 million.

Assuming a recovery rate of 70% there would have been only 6 banks with a loss in excess of capital; these 6 banks had total assets of $385 million and would have a total loss of $18 million. An additional 22 banks would have had a loss of between 50 and 100 percent of capital; these 22 banks had total assets of $1.1 billion and would have a loss of $40 million.

Assuming a recovery rate of 90% there would not have been any banks with a loss in excess of capital and only 2 banks with a loss of between 50 and 100 percent of capital. These two banks had total assets of only $119 million and a total loss of $1 million.

Further analysis identified 83 banks that had at least $10 million of funds invested in CINB and a percent of exposure to capital less than 50%. The exposure in CINB for these 83 banks can be further broken down into 3 groups; greater than

$50 million, $20 million to $49.9 million, and $10 million to $19.9 million. The total assets, demand deposits, time deposits, federal funds sold, exposure, and equity capital of these 3 groups were as follows:

Amount Of Exposure	Total Assets	Demand Deposits	Time Deposits	Federal Funds Sold	Exposure	Equity Capital
	(In Millions of Dollars)					
Greater Than 50	644,999	242	1,803	715	2,760	29,069
20 to 49.9	197,040	61	402	185	648	9,681
10 to 19.9	94,199	63	158	242	463	4,887
Total	936,238	366	2,363	1,142	3,871	43,637

These 83 banks account for 72 percent of the total assets of all 976 banks with an investment in CINB over $100,000. They also account for 55% of demand deposits, 81% of time deposits, 48% of unsecured federal funds, and 65% of the total exposure. Based on this observation, it would seem that these 83 banks (whose exposure to capital was less than 50% and were not considered to be in jeopardy by the FDIC account for the majority of the exposure in CINB, as compared to FDIC's list of 179 banks whose exposure to capital was greater than 50%.

Section 3

Cost analysis used by FDIC to determine the least costly method of assistance.

As part of their monitoring efforts, the federal regulators maintain a list of problem banks, those rated 4 or 5 under the Uniform Financial Institutions Rating System. Problem banks are generally characterized by unsafe, unsound or other seriously unsatisfactory conditions and have a relatively high possibility of failure. From a review and evaluation of these lists or from direct appeal by a bank, the regulators determine if a bank is failing. When a bank has been identified to be failing, the bank's chartering authority, either the state regulatory authority, or the Office of the Comptroller of the Currency, determines whether the bank will remain open or closed. Once this decision is made, the Federal Deposit Insurance Corporation has a cost analysis report prepared listing the types of assistance available and the amount of needed funds. The cost analysis report is evaluated and an assistance package is offered/issued to all parties involved.

COST ANALYSIS

The cost analysis as stated in the previous section is used by the FDIC to determine the least costly method of assistance. The exhibit presented on page 8 is an example of the form used by the FDIC. Basically, the cost analysis is a standardized formula based on the worst case scenario. Data used in the analysis is obtained directly from the failing bank's balance sheet, typically 1 week before closing.

The analysis is divided into three sections. The first section begins with the bank's total deposits. Added to the balance are such items as federal funds borrowed, accrued interest payments made on deposits, other accrued expenses, and estimated losses on contingent liabilities. The sum of these items represents the bank's total liabilities. Subtracted from this total are such items as secured and preferred deposits (normally public funds) and secured borrowings under repurchase agreements. The balance represents Net Total Liabilities and is the base amount used by the FDIC for a recovery attempt.

The second section determines the amount of assets available to cover the bank's liabilities. The section begins with Gross Book Assets which represents the bank's total assets, including such items as the allowance for possible loan losses and unearned discounts. This total is then reduced by two parts, collection values and market values. The first part is an estimate of assets classified by examiners that will not be collected in a liquidation. The percentages used to determine the ultimate collection values are at least 5 years old and based primarily on small bank failures. The second part determines the estimated value of fixed assets under book value. The difference between the Gross Book Assets less the two parts stated above equals Net Free Assets and represents the amounts of assets available to cover the bank's liabilities.

The Net Free Assets are then subtracted from Net Liabilities to yield an excess of Net Liabilities over Net Free Assets. This balance represents the amount of the bank's insolvency.

The third section determines the amount of deficiency shared by FDIC and other creditors. It begins with total deposits, adds accrued interest on deposits, and subtracts uninsured deposits and secured and preferred deposits. The result is total insured deposits which is divided by Net Liabilities to yield a percentage. The percentage is then applied to the amount of insolvency representing the FDIC's share of that insolvency. The remaining amount of the deficiency is applied to other creditors.

Up to this point, the analysis has determined a deposit payoff situation. To determine a deposit assumption case, the cost to process each account is subtracted from the deficiency of other creditors to come up with the premium a healthy bank must pay to assume the deposits and acceptable assets of the closed bank.

COST ANALYSIS CALCULATION

Total Deposits
Add: Other Liabilities: Borrowings
Accrued Interest Expense
Accrued Other Expenses
Other
Estimated loss in contingent liabilities

Total Liabilities
Less: Secured and Preferred Deposits
Secured Borrowings

NET TOTAL LIABILITIES

Gross Book Assets

Less: Loss	x 68.30%	
Doubtful		x 49.45%
Substandard		x 31.67%
Special Mention		x 21.35%
Other Losses		

Sec'd and Pref'd Liab.
Securities Depr.
EV of FA under BV
Other Deductions

Net Free Assets

EXCESS OF NET LIABILITIES OVER NET FREE ASSETS

*Total Deposits
Plus: Accrued Interest on Deposits
Less: Uninsured Deposits
Secured and Preferred

Insured Liabilities

*INSURED LIABILITIES TO NET LIABILITIES

SHARE OF DEFICIENCY: FDIC
OTHER CREDITORS

LESS: NO. OF DEPOSIT ACCOUNTS $5.24/AC

PREMIUM NEEDED FOR A PURCHASE AND ASSUMPTION TRANSACTION

APPENDIX

June 6, 1984

MEMORANDUM TO: A. David Meadows
Associate Director

FROM: Robert V. Shumway, Director
Division of Bank Supervision

SUBJECT: Continental Illinois

This documents a conversation I had this morning with Chuck Collier. I asked him to obtain the following information about Continental Illinois for the Chairman:

1. Data showing the exposure the downstream correspondent banks had in Continental at about the time the assistance package was put in place. This probably includes, as a minimum, correspondent bank accounts exceeding $100M plus unsecured Fed funds as a percentage of capital. This information is needed by June 11 at the latest.

2. Data showing the structure of the holding company debt and who holds both the holding company debt and holding company preferred stock, if any.

3. Data showing the bank's funding sources and maturity structure at the time of the Penn Square closing and at the time of the assistance package. It has been alleged that Continental either could not or chose not to properly diversify its funding sources after Penn Square.

cc: Mr. Collier

cc [illegible]

APPENDIX

DBS:AMS:GNUnthank:co:6/19/84
cc: Mr. Shumway
Mr. Meadows
Mr. Collier
Mr. D. Cooke
Date File

June 20, 1984

MEMORANDUM TO: Chairman Isaac

FROM: Robert V. Shumway, Director
Division of Bank Supervision

SUBJECT: Exposure of Downstream Correspondent Banks to Continental Illinois

Approximately 2,299 banks had funds invested in Continental as of April 30, 1984. Of these, 976 had funds in excess of $100,000 invested. Included in the funding figures are demand and time balances (both domestic and offshore) due from Continental and unsecured Federal funds sold to Continental. The total of the deposit balances and Federal funds was then calculated as a percentage of the correspondent bank's equity capital accounts as of December 31, 1983. No adjustment was made for FDIC insurance coverage. In all, 66 banks had more than 100% of their capital in funds at Continental and another 113 had between 50% and 100% of their capital in funds at Continental. A recap of the total number of banks, their total assets and the states where located follows.

More than 100% of equity capital invested in Continental:

State	Number of Banks	Total Assets (000 omitted)
Illinois	54	$ 3,835,160
Nine other states	12	978,512
	66	$ 4,813,672

50% to 100% of equity capital invested in Continental:

State	Number of Banks	Total Assets (000 omitted)
Illinois	70	$ 7,879,906
Iowa	11	534,418
Indiana	10	781,810
Wisconsin	10	622,977
Eight other states	12	2,485,740
Total between 50%-100%	113	$12,304,851
GRAND TOTAL	179	$17,118,523

Bob, Thanks. I'd like this memo expanded to give me the total [illegible] of the 2,299 banks. Also, the total [illegible] of the 976 banks. For both groups [illegible]

cc: M[illegible]

APPENDIX

DBS/AMS/GNUnthank:cw:co:6/22/84
cc: Mr. Shumway
Mr. Meadows
Mr. Collier
Mr. D. Cooke
Date File

June 22, 1984

MEMORANDUM TO: Chairman Isaac

FROM: Robert V. Shumway, Director
Division of Bank Supervision

SUBJECT: Exposure of Correspondent Banks to Continental Illinois

In response to your request for further information regarding the correspondent banks, the following is offered.

Of the 2,299 banks which had funds invested in Continental as of April 30, 1984, only 976 had total funds in excess of $100,000 invested in the bank. In order to expedite the process, only those 976 banks and their investment or deposit balances were entered into the FDIC computer. This allowed the computer to total the assets of the 976 banks and also to calculate the correspondent bank's exposure to Continental as a percentage of the correspondent bank's equity capital account. It should be noted that the total exposure of the 1,323 banks which were not entered into the computer is estimated at somewhere under $25 million. The following totals relate only to the 976 banks, each of which has a total exposure in excess of $100,000 at Continental; however, these 976 banks represent more than 99% of the funding provided to Continental by correspondent banks as of April 30, 1984.

Total Number of Banks:	976
Total DDA Balances	$ 668,161,000
Total Time Balances	2,925,354,000
Total Unsecured Federal Funds	2,362,660,000
Total Exposure of 976 Banks	5,956,175,000
Total Assets of the 976 Banks	$1,300,542,112,000

Chairman ST GERMAIN. So based upon a 70-percent recovery level——

Mr. DUGGER. Yes.

Chairman ST GERMAIN. Your chart indicates how many banks with greater than 99.4 percent of their assets in Continental would have probably failed?

Mr. DUGGER. The chart indicates that there would be six banks.

Chairman ST GERMAIN. Six banks?

Mr. DUGGER. Yes.

Chairman ST GERMAIN. As contrasted to the testimony last week of 66.

Mr. DUGGER. Yes.

Chairman ST GERMAIN. And 113 additional very probably for a total of 179?

Mr. DUGGER. Yes. The appropriate comparison would be 28 banks versus 179.

Chairman ST GERMAIN. Or 6 versus 66.

Mr. DUGGER. Yes.

Chairman ST GERMAIN. How many million dollars would have been involved in those banks, the six banks, had they failed?

Mr. DUGGER. The total assets of the six banks that would have failed was $385 million, or approximately $60 million per bank. That is a relatively small bank. The total losses to those banks would have been $18 million, roughly $3 million a bank.

Chairman ST GERMAIN. $18 million, as opposed to what? What number were we given for the 66 banks?

Mr. DUGGER. We were given an estimate approximating $1 billion.

Chairman ST GERMAIN. $18 million is 1.8 percent of $1 billion; isn't that correct?

Mr. DUGGER. Yes.

Chairman ST GERMAIN. So they were off by——

Mr. DUGGER. The appropriate comparison would have been 58 of loss versus $1 billion.

Chairman ST GERMAIN. Fifty-eight, so that is 5.8 percent of the billion dollars.

Mr. DUGGER. Correct.

Chairman ST GERMAIN. So they were off by 90 percent, being kind.

Mr. DUGGER. Being kind.

Chairman ST GERMAIN. What is a hundred million here or there? Well, I think that the facts are in the record. In other words, you are telling us the memoranda produced by Messrs. Shumway, and Unthank—what are their capacities at the FDIC?

Mr. DUGGER. Robert Shumway is Director of the FDIC's Division of Supervision and Mr. Unthank is a senior colleague of his.

Chairman ST GERMAIN. They are the gentlemen who work out the numbers for the bank failures traditionally, correct? They are in charge?

Mr. DUGGER. Yes, sir, they are the authors of the two memoranda, but I want to point out that nowhere in their memoranda do they draw the conclusion that 66 banks or 113 or any other number, would fail. They simply do a computation task to derive those numbers.

Chairman St Germain. Have we ever found out where those numbers, 66, 179, $1 billion came from?

Mr. Dugger. Those come from the memorandum.

Chairman St Germain. You say they didn't do the computations.

Mr. Dugger. They did the computation. The conclusions regarding those numbers, the statement, for example, that Mr. Conover made, was based on the numbers in the memoranda. However, Mr. Conover's interpretation of the numbers is his own. It is not reflected in the staff memoranda.

Chairman St Germain. And again, the staff memorandum gave no weight whatsoever to the fact that some of these assets might be sold.

Mr. Dugger. The FDIC staff memoranda gave, perhaps, because of time or data limitations, I don't know, but they did not incorporate deposit insurance repayment or recovery on the sale of assets.

Chairman St Germain. It seems unusual that people working with the FDIC, which is the Federal Deposit Insurance Corporation, would forget about including deposit insurance in their computations; wouldn't it?

Mr. Dugger. I can't explain it.

Chairman St Germain. Maybe it was just a slip of the mind rather than a slip of the tongue. Mr. Annunzio?

Mr. Annunzio. Mr. Chairman, I don't know about the other members of the committee, but I received a notice that the witness for these hearings would be Mr. William Isaac, Chairman of the Federal Deposit Insurance Corporation. I had no idea that we were going to have testimony from our two distinguished staff members, who have done a good job. I haven't had a copy of their staff report so I could read it. I haven't seen these charts before.

I am in no position to ask questions on something I know nothing about. I don't want to play guessing games with these people. I only speak for myelf, but I think the members of the committee would have liked to have had the report, at least a copy of their testimony, 24 hours before these hearings. I found it on my desk here this morning when I came in.

I looked at the witness list and I know who they are—Mr. Dugger is another expert witness. I don't know what your background is, your experience. Have you had any experience examining banks?

Mr. Dugger. No, Mr. Annunzio, I have not.

Mr. Annunzio. Did you talk with the people at the FDIC and the Comptroller of the Currency to find out about these banks you say would not close and they say they are closing? It puts the Members in a tremendous spot to determine which banks are vulnerable, which banks are not vulnerable.

Mr. Dugger. The staff, both majority and minority, have held extensive discussions with examiners and staff of the Comptroller of the Currency and the FDIC. However——

Mr. Annunzio. Can you tell the subcommittee, did minority staff and you have discussions? Did the FDIC people agree with your findings? Did they disagree?

Chairman St Germain. If the gentleman will yield, that is why we put this testimony in first, so that now we can ask Mr. Isaac whether he agrees or disagrees with these conclusions.

Mr. ANNUNZIO. Well, I appreciate that, Mr. Chairman. But even before Mr. Isaac appears, was this information discussed with Mr. Isaac? Mr. Dugger, can you tell me that?

Mr. DUGGER. We met with Mr. Isaac a few days ago for nearly 2 hours discussing a wide variety of aspects of the Continental assistance effort. Among the things we discussed were the two memoranda that are being reviewed here. The purpose of the staff report and this brief presentation is to take a look at one of the items of evidence that has been offered regarding the impact on a Continental Bank failure and to attempt to incorporate into it two considerations which not only we, but others as well, have suggested are important.

Mr. ANNUNZIO. But did he agree with your conclusions?

Mr. DUGGER. I think that you will have an opportunity to——

Mr. ANNUNZIO. We are going to have to ask him. You know, you will forgive me. Coming from Chicago, in 40 years we haven't won a pennant, so all we have got on our minds right now is how to get World Series tickets. You know, I don't want these kinds of surprises in the midst of all that hilarity in Chicago.

We are all very happy and we don't want to throw a wet blanket over our city again. We are starting to come out of the doldrums.

Chairman ST GERMAIN. I want to assure the gentleman there that nothing is going to be brought up about the Cubs.

Mr. ANNUNZIO. Thank you, Mr. Chairman.

Chairman ST GERMAIN. I would like to inform the members of the committee that I worked with staff until the wee hours last night. This memorandum, the brief presentation by Mr. Dugger, wasn't ready last night. It was completed early this morning and I hadn't seen it until this morning myself.

We just went over the facts of what would be prepared. Mr. Wylie?

Mr. WYLIE. I appreciate that observation, Mr. Chairman. I find myself in somewhat the same position as Mr. Annunzio. I am not sure who was off and who is on. I would observe that there are a lot of judgment factors involved here. I have a feeling that Mr. Isaac will have a far different view and I think I might like to use my time with Mr. Isaac, Mr. Chairman. Thank you.

Chairman ST GERMAIN. Mr. Barnard?

Mr. BARNARD. Thank you, Mr. Chairman. I have tried to very quickly analyze the staff report, myself, which I see, Mr. Chairman, is dated October 4. But I didn't find with my copy, Mr. Dugger, your comments that I could follow. Was that part of the report we have?

Mr. DUGGER. No, sir; it isn't. It is a summary of the report——

Mr. BARNARD. So we didn't have the benefit of your analysis at all?

Mr. DUGGER. Yes, you do. The report is it.

Mr. BARNARD. But you had a summary, I believe, your statement with a summary?

Mr. DUGGER. Yes, I finished that this morning literally about quarter of 9. I will be glad to give you a copy.

Mr. BARNARD. I was in my office this morning at 7. If I had had a copy of it I would have been delighted to review it so I would have been better edified myself as to what is being said. But let me ask you this question. Taking that all of what you have said here is true, have you taken into consideration, all right, the alternative would have been to close Continental, to close down Continental, and to keep these six banks afloat? Is that what you are saying is the alternative?

In other words, what you are telling me from what I can hear, is that the FDIC would have been better served by letting the Continental fail and supporting these particular six banks. Is that true?

Mr. DUGGER. No.

Mr. BARNARD. What are you saying then?

Mr. DUGGER. Mr. Barnard, this report attempts simply to clarify certain findings obtained last June by the FDIC staff concerning the exposure of certain banks to a Continental Bank failure.

Mr. BARNARD. But the alternative is there. In other words, they had——

Mr. DUGGER. What has been said—Mr. Conover and others, is that a certain number of banks, 66, 113, 179, 976, 2,400, whichever, various numbers are viewed at various times, that information, those statements or interpretations about the impact of a Continental Bank failure, are based on two FDIC staff memorandums.

Mr. BARNARD. Let's say that——

Chairman ST GERMAIN. Would the gentleman yield to me?

Mr. BARNARD. I would be happy to yield.

Chairman ST GERMAIN. I would like to clarify for the record—gentleman from Georgia, you will recall that when Mr. Conover testified I asked if in reaching these numbers, the regulators had the benefit of cost analyses and projections. He replied in the affirmative. We then called FDIC and they sent Mr. Unthank and Mr. Shumway way up here. Both stated that they had not run the numbers.

Therefore, we decided to run the numbers. With the assistance of GAO we have run the numbers. We have not asked staff to give us any conclusions. We merely want to point out that there is a serious problem here. If a regulator said we did this because we wanted to save 179 banks, then I think it is fair for us to determine the accuracy of that statement.

Mr. BARNARD. Right.

Chairman ST GERMAIN. That is what we are trying to do. That is all.

Mr. BARNARD. This is a point that I am trying to get to. Let's say that their figures are completely wrong and we can go back and retrace our steps. So if we let Continental go down the drain, OK, how much then would it have cost the FDIC corpus as opposed to this figure?

Mr. DUGGER. If you will turn to page 6 in the staff report, Mr. Barnard, there is a table. It is table 4.

Mr. WYLIE. Would the gentleman yield?

Mr. BARNARD. I would be delighted to yield.

Mr. WYLIE. I wonder, Mr. Chairman, and I suggest this respectfully, if it would be appropriate to ask Mr. Isaac to come and present his testimony, and we could have the benefit of that. Maybe some of these questions would be cleared, and I think it might put things in a little better perspective for all of us.

Chairman ST GERMAIN. Well, I would say to the gentleman that since we have had these two gentlemen, in particular Mr. Dugger, here to outline the results of the study they made for the subcommittee, I think it is only fair that whatever Members have questions, they should ask them. Then they can ask questions of Mr. Isaac, but I certainly would not want to be one to shutoff any Members of the committee from asking questions.

Mr. WYLIE. I don't mean to shutoff any members of the staff from asking questions.

Chairman ST GERMAIN. I mean subcommittee.

Mr. WYLIE. I just mean Mr. Dugger and Mr. Bowser will be around for a long, long time we hope. I think it would put a little different perspective on it.

Chairman ST GERMAIN. Are you making a unanimous consent request?

Mr. WYLIE. I would like to make a unanimous consent request.

Mr. BARNARD. I didn't yield my time for that purpose, Mr. Chairman. I would like to regain my time. I hope I haven't been penalized by all this interruption in between.

Chairman ST GERMAIN. No one ever penalizes.

Mr. BARNARD. OK. Mr. Dugger, I still want to know.

Mr. DUGGER. Yes, sir.

Mr. BARNARD. That if Continental had just gone under, belly up, if they had gone under and we had used the insurance funds or other methods to save these 21 banks, what would have been the cost then? I am disturbed, Mr. Chairman, like you are, about what we heard last week. We heard last week a big bank can't go under.

Well, you know, I am just disturbed by that and I think the chairman is and the committee is. But we have got to know at this point what is the alternative. You have come up with some very interesting figures and I don't dispute them, that we are not talking about 66 banks failing. We are talking about six banks failing.

Well, now, that is a very different picture from what has been painted before. But then, what is the writeoff? What is the writeoff, then, as far as the losses to the FDIC and the depositors if Continental had bellied up?

Mr. DUGGER. That is in essence the heart of the question, Mr. Barnard.

Mr. BARNARD. Well, give me the answer.

Mr. DUGGER. On table 4, you will see in essence a summary of the results of what we have done. We have incorporated deposit insurance and varying levels of recovery from the liquidation of Continental Bank, from 0 to 100 percent. We have no idea, really, of what kind of recovery you would get. For the purposes of discussion this morning, we used a number slightly below FDIC's historical average as reported to us by the FDIC staff.

You have asked a question, suppose it was just 6 banks or 28 banks that would be affected and you let a Continental fail. How much would it cost to take care of the 28 banks?

Mr. BARNARD. No; I didn't say that. That is not my question at all.

Mr. DUGGER. Let me make sure I understand it.

Mr. BARNARD. My question is what would it have cost to let Continental go down. We know what would have happened if we had just saved the 28 banks. I think we understood that. Your table has shown us that. But what does the other study show would have happened if Continental had gone down?

Mr. DUGGER. We were unable to find that the agencies had conducted such a study and we don't have the capacity to do that ourselves.

Mr. BARNARD. That is strange to me. If you had the capacity to do this, it looks like that you could have run the cost figures on what it would have cost Continental to go under. I think we have an incomplete report, Mr. Chairman.

Chairman ST GERMAIN. No one contended it was the——

Mr. VENTO. If the gentleman would yield, is the question of the gentleman from Georgia suggesting what would have been the cost of the FDIC insurance for the depositors in Continental?

Mr. BARNARD. I would like to have known, in other words, if Continental had gone under and we say it is solvent. It still had $1 billion in capital. It never did go under, but let's say it did. I think this committee needs to know what it would have cost the FDIC corpus to have insured everything under $100,000. Then what would it have cost depositors beyond that?

Mr. DUGGER. Mr. Barnard, there may be some insight regarding your question.

Mr. BARNARD. Thank you.

Mr. DUGGER. Mr. Shumway, in his May 17 memorandum to the Board of the FDIC, said it would be less expensive to pay out Continental Bank, in other words, to liquidate it, than it would be to assist it.

Mr. BARNARD. It had what, $35 billion on deposit?

Mr. DUGGER. I don't have those numbers.

Mr. BARNARD. I think that it was in the range of $35 billion. You don't know what the figures were under $100,000, do you?

Mr. DUGGER. We met with Mr. Shumway and he recited a brief calculation. Essentially, it involved the deposit insurance payment being smaller than the cost of assistance.

Mr. BARNARD. I think the committee is being asked to make a judgment, you know. Were the evaluations right or wrong? Would it have been better to let Continental go under and salvage these 21 banks? I think these are the questions that keep coming into my mind.

I wish I did have some cost figures to compare that with.

Chairman ST GERMAIN. Would the gentleman yield?

Mr. BARNARD. Yes.

Chairman ST GERMAIN. That is the whole point of this. I am in agreement with you, that is why I asked staff to do this. I want to point out to the gentleman—May 10 to July 26, the bailout package was announced; right?

The FDIC didn't come up with any of this information. We have sought it and sought it. It doesn't exist. They didn't do any of this, you are right. It should have been done.

Mr. BARNARD. See, what we are dealing with is a possible budgetary item of $38 billion.

Chairman ST GERMAIN. The man is right.

Mr. BARNARD. Consequently, you know, I am very confused over whether they did the right thing or the wrong thing. Of course, that is why we are here.

Chairman ST GERMAIN. The problem is, they didn't do it.

Mr. BARNARD. OK. I appreciate all the time that you have given me, Mr. Chairman.

Chairman ST GERMAIN. Mr. Vento.

Mr. VENTO. Thank you, Mr. Chairman. I think on the last point of the CBO study, that we ought to be aware that the $38 billion potential cost CBO estimate is high figure but does not include the difference in the interest rate that might be between the market and Federal Reserve Board.

In other words, we didn't give Chrysler the ability to go borrow money from the Federal Reserve or anybody else. And whatever the cost is ultimately to the insurance fund is not computed into that which may very well be paid as you have indicated by depositors. So that really is a figure that is very low. It seems to me the point we have had staff get into here is to look at one of the predicates, one of the underlying underpinning of why, in other words, Continental Illinois, had to be rescued as it was, because 179 banks were going to fail.

That is one idea. No one said what the cost was to the insurers. But what we have on table 4 here, and I don't know if I can interpret this properly, is an assumption that if you have 100 percent insurance and $100,000 on the vertical or horizontal axis, that on the other axis then, you determine from zero to 100 recovery in terms of the loans.

Is that correct, of the assets of those institutions—of Continental in terms of whether the FDIC could in fact recover those in terms of managing the remaining loan portfolio. Is that correct, Mr. Dugger.

Mr. DUGGER. Yes, this table assumes that $100,000 insurance is paid, and presents the number of banks involved for various levels of recovery from the sale of Continental's assets. Yes, you are right.

Mr. VENTO. In other words, we can pick our own theory and figure out then what the total cost would be on any of these particular lines some of which range quite high. The major point is, Mr. Chairman, when you say from May whatever.

Chairman ST GERMAIN. May 10 to July 26.

Mr. VENTO. But the point is that the Comptroller told us and I think it is in the records and the FDIC now that for almost 2 years, that this bank had been in trouble. So it isn't just a matter of coming on the scene here with just 2 months of time. I assume the Comptroller and FDIC and others have a continuing responsibility from 1982 with respect to this so that the oversight in terms of not exploring and not coming up with this type of information is much more than just a 2- or 3-month timeframe in which this occurred.

I mean the idea that this somehow came down quickly that, the pressure of time did not permit them to have this type of information, simply is not an excuse. Into the vaccum moves the idea. The problem, it seems to me, that this is the main justification that is talked about, that if you make the problem big enough in terms of the issue, then that provides the excuse for extraordinary intervention.

It seems to me that the problem, this balloon, this problem which is a problem with regards to Continental Illinois, has a great deal of gaseous substance blown into its body.

Chairman ST GERMAIN. Sounds like the Gulf of Tonkin.

Mr. VENTO. So I am concerned. I think it is very useful. I think it is only appropriate that the staff that did this report and interpret it and tell us what it means, as opposed to others that did not do this particular report. I hope that this, I think, the exercise here really is to look over the ability of the FDIC, the Federal Reserve, the Comptroller, in terms of what they are doing and what the impact is in terms of the regulatory structure that we have dealing with such problems, because it is clearly evidenced that there are other financial institutions, large and small, that are experiencing severe problems in this so-called economic recovery.

I yield back.

Chairman ST GERMAIN. I thank the gentleman.

Mr. Leach.

Mr. LEACH. Mr. Chairman, I would like to raise a scheduling problem, if I could. As you may know, the President of the United States has invited a part of this committee to the White House at 11:45 this morning to discuss, I think, the unseemly topic of how to make Mr. Wylie chairman. But in any regard, one of our problems with our distinguished witness, Mr. Isaac, is if we go on with our committee witnesses, we have a problem of when Mr. Isaac can testify with the minority present.

And I am wondering if maybe a reasonable solution in which everyone will be given a little fair notice might be to suggest that we go on with these witnesses, and ask Mr. Isaac to appear, let's say, at 1:30. That way we have a full airing of the committee witnesses and at the same time, give Mr. Isaac the chance to testify with the full presentation of the minority being present.

Just because I think it would be very awkward for any of us in the minority to snub our President and at the same time, it would be awkward for Mr. Isaac to testify as a representative of the administration without the minority present.

Chairman ST GERMAIN. Well, I take issue with one little statement, Jim.

Mr. LEACH. I understand that.

Chairman ST GERMAIN. I don't think Mr. Isaac is representing the administration. I think he is representing the FDIC.

Mr. LEACH. Yes.

Chairman ST GERMAIN. I look upon Mr. Isaac as nonpartisan even though he was appointed by the administration. I really do. I don't think there is any partisanship.

Mr. LEACH. Well, I can understand that. In any regard, since there are differences of view on this issue, and obviously, in a nonpartisan way as well, we do have this modest problem of a Presidential invitation.

Chairman ST GERMAIN. I wasn't aware of that invitation, Jim.

Mr. LEACH. I understand that.

Chairman ST GERMAIN. This is the first I have heard of it. What time are you suppose to be there?

Mr. LEACH. We are all asked to leave on a bus at 11:45, the entire Republican membership of the House. Obviously we all assumed Mr. Isaac would be on early.

Chairman ST GERMAIN. Well, he would still be on, you know. I mean he wouldn't be leaving at 11:30 anyway.

Mr. LEACH. I understand that. The problem is, if these witnesses finish next, say, in the next 15, 20, 30 minutes, then suddenly half the committee or a third of the committee would have no benefit of listening to the testimony and also would have an awkward time getting back——

Chairman ST GERMAIN. If the gentleman would agree to this, we would call upon you and your colleagues on this side to question these witnesses, we would then excuse you. We would then ask Mr. Isaac to read his testimony, which you have had.

Mr. LEACH. Surely.

Chairman ST GERMAIN. Therefore, we wouldn't begin the questioning until upon your return.

Mr. LEACH. I think that is fair enough.

Chairman ST GERMAIN. Does that accommodate our brethern on the other side of the aisle? Mr. Isaac?

Mr. ISAAC. I do not intend to read anything, Mr. Chairman. I do not intend to read any testimony. I would like to have the opportunity to testify, but I do not intend——

Chairman ST GERMAIN. I can't hear you.

Mr. ISAAC. I do not intend to read any testimony, Mr. Chairman. I intend to simply respond to questions.

Obviously, there are a lot of them that need responses, because there are obviously some serious information gaps.

Chairman ST GERMAIN. That is fine. Then what we will do is we will conclude with these witnesses, then we will ask you to return at 1:30 and begin the question and answer period.

Mr. ISAAC. That would be just fine.

Chairman ST GERMAIN. We will just put your entire statement in the record.

Mr. ISAAC. Thank you.

Chairman ST GERMAIN. I thought perhaps you might seriously want to summarize your statement for the benefit of those people who aren't here and won't have your statement, to wit, the people that would be edified by your statement watching us through these little lenses.

I am just trying to be fair with you, Bill. It is entirely up to you.

Mr. ISAAC. I, frankly, think there is so much misinformation here it would be more useful to deal with that problem.

Chairman ST GERMAIN. We can stay here all night if you like. If there is objection, we will allow our brethern on the Republican side to ask questions of our staff. Then we will come back to our side and recess until 1:30, when Mr. Isaac will then answer questions.

Without objection. Mr. Leach?

Mr. LEACH. Mr. Chairman, I would just like to comment. I think you have been eminently fair in this. I appreciate it very much. I have no questions of the staff. I would only like to suggest that perhaps based upon the exchange that occurs after Mr. Isaac testifies, that it is possible that a fuller report might even be available, if there is a further meeting.

I personally think that the initiative of the chairman to ask for a staff report makes a good deal of sense. I have no idea how valid or invalid its conclusions are. And I think that the give and take between the staff report and the chairman would be very helpful. But I appreciate very much the efforts of the chairman first on having the report made, and second, in accommodating the minority. I have no questions.

Chairman ST GERMAIN. Mr. McCollum.

Mr. MCCOLLUM. Mr. Chairman, I do not wish to ask questions now. I certainly would concur in what Mr. Leach said. I think it would be helpful for us to review their work and perhaps have more. I am sure you will pursue that after we here from Mr. Isaac. Thank you.

Chairman ST GERMAIN. Mr. Ridge.

Mr. RIDGE. Thank you, Mr. Chairman. As a guest of your subcommittee, I appreciate the opportunity to participate. I look forward to going over Mr. Dugger's statement returning at 1:30 to listen to Mr. Isaac. I have no questions.

Chairman ST GERMAIN. The minority is excused.

Mr. Cooper.

Mr. COOPER. I have no questions.

Chairman ST GERMAIN. Does anyone else have further questions, members of the subcommittee? If not, the subcommittee will be in recess until 1:30.

[Whereupon, at 11:30 a.m., the subcommittee was recessed to reconvene at 1:30 p.m.]

AFTERNOON SESSION

Chairman ST GERMAIN. The subcommittee will come to order. I am given to understand that the expenditious bus transit company will be returning our Republican colleagues to us momentarily. And in view of the fact they were delayed slightly, I thought it might be wise for me to have another opening statement.

Before we get lost in the thicket of numbers, Mr. Isaac, I want to make a couple of points.

All this controversy about numbers—all this confusion in the public's mind about the bailout—might have been avoided had your office done its job up front when the bailout question first came up.

I am shocked that the keeper of the insurance fund did not insist right from the opening gun on a top-to-bottom cost analysis. Perhaps in the final analysis you would have been forced to concede to the other regulators, but I would think the man with the fiduciary responsibility would have thrown down the cost analysis in the very first meeting on Continental. It is your responsibility to protect that fund and to place a heavy burden of proof on any one—including your fellow regulators—who wants to tap it.

In truth and in fact, costs to the insurance fund were an afterthought—you didn't even prepare an analysis that's how little you worried about this part of your job.

I want to give you a full right to reply here today, but I'm just sorry you weren't more concerned about numbers and cost analysis a few months ago.

Our staff didn't create the problem. They've searched your files and found nothing. They've done the best to try to track what the regulators—what you have been talking about—in those sky-is-falling statements.

In that breathless conference call to the Congress the night before the bailout, we all heard the numbers 2,400 and 75—2,400 with relationships with Continental and 75 that would go down the tubes if you didn't let Continental have the money.

Two weeks ago, your fellow regulator C.T. Conover—who sat beside you in the Continental wake—told the committee that 66 banks would have failed without the bailout.

The 75 had slipped, but we still had a big scary number in front of us.

I assume, Mr. Isaac, that you expected some kind of recovery from Continental—a recovery that presumably would have had an impact on this numbers game.

What was the expectation—10, 20, 30, 40, 50, 60, 70, 80, 90, or 100 percent * * * You pick the number. You tell us. We know that your historical recovery rate has been well in excess of 70 percent—even with all those junkyard banks thrown in. And I trust, we don't regard Continental as a junkyard, total loss type of situation.

Mr. Isaac, this committee and the public should have had this data months ago. It shouldn't have to be forced out of FDIC in a hearing. It should be required reading right up front. Now that you are on the defensive, apparently you plan to produce something. Fine. Better this way than never.

STATEMENT OF HON. WILLIAM M. ISAAC, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. ISAAC. Thank you, Mr. Chairman. I would like to ask my full statement be placed in the record.

Chairman ST GERMAIN. Without objection, so ordered.

Mr. Isaac, would you please stand up for a moment. Do you swear that the testimony you are about to give will be the truth, the whole truth and nothing but the truth?

Mr. ISAAC. I do.

[The prepared statement of Chairman Issac on behalf of the Federal Deposit Insurance Corporation follows:]

STATEMENT ON

FEDERAL ASSISTANCE TO CONTINENTAL ILLINOIS
CORPORATION AND CONTINENTAL ILLINOIS
NATIONAL BANK

PRESENTED TO

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS SUPERVISION,
REGULATION AND INSURANCE
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES

BY

WILLIAM M. ISAAC, CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

10:00 A.M.
THURSDAY, OCTOBER 4, 1984
ROOM 2128, RAYBURN HOUSE OFFICE BUILDING

Mr. Chairman, members of the Committee, we are pleased to have this opportunity to discuss the assistance package extended to Continental Illinois National Bank and Trust Company. I will explain why we did what we did and then turn to some of the questions and concerns which have been raised about the package.

I. THE BACKGROUND

During the mid-to-late 1970s, Continental embarked on a strategic plan to become one of the world's largest corporate lenders. The plan entailed a rapid growth rate in loans, which could not be sustained by retail funding sources, particularly in view of the severe branch banking limitations imposed under Illinois law. The risk in this strategy was compounded by the bank's decision to rely heavily on particularly short-term, volatile funding. By shortening its liability structure, the bank was able to purchase funds at a somewhat lower cost than longer term funding.

The first sign of real trouble at Continental appeared when Penn Square Bank failed on July 5, 1982. When I was first briefed on the Penn Square situation, I was informed that the ramifications could spread far beyond Oklahoma City. A number of financial institutions, particularly Seattle-First National Bank and Continental, were extensively involved as suppliers of funds to Penn Square and/or as participants in loans. Under the law, if we were to handle Penn Square in the customary way by merging it into another bank, these financial institutions might be bailed out of many of their problems by forcing the FDIC, in its corporate capacity, to repurchase their loan participations. If instead we were to pay off Penn Square's insured depositors and liquidate the bank, Seattle-First and Continental might be required to absorb substantial losses, though the full extent of their troubles could not be forecast.

Our law contains a "cost test," which requires that we determine that the cost of a merger will likely be less than the cost of an insured deposit payoff. The billions of dollars of potential claims arising from loan participations and letters of credit to which the FDIC would have been exposed, if a merger of Penn Square had been arranged, precluded us from satisfying the cost test. Moreover, we were deeply concerned about the longer range consequences to the financial system of possibly bailing out Seattle-First, Continental and numerous other banks, savings and loans and credit unions, which had been important contributors to the Penn Square debacle through their failure to exercise prudent credit judgment.

It is ironic that some people have chosen to label our Continental assistance package as a large bank bailout. If we had wanted to bail out Continental or Seattle-First, we had the potential to do so in a much less visible way at the time of Penn Square. We chose not to do so, at least in part because we believed that the management and shareholders of those institutions should be accountable for the mistakes made. They have in fact paid a substantial price. I should note that the FDIC's board was of one mind on the appropriate course of action.

During the two-year period following Penn Square, the situation at Continental deteriorated. The loans purchased from Penn Square proved to be worse than anticipated and other problem loans surfaced, particularly in the bank's special industries division. The bank's funding grew even more volatile as sellers of funds resisted longer term commitments. Each day the bank had to purchase in the range of $8 billion, or about 20 percent of its total funding.

The bank responded to Penn Square by tightening controls and making some management changes. However, changes in top management were not made for nearly two years and, when they did occur, the bank did not go outside for replacements. The bank's loan chargeoff policy, at least in hindsight, was not sufficiently aggressive, and its dividend was not reduced. The sale of the bank's profitable credit card operation several months ago was perceived by many as a desperate attempt to raise funds to support the dividend, to the long-range detriment of the bank.

Conditions were ripe for a crisis in confidence. It occurred in May of this year when rumors began circulating that the bank was on the brink of insolvency.

The bank lost approximately $9 billion in funding and the prospect was for the total to reach the $15-to-$20 billion range in short order. Moreover, the funding problem at Continental was beginning to affect financial markets generally. Something needed to be done quickly to stabilize the situation.

II. THE INTERIM PACKAGE

Theoretically, we had four options: close the bank and pay off insured depositors, arrange a hasty merger on an open-or closed-bank basis, grant permanent direct assistance or provide interim direct assistance. We chose the last option.

Continental was not and is not insolvent in the sense of its liabilities exceeding its assets. That is an important test in judging the viability of a bank and the test normally used by the Comptroller in closing a national bank. While the bank had severe confidence and liquidity problems, closing the bank and paying off insured depositors could have had catastrophic consequences for other banks and the entire economy. Insured accounts totalled only slightly more than $3 billion. This meant that depositors and other private creditors with over $30 billion in claims would have had their funds tied up for years in a bankruptcy proceeding awaiting the liquidation of assets and the settlement of litigation. Hundreds of small banks would have been particularly hard hit. Almost 2,300 small banks had nearly $6 billion at risk in Continental; 66 of them had more than their capital on the line and another 113 had between 50 and 100 percent. More generally, closure of a bank, whose solvency was apparently not impaired, in response to its liquidity and confidence problems would have raised concerns about other, soundly managed banks.

Arranging a merger in a few days' time would likely have been impossible. Even if it had been possible, prospective purchasers would not have had an opportunity to evaluate the bank and, thus, would have required substantial FDIC financial involvement to protect against the uncertainties. In short, it would have been a buyer's market and extremely expensive to the FDIC. At the same time, a merger would have had the same effect as a capital infusion in that all depositors and other general creditors of the bank would have been protected, while shareholders would have been exposed to the risk of loss.

Granting permanent direct assistance was rejected for several reasons. First, not enough was known about the bank and its true needs. Second, sufficient time was needed to resolve all of the legal and accounting complexities and to arrange for new management. Finally, we believed we should exhaust every reasonable avenue for a private sector solution before resorting to permanent direct assistance.

By a process of elimination, we were left with but one course of action: render temporary assistance to stabilize the situation while the bank was examined, meetings were held with prospective investors and the permanent assistance package was crafted. The interim assistance package had three key elements: first, a massive infusion of temporary capital -- $1.5 billion from the FDIC and $500 million from leading banks; second, an assurance by the FDIC that the permanent solution to the bank's problems would protect all depositors and other general creditors of the bank against loss; and third, liquidity support from the Federal Reserve and leading banks.

The package was put together in a few short days thanks to superb cooperation among the three banking agencies and the banks. Never before has the system responded so well or so swiftly.

The package worked precisely as intended. It gave us the time we needed to evaluate the bank and fashion a sound, permanent program.

III. THE PERMANENT ASSISTANCE PROGRAM

The permanent program was announced two months later on July 26. It entailed two key elements: top management changes and substantial financial assistance.

On the management side, an internationally recognized management team, John E. Swearingen and William S. Ogden, was installed. The board of directors will be significantly reconstituted as soon as practicable.

The financial assistance program involved the sale of $4.5 billion in problem loans to the FDIC for a price of $3.5 billion (the loans have a face value exceeding $5.1 billion due to over $600 million in earlier chargeoffs by the bank) and the infusion of $1 billion in new capital from the FDIC. The interim package was terminated.

In consideration for the capital infusion, the FDIC has the right to acquire 80 percent ownership of the parent company, Continental Illinois Corporation. The remaining 20 percent interest owned by the current shareholders is subject to forfeiture to the FDIC depending on the losses, if any, suffered by the FDIC in connection with the loan purchase arrangement.

The FDIC paid the $3.5 billion purchase price for the problem loans by agreeing to repay an equal amount in bank borrowings from the Federal Reserve Bank of Chicago, including interest at a market rate. The Federal Reserve loan will be repaid out of collections on the problem loans with a final settlement in five years.

The FDIC has been assigned all claims against present and former officers, directors, employees and agents of the bank and its parent, as well as against bonding companies, accounting firms and the like, arising out of any act or omission that occurred prior to consummation of the permanent aid transaction. These claims will be pursued vigorously and any recoveries will be credited to collections made under the loan purchase arrangement.

The special liquidity arrangements provided under the interim package by the group of leading banks and the Federal Reserve are continued under the permanent program.

As a result of the permanent aid transaction, Continental is now strongly capitalized and comparatively free of problem loans. It is a smaller bank, less dependent on volatile funding sources and positioned to continue providing the full range of services to its customers.

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The FDIC will not interfere with or control the bank's day-to-day operations. The agreements give the FDIC certain basic protections as a major investor, such as the right to object to the continued service of any board member, safeguards against dilution of the FDIC's shares and the right to veto any merger or reorganization. However, the FDIC will not control the hiring or compensation of officers, lending or investment policies or other normal business decisions.

As soon as practicable, the FDIC intends to dispose of its stock interest in Continental Illinois. This could be accomplished through a sale to a private investor group, to one or more banking organizations or to the public in an underwritten offering.

At this time, it is not possible to make an accurate forecast of any eventual gains or losses to the FDIC under the permanent assistance program. That will depend on the price the FDIC receives when it sells its stock interest in Continental Illinois and on any losses incurred under the loan purchase arrangement. We believe that any FDIC losses will be comparatively modest, and there is a possibility of a gain.

IV. <u>RESPONSES TO QUESTIONS AND CONCERNS</u>

The FDIC's response to the crisis at Continental Illinois has engendered considerable public comment -- some informed and thoughtful, some wide of the mark. I will devote the balance of my testimony to responding to some of the most frequently expressed concerns and commonly asked questions.

Q. **<u>Why did the FDIC provide its assurance on May 17 that all depositors and other general creditors of the bank would be protected in any subsequent transaction to permanently resolve the bank's problems</u>**? By placing the interim capital of $2.0 billion in the bank on top of its existing $2.2 billion in book capital and reserves, the FDIC was in fact providing more than enough cushion to protect all depositors and other general creditors against loss. Since the purpose of the interim capital was to stabilize the bank's funding sources to give us the time needed to evaluate the bank and arrange a sound and orderly permanent solution, we felt we should simply state what we already believed to be the case rather than leaving it to individual depositors to make their own judgments.

Q. **<u>What legal authority did the FDIC have to extend the $100,000 deposit insurance ceiling in this fashion</u>**? The assurance given by the FDIC is widely misunderstood. The FDIC did not increase the $100,000 insurance limit. In giving the assurance, the FDIC was simply stating that it would not resolve the bank's problems through a payoff of insured depositors -- that the permanent solution would involve either a merger or direct financial aid, both of which would necessarily protect all depositors and other general creditors. In recent decades, approximately 75 percent of bank failures have been handled through a merger or direct financial aid, and depositors and other general creditors have been fully protected.

Q. Are there any precedents for this type of assurance, particularly at smaller banks? In 1981, the Greenwich Savings Bank was experiencing a run. The FDIC issued a press statement acknowledging the bank's difficulties and assuring all depositors and other general creditors that they would be protected when a solution to the problem was developed. The action gave us the time we needed to arrange an orderly merger, which made whole all depositors and other general creditors. In 1983, the FDIC provided an interim $25 million capital infusion to the United Southern Bank in Nashville and also issued an assurance to depositors. Again, the action gave us the time we needed to arrange an orderly merger. Finally, later in 1983, the FDIC provided interim capital of $100 million to First National Bank of Midland before putting together a merger. In those cases, as with Continental, the interim assistance was initiated not by the banks but by the FDIC to protect its own interests -- to calm a liquidity crisis, thereby preserving franchise value and holding down the cost to the FDIC of the permanent solution.

Q. Did the interim solution work or did the run on Continental continue despite the assurance? The interim program worked well, particularly through most of June. The bank's borrowings from the Federal Reserve, the FDIC and the safety net banks totalled $9.4 billion on May 18, with the prospect that the number would have climbed to the $15-to-$20 billion range in short order if nothing had been done. One month later, on June 18, the borrowings from these three sources had declined to $8.2 billion. In late June and throughout July, the situation deteriorated as adverse press stories and speculation appeared almost daily and as funds suppliers became anxious about the nature of the permanent solution. Would there be a merger and, if so, with whom? Would there be direct assistance and, if so, how much? Would there be management changes and, if so, would the new people be competent? Would the government run the bank? Would the new institution be viable? By July 26, the borrowings from the three sources had increased to $12.6 billion. The only surprise was that it had not gone higher considering the volatile nature of the funding, the uncertainties regarding the permanent solution and the intense media coverage. Since the announcement of the permanent program, the funding has remained fairly steady. As of September 21, borrowings from the three sources declined slightly to $12.3 billion. The absence of significant improvement is due primarily to the lack of favorable ratings which would make it possible for institutional investors, such as money funds, to return to the bank. The bank could not get its ratings upgraded until after the permanent aid program was approved by the shareholders, and, though we hope not, some rating services might wait until a quarter or two of earnings are produced. When the ratings are upgraded, the bank is expected to once again become self-sufficient.

Q. How do you justify the expenditure of tax money by unelected officials to bail out Continental? First, not one nickel of taxpayer money is involved. The FDIC is funded entirely by bank assessments and interest on its investment portfolio. It was created by Congress in 1933 for precisely this purpose and has acted well within its statutory authority. Second, there has been no bailout. Shareholders have suffered an 80 percent dilution and could lose their entire investment, depending on the FDIC's losses under the loan purchase arrangement. Top management changes have been made and more are contemplated. All legal claims against officers, directors and others have been assigned to the FDIC and will be vigorously pursued. In short, the bank has been handled as if it had failed. Depositors and other general creditors have been protected, but they are protected in most bank failures.

Q. Perhaps no taxpayer money is involved, but won't bank customers indirectly foot the bill because banks will pass along the higher cost of deposit insurance? If the FDIC loses money at Continental, banks will try to pass at least some of the added cost of deposit insurance to their customers. It is not clear that they will be able to do so in today's highly competitive marketplace. It is conceivable that the FDIC will not lose any money or will make a profit at Continental. In any event, there is little doubt that the FDIC would have lost more money had it handled Continental in some other fashion. An analogy can be made to casualty insurance. Automobile manufacturers pay premiums for casualty insurance, and when losses rise so do premiums. These costs are passed along to car buyers to the extent possible. That does not transform the expenditure into a tax dollar.

Q. But doesn't the FDIC have the right to draw upon tax dollars? The FDIC has the right to borrow up to $3 billion from the U.S. Treasury. If it does, it must pay the money back at a market rate of interest. The FDIC has never needed to borrow from the Treasury and does not foresee a need to do so.

Q. What about the assumption of Federal Reserve debt by the FDIC -- isn't this unprecedented and why was it done? The FDIC paid for the problem loans by agreeing to repay an equivalent amount of the bank's Federal Reserve debt over a five-year period. Similar transactions were structured in 1974 when Franklin National Bank failed, in 1981 when Greenwich Savings Bank failed and in 1983 when First National Bank of Midland failed. The FDIC in the past has also agreed to repay savings bank borrowings from the Federal Home Loan Bank system. The Federal Reserve debt bears a market rate of interest so no subsidy is involved. The transaction permits Continental to shrink in size, reducing its need for volatile funding, and enhance its earnings by removing most of its nonperforming loans. The cost, if any, of the transaction will be borne first by the shareholders and then by the FDIC. The FDIC could have purchased the loans using its own cash, but assuming the Federal Reserve debt enables the FDIC fund to conserve its liquidity.

Q. <u>Speaking of the FDIC fund, isn't it getting stretched pretty thin by Continental and all the other bank failures in recent years?</u> Despite absorbing record losses from 1981 through 1984, the FDIC fund is stronger and more liquid than ever. At the beginning of 1981, the fund totalled $11 billion. Today it stands at nearly $17 billion. The fund is invested in U.S. Treasury obligations with an average maturity of just over 2½-years. Gross income from bank premiums and interest on the FDIC's investment portfolio will be in the range of $3 billion this year. Net positive cash flow during the next twelve-months is expected to exceed $5 billion. When you consider that Continental was larger than the combined total of all the banks that have failed in the history of the FDIC, it is remarkable and extremely reassuring to witness the ease with which the insurance fund handled it.

Q. <u>Why did the FDIC assist the parent holding company instead of only the bank -- didn't that provide unjustified protection to the holding company's creditors?</u> The FDIC would have preferred to place the new capital directly in the bank rather than using the holding company as a conduit, but it could not be done. The holding company had outstanding several indenture agreements which would have been violated. Some of them had no mechanism for obtaining a waiver of default. In any event, the issue was largely an academic one at Continental since the holding company had assets roughly equal to its liabilities, even if its investment in the bank were valued at zero. Thus, as a practical matter, the holding company's creditors would not have lost much, if anything, irrespective of the structure of the aid program.

Q. <u>Isn't Continental, in effect, "nationalized" -- why didn't you put together a private-sector transaction?</u> Continental remains under private-sector control. The FDIC has made a major investment but will not be involved in or interfere with the normal operations of the bank. The FDIC intends to sell its ownership position as soon as it can be done consistent with minimizing costs or maximizing the return on the FDIC's investment. Contrary to some uninformed reports in the press, the FDIC made it clear to prospective purchasers from May 17 forward that it would be willing to assist a private-sector solution to the extent necessary. Several private-sector proposals were received, but none would have created as strong a bank, at as low a cost to the FDIC, as the permanent assistance program.

Q. <u>Why are the rich and powerful getting bailed out at Continental while small banks are permitted to fail?</u> First, the rich and powerful are not being bailed out. Shareholders and top management are being handled as if the bank had failed. All depositors are being protected, but they are when most banks fail. Among the principal beneficiaries of this protection are some 2,300 small banks which had nearly $6 billion at risk in Continental. Second, the assistance to Continental is designed to minimize the cost to the FDIC. If it had been handled in some other fashion, the direct cost of the transaction would have been very high and the cost of the domino effect, as other banks failed, would have been incalculable. Third, unlike every small bank that has failed, Continental was not and is not insolvent on a book basis. It was experiencing a severe liquidity crisis, but it had book capital and reserves approximating $2.2 billion on May 17 and continues to have nearly $1.0 billion today without regard to the FDIC assistance. Solvent small banks seldom face severe liquidity problems, but when they do, assistance is normally available from the Federal Reserve. Due to the extremely volatile nature of its funding, that type of assistance was not sufficient to stem the tide at Continental. Finally, if the FDIC had wanted to bail out Continental, as previously noted it had the potential to do so in a far less visible fashion at the time of the Penn Square Bank failure.

Q. But uninsured depositors at small banks are sometimes placed at risk -- how do you justify the different treatment at Continental? Primarily because of our concern about the effect of a payoff on the entire banking system and the fact that Continental was not insolvent. This is not to say there is not a serious perception problem. During the fifty-year history of the FDIC, nearly 50 percent of all bank failures have been handled as straight liquidations, wherein uninsured depositors have been placed at risk. A large bank has never been handled in this fashion, creating the impression that a large institution is safer from the standpoint of an uninsured depositor. The FDIC is deeply concerned about this perception and has been endeavoring to change it. A principal difficulty with a large bank payoff is that the volume of uninsured funds is so massive. One way to alleviate the adverse economic impact of a large bank payoff would be to advance to the uninsured depositors, at the time of failure, an amount equal to what the FDIC estimates they would ultimately receive from the liquidation of the bank. The FDIC calls this type of transaction a "modified payoff." It was recently developed and tested by the FDIC as a possible way to handle bank failures of all sizes in an even-handed manner. It also offers the advantage of encouraging large depositor discipline in the system.

Q. Why didn't you handle Continental as a modified payoff? First, as noted earlier, the bank was not insolvent. Second, we could not have handled it administratively in a bank of this size at this time -- we needed more of an opportunity to test and develop the procedures. Third, it would have entailed an abrupt policy change on a massive scale, which we had promised we would not do, and would have seriously injured scores of small banks which maintained correspondent relationships with Continental.

Q. Is the modified payoff plan dead? The testing phase of our modified payoff plan ended before the May 17 Continental package. It was used in 9 out of 17 failures from March 16 to May 11, most of which would otherwise have been handled as a straight payoff due to the lack of acceptable bids or to the existence of large contingent claims which made mergers impossible. We are evaluating the results of the tests and are planning to consult with bankers and others before deciding how to proceed. If we decide to go ahead, we will provide substantial public notice and lead time as promised in our press release of March 16. This will give weaker banks an opportunity to correct their problems and allow for the possible development of private-sector deposit insurance on amounts over the FDIC insurance limit. In the meantime, modified payoffs may be used to alleviate the disruption when a straight payoff would otherwise be indicated.

Q. Do you agree with those who say that the modified payoff test made financial markets jittery and may have helped fuel the run on Continental? This speculation has no basis in fact and lacks historical perspective. First, the FDIC announced in several press releases that the modified payoff was a test and would not be employed generally without adequate public notice. Second, the procedure was used in the successive failures of three affiliated banks in Texas over a two-month period and in each one a significant proportion of the uninsured deposits remained. Third, the Continental run started abroad and the foreign bankers with whom we have subsequently met had never heard of the concept. Finally, large banks with a heavy dependence on volatile funding were subject to liquidity crises long before modified payoffs were even considered. Franklin National Bank lost nearly 25 percent of its deposits in four days in 1974 when adverse news regarding its condition was made public. The run exceeded 50 percent of deposits by the time a merger was finally arranged. First Pennsylvania Bank lost over $1 billion in deposits in 1980 in reaction to negative publicity. In 1981, the Greenwich Savings Bank lost nearly $500 million in funding when word of its difficulties surfaced. These runs occurred despite the conventional wisdom that the authorities would never allow depositors to suffer a loss in a sizable bank. The liquidity crisis at Continental developed for one simple reason: suppliers of funds, who had no particular loyalty to the bank, lost confidence in the institution and its policies. It would be hard to argue that the markets behaved irrationally.

Q. Does the FDIC still believe there is a need for market discipline? The need for market discipline is growing, not diminishing. It is the only truly effective way we know of in a deregulated interest-rate environment to protect the vast majority of banks that are prudently operated. In the absence of market discipline, the money will simply flow to the banks that pay the highest rates, which tend to be the marginal operators. Market discipline is essential to the maintenance of a strong, free-enterprise banking system.

Q. Are there ways other than the modified payoff to encourage more discipline? In our deposit insurance study submitted to Congress last year, we suggested an alternative whereby discipline could be encouraged through the suppliers of capital to banks, specifically subordinated debtholders. The federal banking agencies currently require equity capital in the 5-to-6 percent range for a well-run bank. We could gradually raise the minimum standard to the 9 percent range and allow the additional amount to be satisfied with subordinated debt. A well-run bank should be able to issue subordinated debt at a comparatively modest cost above the CD rate. A marginal bank would pay a premium or perhaps not be able to issue the debt, thereby limiting its ability to grow. We believe this system, coupled with the depositor preference bill we have pending before the Congress, could be nearly as effective as the modified payoff procedure in maintaining discipline and would enable us to arrange for the merger of nearly every failed bank. At least prior to Continental, however, the banking industry had indicated its preference for the modified payoff approach. One problem is that the savings and loan industry has far lower capital standards than those to which banks are subject. We have also suggested other supplemental steps such as risk-based FDIC premiums and limitations on the use of brokered funds. None of these measures is easy to sell politically. While a great many people in and out of government deplore the necessity of Continental-type rescue efforts, fewer appear to be willing to make fundamental changes in the system that gave rise to it.

Q. Doesn't the situation at Continental prove that deregulation doesn't work? It is ironic that competitors of banks and the foes of deregulation are attempting to use the Continental episode to bolster their case. In our judgment, the situation at Continental simply demonstrates that the policies of the past must be altered. The fact is that we do not currently have meaningful deregulation. The only deregulation in place is on the liability side of bank balance sheets. Banks have been forced to pay more for their deposits but have not been given the opportunity to make up the lost income on the asset side. Rather than permitting banks to invest sensibly in domestic financial-services ventures, public policy has tempted some of them to take higher credit risks to offset their higher liability costs. When banks try to raise service charges to help cover their increased expenses, they are roundly criticized. Banks such as Continental are hemmed in by branching restrictions, which preclude the development of a strong core deposit base and lead to excessive reliance on volatile funding. Until this summer when Illinois adopted emergency legislation, Continental's choices of partners for a voluntary merger were severely limited by restrictive laws. This is not to argue that Continental would not have gotten into difficulty had the regulatory climate been more favorable. Continental's management made serious mistakes and has no one to blame but itself. But deregulation clearly did not cause the problems and a persuasive case can be made that excessive regulation helped create or exacerbated them.

Mr. Chairman, members of the Committee, let me thank you once again for providing this forum for a constructive dialogue on the situation at Continental Illinois. It is an unfortunate, historic event which has caused considerable pain for many people. We owe it to the American public to learn from this episode and, if there is any way possible, to prevent others from arising in the future. We pledge to assist you in that endeavor.

I would be remiss if I closed without expressing my deep appreciation to the hundreds of individuals at the FDIC, the other banking agencies and at the bank who made the rescue effort possible -- people who toiled, for the most part, in anonymity late into the evenings and throughout the weekends. In Continental, and in scores of other situations throughout the past several years, they have shown their dedication and their worth. They are one of the most deserving and least recognized and rewarded groups in our nation.

* * * * *

Chairman ST GERMAIN. All right.

Mr. ISAAC. This will probably turn into be a somewhat long afternoon with heavy questioning, and I thought that since we are——

Chairman ST GERMAIN. Excuse me. Maybe you could get a little closer to the microphone.

Mr. ISAAC. Maybe it is not on. Is it on?

Chairman ST GERMAIN. Yes.

Mr. ISAAC. This will be probably a somewhat long afternoon with a lot of heavy, serious questioning. I thought the chairman might appreciate starting off on a little bit of a light note.

As our staff was rummaging through the files a couple of months ago, they produced a document which I want to share with you. It is dated July 13, 1937. It is a rider attached to and made part of the statement of Continental National Bank & Trust Co. of Chicago under title I of the Bank Act of 1935. It is a form they filled out to pay their FDIC premiums. The rider that is attached to it states:

> The within statement is filed and payment of $681.96 is made under protest, solely to prevent the imposition of penalties provided for in title I of the Banking Act of 1935. The undersigned alleges that said title I of said act is invalid and unconstitutional. By filing this statement and paying said sum, the undersigned does not waive any of its constitutional rights, including its right to a refund of said sum but expressly reserves all rights.

It's signed by Continental National Bank & Trust Co. of Chicago, Frank King, cashier.

The chairman is a distinguished lawyer from the Boston University School of Law. I would like to ask your opinion—do you suppose it's too late?

[Laughter.]

Chairman ST GERMAIN. The chair will deliver a brief later.

Mr. ISAAC. Thank you.

Before we begin, I would really like to say something. Frankly, I'd like to get something off my chest. I took great personal offense at what I witnessed this morning, and I know our staff did, as this agency's intelligence and integrity and mine were called into question, as well as the other bank regulatory agencies.

The committee staff knows better. They have met with our staff. They know what we did. They know why we did it. And what we heard this morning, frankly, was disgraceful, in my judgment. We had at the time of Continental in May, estimates of the amount of deposits placed in Continental by other banks. The estimates didn't come in June. Your staff knows that. I asked for the data to be reviewed in June, after the interim package was put in place, because I wanted more accurate data.

I wanted to know exactly what the situation was. I was told between May 10 and May 17, when we were working on the interim Continental transaction, that there was between $3 to $4 billion in deposits and Fed funds in Continental placed by something like 500 to 1,000 banks. I was told that orally.

So I knew we had a problem with a bunch of small banks. I didn't know the exact number of banks or the exact dollar amount of the exposure. That is why I asked for that memo in June from our staff. The memo from our staff noted that each of those banks was entitled to $100,000 deposit insurance coverage. They didn't need to tell me that. I knew the law. If you multiply $100,000 times

2,300 banks you come up with roughly $230 million in insured deposits out of the total of $6 billion, leaving us with roughly $5.8 billion in uninsured funds.

I knew that then. I know it now. Your staff knew it months ago. The $5.8 billion in uninsured funds, if you apply your staff's loss figure of 30 percent, would have cost those 2,300 banks $1.7 billion. That is what we were concerned about. I have never predicted and this agency has never predicted the number of banks that would have failed as a result of a deposit payoff in Continental.

Chairman St Germain. Well, how can you know unless you run some numbers to determine that, Mr. Isaac.

Mr. Isaac. I didn't have——

Chairman St Germain. You are giving us a generalization again, with no specifics. None whatsoever.

Mr. Isaac. I will—I just——

Chairman St Germain. Let's look at the graph.

Mr. Isaac. The graph is meaningless.

Chairman St Germain. If the graph is inaccurate, then tell us so.

Mr. Isaac. The graph is meaningless, Mr. Chairman. What I was concerned about is that 2,300 banks would have suffered $1.7 billion in losses——

Chairman St Germain. On what do you base that? You mean to tell me there would be no recovery?

Mr. Isaac. No. I used your staff number of assuming a 70 percent recovery on $5.8 billion. And a full recovery on $230 million in insured money.

Chairman St Germain. Now wait a second.

Mr. Isaac. Frankly, when I was making my estimates in May I assumed a higher recovery than 70 percent. I would have assumed perhaps a 20 or 25 percent loss which would have put the loss to those banks in the range of $1.1 billion. That was a hit that would have been a very serious blow to a lot of small banks. I would be willing——

Chairman St Germain. Wait a second now. Again, you are making a statement, a serious blow to many small banks. How many banks would have failed? Of course there would be a serious blow. Of course——

Mr. Isaac. Again you are——

Chairman St Germain. How about the people, Mr. Isaac, that lost money in Penn Square, the credit unions all over the country? It was a serious blow that hit them; wasn't it?

Mr. Isaac. Mr. Chairman?

Chairman St Germain. How many of them got hit bad?

Mr. Isaac. Mr. Chairman, we did not justify the Continental transaction on the basis of *x* number of small banks failing. It was simply a factor in our decision.

Chairman St Germain. It was part of the public relations; wasn't it?

Mr. Isaac. Pardon?

Chairman St Germain. Public Relations?

Mr. Isaac. Part of it was in response to the politicizing of the issue saying that this was a big bank bail out. We were pointing out that some of the principal beneficiaries of making depositors whole were some 2,300 banks that would have lost in the area of $1.7 billion had we paid it off.

Chairman ST GERMAIN. Mr. Isaac, there was no politicizing with that announcement. The night that I was on the phone with the regulators along with the chairman of the Senate Banking Committee and other Senators and Mr. Wylie, and the regulators, we were told about all these banks that were going to fail if this——

Mr. ISAAC. You were not told how many banks——

Chairman ST GERMAIN. No one had labled it a big bank bailout because we didn't know what was happening.

Mr. ISAAC. You were never told by Bill Isaac how many banks would have failed?

Chairman ST GERMAIN. We were told in that conversation.

Mr. ISAAC. No, you were not, sir, with all due respect. Bill Isaac has never predicted in any public forum how many of those banks would fail, and your staff does not know. Your staff doesn't have any idea of the condition of the banks that had deposits in Continental and their ability to weather a $1.7 billion loss and the loss of income on that money.

Chairman ST GERMAIN. Does your staff have an idea?

Mr. ISAAC. A rough idea.

Chairman ST GERMAIN. A rough idea. We have been looking for the information from them for a long period of time and have gotten absolutely nothing because there was nothing there.

Mr. ISAAC. We are not about to make the number public because it is not a number that you can place any great degree of confidence in.

Chairman ST GERMAIN. Mr. Isaac, we told you we would keep it in confidence if you felt it had to be kept in confidence.

Mr. ISAAC. I told your staff confidentally the other day about how many would fail.

Chairman ST GERMAIN. Based on what?

Mr. ISAAC. Based upon our analysis.

Chairman ST GERMAIN. Which analysis?

Mr. ISAAC. The analysis of the amount of exposure the banks had in comparison with the condition of those banks.

Chairman ST GERMAIN. When was that done?

Mr. ISAAC. Pardon?

Chairman ST GERMAIN. When was that done?

Mr. ISAAC. This summer.

Chairman ST GERMAIN. This summer? When?

Mr. ISAAC. This summer.

Chairman ST GERMAIN. When this summer?

Mr. ISAAC. I don't know.

Chairman ST GERMAIN. Well, is it available?

Mr. ISAAC. If you are asking me whether it was done during the week of May 10, when we were handling the potential failure of Continental, no, it was not done.

Chairman ST GERMAIN. When approximately was it done?

Mr. ISAAC. In the months of July or August, I believe. Perhaps September.

Chairman ST GERMAIN. Then where are the analyses?

Mr. ISAAC. There are no written analyses.

Chairman ST GERMAIN. Pardon?

Mr. ISAAC. There are no written analyses.
Chairman ST GERMAIN. There are no written analyses?
Mr. ISAAC. That is correct.
Chairman ST GERMAIN. It was all mental?
Mr. ISAAC. That is correct. Estimates.
Chairman ST GERMAIN. Estimates. Mental estimates?
Mr. ISAAC. That is correct.
Chairman ST GERMAIN. In other words, guesses.
Mr. ISAAC. That is what this business is——
Chairman ST GERMAIN. Educated guesses?
Mr. ISAAC. That is what this business is, educated guesses.
My point is, Mr. Chairman, the FDIC has never represented how many of those 2,300 banks would have failed.
Chairman ST GERMAIN. Do you now know as a result of this educated——
Mr. ISAAC. I know about how many.
Chairman ST GERMAIN. How many?
Mr. ISAAC. Would have failed in the first round?
Chairman ST GERMAIN. How many?
Mr. ISAAC. There would have been continuing ripple effects.
Chairman ST GERMAIN. How many?
Mr. ISAAC. I would be willing to tell you fewer than 25 would have failed in the first round.
Chairman ST GERMAIN. Fewer than 25?
Mr. ISAAC. In the first round.
Chairman ST GERMAIN. Yes.
Mr. ISAAC. Of the small banks.
Chairman ST GERMAIN. This is, again, without using any computer or any math, adding machines, or slide rules?
Mr. ISAAC. I am sure people used adding machines and calculators to make some assessment.
Chairman ST GERMAIN. You told me you had no written figures. It was just mental.
Mr. ISAAC. That is correct.
Chairman ST GERMAIN. So, do you always do this mentally rather than using a computer on the smaller banks when you try to make a decision whether you should pay out——
Mr. ISAAC. At the point when we were doing this it was a totally moot question. Continental had already been taken care of on May 7. We had decided on May 17 that the bank would not be permitted to fail. Anything we did in June or July——
Chairman ST GERMAIN. Oh, so you made a decision without ever having any written analyses, right?
Mr. ISAAC. Pardon?
Chairman ST GERMAIN. You made that decision without having ever run these numbers?
Mr. ISAAC. I didn't say that. I said——
Chairman ST GERMAIN. That is what you just said. It would have been moot because you said a decision was made on May 17.
Mr. ISAAC. I told you, Mr. Chairman, that I had some rough numbers that I was given at that time. We could not come up with better numbers. We did not have time.
Chairman ST GERMAIN. You said you got those numbers in June or July.

Mr. ISAAC. No. I got the first numbers in May.
Chairman ST GERMAIN. In May?
Mr. ISAAC. Yes.
Chairman ST GERMAIN. Those are just rough numbers, right?
Mr. ISAAC. Very rough.
Chairman ST GERMAIN. Very rough. You say the question was moot because the decision was made that Continental would not fail on May 17?
Mr. ISAAC. I'm sorry?
Chairman ST GERMAIN. Is that what you just said?
Mr. ISAAC. I said this summer when we were talking about how many of those small banks actually would have failed, that the question at that point was moot. That is why I am not sure why your staff went——
Chairman ST GERMAIN. I am sorry. I thought I heard you say the question was moot on May 17 because at that meeting the decision was made that Continental would not fail.
Mr. ISAAC. That is not what I said.
Chairman ST GERMAIN. Well, is that an inaccurate statement? We are going to go into that a little later during my second round. Was that decision not made on May 17, that Continental would not fail?
Mr. ISAAC. The decision was made on May 17 that Continental would not fail, yes.
Chairman ST GERMAIN. Correct. That is prior to any of the June numbers on how many banks would fail——
Mr. ISAAC. Obviously since it was May 17, it is obviously prior to the June numbers.
Chairman ST GERMAIN. Correct.
Mr. ISAAC. But not prior to the May numbers.
Chairman ST GERMAIN. On what basis was that decision made on May 17?
Mr. ISAAC. Now, we are to the point. It seems to me that these hearings, and I frankly look forward to them, raise a number of legitimate questions. One is why did the regulators do what they did?
It was a judgment call. Was it the correct judgment? I will be happy to respond this afternoon to that line of questioning.
Another very important set of issues is, even assuming we did the right thing in this case, is it the right policy to be pursuing in the future and what, if anything, can we do to change those policies? What changes need to made in the insurance system? That to me is the line of inquiry we ought to be pursuing.
Chairman ST GERMAIN. As usual, I want to compliment you. As usual your perspicacity is fantastic. That is really and truly the case. But now I would like you to answer the question I asked you, which was, on what legal basis, and now we are talking about 13-C, was the decision made on May 17?
Mr. ISAAC. The narrow legal basis which the FDIC relied on, you are asking me for the statutory——
Chairman ST GERMAIN. Correct.
Mr. ISAAC. Was the essentiality test, not the cost test and thus, the numbers we have been discussing were not of overriding importance.

Chairman St Germain. OK. Now, let's discuss that. And I beg the indulgence of the committee because this is a very crucial point on which we should have a little continuity. Essentiality test. Now the hearings that were held before this subcommittee a few years ago were designed to give an opportunity for regulators to testify, give evidence to and tell us there should be an amendment to 13-C.

I assume you and your counsel have reviewed those particular hearings. And at that time, this memorandum, this chairman, who was then chairman of the subcommittee, was told that it was absolutely essential that we have amendments to 13-C. And what were those amendments? Those were the amendments that deal with the numbers, the cost. As far as essentiality, there was no change.

Why was an amendment sought? Because there were savings banks in New York City about to fail. The concern by the FDIC expressed to them, and by them to me, was that the essentiality test did not apply. If the biggest mutual savings bank in New York City were about to fail, you would not find it essential to the city of New York, because there were some savings banks in the city of New York.

Is that not correct?

Mr. Isaac. I am listening.

Chairman St Germain. Well, you do recall this? I believe you were on the Board at the time.

Mr. Isaac. The FDIC wanted an amendment to the law in part to take care of the savings bank problem.

Chairman St Germain. Yes, because it was felt that a savings bank in New York City, were it to fail, could not be deemed essential to New York City.

Mr. Isaac. I don't recall that we ever said that the largest savings bank in New York or any other city couldn't be deemed essential. We said that there were a number of savings banks around the country that were in trouble; that we would have difficulty——

Chairman St Germain. Then I will get the testimony from record. I will ask staff to bring me the testimony because this member has a pretty good memory and I met with you people, and the FDIC said to me, we have got this problem in New York City. We cannot find that the Bowery Savings Bank is essential to New York City; that being the case we need to change 13-C and we amended 13-C as a result thereof.

Mr. Isaac. I will be surprised, Mr. Chairman, if you can find testimony from the FDIC indicating that the Bowery Savings Bank would not be deemed essential in New York City. I think you may find testimony which said that in a city like New York some of the smaller savings banks, in particular, we would have trouble making an essentiality finding on.

Chairman St Germain. Naturally, we didn't mention Bowery in the hearing, the reason being we didn't want to harm the institution at the time. The date of these hearings was July 14, 21, 22, and 23, 1981.

The FDIC now has seven basic options in handling failed or failing banks. We have utilized these 577 times in the Corporation's history. They are described in detail in my statement. While these procedures have served us well over the years, they are insufficient today, and we ask you to provide us with two additional tools to help us do our job in today's environment.

First, we seek authority to make capital infusion in instances where severe financial conditions exist which threaten the stability of a significant number of insured banks. Today, in order to make the capital infusion, we must find that an institution is essential to its community before providing such aid. The language is, very frankly, designed to provide us with the option of providing capital assistance to the New York thrifts.

It is very specific.

Mr. ISAAC. I agree.

Chairman ST GERMAIN. Very specific. And the conservations in my office went to the fact that you could not find a thrift in New York City that was essential to New York City.

Mr. ISAAC. I would agree that we felt we had problem with some of the smaller thrifts in New York City——

Chairman ST GERMAIN. Don't say smaller. It was the bigger ones. It was Bowery that was about to fail.

Mr. ISAAC. This is——

Chairman ST GERMAIN. Bowery was about to fail.

Mr. ISAAC. This is 2 or 3 years later and it hasn't.

Chairman ST GERMAIN. That's right. It didn't. But that was the fear. So my question is, How, if we couldn't find essentiality for one of the largest thrifts in New York City, how could we find essentiality for Continental, with all the banks in this world of ours today on the world scene?

Mr. ISAAC. If I understand what the chairman just recited, the legislative history in 1982 is that essentiality test, if anything, was intended to be broadened, not narrowed.

Chairman ST GERMAIN. It was not broadened.

Mr. ISAAC. If anything, it was intended to be broadened, not narrowed.

Chairman ST GERMAIN. That wasn't touched. We added C-2.

Mr. ISAAC. I understand. If anything, though, the essentiality test was broadened, not narrowed.

Chairman ST GERMAIN. Well, we have a very——

Mr. ISAAC. Our authority was broadened, not narrowed. Is that correct?

Chairman ST GERMAIN. No. Paul Volcker said they wanted it narrowed. I will get Paul Volcker's testimony, too.

Mr. ISAAC. I am not aware of anybody ever making a statement that the 1982 Garn-St Germain law was intended to narrow the regulator's authority.

Chairman ST GERMAIN. On essentiality?

Mr. ISAAC. On essentiality or any other subject.

Chairman ST GERMAIN. It did not touch essentiality.

Mr. ISAAC. All right, then——

Chairman ST GERMAIN. We added another section so that that section could be used.

Mr. ISAAC. OK.

Chairman ST GERMAIN. Instead of essentiality, because essentiality did not apply.

Mr. ISAAC. OK. Let's assume then that essentiality was untouched.

Chairman ST GERMAIN. All right.

Mr. ISAAC. OK? In 1980, the FDIC provided direct capital assistance to First Pennsylvania Bank, under the essentiality test. The situation at First Pennsylvania without question was much harder to justify than what we did at Continental. It was a smaller bank. The ripple effects throughout its region, throughout the United States, and throughout the banking system would have been far less severe.

First Pennsylvania had something like 500,000 or 600,000 deposit customers. Continental had 850,000 to 1 million deposit customers. First Pennsylvania had much smaller course banking network than Continental. The shareholders in first Pennsylvania were given an out and out subsidy whereas in Continental they have the potential to lose everything. Much harder, much more difficult to justify an essentiality finding in First Pennsylvania. The Banking Committee in the House and the Banking Committee in the Senate did not hold hearings on First Pennsylvania. They did not question the authority that was used.

In 1982, Congress had an opportunity to narrow the authority if it had so chosen. It did not. The FDIC staff has rendered an opinion that what we have done in Continental is perfectly legal. I have the highest regard for that staff. It is one of the best in the Nation. I will rely on it.

Chairman St Germain. The Chair might state that unfortunately we didn't have hearings on First Pennsylvania. We should have.

Mr. Isaac. I think it was unfortunate myself.

Chairman St Germain. Yes; but unfortunately you can't always do it. So the fact that it was done there doesn't justify the Continental situation.

Mr. Isaac. It does in terms of statutory authority because the Congress had a chance to deal with the essentiality test in 1982 and to narrow it if it didn't like what was done in First Pennsylvania or didn't agree with it. It chose not to do so. There is not one word of legislative history in 1982 that will show that the essentiality test was intended to be narrowed.

Chairman St Germain. Nor was it expanded.

Mr. Isaac. I would be willing to concede it wasn't intended to be expanded.

Chairman St Germain. We shall return.

Mr. Annunzio?

Mr. Annunzio. Thank you, Mr. Chairman. I had hoped, Mr. Chairman, that after you finished your statement, that I could go on and read my statement before you started to ask questions. Nevertheless, you know, I did not make an opening statement this morning. However, in view of what happened this morning, I am compelled to make a statement this afternoon.

The staff presentation this morning raised a great deal of new and important information. As Mr. Barnard said this morning, it now puts the committee in the position of judging whether the staff or the FDIC and Comptroller is correct.

I would suggest, given the magnitude of the staff's presentation, it would have been far better to have waited until members of the committee had a chance to study the information before making it public.

I would also like to commend the persons who prepared the charts for the committee. I have found it very difficult to get such art work performed in the middle of the night, but apparently, Mr. Chairman, you have better sources than I do.

Let me make just a few observations about the staff conclusions. It was stated that the staff opinion is that only six banks would have failed if Continental had been allowed to fold, and that the rest of the banks with deposits in Continental would have received roughly 70 percent of their money through various sources such as FDIC insurance, portfolio liquidation, et cetera. Let us assume that the staff position is totally correct. What was not brought out is the time factor that is involved under such payments that would have been made. It was assumed the payouts would have been completed the day the bank failed. It would take from 5 to 10 years for the payouts to reach a 70-percent level. I would remind the committee that in the Penn Square liquidation, more than 2 years have elapsed and the payout to uninsured depositors has only reached 35 cents on the dollar. How would all those banks with Continental uninsured deposits have survived while waiting for their money? And, again, I want to remind the committee that I am talking about banks in Illinois and in the Midwest. How many businesses that have deposits in these banks could have lasted for 5 or 10 years while waiting for their money?

I suggest that the staff study would have been more effective if it had been done with an eye toward answering questions about Continental, rather than what appears to be a study put together to meet a deadline.

Now, Mr. Isaac, I am trying to get to the root of this thing. And I have been asking this question. I asked Mr. Conover what kind of shape the bank is in now? Will it survive? Will it stay open? And he emphatically said, yes, that it was in good shape and that it would stay open. Now what I would like to know from you is, if Continental had failed and a payout procedure begun as staff has suggested, how long would it have taken to complete that payout?

Mr. ISAAC. Let me try to break it down in a couple of different areas. First of all, because of the size of the bank—I am talking about the number of deposit accounts and the number of loans you would have to search through for offsets and the like when we do a deposit payoff—our staff estimated that it would have taken us between 1 month and 2 months to make the insured deposits available to the insured depositors.

I am talking about the insured acounts now, not the uninsured.

Mr. ANNUNZIO. I understand.

Mr. ISAAC. It would have taken 1 month to 2 months to make those checks available to those people. No grocery money, no payroll, no money to pay your mortgage. Accounts would have been frozen for 850,000 depositors for 1 month to 2 months. Now you go to the uninsured. Those people had over $30 billion worth of exposure. And that money would have been frozen in a bankruptcy proceeding for years and years and years while we gathered it to pay those people off.

Twenty-three hundred insured banks would have had $5.8 billion frozen. They would have gotten receivership certificates. Ultimately they might well have collected 70 or 80 cents on the dollar on that $5.8 billion, but it would have taken a good long time and they would have had a piece of paper until it happened.

Then there are the corporate bankrupticies. Right now Continental is a functioning bank. You ask what condition it is in—it is one of the strongest banks in the world. But if we had done a deposit payoff in Continental, we would have been in a collection mode on every one of its loans. Every one of those borrowers would have had their lines of credit cutoff.

You would have had corporate bankruptcies throughout the land. Moreover you would have shaken confidence in other major institutions. Keep in mind, Continental was not insolvent and is not to this day insolvent. After having had to take a $1.1 billion charge off this summer, Continental still had shareholders equity in reserves approaching $1 billion.

The bank is not broke. It was not then; it is not now. If we had closed down a solvent bank and paid off insured depositors, what message would we have sent to the rest of the world trying to deal with U.S. banks? Our friends at the Bank Board, they are dealing with a problem the size of Continental out in California. Would they have had any option? Would that S&L have lasted 24 hours if you had done an insured deposit payoff in Continental?

Mr. ANNUNZIO. The Democrats might have won the election.

Mr. ISAAC. I won't touch that line. All I am saying is, the ramifications could have been catastrophic. It would have been irresponsible under present conditions, to do a deposit payoff in Continental. I think I'm probably about as hard line on the need for discipline in the banking system as anybody in the country. And I frankly didn't have the courage to do it.

Mr. ANNUNZIO. You have explained about the depositors and how long it would take. You have explained about small corporations and how they would have gone under because of the payoff time.

I am just wondering—and I have thought about this quite often, and I have lived with this situation—as to what would have happened in the Midwest, and in fact all over the United States, and in fact in a lot of the European countries, if a large $40 billion institution would have gone under. I am just wondering if you would have been sitting here today before this committee being praised if Continental had gone under?

What would have been the consequences, say, that Continental had gone under—say we have a crystal ball here.

Mr. ISAAC. If Continental had failed?

Mr. ANNUNZIO. We are being Monday morning quarterbacks now.

Mr. ISAAC. And we had not handled it the way we did, you mean? I think this committee probably would have been justified to consider lynching me.

Mr. ANNUNZIO. Can you give us some idea of the effect of this, the domino effect that the closing of Continental—not only about the 75 or 100 banks that are Illinois institutions that would have gone under, but the other correspondent banks, 179. Would it have had a domino effect to affect the entire banking industry, thrift institutions, and so forth, around the Nation?

Mr. ISAAC. The effects could have been catastrophic, and——

Mr. ANNUNZIO. It would have been——

Mr. ISAAC [continuing]. It would have gone on.

For example, let's take FCA, the thrift out in California that appears to be stabilized now. They appear to have that under control.

That wouldn't have lasted 24 hours if we had paid off Continental. They would not have had the options that they had. There could have been widespread instability throughout banking, throughout the thrift system, and there would have been massive corporate bankruptcies throughout the Midwest and elsewhere.

Mr. BARNARD. Would the gentleman yield?

Mr. ANNUNZIO. I would be happy to yield to my friend from Georgia.

Mr. BARNARD. Mr. Isaac, I have to point out here, though, that at least there was some very quick precipitous action taken in FCA. They didn't let the thing linger and linger and linger, you know, when they sensed a problem.

I must compliment the Home Loan Bank Board. They moved right in with new management and some very significant and meaningful management changes to offset what you just said. I think that that had something to do with the fact that FCA has——

Mr. ISAAC. I think they did move quickly with management. I am glad they did. That was my advice early on. I would tell you, though, that all the management in the world wouldn't have done any good if those uninsured depositors had witnessed a payoff of deposits at Continental Illinois.

Mr. BARNARD. Could you consider the fact that maybe the supervisory regulators have learned a lesson in waiting around for a bank to correct its own problems, such as Penn Square, Seattle First——

Mr. ISAAC. I didn't need the lesson.

Mr. BARNARD. Penn Square? United American?

Mr. ISAAC. I didn't need the lesson.

Bad management is the No. 1 problem we have in problem banks, and we need to move aggressively on them. We try to wherever we can within the laws you have given us.

We asked you to strengthen the law. We have had a bill pending before the Congress for 1 year asking you to strengthen removal authority.

I would like——

Chairman ST GERMAIN. The time of the gentleman has expired.

I might say, I didn't realize, Mr. Isaac, that you had such a crystal ball. It is unbelievable.

Mr. Hubbard.

Mr. ISAAC. In what area, sir?

Chairman ST GERMAIN. You are predicting what would have happened had Continental been allowed to fail. You know, it is funny; it didn't happen when Penn Square failed.

Mr. ISAAC. It did happen with Penn Square, because of the——

Chairman ST GERMAIN. Were there reverberations from that?

Mr. ISAAC. We are still feeling the reverberations from Penn Square. It doesn't take a crystal ball. The FDIC has handled 200 bank failures of all sizes since I've been Chairman. We know what happens when a bank fails.

Chairman ST GERMAIN. Mr. Hubbard.

Mr. HUBBARD. Thank you, Mr. Chairman.

I don't have any questions of Mr. Isaac. I would just simply like to say, as a Democrat, that I sincerely believe that Bill Isaac is a big plus for the U.S. Government and a super Chairman of the FDIC. He obviously is a friend of mine that I have a lot of admiration and respect for. The fact that he is a Kentuckian helps some; I must admit. But I am very proud of Bill Isaac, and the entire Commonwealth of Kentucky is proud that he is Chairman of the FDIC. And I think he is doing an excellent job. And I am not in a position to question his wisdom or his judgment on what happened with Continental Bank.

Thank you, Mr. Chairman.

Chairman ST GERMAIN. I certainly have all the admiration in the world for Mr. Isaac myself, but we are arguing the facts here. That has nothing to do with his brilliance.

Mr. Barnard.

Mr. BARNARD. Thank you, Mr. Chairman.

Mr. Isaac, just a moment ago you indicated that FDIC has handled 200 bank failures. Actually, how many of those have actually been liquidated?

Mr. ISAAC. You mean insured depositors paid off?

Mr. BARNARD. Yes.

Mr. ISAAC. I would guess, just an estimate, but roughly 20 percent.

Mr. BARNARD. Twenty percent have actually been liquidated?

Mr. ISAAC. That is right.

Mr. BARNARD. In those 20 percent that were liquidated, were all depositors and general creditors protected?

Mr. ISAAC. No.

Mr. BARNARD. In answer to one of the questions that you asked yourself in your testimony on page 7, you ask yourself a question: How do you justify the expenditure of tax money by unelected officials to bail out Continental? In the last sentence, you said, depositors and other general creditors have been protected, but they are protected in most bank failures.

How do you account for that?

Mr. ISAAC. Eighty percent is "most."

Mr. BARNARD. Do you think that is a good precedent?

Mr. ISAAC. What?

Mr. BARNARD. To protect all bank depositors and other general creditors?

Mr. ISAAC. No. That is one of the fundamental policy issues I think we have to come to grips with somehow, particularly in this deregulated banking environment. We need to find ways to have more discipline in the system supplied by the marketplace.

Mr. BARNARD. Are you saying then that we have a haphazard type of policy?

Mr. ISAAC. No.

Mr. BARNARD. No?

Well, what kind of policy do we have? No policy?

Mr. ISAAC. No.

Mr. BARNARD. What kind of policy do we have?

Mr. ISAAC. In the past, say for the past decade or two—we have tried to arrange a merger whenever a bank fails. The ocassions when we don't do that are two, basically. One is, you have got a bank somewhere that nobody wants to buy; we just don't have any bids for it. That happens once or twice, three times a year. Ordinarily it is not too harmful in the community, because those banks are almost always very close to fully insured.

I will give you a statistic. Ninety-five percent of all deposits in banks under $100 million in size are fully insured or secured.

Then you have the kind of situation you had in Penn Square where you have massive contingent liabilities or potential exposure. When a merger is arranged, the FDIC must protect the acquiring bank against those contingent claims—all the off-balance sheet type claims. In Penn Square, we had a $500 million bank and we had potentially $3 billion worth of off-balance sheet claims against us by Continental, Seattle First, and a host of others. We simply could not justify under our statute, or just in terms of good business sense, taking on that contingent liability by arranging a merger of Penn Square. So we chose not to. There are some of those each year.

That basically accounts for your 20 percent. In other cases, we arrange mergers.

Now, earlier this year we began to test a modified payoff procedure. We used it in something like eight or nine cases over a 2-month period. What we were trying to do there was develop a mechanism which would enable us to do modified payoffs in larger and larger bank failures, because there is at least a perceived problem that small bank failures are handled differently than large bank failures. So we began to test this modified payoff procedure.

What it does different than an ordinary payoff are a couple of things. Under an ordinary payoff, you simply shut down the bank and you hand people their checks, all the insured depositors. You don't continue banking services for anybody. In a modified payoff, we try to transfer all the insured accounts over to a new institution so that the banking services are automatically continued for those people.

Second, in a regular payoff, you don't sell the bank to anybody; you don't transfer any accounts anywhere. So there is nothing for anybody to bid on. The FDIC simply loses the franchise value of the institution. In a modified payoff, we transfer the insured accounts to a new institution. They bid for it and we get a premium which reduces our cost.

Finally, and most importantly, in a regular payoff, anybody over the insurance limit simply has to wait for their money. They don't get it until years later, as Mr. Annunzio pointed out. In a modified payoff, we try to make an estimate on the date that the bank failed how much money those people are ultimately going to receive on a present value basis, and we give it to them right up front to lessen the disruption caused by the failure. We were testing that procedure this spring because we think that it may be a way to——

Mr. BARNARD. I hate to interrupt, but my time is expired and I haven't said anything.

How did you classify the United American Bank? Which one of these procedures did you include there?

Mr. ISAAC. It was handled as a modified payoff. I, frankly, don't know off the top of my head if we had not done a modified payoff, how it would have been handled. Most of the eight or nine banks that we used modified payoffs on would have been handled as straight payoffs otherwise, because either we had a lack of bids or we had large contingent claims we were not willing to assume.

I don't know which category United American fell into.

Mr. BARNARD. In that particular situation—Mr. Chairman, if I could have just an additional minute.

Chairman ST GERMAIN. Yes.

Mr. BARNARD. In the United American situation, you know——

Mr. ISAAC. Sorry, Mr. Barnard. Were you talking about Tennessee?

Mr. BARNARD. Yes.

Mr. ISAAC. I am sorry. There was a United of America Bank in Chicago. I thought you were referring to it.

Mr. BARNARD. I don't even know about them. I do know about the United American Bank in Tennessee.

Tell me which one they fell in.

Mr. ISAAC. UAB was handled as a merger. I think we have had something like 20 bank failures in Tennessee in the past couple years. All but one were handled by mergers into other institutions——

Mr. BARNARD. Why is it that you estimated losses if moved from under $300 million estimated to $1 billion?

Mr. ISAAC. Well, I noticed the chairman's reference to the $1 billion dollar figure in the statement this morning. I don't know who dreamed that number up. The FDIC surely didn't.

Mr. BARNARD. I thought it was something FDIC had.

Mr. ISAAC. No; I read in an article that some bank analyst, unnamed, speculated we may lose that much. Frankly, it never ceases to amaze me how people talk about things they have no knowledge of.

Mr. BARNARD. Let me ask you, haven't you had to change your purchase agreement with First Tennessee twice?

Mr. ISAAC. We changed it twice, yes.

Mr. BARNARD. And why did you do that?

Mr. ISAAC. First of all, we did a very, very unusual transaction there. We tried to arrange a transaction, because of the nature of the problems in Tennessee, whereby First Tennessee would take over most of the problem loans, instead of the FDIC having to handle them.

Mr. BARNARD. $81 million worth?

Mr. ISAAC. It is a lot more than that.

The first problem we had was First Tennessee, frankly, made a mistake.

Mr. BARNARD. So did the FDIC.

Mr. ISAAC. No.

Mr. BARNARD. You honored a nonconforming bid. If you recall, you know, you put out a bid basis on how that bank would be acquired, and then the First Tennessee took it without a nonconforming bid. Am I wrong there?

Mr. ISAAC. The bid was some $30 million better than the next bid.

Mr. BARNARD. It has not proved to be that, because you changed it twice.

Mr. ISAAC. There is no question it was $30 million better than the second bid. The problem is that First Tennessee agreed to assume $86 million, or something like that, in losses as part of their bid.

Because they failed to take into account the staggering volume of nonperforming loans, and there was no way for them under the original agreement to be reimbursed for that, their losses would have mushroomed way beyond anything they ever dreamed. It wouldn't have been an $86 million bid by First Tennessee; Lord knows, but it would have probably been double or more than that if we had not restructured the agreement.

Mr. BARNARD. So the essentiality factor came into play there?

Mr. ISAAC. Not at all. The FDIC and First Tennessee worked under extremely tight time pressures in that situation to put together a deal. They said they would absorb the first $86 million in losses. The way the deal was actually structured, they were responsible for considerably more than $86 million losses. It could have caused serious injury to their earnings.

The FDIC recognized that it had a responsibility to act in good faith. They thought they were going to absorb $86 million in losses, and we had an obligation to make sure the agreement was written and operated that way and not to stick them with $86 million in losses.

Mr. BARNARD. Thank you, Mr. Chairman. I will wait until my next round.

Chairman ST GERMAIN. Before calling on Mr. Vento, I would like to recite a story, because Mr. Isaac told us about the grocery money and the shoes for the kids and the aspirin and cough medicine you couldn't buy if the place was closed. Hey, that was touching. Really, it was touching.

So I want to try this one out. A very well-respected U.S. corporation wanted to become a giant corporation, and they wanted to do it fast. They rushed headlong into expansion, decentralized management, had few controls to prevent abuses, and went ahead and extended credit to anyone who walked through the door. To cover their tracks, they became lax about internal auditing, painting a healthy financial picture where none existed.

Despite this, outside auditors gave the corporation a clean bill of health. This story has a strange twist, however, because rather than propping up the corporation, the Government and all the U.S. citizens let it die, leaving 80,000 employees out of work—80,000 people worked for this corporation—8,000 investors unpaid, 1,070 stores throughout the country nationwide were closed. The corporation was the giant retailer, W.T. Grant, whose 1976 liquidation was then the biggest retailing failure in history.

You know, there was another thing, when Grant went under, so did $234 million in bank loans, and you probably bought $48 million when you put together that little package because Continental had $48 million. So I am sure that we all would have sympathized with Continental—we all sympathize with Continental's plight with the grocery thing and so on.

But what do we do if we are going to help the Continental people and their creditors and borrowers and all, how do we justify letting this giant W.T. Grant go down the tube with 80,000 people now unemployed?

Mr. ISAAC. I think perhaps Sears and the other retailers might get together and see if they want to form a Federal retailer insurance corporation and pay premiums.

Chairman ST GERMAIN. That is not the answer, and you know it as well as I do. You know what the point is. The point is that we did indeed go over and beyond the bounds with Continental and not because of the facts you stated. By the same token, if you are going to have sympathy one place, why don't you have it another place? That is not you, Mr. Isaac, that is the American people.

Mr. ISAAC. My point is, Mr. Chairman, the Congress established the FDIC because it doesn't want to return to a situation like we had between 1929 and 1933.

Chairman ST GERMAIN. I wholeheartedly agree. A lot of people lost their jobs at Grants too, and a lot of businesses went bankrupt around the country.

Mr. ISAAC. That is true.

Chairman ST GERMAIN. Mr. Vento.

Mr. VENTO. Thank you, Mr. Chairman.

Mr. Isaac, when Mr. Conover testified, he pointed out that for nearly 2 years Continental had been in difficulty and that they had essentially been on report and so that this incident that occurred in May of this year was not something that came up suddenly other than the fact that there was this run on the bank with regards to the questioning of the loan portfolio and so forth.

So this was not something that you had not had notice of, and when you have other banks in trouble—you can probably list in a closed hearing other banks similarly situated—I hope not as large—but that this was not altogether unexpected.

Let me establish that as to the predicate in terms of this discussion that was made in May.

Mr. ISAAC. Not altogether unexpected?

Mr. VENTO. Yes; that there would be a problem occurring. In other words, what was going on in terms of Continental Illinois National Bank was not news to you in May, is that right?

Mr. ISAAC. Well, it was news in the sense that it became a crisis in May when the funding dried up. But at the time we handled Penn Square in July 1982, we were very concerned that it could precipitate a serious problem in Continental and Seattle First.

In fact, it did. Continental's funding began to show serious problems throughout July and some of August 1982. Then it settled down.

Mr. VENTO. Their total portfolio of problem loans of some $5 billion, 20 percent were Penn Square related. The other 80 percent, the other $4 billion apparently were not of the problem loans, is that correct? They were other than Penn Square? So their problems went well beyond Penn Square.

Mr. ISAAC. The percentage of their problem loans from Penn Square was propably in the 20- to 25-percent range, but if you look at the losses in the loan portfolio, I think Penn Square represents a heavier proportion.

I don't know for sure but I think it would be in the 40- to 50-percent range.

Mr. VENTO. Two weeks ago, we have asked the Comptroller, apparently the staff has been asking the Comptroller, and I don't know if the FDIC or not—but let me make the claim as to the number of foreign deposits, the foreign loans and foreigh assets that were involved in terms of Continental Illinois National Bank.

You have not mentioned that. We talked today about 179 domestic institutions. Do you have any type of idea as to the numbers of foreign banks, foreign debt—foreign assets involved in Continental Illinois National Bank?

Mr. ISAAC. It is my understanding—and I really would like to have you check with the Comptroller's Office or Continental to make sure the numbers are correct—but it is my understanding that Continental has approximately $2 billion worth of sovereign risk exposure in total.

Mr. VENTO. Two billion dollar's worth of international loans?

Mr. ISAAC. Sovereign risk exposure.

Mr. VENTO. Sovereign risk exposure.

Mr. ISAAC. Which is comparatively low in relationship to other banks.

Mr. VENTO. What about the number of institutions? You are not aware of any international institutions or banks that would have had troubles as a consequence of this?

Mr. ISAAC. Oh, I think if we had done a deposit payoff in Continental, we would have been running the risk of causing consequences beyond our domestic financial system, I think it could have spread quite easily.

Mr. VENTO. In answering the question on page 5 of your statement, you say what legal authority did the FDIC have to extend the $100,000 deposit insurance ceiling in this fashion? This is your own question or our question? But as I read that, I don't see any answer there. I see it says to me, in giving the assurance the FDIC was simply stating it would not resolve, in other words, there is a misunderstanding, it would not resolve the problems, it would be dealt with by merger or other means.

It seems to me you are not citing any authority to do that. Is that the essentiality test? I don't want to revisit that ground if that is what the authority is that you cite in terms of that instance. Is that it?

Mr. ISAAC. Yes. We said that we would resolve it through merger or capital infusion. That is what we were saying, and in saying that, we were relying on our ability to do so under our essentiality test.

Mr. VENTO. Using the insurance premiums for the $100,000 insurance; is that right? Using the insurance premium revenue from the $100,000 insurance that you received, the insurance revenue that is the payments the banks paid for the insurance?

Mr. ISAAC. All of our money comes from assessments against insured banks and interest on our investment portfolio.

Mr. VENTO. What is the description of that revenue to be used for? Isn't it for the insurance; that they provide the $100,000 insurance for, or is it for something else, Mr. Isaac?

Mr. ISAAC. To carry out our insurance responsibilities, yes.

Mr. VENTO. So, when you talk about the capital infusion that you put in and the loans you bought back, how do you explain going over on the insurance coverage of $100,000?

Mr. ISAAC. Because if you put in capital, you are putting the bank in a position where it can——

Mr. VENTO. What authority do you have to go beyond the $100,000?

Mr. ISAAC. We have the authority to do a capital infusion. We also have the authority to do a merger. That is what we——

Mr. VENTO. You implied you would cover beyond $100,000.

Mr. ISAAC. No, we didn't.

Mr. VENTO. You imply that in the statement that you would go beyond the $100,000 limit.

Mr. ISAAC. If I implied that, I apologize. We did not go beyond the $100,000 limit.

Mr. VENTO. It is really a pretty big misunderstanding, isn't it?

Mr. ISAAC. Not on my part.

Chairman ST GERMAIN. I seem to have read in the press release your grounds. Didn't you at one point say to the world at large that the FDIC would cover deposits beyond $100,000?

Mr. ISAAC. We said that no depositor or other general creditor of the bank will suffer loss when we arrange the permanent solution.

Mr. VENTO. Mr. Chairman, maybe the Chairman of the FDIC would like to make a clarification today to the world to announce that, to say that anyone with over $100,000 on deposit is not insured for that particular loss. We will give you that opportunity right now to do that.

Mr. ISAAC. I don't understand.

Mr. VENTO. Anyone over $100,000 does not have insurance from the FDIC; anyone with an outstanding liability of over $100,000 to Continental Illinois National Bank today does not have insurance for their possession in that financial institution.

Mr. ISAAC. This has been done before. I was surprised by the reaction to it. We did it in the Greenwich Savings Bank in 1981 when it was experiencing a run. We did it in a small little bank in Tennessee that nobody ever heard of, United Southern Bank, Nashville, TN, in 1983, and we did something similar, a capital infusion in Midland, TX, in 1983.

The FDIC needed time to deal with Continental. We were faced with a crisis in May 1984. The bank had lost $9 billion in funding. The prospect was for it to reach the $15 to $20 billion range in short order if nothing were done. The FDIC, upon its own initiative—Continental didn't ask for that interim help—upon its own initiative to protect its own interests, the FDIC stepped in to buy time to handle Continental in a sensible, orderly way.

We had to stop the run or there wouldn't be anything left of the bank, and it would have been much more expensive to the FDIC to handle it.

Mr. VENTO. Well, Mr. Chairman, I asked for the legal authority to go over $100,000 and what the statement is, I get a rationale saying that this was necessary or by necessity. The point is——

Mr. ISAAC. That is the legal rationale. We have that authority.

Mr. VENTO. Well, I think there is a question with regards to that. I don't know about the essentiality argument between you and the chairman, but I think there is a real question about the statement that have been made with regards to the $100,000 or anything over that.

Chairman ST GERMAIN. Will the gentleman yield?

Mr. VENTO. Yes.

Chairman ST GERMAIN. In your joint news release, May 17, 1984, you stated:

In view of all the circumstances surrounding Continental Illinois Bank, the FDIC provides assurance that in any arrangements that may be necessary to achieve a permanent solution, all depositors and other general creditors of the bank will be fully protected and service to the bank's customers will not be interrupted.

Is that accurate, Mr. Isaac?

Mr. ISAAC. It sounds precisely accurate.

Chairman ST GERMAIN. Yes, I am reading right from your press release.

It seems to me that based upon this, weren't you actually insuring people with amounts over $100,000 on deposit in that institution in this release "not to worry"?

Mr. ISAAC. That was the purpose of it.

Chairman ST GERMAIN. "You are protected"?

Mr. ISAAC. That was the purpose of it, yes.

Chairman ST GERMAIN. Correct.

Let's say you could not—let's say you found that you could not keep Continental alive, as you have; all right? Then you would have decided on a payout.

How much would you have paid to Chalmers Wylie, who had $150,000 in his account in Continental?

Mr. ISAAC. That was never going to happen. By issuing that statement, we were guaranteeing that we would not go to a deposit payoff. That is all we were guaranteeing.

Chairman ST GERMAIN. On May 17, you did not say that deposit insurance was now over $100,000?

Mr. ISAAC. No. We said——

Chairman ST GERMAIN. Do you feel you have the authority to exceed the $100,000 limit on deposit insurance?

Mr. ISAAC. It is set statutorily.

Chairman ST GERMAIN. Pardon?

Mr. ISAAC. It is set statutorily.

Chairman ST GERMAIN. At $100,000?

Mr. ISAAC. Yes, sir.

Chairman ST GERMAIN. Therefore, you don't have the authority, the power or anything else statutorily or any other way to pay more than $100,000 of the $150,000 that Chalmers Wylie had in that bank if it had to go to a deposit payoff?

Mr. ISAAC. No. What we have the authority to do is what we did, and that is to guarantee to people that we will arrange a merger or a capital infusion as the permanent solution to the bank's problems rather than using a deposit payoff. We have done that several times.

Chairman ST GERMAIN. So when you found that nobody wanted it, then you had no alternative; and as a result, the May 17 statement was issued to then proceed, as you did.

Mr. ISAAC. Well,——

Mr. VENTO. If I can interject, Mr. Chairman.

I think you have the authority, Mr. Isaac, to protect up to $100,000 in terms of deposit, and to use your resources in such a manner as to accomplish that. But I think there are real questions when you begin to imply that this—in other words, when you say you are not going to give anything to Mr. Wylie, that is wrong, too, because you have to give him at least $100,000.

The fact is that I think no one is questioning the authority up to that point. But since it is statutorily set, since it is statutory, I want to know what authority you have. You could say you are going to keep it afloat; the Federal Reserve Board could have said that. The Comptroller could have said that, too.

But I don't understand the use of revenue paid for by banks in terms of insurance, how you can say that. It seems to me you are saying two things. This is just a little bit of a problem.

Mr. ISAAC. It is undoubtedly my fault. Somehow I am not making this clear enough.

All we were saying was this is an interim solution; this is not a permanent solution. We have to do something different than a $2 billion capital infusion. We won't do a deposit payoff.

Let me make two points about it. One, the bank had $2.2 billion in shareholders' equity and reserve. The FDIC, on May 17, put in $2 billion in subordinated debt on top of that. So you had $4.2 billion in coverage against losses in Continental. I don't think even the Congressional Budget Office staff would have estimated that the bank would have had losses in excess of that.

So, by virtue of simply putting the $2 billion in capital in the bank, we were guaranteeing that no depositor or other general creditor was going to suffer any loss. However, to make sure that everybody understood that, we said that when it comes time to do the final solution, we will do a merger, which we have statutory authority to do, or we will do a capital infusion to make the bank well, which we have the statutory authority to do. So if you are over $100,000, stop worrying. That is all we said.

Mr. VENTO. That is what the problem is. If you are under $100,000, don't worry; if you are over, you better damn well be worrying.

It is not up to you to make the decision. The $100,000 is in the statute. If the Federal Reserve or Comptroller or somebody else made that statement, it would be different. But we insure to $100,000. That is the job you have. That is what you should protect to. Certainly, if that much money is in there, I understand the concern with regards to exposure, and I understand the other concerns. But it isn't up to you to say that and imply—and I think it is clear to me you implied that deposits over $100,000 were to be made whole.

I think it is wrong. I think it is inappropriate in terms of doing that. I think it sets us up for criticism, and I think justified criticism, of a double standard in this particular instance.

Mr. ISAAC. If the Congress would like to curtail the FDIC's authority to arrange mergers and to do capital infusions——

Mr. VENTO. We have a statutory limit of $100,000. What more curtailment do you need? What more specificity do you need in terms of that? None.

I say you are undermining that particular statute.

Mr. ISAAC. The Congress has also given us the authority to arrange mergers and do capital infusions under certain circumstances. We have met the statutory language. If Congress wants to curtail our authority, I think it would be a mistake, and I think you better be very careful about how you do it.

But the Congress has given FDIC a fair amount of discretion to arrange mergers, and to arrange capital infusions. I think that that is——

Mr. VENTO. Mr. Chairman, I am not——

Mr. ISAAC. I don't think it has ever been abused; I don't think it was abused in this case. But if Congress wants to curtail that authority——

Mr. VENTO. Mr. Isaac, I am not concerned about the authority we give you. I am concerned about the authority that you assumed, and misuse of it in this circumstance.

Mr. ISAAC. Mr. Vento, FDIC's legal staff wrote the law, there is no question of our legal authority. If Congress wants to change our legal authority—I think it would be a mistake, but——

Chairman ST GERMAIN. Wait a second. Don't say there is no question of your legal authority.

Mr. ISAAC. There is none, in my mind.

Chairman ST GERMAIN. Maybe in your mind. Just say that. Say "in my mind."

Mr. ISAAC. I thought that was implict in what I was saying.

Chairman ST GERMAIN. However, there were other agencies who were questioning that authority; were there not? Were there not legal opinions from other agencies contrary to that of your General Counsel?

Mr. ISAAC. There was a Treasury opinion that was contrary as to certain aspects—not this aspect; not the May 17 assurance.

Chairman ST GERMAIN. No, no. Let's be specific.

It was contrary as to the essentiality test?

Mr. ISAAC. No, it was contrary as to our ability to deal through a holding company instead of through the bank.

Mr. WYLIE. May I interrupt here? I wanted to put this in the record.

One is from the Congressional Research Service, a Library of Congress study on assistance to assist a bank on the ground it is essential in its community. They say here: "Nothing in § 13(c) or its legislative history indicates what factors the FDIC should deem relevant to determining whether a bank is essential." They go on and say precisely what Mr. Isaac has been saying; that he did have the authority.

I would like unanimous consent to put that——

Chairman ST GERMAIN. Reserving the right to object.

I would say to the gentleman that I read the entire piece. It was done up by one young chap in CRS, a young attorney over at CRS. And, very frankly, I don't buy the reasoning he has in that particular legal brief.

Mr. WYLIE. Let's put it together with another one from the Board of Governors of the Federal Reserve System which quotes the Honorable Mr. St Germain, chairman of the House Banking Committee, which says, "I am convinced that we must provide the

FDIC and FSLIC with better tools to handle problems so clearly evident in the financial system today."

Chairman ST GERMAIN. Yes? So?

Mr. WYLIE. May I have unanimous consent to put——

Chairman ST GERMAIN. What does that mean, though?

Mr. WYLIE. It says that they——

Chairman ST GERMAIN. You just quoted me, Chalmers.

Mr. WYLIE. It says they have the flexibility to do what they did.

Chairman ST GERMAIN. It does, like ducks.

Mr. WYLIE. What?

Chairman ST GERMAIN. It does, like ducks.

Mr. WYLIE. Then we ought to say to the Board of Governors of the Federal Reserve System that they——

Chairman ST GERMAIN. They misquoted me.

Mr. WYLIE [continuing.] Misquoted you?

Chairman ST GERMAIN. That is right.

I will not let that misquote go in the record.

Mr. WYLIE. All right. Well, OK.

Chairman ST GERMAIN. Chalmers, don't put words in my mouth.

Mr. WYLIE. Where did they get it from?

Chairman ST GERMAIN. How would I know? It is immaterial.

Mr. WYLIE. They say they got it out of the Congressional Record. Maybe you should have revised and extended your remarks.

Chairman ST GERMAIN. No, Chalmers. Let me enlighten you. If you had been here for my colloquy with Mr. Isaac, the Chairman of the FDIC, when we were considering amendments to 13(c), I was reenacting the time period from where the FDIC said that essentiality in New York City for the big savings banks wouldn't apply. So we did indeed give them different tools, yes. We added 13(c)(2). That is what that refers to. That doesn't have anything to do with the essentiality test. Bad quote?

Mr. WYLIE. Bad quote.

Chairman ST GERMAIN. Misquote.

If you would like to put in the CRS opinion that was drafted by that nice, young gentleman—I don't know what law school he went to; obviously, not Boston University—but nonetheless, we will put it in the record. But it is not too impressive. I read it.

Mr. WYLIE. Well, it will add to the other information we have.

Chairman ST GERMAIN. Without objection, so ordered.

Mr. WYLIE. Thank you.

[The Congressional Research Service study submitted for the record by Congressman Wylie entitled "Federal Deposit Insurance Corporation Assistance to an Insured Bank on the Ground That the Bank Is Essential in Its Community" follows:]

Congressional Research Service
The Library of Congress

Washington, D.C. 20540

FEDERAL DEPOSIT INSURANCE CORPORATION ASSISTANCE TO AN INSURED BANK ON THE GROUND THAT THE BANK IS ESSENTIAL IN ITS COMMUNITY

Henry Cohen
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October 1, 1984

Executive Summary

Under §13(c)(1) of the Federal Deposit Insurance Act, 12 U.S.C. §1823(c)(1), there are three grounds upon which the FDIC may provide assistance to an insured bank: to prevent it from closing, to reopen it, or to lessen the risk to the FDIC when severe financial conditions threaten the stability of insured banks. Whichever ground is used, under §13(c)(4)(A), the amount of assistance may not exceed the cost of liquidating the bank, unless the FDIC "determines that the continued operation of such insured bank is essential to provide adequate banking services in its community." This quoted clause embodies what is referred to as the "essentiality test."

This report reaches two conclusions concerning the essentiality test: (1) Nothing in §13(c) or its legislative history suggests any legal limit, apart from the FDIC's obligation to effectuate the purposes of the Federal Deposit Insurance Act, to the amount of assistance the FDIC may provide to an insured bank it determines to be essential; and (2) Nothing in §13(c) or its legislative history indicates what factors the FDIC should deem relevant to determining whether a bank is essential. In a recent memorandum, the FDIC listed several factors it has used in the past to determine whether a bank is essential. These factors include the number of depositors, the location of offices, relative size of the bank, whether the bank is a significant provider of services, and the impact on the economy if the bank fails. The FDIC, however, does not consider itself to be limited to these factors.

FEDERAL DEPOSIT INSURANCE CORPORATION ASSISTANCE TO AN INSURED BANK ON THE GROUND THAT THE BANK IS ESSENTIAL IN ITS COMMUNITY

Section 13(c) of the Federal Deposit Insurance Act, 12 U.S.C. §1823(c), authorizes the Federal Deposit Insurance Corporation (FDIC) to provide assistance to banks it insures that are in financial trouble. Specifically, the FDIC is authorized, provided the conditions set forth in §13(c) are met, "to make loans to, to make deposits in, to purchase the assets or securities of, or to make contributions to, any insured bank." 12 U.S.C. §1823(c)(1).[1/]

The FDIC may provide assistance under §13(c) only for the purposes of preventing a bank from closing, reopening a closed bank, or lessening the risk to the FDIC when severe financial conditions threaten the stability of insured banks. 12 U.S.C. §1823(c)(1). Assistance may not exceed the cost of liquidating the bank, including the cost of paying insured accounts, unless "the Corporation determines that the continued operation of such insured bank is essential to provide the adequate banking services in its community." 12 U.S.C. §1823(c)(4)(A).

This report will focus on the clause just quoted — the "essentiality" test. Specifically, it will address two questions: (1) if the essentiality test is met, is there any legal limit to the amount of assistance the FDIC may provide?, and (2) what factors are relevant to determining whether a bank is "essential"? Consideration of these questions requires an examination of the history of §13(c).

1/ A copy of §13(c) appears as an appendix to this report.

History of §13(c)

The Federal Deposit Insurance Act was originally §12B of the Federal Reserve Act of 1913, as added by §8 of the Banking Act of 1933, 48 Stat. 162. In 1950, §12B became a separate law called the Federal Deposit Insurance Act; it was at this time that §13(c) was added. 64 Stat. 873, 888. As originally enacted, §13(c) required a finding of essentiality before assistance could be provided, and contained no reference to the cost of liquidation. In 1950, §13(c) provided, in full:

> In order to reopen a closed insured bank or, when the Corporation has determined that an insured bank is in danger of closing, in order to prevent such closing, the Corporation, in the discretion of its Board of Directors, is authorized to make loans to, or purchase the assets of, or make deposits in, such insured bank, upon such terms and conditions as the Board of Directors may prescribe, when in the opinion of the Board of Directors the continued operation of such bank is essential to provide adequate banking service in the community. Such loans and deposits may be in subordination to the rights of depositors and other creditors.

Thus, prior to the 1982 amendment, a finding of essentiality was required before the FDIC could provide <u>any</u> assistance to an insured bank.

Section 13(c) was amended twice, once in 1982 and once in 1983. The first amendment was made by §111 of the Deposit Insurance Flexibility Act, which was Title I of the Garn-St Germain Depository Institutions Act of 1982, Public Law 97-320. The second amendment was made by §1 of Public Law 97-457; it was a technical amendment to §13(c)(5)(A). Only the 1982 amendment is relevant to this report. For present purposes, the most significant changes it made were to add the provisions that assistance may be provided to lessen the risk to the FDIC when severe financial conditions threaten the stability of insured banks, and that assistance may not exceed the cost of liquidation unless the essentiality test is met.

Legislative History of 1950 Law

The bill (S. 2822, 81st Cong.) that became the Federal Deposit Insurance Act in 1950 originally did not include the essentiality test. The test was later added to the Senate version of the bill, but not to the House version. At the time the Senate held hearings on the bill, the test had not been added, and the hearings do not appear to mention it. 2/ A study, however, citing these hearings, suggests that the Senate added the essentiality test as a result of the Federal Reserve Board's warning about the possibility of free-wheeling aid. 3/ The Senate report merely restates the language of the bill regarding the test. 4/

The House report states that the committee favored omitting the essentiality test on the ground that to do so would be

> of particular benefit to mutual savings banks as these banks cannot be merged or consolidated with commercial banks, and there frequently is only one mutual savings bank in the community. 5/

2/ Amendments to Federal Deposit Insurance Act, Hearings before a Subcommittee of the Senate Committee on Banking and Currency on S. 80, S. 2094, S. 2300, S. 2307 and S. 2822, 81st Cong., 2d Sess. (Jan. 11, 23, and 30, 1950). The provision that became §13(c) is discussed at 131-137.

3/ Penning, Ann Cooper, Aid to Distressed Banks — Yesterday and Today: An Historical Survey of Federal Assistance to Distressed Banks (2 vols., 1968) at 51 (unpublished; available at the library of the American Bankers Association in Washington, D.C.)

4/ S. Rep. No. 1269 at 3.

5/ H.R. Rep. No. 2564 at 10; reprinted in 1950 U.S. Code Cong. Serv. at 3773.

At hearings before the House Committee on Banking and Currency, the General Counsel of the National Association of Mutual Savings Banks testified that the essentiality test was undesirable for two reasons:

> First, the power of the Corporation to make preventive loans or repair loans should not be limited. This is an important feature from the standpoint of preserving the integrity of the fund. It enables the doctor to take steps to cure his patient by treatment before it is too late. Secondly, this limitation might very well strike at our dual system of banking. For example, assume that in a particular community there exists a national bank and a State bank. If the State bank should need assistance of a temporary nature, the Corporation might feel that it would be precluded from giving proper help if it finds that the national bank furnishes adequate banking service in the community. 6/

The Conference report states simply that it "retains the provisions of the Senate bill" with respect to the essentiality test. 7/ The floor debates do not appear to mention the test. 8/

Legislative History of 1982 Amendment

In 1982, Congress amended §13(c) to permit aid to banks without regard to essentiality, provided the aid does not exceed the cost of liquidating the bank. Where a finding of essentiality is made, this limitation does not apply.

The 1982 amendment to §13(c) derived from H.R. 4603 (the Deposit Insurance Flexibility Act), which passed the House, and from S. 2879. As reported, both

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6/ Amendments to Federal Deposit Insurance Act, 1950, Hearings before the House Committee on Banking and Currency on S. 2822, 81st Cong., 2d Sess. (June 20, 21, and 22, 1950) at 69.

7/ H.R. Rep. No. 3049 at 4; reprinted in 1950 U.S. Code Cong. Serv. at 3778.

8/ 96 Cong. Rec. 10648-10671, 10726-10737 (1950).

bills included the substance of the amendment to §13(c) that was added to H.R. 6267 (the Net Worth Guarantee Act) and enacted as Title I of Public Law 97-320.[9/]

The House report that accompanied H.R. 4603 states:

> The Corporation, under the provisions of the bill, can provide assistance when the action (1) is to prevent insolvency, (2) is to restore a closed bank to normal operation, or (3) is to reduce the risk of loss to the insurance fund when severe financial conditions exist which threaten the stability of a significant number of insured institutions or of insured banks having significant financial resources. These changes eliminate the existing requirement of law that a particular institution be "essential" before capital infusion is authorized. 10/

This comment is repeated in substance in the Senate report that accompanied S. 2879.[11/] The Senate report also states:

9/ As introduced, H.R. 4603 would have authorized assistance to prevent banks from closing or to reopen closed banks only when such banks were essential, but would have authorized assistance to reduce the risk to the FDIC when severe financial conditions threatened insured banks, regardless of their essentiality.

10/ H.R. Rep. No. 97-272 at 11-12. It would appear more accurate to have said that these changes eliminated the essentiality test provided the assistance does not exceed the cost of liquidation. The same House report, at 39, more accurately summarizes the amendments to §13(c): "The bill would permit FDIC to provide direct assistance or assistance to facilitate a merger not only to prevent the insolvency of an insured bank or to restore a closed insured bank to normal operation, but also to provide assistance when severe financial conditions exist which threaten insured banks having significant financial resources, if the Corporation's risk of loss would thereby be lessened. . . . The amount of FDIC insurance is limited to that necessary to save the cost of liquidation, unless the FDIC finds that the institution is essential to provide adequate banking service in its community, in which case the assistance limit would not apply."

11/ S. Rep. No. 97-536 at 5; <u>reprinted in</u> 1982 U.S. Code Cong. & Ad. News at 3059.

> With respect to both direct assistance or assistance for a merger, the amount of FDIC assistance is limited to that necessary to save the cost of liquidation, unless the FDIC finds that the institution is essential to provide adequate banking service in its community, in which case the assistance limit does not apply. 12/

The identical House and Senate Conference reports provide no additional enlightenment on the essentiality test. 13/

The only floor statement found that appears relevant for purposes of this report was Representative Paul's comment in opposition to the conference report:

> This conference report is an open-ended guarantee of hyperinflation. . . . Not only is the FDIC given unlimited power to act unilaterally, its actions may include loans, deposits, exchanges, and gifts to any of the 15,000 insured banks that the FDIC chooses. . . . This conference report makes clear exactly what "lender of last resort" means. It means that the Government stands ready to print any amount of paper money or create credit for anyone, at anytime, in order to keep a financial institution open.
>
> Some may object that the insurance reserves of the FDIC are only 1 percent of the insured deposits, which is, of course, accurate. The FDIC has about $11 billion in reserves and insures deposits totaling over $1 trillion. But that is not really important any longer. Last March, the Congress passed House Concurrent Resolution 290, pledging the full faith and credit of the U.S. Government to deposits in insured institutions. It is not any longer simply a matter of using up $11 or $12 billion. The Government has made a moral obligation to bail out everyone, everywhere, to the tune of $1 trillion. 14/

12/ *Id.* at 45; reprinted at 3099.

13/ H.R. Rep. No. 97-899; S. Rep. No. 97-641; reprinted in 1982 U.S. Code Cong. & Ad. News at 3128.

14/ 128 Cong. Rec. H 8437 (daily ed. Oct. 1, 1982); Representative Paul earlier made similar remarks, objecting in particular to allowing the FDIC to make "contributions" to insured banks, as §13(c)(1) now does. 127 Cong. Rec. H 7835 (daily ed. Oct. 28, 1981).

Representative Paul apparently saw no legal limit on the amount of assistance that the FDIC may provide under §13(c).

In Senate hearings, an assistant secretary from the Department of Treasury stated that the administration "will not oppose the broadened assistance provisions of S. 2532," which contained the amendments to §13(c) that were enacted. He added that the FDIC and FSLIC

> have demonstrated due regard for the soundness of management and the long-term viability of troubled institutions, not simply providing wholesale bailouts for all. 15/

An examination of House hearings did not reveal any discussion of the essentiality test. 16/

FDIC Policy Statement

The FDIC has issued a "Statement of Policy and Criteria an Assistance to Operating Insured Banks Which Are in Danger of Failing." 48 Fed. Reg. 38669 (Aug. 25, 1983). This policy statement does not discuss the essentiality test.

History of Assistance Under §13(c)

A recent FDIC memorandum states that the assistance to Continental National Bank and Trust Company in 1984 was the sixth use of §13(c) since its enactment

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15/ Capital Assistance Act and Deposit Insurance Flexibility Act, Hearings before the Committee on Banking, Housing and Urban Affairs, on S. 2531 and S. 2532, 97th Cong., 2d Sess., (1982) at 158, 169.

16/ The Deposit Insurance Flexibility Act, Hearings before the Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the House Committee on Banking, Finance and Urban Affairs, on H.R. 4603, 97th Cong., 1st Sess. (1981).

in 1950.[17/] A study completed in 1968 states that §13(c) "has never been used."[18/]

The FDIC memorandum lists the first five uses as follows:

(1) In 1971 the Unity Bank and Trust, Boston, Massachusetts;
(2) in 1972 the Bank of the Commonwealth, Detroit, Michigan;
(3) in 1974 the American Bank and Trust Company, Orangeburg, South Carolina;
(4) in 1976 the Farmers Bank of the State of Delaware, Wilmington, Delaware; and
(5) in 1980 the First Pennsylvania Bank, NA, Philadelphia, Pennsylvania.

The fifth case listed gave rise to a reported court decision, Zinman v. Federal Deposit Insurance Corp., 567 F. Supp. 243 (E.D. Pa. 1983). This decision does not discuss the essentiality test, although it does state:

> The expansive regulatory purposes of the Federal Deposit Insurance Act, the broad language of § 1823(c) allowing loans to be made "upon such terms and conditions as the Board of Directors prescribes" and the stated intent of Congress that the FDIC exercise "such incidental powers as are necessary," 12 U.S.C. § 1819, lead us to conclude that Congress intended 12 U.S.C. § 1823(c) to be construed liberally to effectuate the purposes of the Act and achieve stability in the banking community for the sake of the nation's economy [p. 247].

Footnote 8 of Zinman lists the four prior occasions when assistance was provided under §13(c), and states, "None appears to have been the subject of judicial consideration." We have found no other relevant court cases.

Note that all five uses of §13(c) prior to Continental occurred before the 1982 amendment, and therefore required a finding of essentiality. The FDIC memorandum states:

17/ Legal Authority for Section 13(c) Assistance to Continental National Bank and Trust Company, Memorandum to FDIC Board of Directors from Margaret L. Egginton, FDIC Acting General Counsel (July 25, 1984).

18/ Note 3, supra, at 55.

> There is no set formula for determining the essentiality of a bank for purposes of satisfying the theshold requirement of § 13(c). The legislative history contains no explanation as to the meaning of the essentiality provision. The FDIC based its previous findings of essentiality on such factors as the number of depositors, the location of offices, the relative size of the bank, whether the bank is a significant provider of services (including clearing for other banks), and the impact on the economy if the bank failed. The Board, however, is not limited to these factors. It can, for example, consider such factors as how the failure of one significant bank could affect other banks and how the resulting economic and social tremors would undermine confidence in the country's banking system [pp. 2-3].

An attorney with the FDIC informed us that there are no published materials concerning the agency's five decisions prior to Continental to provide assistance under §13(c). The factors listed above, she said, were gleaned from internal FDIC memoranda relating to these decisions.

Conclusion

Under §13(c)(1) of the Federal Deposit Insurance Act, 12 U.S.C. §1823(c)(1), there are three grounds upon which the FDIC may provide assistance to an insured bank: to prevent it from closing, to reopen it, or to lessen the risk to the FDIC when severe financial conditions threaten the stability of insured banks. Whichever ground is used, under §13(c)(4)(A), the amount of assistance may not exceed the cost of liquidating the bank, unless the FDIC "determines that the continued operation of such insured bank is essential to provide adequate banking services in its community." This quoted clause embodies what is referred to as the "essentiality test."

In other words, after the 1982 amendment, if a bank is not determined to be essential by the FDIC in accordance with the factors it deems relevant, then the amount of assistance to the bank may not exceed the lost of liquidating the bank. If, however, the bank is determined to be essential, then there appears to be no specific limit on the amount of assistance that the FDIC may provide.

This report reaches two conclusions concerning the essentiality test: (1) Nothing in §13(c) or its legislative history suggests any legal limit, apart from the FDIC's obligation to effectuate the purposes of the Federal Deposit Insurance Act, to the amount of assistance the FDIC may provide to an insured bank it determines to be essential; and (2) Nothing in §13(c) or its legislative history indicates what factors the FDIC should deem relevant to determining whether a bank is essential. In a recent memorandum, the FDIC listed several factors it has used in the past to determine whether a bank is essential. These factors include the number of depositors, the location of offices, relative size of the bank, whether the bank is a significant provider of services, and the impact on the economy if the bank fails. The FDIC, however, does not consider itself to be limited to these factors.

Henry Cohen
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October 1, 1984

Appendix

The following is the text of §13(c) of the Federal Deposit Insurance Corporation Act, 12 U.S.C. §1823(c), as in effect:

(c) Assistance to insured banks

(1) The Corporation is authorized, in its sole discretion and upon such terms and conditions as the Board of Directors may prescribe, to make loans to, to make deposits in, to purchase the assets or securities of, to assume the liabilities of, or to make contributions to, any insured bank—

(A) if such action is taken to prevent the closing of such insured bank;

(B) if, with respect to a closed insured bank, such action is taken to restore such closed insured bank to normal operation; or

(C) if, when severe financial conditions exist which threaten the stability of a significant number of insured banks or of insured banks possessing significant financial resources, such action is taken in order to lessen the risk to the Corporation posed by such insured bank under such threat of instability.

(2)(A) In order to facilitate a merger or consolidation of an insured bank described in subparagraph (B) with an insured institution or the sale of assets of such insured bank and the assumption of such insured bank's liabilities by an insured institution, or the acquisition of the stock of such insured bank, the Corporation is authorized, in its sole discretion and upon such terms and conditions as the Board of Directors may prescribe—

(i) to purchase any such assets or assume any such liabilities;

(ii) to make loans or contributions to, or deposits in, or purchase the securities of, such insured institution or the company which controls or will acquire control of such insured institution;

(iii) to guarantee such insured institution or the company which controls or will acquire control of such insured institution against loss by reason of such insured institution's merging or consolidating with or assuming the liabilities and purchasing the assets of such insured bank or by reason of such company acquiring control of such insured bank; or

(iv) to take any combination of the actions referred to in subparagraphs (i) through (iii).

(B) For the purpose of subparagraph (A), the insured bank must be an insured bank—

(i) which is closed;

(ii) which, in the judgment of the Board of Directors, is in danger of closing; or

(iii) which, when severe financial conditions exist which threaten the stability of a significant number of insured banks or of insured banks possessing significant financial resources, is determined by the Corporation, in its sole discretion, to require assistance under subparagraph (A) in order to lessen the risk to the Corporation posed by such insured bank under such threat of instability.

(3) The Corporation may provide any person acquiring control of, merging with, consolidating with or acquiring the assets of an insured bank under subsection (f) of this section with such financial assistance as it could provide an insured institution under this subsection.

(4)(A) No assistance shall be provided under this subsection in an amount in excess of that amount which the Corporation determines to be reasonably necessary to save the cost of liquidating, including paying the insured accounts of, such insured bank, except that such restriction shall not apply in any case in which the Corporation determines that the continued operation of such insured bank is essential to provide adequate banking services in its community.

(B) The Corporation may not use its authority under this subsection to purchase the voting or common stock of an insured bank. Nothing in the preceding sentence shall be construed to limit the ability of the Corporation to enter into and enforce covenants and agreements that it determines to be necessary to protect its financial interest.

(5)(A) During any period in which an insured bank has received assistance under this subsection and such assistance is still outstanding, such insured bank may defer the payment of any State or local tax which is determined on the basis of the deposits held by such insured bank or of the interest or dividends paid on such deposits.

(B) When such insured bank no longer has any outstanding assistance, such insured bank shall pay all taxes which were deferred under subparagraph (A). Such payments shall be made in accordance with a payment plan established by the Corporation, after consultation with the applicable State and local taxing authorities.

(6) Any assistance provided under this subsection may be in subordination to the rights of depositors and other creditors.

(7) In its annual report to the Congress, the Corporation shall report the total amount it has saved, or estimates it has saved, by exercising the authority provided in this subsection.

(8) For purposes of this subsection, the term "insured institution" means an insured bank as defined in section 1813 of this title or an insured institution as defined in section 1724 of this title.

Chairman ST GERMAIN. We are going to vote. We have a quorum and a quick vote. We will be right back.

[Recess.]

Chairman ST GERMAIN. The subcommittee will come to order. The chair would like to make the statement that he is very proud of our staff, Mr. Isaac and his staff, and members here since we are all working for free this afternoon, the Government having shut down.

Mr. ISAAC. But since the FDIC is not an appropriated agency, we will continue running.

Chairman ST GERMAIN. You mean your getting paid?

Mr. ISAAC. Of course.

Chairman ST GERMAIN. What happened to fairness, equity and a level playing field?

Mr. ISAAC. You didn't ask how much I am getting paid for this.

Chairman ST GERMAIN. Mr. Issac, as a result of your colloquy with the genial, gentle, Mr. Vento, what essentially you have told us is that you have the statutory authority to arrange mergers or to provide capital infusion. You told us that on May 17, you issued a release that said that nobody could lose. What is the size of the FDIC fund at the present time?

Mr. ISAAC. Oh, in the range of $17 billion.

Chairman ST GERMAIN. Seventeen?

Mr. ISAAC. Billion.

Chairman ST GERMAIN. Billion. That is with a B?

Mr. ISAAC. Yes.

Chairman ST GERMAIN. For the vast listening audience, billion, as in many millions. OK. And $3 billion, not million, but $3 billion draw on Treasury, right?

Mr. ISAAC. That is correct.

Chairman ST GERMAIN. So there is $20 billion, which means that as a result of the May 17 statement, if it had cost up to $20 billion, so be it.

You had the authority and you could do it if that were necessary. Is that not theoretically correct?

Mr. ISAAC. I almost hesitate to respond to that, since it was just inconceivable that we were talking about those kind of numbers. But, yes, theoretically——

Chairman ST GERMAIN. Well, there could be another institution coming down the back road when nobody is looking, blindsiding us.

Mr. ISAAC. No, but what I am saying is, when we put the $2 billion insubordinated debt in the bank on May 17, that was more than enough to cover any obligations we would have.

Chairman ST GERMAIN. You mean that you would have had the bank shut down? You had to put more money in, not money, but continued capital infusion. Now, you also have to buy some bad loans, right?

Mr. ISAAC. I am just saying that the bank had $2.2 billion in book equity and reserves on that date. It had $2 billion insubordinated money from the FDIC on that date; $4.2 billion worth of cusion against losses in the asset portfolio and nobody, who understood the bank at all had any fear that that was not enough cushion to take care of the losses in the bank.

That is all.

Chairman St Germain. But subsequently we had to put a little more in, haven't we?

Mr. Isaac. No, actually——

Chairman St Germain. Well, you didn't put it in, but you are obligated.

Mr. Isaac. Well, what we did—we restructured the deal. We actually have a billion dollars less commitment right now.

Chairman St Germain. How about those bad loans that you bought?

Mr. Isaac. Excuse me, Mr. Chairman. A billion less commitment in terms of capital.

Chairman St Germain. Yes.

Mr. Isaac. Then we have taken out $3½ billion worth of paper. Well, actually, that was the purchase price of the paper. It has a face value of $5.1 billion.

Chairman St Germain. An old face value.

Mr. Isaac. An old face value of $5.1 billion.

Chairman St Germain. Like the bonds issued in 1912.

Mr. Isaac. A purchase price of $3.5 billion. We have assumed Federal Reserve debt in connection with that. We have agreed we will pay the Federal Reserve back from collections and 5 years from now we will settle up with them.

Chairman St Germain. That is the latest number on the Federal Reserve debt?

Mr. Isaac. I don't have the latest number. In my testimony I gave you the latest number prior to the permanent assistance package.

Chairman St Germain. What was that again?

Mr. Isaac. The Borrowings on that date totalled $12.3 billion. That included $2 billion in subordinated debt from the FDIC and $4.1 billion from the safety NRT banks. So the Fed debt must have been about $6.2 billion——

Chairman St Germain. It has gone higher. It was up to $7.5 billion at one point.

Mr. Isaac. It has fluctuated around.

Chairman St Germain. Yes, but that is a contingent liability.

Mr. Isaac. It technically is, but the Federal Reserve is more than 100 percent, actually they may even be 200- or 300-percent collateralized. The Federal Reserve has never been at risk a penny in this bank. Still isn't.

Chairman St Germain. You are paying interst on that money.

Mr. Isaac. At a market rate.

Mr. Vento. Mr. Chairman, the point is that if the action in May and subsequent actions had not been successful in terms of stopping the depositors from removing their assets, that $4.2 billion would not have been sufficient because many of the loans could not have been called in even though they are probably good debt, some could not have been called in that quickly. Subsequently the Federal Reserve money or discount window and subordinated debt that you purchased. So in other words, essentially, the FDIC, while probably not losing all of the amount of money that is indicated, still had run the string out. The string had continued to run out on it. So it was very important that you create a certain change in terms of the market behavior; is that correct?

Mr. ISAAC. Oh, no question. I think I understand your concern now. I honestly didn't understand it before. If you are saying that, "what if the run had continued despite our efforts, our assurances and the infusion of capital, where was the money going to come from"; it was going to come from the Federal Reserve.

Mr. VENTO. Well, I think that my concern is with the personal commitment, your involvment, what extent of exposure is that you have as opposed to other people involved in terms of regulating what the purpose of your fund is, not questioning necessarily authority. I can leave that to the lawyers to answer, but I do not know what the statutory limits are and I think the intent is to stay within them.

I guess we have to go vote.

Chairman ST GERMAIN. I think among Congressman Vento's concerns was—and that of a lot of people, Mr. Issac, was that though the wording in your release was accurate, nonetheless, the word went out to the world at large that the FDIC has just made it very clear that if you have got over $100,000 in Continental, don't worry about it.

You are not going to lose anything.

Mr. ISAAC. That is exactly what we intended to make clear.

Chairman ST GERMAIN. Yes, but unfortunately, that was interpreted as meaning no matter what happens. If the bank fails, we will still pay you off to the total amount of your deposit.

Mr. ISAAC. What we were saying is this bank is not going to be handled——

Chairman ST GERMAIN. What you were saying, Mr. Isaac, and what people heard, unfortunately, but it happens in public office all the time was one thing and the people heard another thing. The fact is, that was heard around the globe. Maybe you weren't aware of that.

Mr. ISAAC. No, I am aware of that.

Chairman ST GERMAIN. Indeed that was the interpretation placed on it by a great many people.

Mr. ISAAC. I am aware of that. In fact, in my testimony, I think when we got to that part of the testimony, it says the assurance issued by the FDIC on May 17 is widely misunderstood.

Chairman ST GERMAIN. Correct.

Mr. ISAAC. That language is in our testimony.

Chairman ST GERMAIN. And I don't argue with the fact that your language was specific and accurate. But as I say, I am positive it was misinterpreted. We will be back soon. You can finish your Coca-Cola, and we will be right back.

Chalmers is looking forward with bated breath to talk with you.

[Recess.]

Chairman ST GERMAIN. Mr. Wylie?

Mr. WYLIE. Thank you very much, Mr. Chairman. Mr. Isaac, just to be positive here for the record, if I may, on this question of essentiality, it is your judgment that there is no limit on the amount the FDIC can spend in a capital infusion. It is only when the bank closes that you get into the issue of $100,000 limit on insurance.

Mr. ISAAC. That is correct.

Mr. WYLIE. OK. It is my judgment that you are right on that, based on some points that have been referred to before. The article as I say, was from Congressional Research Service, Library of Congress, and I have found them to be pretty good. I don't know personally the young man who prepared this, but I have a feeling that he has a pretty good legal background.

Mr. ISAAC. Sounds like he does.

Mr. WYLIE. Since he agrees with you. Members may have seen an article in today's New York Times, beginning on the front page, not on the business page, but the front page, about the unusual loss of about $70 million taken by First National Bank of Chicago for the third quarter of this year as a result of a revaluation of its energy, agriculture, shipping, and construction loans.

The article suggests that the chargeoff might have come at least to some extent at the behest of the Comptroller's Office. Several other articles in the business section discuss both the positive and negative aspects of the outlook for the banking industry in the wake of the sharp decline of First Chicago stock, which was off three and half points yesterday, I believe, and there were smaller declines in other bank stocks.

Now, this is all by way of preface on my part to a question about the data we have heard here today or that I read in your testimony. Assuming for the sake of argument there are some shortcomings in the analysis of the potential ripple effects of a Continental failure upon small banks with Federal funds at Continental, are there not also built-in limitations in the recalculation of the FDIC data?

For example, staff points out that the data considered by the FDIC go back to April 30, a date prior to the enormous deposit outflows and public concerns about Continental. Is it not also true that the data precede the crisis at the Financial Corporation of America and fail to take into account potential problems that have existed off and on since spring at other institutions, all of which would have their own constellations of potential ripple effects.

If these potential problems were also considered, might it not put the figures we have before us today in an entirely different light?

Mr. ISAAC. Mr. Wylie, I think you have really hit the nail on the head in terms of some of the things that were of concern, if we had handled Continental a different way. You mentioned First Continental Chicago's announcement yesterday. Let me say a word about First Chicago.

First of all, the bank doesn't have the Penn Square problem. It's capital after this very large charge off, remains at 5.9 percent, which is comparatively high for a money center bank. It has nonperforming loans in the $8 million to $900 million range contrasted with Continental's $2.5 to $3 billion prior to the FDIC assistance.

So this is a situation that is not anywhere near the kind of problem that we were dealing with in Continental. I would also point out that in the case of First Chicago, the writeoff they took in the third quarter was more than $100 million in excess of what was required in the examination report they just received.

So the bank really decided to bite the bullet and face up to its problems to a greater degree than they were asked to by the regulators and I commend them. There has been no funding problem. It has been a nonevent in the marketplace but there is no question in my mind it might have been a different story today if we had handled Continental differently.

A bank that is facing up to its problems might not have been able to get through this if we had treated Continental differently than we did. And as I said, earlier, FCA clearly would not have made it in my judgment. They wouldn't have had the options to stabilize that institution the way they did.

Mr. WYLIE. The point I wanted to make was that the analogy was drawn a little earlier, too, with W.T. Grant, the fact that they went belly up and the Government did not intervene in that case. It is my judgment that banks are in a unique and special position for a variety of reasons and that there really isn't any analogy between Continental Illinois and with W.T. Grant. There might be an analogy with Sears, but not with the W.T. Grant.

How would you comment on that? You threw Sears in there—I got that from Jim Leach—because we don't know where they are going yet.

Mr. ISAAC. Banks are very important to the economy obviously and there are a lot of aftershocks that are felt when banks fail. In addition, banks are vulnerable in terms of public confidence. If we had handled Continental differently, particularly when you consider the bank was not insolvent, is not today insolvent, we could have shaken public confidence in a serious way and I think it would have been irresponsible for us to do so. I have had to make a lot of tough decisions over the last 3 years in dealing with banks and Continental was one of the easiest decisions I have ever made.

Mr. WYLIE. I will return to the Federal Reserve Board legal memorandum. This addresses the congressional intent behind the 1982 amendments and I do think it is important to try to clarify this. The amendment to section 13 of the Federal Deposit Insurance Act, among other things, reenacted the essentiality test which was found in the prior law. We just repeated the law in that regard, however, as explained in the Federal Reserve Board memorandum, the overall purpose of the amendment was to increase the flexibility of the FDIC to handle troubled institutions.

For example, the Federal Reserve memorandum states the current language of section 13(c) results from amendments enacted by the Garn-St Germain Depository Institutions Act of 1982. As indicated in the House report the purpose of the Garn-St Germain amendment is as follows: "In making these changes in authority of the Federal deposit insuring agencies, the goal has to be to provide maximum flexibility for each of the agencies. This flexibility will allow the insurance funds to be leveraged to the maximum extent possible. This will require each of the agencies to consider all their options, capital infusions, other financial assistance mergers and acquisitions, when searching for solutions to particular problem cases."

It is not intended that one solution may be utilized without consideration of the other options. The Federal Reserve memorandum states and quotes from House remarks by the chairman—and I referred to those earlier: "I am convinced that we must provide the FSLIC and FDIC with better tools to handle the problems so clearly evident in the financing system today."

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I am not quarreling with that. "If enacted", the chairman said, "this bill will help to stabilize our financial system. It will provide our ensuring institutions with the flexibility they need to address the very real problems that they have."

The memorandum quotes Senator Riegle as follows: "The purpose of this legislation is to expand the authority of the FDIC, FSLIC, and NCUA to assist these troubled depository institutions through brokered merger options and financial aid."

There is another quote, from the case of *Zinman* v. *FDIC*, that says, "the expansive regulatory purposes of the Federal Deposit Insurance Act, the broad language of § 1823(c) allowing loans to be made 'upon such terms and conditions as the Board of Directors prescribes' and the stated intent of Congress that the FDIC exercises 'such incidential powers as are necessary' lead us to conclude that Congress intended 12 U.S.C. § 1823(c) to be construed liberally to effectuate the purposes of the act and achieve stability in the banking community for the sake of the Nation's economy."

Based on that legislative history which illustrates to me a clear intent of Congress to broaden the FDIC's ability to help troubled institutions and to increase its flexibility, the essentiality test as reenacted in 1982 should not be construed narrowly but instead should be construed liberally to permit the FDIC to effectuate the goals of the act and assist troubled institutions.

Chairman ST GERMAIN. This is not all from the Federal legal opinion?

Mr. WYLIE. Yes. That is a comment on the Federal legal opinion.

Chairman ST GERMAIN. I wish you had encapsulated the quotes. I think one of your staffers wrote that for you, right?

Mr. WYLIE. The comment at the end is by staff and the rest is a quote.

Chairman ST GERMAIN. So it is not from the Federal Reserve legal memorandum?

Mr. WYLIE. The part where I say, "based on this legislative history which illustrates the clear intent of Congress to broaden the FDIC's ability to assist troubled institutions"—which happens to be my own feeling—"and to increase its flexibility, the essentiality test as reenacted in 1982 should not be construed narrowly," are my words and I would ask for a comment from the Chairman of the FDIC in that regard. I think he has already commented on it. As a matter of fact he has on several occasions. But is that your view that you did have some discretion to act as you did in this situation?

Mr. ISAAC. I have no question we have legal authority.

Mr. WYLIE. And I think part of the fact that you say you have no question that you have the legal authority might have been based on those particular sections of the law and of statements made by the chairman with reference to that.

On page 1 you state——

Chairman ST GERMAIN. Excuse me. Your time has expired.

Mr. WYLIE. Thank you very much.

Chairman ST GERMAIN. I would like to state that the quote that you have from me in there and repeated just now, came from the record during floor debate, and it is all right if you were quoting somebody else and were trying to interpolate what they mean, but

I am here and therefore can tell you what I meant, and that the flexibility was accorded not through a change as that memorandum just stated. There was no change in the essentiality test. What it did was add other criteria to section 18(c)(2), which is what I said earlier.

Mr. WYLIE. It is important that I bring it up here, because the Federal Reserve legal memorandum was based in part on your statement on the floor.

Chairman ST GERMAIN. Wait now. Stop telling me what—flexibility, increased flexibility was to add additional powers for mergers and with specification, it defined how mergers would occur interstate as well as intrastate.

In addition to that, the flexibility was to take care of the New York City mutual savings bank situation whereby they could save a large thrift institution that would not have been considered prior to this act to be essential. That is where the increased flexibility comes. It wasn't increased flexibility as far as essentiality is concerned. We are talking section 13(c).

Mr. Patman.

Mr. PATMAN. Thank you, Mr. Chairman.

Mr. Isaac, you have talked about market discipline and how important that is. What is market discipline and why is it good, in your concept?

Mr. ISAAC. We probably have the problem to a fair degree, even in a highly regulated environment, but in a deregulated interest rate environment we have the serious problem of trying to ensure that the funds in our financial system flow to the best institutions and not simply to the ones that pay the highest rates, because the ones that pay the highest rates tend to be marginal operators. Often there are abusive practices.

Mr. PATMAN. Your interest in it comes from not wanting to pay out more from the FDIC fund than you otherwise would?

Mr. ISAAC. In the end it is the fund I am worried about and the stability of the system, yes. I would like to see the money flow to the best banks, not just the banks that are paying the highest interest rates. If we don't find a mechanism for discipline in the system we won't have that.

Mr. PATMAN. The less risk, the less likely you are to pay out additional moneys from your funds or any moneys?

Mr. ISAAC. Exactly.

Mr. PATMAN. So you feel in order to encourage this the investor should take some risk when they invest in depositor institutions, isn't that the essence of the argument, they should help you manage the situation?

Mr. ISAAC. First of all, I have no trouble with the notion that smaller depositors ought to be given full protection.

Mr. PATMAN. That is your obligation.

Mr. ISAAC. That is desirable. Even if it weren't our obligation I would favor that kind of protection.

Mr. PATMAN. That is not before us. Bigger deposits are.

Mr. ISAAC. We have a question before us now that frankly we want guidance from the Congress on.

Mr. PATMAN. You have advocated that depositors above the $100,000 suffer some loss when a bank fails in which they have invested their money?

Mr. ISAAC. I have said in the past that we have to find a way to impose discipline on depositors above the $100,000 or some other mechanism. We have suggested an alternative involving higher capital ratios. We must have a mechanism for having a greater degree of marketplace discipline in the banking system, yes.

Mr. PATMAN. But basically that involves an investor taking loss when he invests more than $100,000 in an institution?

Mr. ISAAC. Somebody must take a loss.

Mr. PATMAN. And you favor an investor taking a loss in a case like that where he invested in an institution imprudently and not checking out everything and knowing that he would get his money back, the institutions being well managed.

Mr. ISAAC. Either the suppliers of capital and subordinated debt should be required to take losses in banks that fail——

Mr. PATMAN. I am not talking about the stockholders.

Mr. ISAAC. The problem is what——

Mr. PATMAN. I am just talking about depositors and that is what you have been talking in general about on market discipline, isn't that true?

Mr. ISAAC. Could I back up a little bit?

Mr. PATMAN. My time is running out. Let me move on and we will come back to that.

Mr. ISAAC. You are on a very, very important point.

Mr. PATMAN. I don't want to gloss it over. You do get market discipline under the payout procedure where you take over a bank and pay off the depositors or where you have a modified payout?

Mr. ISAAC. In those transactions.

Mr. PATMAN. Because the depositors of over $100,000 take some loss, if not an entire loss above the $100,000?

Mr. ISAAC. That is true.

Mr. PATMAN. Depositors customarily do not take a loss, but possibly some do, but you don't get any market discipline if you have a capital infusion or a merger that is averaged by the FDIC, do you?

Mr. ISAAC. This transaction is not entirely devoid of discipline and if we had arranged a merger as we do with most bank failures it would not be devoid of discipline, but not nearly as much as you would have in a payoff or modified payoff situation. However, at continental the shareholders have the potential of losing their entire investment.

Mr. PATMAN. I am just talking about the depositors. You shouldn't be concerned about the shareholders should you?

Mr. ISAAC. There is no depositor discipline in the typical bank failure. As Congressman Barnard pointed out earlier, 80 percent are handled by a merger or capital infusion and in those cases there is no depositor discipline.

Mr. PATMAN. In other words, no market discipline?

Mr. ISAAC. Not much except whatever the shareholders and directors and officers get caught up with.

Mr. PATMAN. I am talking about market discipline for the depositors. I am not worried about the shareholders and I don't think you should be, do you?

Mr. ISAAC. No.

Mr. PATMAN. What market discipline will investors of over $100,000 in Continental National Bank experience?

Mr. ISAAC. None.

Mr. PATMAN. Regardless of the amount of their deposits?

Mr. ISAAC. That is right.

Mr. PATMAN. Is it not true that many of these deposits came from Southeast Asia?

Mr. ISAAC. I don't know. I would be surprised.

Mr. PATMAN. Are there not many foreign deposits in Continental Illinois?

Mr. ISAAC. There were a number of foreign deposits but I think that comprised the biggest chunk of $9 billion that left. I don't know what is left in the way of foreign deposits.

Mr. PATMAN. Were they not attracted to Continental Illinois because of the high yields on deposits there?

Mr. ISAAC. Prior to Penn Square Continental was thought to be a good bank and as far as I know, was not paying a premium for the funds. After Penn Square, I think Continental was paying a premium for funds.

Mr. PATMAN. Is it now?

Mr. ISAAC. I don't know.

Mr. PATMAN. Well, you are guaranteeing the solvency of the bank virtually, aren't you?

Mr. ISAAC. We have made the bank solvent by investing in it.

Mr. PATMAN. Or guaranteed it?

Mr. ISAAC. It was solvent already but we have made it more solvent, one of the best capitalized banks in the world.

Mr. PATMAN. What is a solvent bank?

Mr. ISAAC. One that has assets that have a greater value than its liabilities.

Mr. PATMAN. What is your testimony as to whether or not a small bank would fail if Continental had not been bailed out? What would have caused it to fail? Would its assets have become less in value than its liabilities?

Mr. ISAAC. Yes.

Mr. PATMAN. Would its equity have been wiped out?

Mr. ISAAC. It depends.

Mr. PATMAN. What is your testimony—why does a bank fail? What will be the point at which a bank fails? What will the point in financial condition be when a bank will fail?

Mr. ISAAC. A bank fails when it incurs losses such that the value of the liabilities exceeds the value of the assets. In other words, the capital is eliminated. That is generally when a bank fails.

Mr. PATMAN. Well, you hear a lot of talk about the nine largest banks in this country having more than their capital in Third World country loans. Are you telling us that all those banks would fail if those loans went bad and had no value?

Mr. ISAAC. If you assign no value to the loans I think the mathematical computation is that the bank wouldn't have any capital, but I don't assign, and I don't know of anybody that does, zero value to those loans.

Mr. PATMAN. Would they then fail if that happened, if they had no capital, if they had no equity value?

Mr. ISAAC. A bank that doesn't have any equity isn't solvent.

Mr. PATMAN. Then that is the test then on whether or not a bank fails, whether it loses its equity?

Mr. ISAAC. Generally speaking.

Mr. PATMAN. When you were talking about those small banks that would fail would it be because they had lost their equity?

Mr. ISAAC. Yes.

Mr. PATMAN. Every one of them lost their equity or were there some other conditions under which they would have failed?

Mr. ISAAC. No. If they had lost their equity and were not able to get recapitalized they would fail.

Mr. PATMAN. Any bank could succeed and become viable, operational with the kind of help that was given Continental Illinois National Bank, isn't that true?

Mr. ISAAC. Well one would think——

Mr. PATMAN. Penn Square would still be doing business if you came in there and did the same thing for it that you did for Continental Illinois, isn't that true? Are there any of those 55 banks that have failed this year that would not still be in business if you did the same thing for them that you did for Continental?

Mr. ISAAC. You mean if we bought $3.5 billion of bad loans? If you are talking about helping them proportionately, no, most of them would not have been.

Mr. PATMAN. What is the measure? How far did you have to go with Continental Illinois? You put in all the money you needed to to keep it going, is that right?

Mr. ISAAC. Continental had, after this summer's $1.1 billion chargeoff, book equity and reserves of nearly a billion dollars.

Mr. PATMAN. Is that counting a large reduction in the value of its foreign loans? If those loans had been properly valued would it still have had that large surplus?

Mr. ISAAC. Those loans are properly valued.

Mr. PATMAN. Are they valued at full book value?

Mr. ISAAC. Some are, some aren't.

Mr. PATMAN. To what extent were they diminished from full market value? How far below full book value are they now?

Mr. ISAAC. It depends on the loan.

Mr. PATMAN. Say on the average?

Mr. ISAAC. There is no average. It depends on the loan.

Mr. PATMAN. Thank you.

You see, you can go ahead now I assume with the indulgence of the chair, and finish your explanation.

Mr. ISAAC. I just did.

Mr. PATMAN. Did you give as much as you wanted to on market discipline?

Chairman ST GERMAIN. We will get back to that. We gave you 2 minutes, Bill.

Mr. PATMAN. Thank you.

Chairman ST GERMAIN. In the test of essentiality you don't ask how many jobs would be lost do you? You don't factor in the loss of employment, do you?

Mr. ISAAC. It was mentioned as a factor in both First Pennsylvania and Continental.

Chairman ST GERMAIN. What was?

Mr. ISAAC. It was mentioned in the essentiality memo for both Continental and First Pennsylvania.

Chairman ST GERMAIN. You are now considering the number of jobs lost as essentiality?

Mr. ISAAC. I didn't give that a whole lot of weight but it was an element.

Chairman ST GERMAIN. Do you think that that should be an element? I thought it was essential to the community.

Mr. ISAAC. Right, and that is part of what you are looking at when you look at the economic impact on a community.

Chairman ST GERMAIN. I thought essentiality meant that that community needed that institution, not because of employment but as a safe depository and as a source of loans.

Mr. ISAAC. In considering essentiality you try to consider all the economic repercussions and that is an element. If you are asking me did we save Continental or rescue Continental because we were concerned about the job impact, whether that was a key element in our essentiality decision, the answer is no.

Chairman ST GERMAIN. Maybe when I get around to questioning you again, maybe you could tell us what are the elements of essentiality? It is not my turn to question. Somebody might be thinking on that in the interim.

Mr. Leach.

Mr. LEACH. Thank you, Mr. Chairman.

First, let me thank you for deferring this hearing a bit. We appreciate it very much. The President took a little longer than we suspected but we were not worried because we knew Mr. Annunzio was here to protect the administration position.

In that regard, Mr. Isaac, you mentioned to us that it was an easy decision to do what you did on Continental. I would simply say from a different chair that there has never been a easier decision than to criticize the regulators in their handling of Continental. It strikes me that you have three problems that are very obvious. One is that it appears that an individual bank's problems were not identified early enough; and second, there appears to be a collective bank problem stemming from the regulators decision to allow some books to grow faster without adequate capitalization, and finally it doesn't appear as if the regulators had in place a plan for this type of problem in advance.

I think on all three points there is some criticism that can be leveled, but I would like to talk instead about what types of solutions we have ahead, and as I read the press and your statements and from comments that have been made by a number of the banking regulation community, there are two types of potential solutions.

One is that one can move to give consideration to a higher capital base for banks.

Second one could put large depositors at greater risk in the event of problems.

The second alternative seemed to be a preferred position internally and now seems to have changed your opinion and now you are working toward applying a higher capital base. I applaud very much the movement in that direction. But you asked earlier, is there any guidance from Congress and I would say that your approach of moving from 5½ to 9 percent, which is partly under consideration, is positive, but it appears to me to be much less than meets the eye.

If you allow subordinated debt securities to count as capital, you are really not exactly dealing with the problem. The old fashioned way of dealing with a debt problem is not to take on more debt. The old fashioned way is to sell equity. What we have here is regulatory squeamishness to deal with the large banks on a firm basis. They obviously don't want to sell equity when their stock appears to them to be selling below book value. Their stock is selling for less than book value because of their own poor business practices, so their own stockholders ought to take the losses that may occur if they sell more equity because they have to increase their capital base.

I would only stress to you as someone who has been very involved in writing the legislative title that deals with equity that it is not sufficient to talk about round about approaches that are really only dealing with taking on debt in new ways. The way you increase a bank's capital is to increase a bank's capital, not to define capital in very expansive manners.

I know you share this perspective to some extent as do some of the other regulators, but I have sensed that one of the problems in terms of regulation of the large banks is real reluctance of the regulatory to stand up to very powerful institutions in terms of discounting loans, and in terms of requiring greater capital, I would simply urge you to recognize that not only do you have to raise percentages but you have to raise them meaningfully. A meaningful increase in percentage is not simply to have the banks market subordinated debt securities that may provide a little bit of market discipline for growth in banking but don't really deal with the current liabilities of large banks as they currently exist. I would just hope that in terms of any kind of congressional guidance that we can offer, it should be to urge that the banks raise capital the old fashioned way by selling equity, rather than creating new fanciful definitions of raising capital.

Would you care to comment on that.

Mr. ISAAC. Yes. I guess I agree with much of what you have said. I would like to maybe comment on a couple of things. One was you said that the regulators could be faulted for not having a plan for dealing with a situation like Continental before it occurred when in fact we did.

Mr. LEACH. The plan was to cave. If caving is a plan you had a plan.

Mr. ISAAC. I don't think we caved, I think we did what we needed to and that plan was ready and in place before Continental occurred. We didn't know it would be Continental but we had a plan in place for dealing with this kind of contingency.

On the subject of whether the regulators have the will to stand up to a large organization, I guess the best thing I could do there is to cite the fact that the FDIC, beginning in 1981, set forth for the first time an explicit minimum capital ratio that every institution of any size was required to meet. Banks that did not meet our capital ratio requirement were not invited to bid on failed institutions.

In other words, when the FDIC draws up a list of eligible bidders on failed banks and anybody who did not meet that test, no matter how big, was not invited to participate in those transactions.

Mr. LEACH. That doesn't seem to be the worst punishment.

Mr. ISAAC. I guess I have to back up and talk about the regulatory system. That is about the strongest action the FDIC has available with respect to a bank other than a State——

Chairman ST GERMAIN. What was the capital adequacy requirement initiated—was that 3 percent?

Mr. ISAAC. Five in the 1981 was the minimum.

Chairman ST GERMAIN. What?

Mr. ISAAC. In 1981 we issued a minimum capital requirement of 5 percent equity for banks of any size.

Chairman ST GERMAIN. What is it now?

Mr. ISAAC. There is a proposal out to take the equity number to 5½ percent and the total capital number, which would include subordinated debt to six. That is on the table now.

Mr. LEACH. It has to be stressed at every turn that included in capital are things like loan loss reserves. In other words, lost money is capital. It is the only institution in the world that can account that way.

Mr. ISAAC. The loan loss reserve is part of the cushion that protects against adversity. If we recognize a loan as a loss loan it is written off and is out of the capital structure.

On the issue of subordinated debt, I was one of the strongest proponents of getting subordinated debt out of the picture——

Mr. LEACH. Of the three regulatory agencies yours comes out easily the best at every turn. So to that I tip my hat.

Mr. ISAAC. If I could say a brief word about subordinated debt. The idea of going to a 9-percent capital ratio and allowing it to be satisfied through subordinated debt is not because we think that Bank capital is so inadequate, it is because we are trying to look for mechanisms to force banks into the marketplace to raise this capital and thus be disciplined. The purchasers of the subordinated debt will be very sophisticated purchasers and they will discipline the banks.

Mr. LEACH. If I could return to one part of your statement that you submitted for the record. You have two extensions. We have also suggested other supplemental steps such as risk based FDIC premiums and limitations of use of brokered funds. None of these measures is easy to sell politically. Do you mean to the public at large, to this committee or do you mean to those that you are regulating?

Mr. ISAAC. Probably some combination, but let's talk about risk-related premium. I guess our problem there is with the Congress. This past March I addressed the Leadership Conference of the American Bankers Association on risk-related premiums and other issues. That group, which was comprised of bankers from all over the country, voted unanimously to endorse risk related premiums. Yet there has not been a congressional hearing on the bill we submitted last year.

On broker deposits, the securities industry is upset about that one. They would like to have the Federal subsidy and be able to sell these deposits and place them in banks irrespective of risks.

Mr. LEACH. Congressman Wylie called earlier in the day for hearings next year on a series of these issues.

Let me ask about a final thing that reflects on the FDIC. I understand from background information supplied that in late 1982 and early 1983 the FDIC argued that the rating of Continental should be a four, but the Comptroller argued against that categorization, is that correct? And whether or not it is correct, do you think as insuring agency that you ought to have statutory or regulatory authority that gives you more powers which would enable you to act without the support of the other two regulatory agencies when you are dealing with a bank in great difficulty?

Mr. ISAAC. Yes, we recommended that Continental be considered a problem bank. I think it was around February or so of 1983. As far as I know, the fact that the Comptroller didn't call it a problem bank didn't influence their judgment on how they dealt with it.

As to the question of whether or not the FDIC ought to have the full range of enforcement powers over any bank it insures, I don't know of any rationale for not granting the insurance agency have that authority. We have had a bill pending before the Congress since last fall asking for that authority.

Mr. LEACH. I am glad you were able to raise that point. I would just note that even though you don't want to differ with the Comptroller, the Comptroller did not require greater capital savings or cushion growth although apparently the two of you agreed that to require this in a decision in February of 1983.

Mr. ISAAC. I don't want to get into the supervisory issue, but it would have been very, very difficult at that stage to get Continental to increase its capital base. The markets were not particularly receptive to Continental at that stage.

Mr. LEACH. The markets are receptive, the point is it probably would have involved dilution of stock value.

Mr. ISAAC. You could probably have sold it at some price.

Mr. LEACH. That is the point that we in Congress are stressing because if you had sold $2 billion or $3 billion worth of stock and the stock had plummeted from $18 to $5, that is a lot better than paying out $2 billion or $3 billion FDIC funds. That is my point in saying that you regulators in general have bought the large bank's plea, "Don't force us to sell capital when our stock is valued less than book."

Their stock is valued less than book because it should be and if you are going to shore up the banks have them buy capital. If you had forced them to do that you would not be sitting here today responding to this committee's inquiries.

Mr. ISAAC. I understand your point and I would guess that you probably can sell capital at some price. What you said about controlling growth, stopping it from growing, I think Continental in fact shrunk during that period. You may say not enough, but it did shrink in size during that period in question.

Mr. LEACH. Thank you, Mr. Chairman.

Chairman ST GERMAIN. I am looking at some of these resolutions of the FDIC to provide assistance under the essentiality section. September 1974 deals with the American Bank Trust, Orangeburg, SC. It says here, it is essential to provide adequate banking services, to South Carolina communities where the bank operates the only commercial banking facilities within $5 million or more. And in three counties and two other communities of South Carolina where the bank's officers provide the only alternative to some competitor bank for bank service. It doesn't discuss how many people are going to be unemployed or how many other banks will be affected, see.

Then the Commonwealth Bank of Detroit, MI——

Mr. WYLIE. What was that, Mr. Chairman?

Chairman ST GERMAIN. I gave the date, September 1974. And now I am looking at the Bank of the Commonwealth of Detroit, MI, BOC. It operates 57 offices in the Detroit metropolitan area. Is is the fourth largest commercial bank of the city of Detroit, the fifth largest in the State of Michigan, among the 60 largest in the United States? No mention of unemployment, no money for the groceries and no money for the aspirin and the shoes for the children.

Mr. ISAAC. It is obvious our board was not as sympathetic——

Chairman ST GERMAIN. This is very serious.

Then we get to the Farmers State Bank of Delaware. Likewise, essential to the community, but they don't go into anything about unemployment, et cetera.

Then there is the little bank in Boston. The community's only black bank. Serves the black community—Roxbury, Dorchester—90 percent of the depositors are black. The bank has *x* number of shareholders. But it was saved because it was deemed essential to the black community of the Roxbury-Dorechester community area of Boston.

Then we get to First Pennsylvania and my goodness gracious, you can get even food stamps and all those other things in here, a brandnew concept, and why? I will tell you why I think you went into that—that preceded your tenure, didn't it?

Mr. ISAAC. I was on the Board.

Chairman ST GERMAIN. You were on the Board and you had a different General Counsel. It talks about the employees, a brandnew element. We have not seen that in any of the others before. A brandnew element, and my own personal opinion is that in this particular instance, that is where the stretching began, because when we look at the statute, the statue says very specifically.

> No assistance shall be provided under this subsection in any amount in excess of that amount which the corporation determines to be reasonably necessary to save the cost of liquidating, including paying the insured accounts of such insured bank except that such restrictions shall not apply where the corporation determines that the bank is essential to provide adequate services in its community.

So when you add unemployment, that is a new element that is not specified in the statute. Incidentally that I read to you, another factor applied. They compare and they tell us how much it would cost to pay out if there weren't any capital infusion, and instead of that the bank would just close. How much would it cost for the payout to depositors up to the limits of the FDIC insurance?

This was not considered in the First Pennsylvania and the Continental incidents. Instead of looking at that aspect, you looked at the number of unemployed, which is as I say, a new factor. I wonder, do you know when that one snuck under the tent?

Mr. ISAAC. That is an interesting theory you have that the stretching began there. If you want to look at a case where you have to stretch, let's look at the Bank of Commonwealth or Farmers Bank of Delaware, that is really stretching to meet an essentiality test.

I have another theory. I think you started seeing a lot more enumeration of the factors in First Pennylvania not because we were stretching to meet an essentiality test any more than we would have been any other case. It is just that I think there was lot more political sensitivity due to the fact that First Pennylvania was in the top 25 banks in the country. We were fearful that we were going to be criticized by the Congress more vociferously than we would be if we were dealing with a small bank somewhere that nobody took much note of. We could do something in the Farmers Bank of Delaware or in the Unity Bank and Trust Co. in Roxbury, MA, or in United Southern Bank without being criticized. When you are dealing with a First Pennylvania or a Continental, the whole issue becomes very political because of the size of the institution. So you buttress your case more.

Chairman ST GERMAIN. In other words, you are building a case. You bring in everything under the sun?

Mr. ISAAC. You try to explain much more fully why you are doing what you are doing.

Chairman ST GERMAIN. But where in the statute or in the legislative history is there any mention of unemployment created as a result of shutting down the institution?

Mr. ISAAC. It is simply a factor. I didn't say it was the key factor. I didn't say it was a terribly important factor.

Chairman ST GERMAIN. It happened that the counsel in First Pennsylvania threw it in and now every counsel will have it in there.

Mr. ISAAC. Unless it is a small bank.

Chairman ST GERMAIN. It is like the forms—are you an attorney?

Mr. ISAAC. Not practicing.

Chairman ST GERMAIN. But you do have legal background?

Mr. ISAAC. But not from Boston University.

Chairman ST GERMAIN. You never practiced?

Mr. ISAAC. Yes, I have practiced.

Mr. WYLIE. Would the chairman yield?

Chairman ST GERMAIN. In a second.

When you practice the law, and this may come as a shock to a lot of clients, but oftentimes the secretary can draw up the contract, the will and many other things and the deed, because they have form books. So, when your attorney and you are in the General Counsel's office, and you are probably one of the newest attorneys there, he says prepare the resolution that will be adopted by the Board. You look at the previous resolutions and he says well, in that instance they employed 10,000 but in this case it is 14,000, so you just have to change the 10,000 to 14,000. Everytime a new counsel or assistant counsel comes along he has another brilliant idea, we will add to it.

But I think it is perhaps time to get back to the basics and find out what essentiality really is as far as essentiality to the community is concerned and that is my concern at this point, Mr. Isaac. That is why we are having these hearings. We are learning a lot. We are learning a lot that we should have known but unfortunately our workload is big. We can't concentrate just on the wonderous actions of the regulators, though we would like to, because we rely upon you.

When we get a big one like this everybody demands we look into it. I think the situation in the future demands that the manner we go into this is handled thoroughly so that we can determine whether any changes have to be made or should not be made.

Mr. ISAAC. Mr. Chairman, I salute you for that. The only thing I am taking issue with on essentiality is any challenge that might be made to our legal authority to do what we did. I think we have that authority and I think there are plenty of precedents for it. This is just one of a line of cases. If, though, you are raising the issue in the context of from a policy point of view—should we be doing those kinds of things—I couldn't agree more with having a full and open discussion of that issue. It needs to be discussed.

Mr. WYLIE. If the chairman would yield.

I think you are making an excellent point and in view of the emphasis which is placed on the essentiality testimony, I wanted to offer memoranda. You referred to the *Unity Bank and Trust Company* case. I have a memo here supplied to me in connection with that case, also the Farmers Bank of the State of Delaware, other memoranda dated May 17 and July 25, 1984. I think it might be useful as a background to provide a kind of a history of essentiality and you have gotten into it very, very well, and I think that you are on to something, and I would like to ask unanimous consent to place these memoranda in the record.

Chairman ST GERMAIN. Is there objection?

The Chair hears none.

[The memoranda submitted for the record by Congressman Wylie follow:]

May 17, 1984

MEMORANDUM: The Board of Directors

FROM: Robert V. Shumway, Director
Division of Bank Supervision

SUBJECT: Continental Illinois National Bank and Trust Company of Chicago-Section 13(c)(2) Assistance

Because of recent deposit run offs, borrowings from the Federal Reserve Bank of Chicago by Continental have increased from $2.8 billion on Friday, May 11, 1984 to $4.0 billion on Tuesday, May 15, 1984. Additionally, Continental has accessed $2.25 billion of a $4.5 billion line of credit established last weekend by 16 large commercial banks. These are overnight funds and the commitment runs for 30 days.

As of April 2, 1984, the OCC determined that Continental had no significant additional domestic liquidity available, excluding the FRB Discount Window, at current pricing premium levels. Additionally, major sources of international funding have been drying-up in recent days.

The Comptroller of the Currency has determined that Continental's ability to obtain funding from domestic and international sources has continued to deteriorate. Therefore he has written a letter dated May 17 to the FDIC stating that Continental may become unable to meet its obligations as they become due.

Against this background, DBS believes that there are sufficient facts to determine that Continental is in danger of closing. We have determined that the amount of assistance required to facititate a merger, consolidation or the sale of the assets and assumption of the liabilities of Continental is an amount in excess of that amount reasonably necessary to save the cost of liquidating, including paying the insured accounts, of Continental. However, we believe that the continued operation of Continental is essential to provide adequate banking services to its community.

Continental has a major correspondent relationship with hundreds of downstream correspondent banks. These banks rely on Continental for check clearing and other vital banking services. It would be extremely disruptive to these banks and their customers should these services be interrupted. It also would be very difficult to reestablish such a large number of correspondent relationships in a short time.

In addition, many of these downstream correspondent banks have significant exposure in terms of deposits at and Fed Funds sold to Continental. The potential losses in these accounts that would result if Continental closed would have a significant adverse impact on the liquidity and capital position of these banks. Also a large number of major banks have provided significant funding to Continental. Such funding includes Fed Funds sold, domestic deposits and offshore deposits. The liquidity and capital of the funding banks could be significantly impaired as well. The possible losses to the downstream correspondent banks and banks that have provided funding to Continental would threaten the stability of the U.S. banking industry.

Many corporate relationships would be severely disjointed if Continental were to fail. It has domestic commercial and industrial loans of nearly $13 billion (and financing commitments of nearly $16 billion as of 12/31/83) and loans to financial institutions of $2.5 billion. Many of these entities also maintain deposit relationships and have additional vital services, such as payroll, performed by Continental. Additionally, Continental handles the clearing accounts of major commodities exchanges. An interruption of functions provided to commercial customers would severely disrupt the operation of the commodity exchanges and harm the commercial, industrial and institutional customers because of the difficulty for these entities to reestablish banking relationships.

A failure of Continental would severely disrupt international and domestic money markets. It would cause foreign and domestic investors to avoid bank CD's in general or demand a large premium for them. This increase in the cost of funds would adversely affect a broad spectrum of financial institutions.

Continental holds nearly 5% of the individual savings deposits held by commercial banks and thrifts in Cook County and approximately 9% of all deposits that are less than $100,000.00. Thus a significant portion of consumer depositors in Cook County would be left without deposit services until new relationships could be established.

Conclusion

Based on the foregoing, DBS recommends that the Board of Directors find that Continental is in danger of closing, that the continued operation of Continental is essential to provide adequate banking services in its community and that, pursuant to Section 13(c)(2) of the FDI Act, the Board authorize assistance to Continental in the amount of $2 billion. It is also recommended that attempts be made to participate portions of this assistance to other banks.

July 25, 1984

MEMORANDUM TO: The Board of Directors

FROM: Robert V. Shumway, Director
Division of Bank Supervision

SUBJECT: Continental Illinois National Bank and
Trust Company of Chicago -- Section 13(c) Assistance

We addressed the issue of FDIC assistance for Continental Illinois National Bank and Trust Company of Chicago ("Continental") on May 17, 1984[1] at which time we concluded that there were sufficient facts to determine that Continental was in danger of closing but that in our opinion the continued operation of Continental was essential to provide adequate banking services in its community. Since then Continental's financial condition has worsened.

Continental is continuing to experience severe funding difficulties. In addition to the $2 billion of subordinated notes purchased by the FDIC with the participation of large commercial banks, the bank has accessed borrowings as of Tuesday the 24th, of $6.15 billion from the Federal Reserve Bank of Chicago and utilized $4.13 billion of a $4.5 billion line of credit established with 28 large commercial banks. These are overnight funds. The Comptroller of the Currency in a letter to the FDIC dated May 17, 1984, indicated that Continental might become unable to meet its obligations when they came due; subsequently, the interim financial assistance package was put in place. While that package succeeded in providing some needed time, funding has continued to deteriorate. In a letter dated July 25, 1984 the Comptroller has indicated that funding problems can be expected to become more severe after the announcement of second quarter 1984 financial results and that "absent a final assistance package from the FDIC and the continued lending of the Federal Reserve System it is unlikely that, in the near future, the Bank will be able to meet its obligations as they become due". Given this worsened financial condition, and the need for further assistance, DBS believes that sufficient facts exist to determine that Continental is in danger of closing and assistance is necessary to prevent the closing of the bank.

Continental is one of the ten largest banks in the United States, with $34 billion in assets, 57 offices in 14 states and 29 foreign countries staffed by several thousands of people. It provides a full range of commercial, individual and trust services throughout the midwest, has a major correspondent relationship with hundreds of downstream correspondent banks, and has major corporate relationships throughout the world. For these reasons

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[1] Memorandum to the Board of Directors from Robert V. Shumway regarding Section 13(c) assistance for Continental.

and the others listed below, DBS continues to believe that the continued operation of Continental is essential to provide adequate banking services in its community.

- Continental has a major correspondent relationship with hundreds of downstream correspondent banks. These banks rely on Continental for check clearing and other vital banking services. It would be extremely disruptive to these banks and their customers should these services be interrupted. It also would be very difficult to reestablish such a large number of correspondent relationships in a short time.

- Many downstream correspondent banks and a number of major banks have provided significant funding to Continental through deposit balances (domestic or offshore) and Fed Funds sold. The potential adverse impact on the liquidity and capital position of these funding banks could be significantly disruptive to the U.S. banking industry.

- A failure of Continental would severely disrupt international and domestic money markets. It would cause foreign and domestic investors to avoid bank CD's in general or demand a large premium for them. This increase in the cost of funds would adversely affect a broad spectrum of financial institutions.

- Many corporate relationships would be severely disjointed if Continental were to fail. It has domestic commercial and industrial loans of about $13 billion (and financing commitments of about $15 billion). Many of these entities also maintain deposit relationships and have additional vital services, such as payroll, performed by Continental. Additionally, Continental handles clearing accounts of major commodities exchanges. An interruption of functions provided to commercial customers would severely disrupt the operation of the commodity exchanges and harm the commercial, industrial and institutional customers because of the difficulty for these entities to reestablish banking relationships.

- A significant portion of consumer deposits in Cook County are held by Continental; if Continental were to fail, these depositors would be left without deposit services until new relationships could be established.

Conclusion

Based on the foregoing, DBS recommends that the Board of Directors find that the continued operation of Continental is essential to provide adequate banking services in its community, and that the FDIC provide appropriate assistance pursuant to Section 13(c) of the FDI Act to prevent the closing of the bank.

39-133 O—84——34

August 12, 1971

Unity Bank and Trust Company
Roxbury, Massachusetts

Facts which provide the basis for the resolution and findings contained therein relating to the Unity Bank and Trust Company, Roxbury, Massachusetts, approved by FDIC Board of Directors at a special meeting held in Boston, Massachusetts, July 22:

Finding One: "That the bank is in danger of closing."

Report of examination of the FDIC dated March 19, 1971, showed the Unity Bank to be in a capital deficit position of approximately $300,000 based on the FDIC classifications.

On July 22, 1971, Massachusetts Bank Commissioner, Freyda Koplow, certified to the FDIC that the bank was in danger of closing, and announced her intention to appoint Richard L. Banks, pursuant to provisions of Section 40, Chapter 172, of the General Laws of the Commonwealth of Massachusetts, as conservator, effective at the close of business Monday, July 26.

Finding Two: "That the continued operation of Unity Bank is essential to provide adequate banking services in the community."

Unity Bank, a $9.6 million deposit institution, was established in 1968 as a community venture to serve the black community of Roxbury-Dorchester. That community obviously takes pride in the bank. An estimated 90% of its depositors are black, and although the bank has a number of white shareholders, there has been a wide distribution of stock in the community. The bank has some 3,216 shareholders. The bank has been operated with a black president and chief executive officer and with virtually all black directors and employees. The City of Boston had a total population of 641,071 in 1970 of which 104,707 were Negro. Unity Bank serves an almost totally Negro area in the Roxbury-Dorchester area of Boston including all or parts of census tracts P-4, P-5, Q-5, T-6, T-7A, T-7B, U-1, U-2, U-4, U-5, U-6A, U-6B and V-1. These census tracts had a population of 48,282 in 1970 of which 40,830 were Negro. The only other commercial banking office in this area is a small branch of United States Trust Company located 14 blocks south of Unity Bank on Warren Street, although there is an office of State Street Bank and Trust Company and an office of First National Bank of Boston just outside of the area and 19 blocks from Unity Bank. Other than Unity Bank, there are no black-owned or operated banks in Boston or its suburbs. See also the memorandum opinion of the General Counsel of the FDIC dated June 24, 1971, concerning the meaning of "community" under Section 13(c) of the FDI Act.

RESOLUTION

WHEREAS, Robert C. Cleveland, Commissioner of Banking of the State of South Carolina, has advised the Federal Deposit Insurance Corporation that American Bank & Trust, Orangeburg, South Carolina (the "Bank") will be closed by the South Carolina Board of Bank Control unless the current liquidity crisis of the Bank is resolved; and

WHEREAS, the Federal Reserve Bank of Richmond has declined to provide the necessary liquidity under its emergency lending authority because it allegedly does not have the statutory authority to do so except through a member bank which is not available; and

WHEREAS, the Bank has applied to the Corporation for assistance pursuant to Section 13(c) of the Federal Deposit Insurance Act (12 U.S.C. §1823(c)) to prevent the closing of the Bank, and enable it to provide needed banking services in certain of the communities it serves; and

WHEREAS, it is the opinion of the Board of Directors of the Corporation that the Bank is in danger of closing and that the continued operation of the Bank is essential to provide adequate banking services in (i) ten South Carolina communities where the Bank operates the only commercial banking facilities within five miles or more, and (ii) in three counties and two other communities of South Carolina where the Bank's offices provide the only alternative to some competitor bank for banking service;

NOW, THEREFORE, BE IT RESOLVED, that in order to prevent the closing of American Bank & Trust, Orangeburg, South Carolina, the Corporation grant temporary assistance under Section 13(c) of the Federal Deposit Insurance Act (12 U.S.C. § 1823(c)), and place short-term loans not to exceed ten million dollars in the aggregate due on demand and bearing interest at the rate of 10% per annum.

BE IT FURTHER RESOLVED, that the said grant of assistance under Section 13(c) of the Federal Deposit Insurance Act shall terminate at the close of business on September 6, 1974.

BE IT FURTHER RESOLVED, that the Executive Secretary of the Corporation be and hereby is authorized to execute on behalf of the Corporation any credit agreement that may be necessary, and that the appropriate officers of the Corporation be and are hereby authorized to take such other actions as may be required to carry out the terms of such agreement.

BE IT FURTHER RESOLVED, that to facilitate the assistance granted under Section 13(c) of the Act herein provided, the Controller of the Corporation be and hereby is authorized forthwith to issue funds through the facilities of the United States Treasurer for wire transfer to the account of American Bank & Trust, Orangeburg, South Carolina, in the Federal Reserve Bank of Richmond, Virginia, in amounts not to exceed in the aggregate ten million dollars ($10,000,000).

Bank of the Commonwealth
Detroit, Michigan

Exhibit 6.

The following are facts which provide the basis for the resolution approving assistance under Section 13(c) of the Federal Deposit Insurance Act relating to the Bank of the Commonwealth, Detroit, Michigan, a State chartered bank which is a member of the Federal Reserve System, hereinafter "BOC", approved by the Board of Directors of the Federal Deposit Insurance Corporation at a special meeting held in Washington, D. C., January 17, 1972:

Finding One: That BOC is in danger of closing.

The Commissioner of the Financial Institutions Bureau of the State of Michigan, Robert P. Briggs, the primary supervisor of BOC, in a letter to the Board of Directors of the Federal Deposit Insurance Corporation dated January 13, 1972, certified that BOC is in danger of closing.

The Board of Governors of the Federal Reserve System, the secondary supervisor of BOC, in a letter to the Board of Directors of the Federal Deposit Insurance Corporation dated January 14, 1972, also certified that BOC is in danger of closing.

The Federal Deposit Insurance Corporation has independently reviewed the most recent report of examination of BOC and other information made available to it and concurs in the conclusion reached by the Board of Governors of the Federal Reserve System and Commissioner Briggs that it is in danger of closing.

Finding Two: That the continued operation of BOC is essential to provide adequate banking services in the community.

BOC, a $1.026 billion deposit institution, with assets of $1.257 billion, was organized in 1916, joined the Federal Reserve System in 1941 and adopted its present corporate title in 1953. It operates 57 offices in the Detroit metropolitan area, and is the fourth largest commercial bank in the City of Detroit, the fifth largest in the State of Michigan, and among the 60 largest in the United States.

The metropolitan area of Detroit, 140 square miles, with a population of 1,511,000 (1970 census) including 660,000 or 44% Negro, is served by BOC and by 6 other Detroit banks: (a) National Bank of Detroit with 104 offices, including 42 in Detroit, and $3.6 billion in deposits; (b) The Detroit

Bank and Trust Company with 83 offices, including 50 in Detroit, and \$2.1 billion in deposits; (c) Manufacturers National Bank of Detroit with 71 offices, including 26 in Detroit, and \$1.9 billion in deposits; (d) Michigan Bank, National Association, with 28 offices, including 20 in Detroit, and \$730 million in deposits; (e) City National Bank of Detroit with 30 offices, including 15 in Detroit, and \$623 million in deposits; and (f) First Independence National Bank of Detroit, a recently opened bank with 1 office and approximately \$12 million in deposits. 8570

BOC holds a share of total deposits (21.8%), deposits under \$100,000 (22.3%) and offices (27%) in the black community of Detroit considerably larger than its total share of deposits among banks headquartered in Detroit (10%). This together with the fact that it is a significant supplier of commercial mortgages, installment loans, personal loans and home improvement loans in these same sections of the city, shows a commendable effort to meet the banking needs of the black community of Detroit. Consistent with its efforts to serve the Detroit black community, BOC employs approximately 700 blacks out of its Detroit work force of 1,770. While one black-owned bank, the First Independence National Bank of Detroit, recently opened in Detroit and may be expected in time also to provide significant banking service to the black community of Detroit, its deposits totalled only \$12,047,000 in June of 1971 and its contribution to the banking needs of that community is still limited relative to the contribution being made by BOC and the five larger banks in Detroit.

BOC is a significant competitor in the Detroit Standard Metropolitan Statistical Area, an area with a population of over 4 million people served by only 5 other banks of total deposit size of \$500 million or larger. These six banks have over 80% of all banking business in the Detroit SMSA, a percentage which represents a higher degree of concentration than in most other SMSA's of comparable size in the country. BOC has an 8% share of this particular market. Should BOC close, or be merged with an existing bank in this already highly concentrated banking market, the effect would be inimical to banking competition in the Detroit SMSA.

BOC has acquired its share of the Detroit SMSA market in part through a series of competitive banking innovations. Examples of such innovations introduced since 1964 include no minimum balance checking accounts when coupled with savings of \$500, time certificates of deposit for less than \$100, free checking services for widows and senior citizens, and a "First Mortgages" program for principal amounts as low as \$1,000, the average balance of such loans being about \$2,800 at present. In general, BOC has been among the first to increase rates and the last to decrease rates paid to retain depositors on passbook accounts and certificates of deposit.

The continued existence of BOC to provide a banking alternative for the public and to continue the banking innovations that it has shown itself capable of producing seems desirable.

BOC has been and is a significant depositary for the Detroit Board of Education and other local governmental bodies in excess of insurance limits. As of the end of 1971, various governmental bodies had over $135 million on deposit with BOC unsecured and in excess of the insured limits, and an additional $28 million secured. The Detroit Board of Education alone had nearly $60 million of unsecured funds on deposit with BOC. Support for BOC's role as such a depositary comes in part from its willingness to participate in the underwriting of municipal issues by the City of Detroit and other municipalities throughout the State of Michigan. Since January 1, 1965, it has participated in the underwriting of over $1 billion of municipal issues in the State of Michigan.

BOC is not only the fourth largest bank in Detroit and the fifth largest in Michigan, it is the fourteenth largest in the Upper Great Lakes region of the nation (i.e., the states of Michigan, Ohio, Illinois, Indiana, and Wisconsin), and as such its influence is felt throughout the region. Not only has it been a major underwriter for Detroit municipal issues and for many other Michigan local governmental bodies, it is also a significant underwriter for such bodies in all of the other states in the Upper Great Lakes region. In the two-year period, 1970 - 1971, BOC participated to the extent of almost $70 million in underwriting issues of local governmental bodies in this Upper Great Lakes region. In addition to its underwriting activity, BOC has been a significant lender and viable banking alternative to commercial borrowers throughout this region.

The underwriting activities of BOC have not been limited to the states in the Upper Great Lakes region. During 1970 and 1971, for example, BOC participated to the extent of almost $100 million in underwriting municipal issues in states throughout the country outside of the Upper Great Lakes region. This is some indication of its broad influence throughout many communities in various parts of the United States.

A basic purpose, moreover, of the Federal Deposit Insurance Corporation is to maintain public confidence in the nation's banking system. The Board of Directors of the Corporation is deeply concerned that the failure of BOC, a $1 billion bank, would result in erosion of public confidence in the banking system of the country in unpredictable but probably quite unfavorable ways throughout the nation.

Public confidence in the nation's banking system in each community BOC serves, as well as in other communities throughout the nation, could easily be shaken by BOC's failure, a result which the Board feels should be avoided if at all possible.

Conclusion

It is the conclusion of the Board of Directors of the Federal Deposit Insurance Corporation that BOC is in danger of closing and that its continued existence, in accordance with the terms of the proposed Capital Note Agreement to be executed between BOC and the Federal Deposit Insurance Corporation, is essential to provide adequate banking service in the communities it serves.

April 28, 1980

MEMORANDUM TO: The Board of Directors

FROM: Frank L. Skillern, Jr.
General Counsel

SUBJECT: First Pennsylvania Bank, N.A.
Bala-Cynwyd, Pennsylvania
Application for Assistance under Section 13(c)

First Pennsylvania Bank (the "Bank") has applied to the Corporation for assistance under Section 13(c) of the Federal Deposit Insurance Act. Section 13(c) authorizes the Corporation to make loans to, purchase assets of or make deposits in an insured bank when the Corporation has determined that the bank is in danger of closing, the loan, purchase or deposit is made in order to prevent the closing, and the Board of Directors is of the opinion that the continued operation of the bank is essential to provide adequate banking service in the community.

Both the Comptroller of the Currency and the Board of Governors of the Federal Reserve System have advised the Corporation that the Bank is in danger of closing and any assistance that the Corporation renders clearly would be in order to prevent the closing. Therefore, the first requirement of the statute has been met and the second requirement can be met if the Board determines to grant assistance. The third requirement is the so-called "essentiality" test. It is my opinion that the facts involved in the application give a sufficient legal basis to support a finding that the continued operation of the Bank is essential to provide adequate banking service in the community, should the Board desire to make such a finding.

For the purpose of this opinion, "community" is assumed to mean the trade area served by the Bank, which is essentially the five-county Delaware Valley area.

The following facts concerning the Bank itself should be considered in making a determination of whether its continued operation is essential to provide adequate banking service in the community (these facts are represented by the Bank to be true and they have generally been verified by the Office of the Comptroller of the Currency):

1. The Bank is the largest bank in Philadelphia, the second largest bank in Pennsylvania and the 23rd largest bank in the United States.

2. The Bank has 69 offices, with 40 offices in the Philadelphia area.

3. The Bank has approximately 583,000 depositors.

4. The Bank has over 270,000 consumer loans and credit card customers with total outstanding balances of $425 million.

5. The Bank has approximately 2,000 borrowers serviced by its small business unit (customers with sales of $5 million and under), with total outstanding balances of $80 million.

6. The Bank has been involved in several major programs to help in the revitalization of the City of Philadelphia, including the Philadelphia Mortgage Plan, which carries over 1,000 residential mortgage loans in inner city neighborhoods.

7. The Bank is heavily involved in construction and land loans in the Delaware Valley market; at the present time, it has over $100 million in commitments to local builders.

8. The Bank has a permanent mortgage portfolio with companies located in the Delaware Valley of $223 million.

9. Commercial lending in the Bank's region is approximately $500 million plus unfunded commitments of $500 million.

10. Each year the Bank clears 10 million share drafts for credit unions and has a full-time staff serving credit unions.

11. The Bank is the largest lender to the City of Philadelphia and the Philadelphia School District.

12. The Bank has a subsidiary which handles direct delivery of welfare checks and the distribution of Food Stamps in the City of Philadelphia.

13. The Bank's Trust and Investment Group manages approximately 8,500 personal fiduciary accounts with $1.8 million in assets for 24,000 beneficiaries, most of whom reside in the Bank's trade area.

14. The Bank employs 4,000 people in the Philadelphia area, paying annual salaries of over $60 million to these employees.

In addition to these facts about the Bank, you should consider the following additional factors:

A payoff to 583,000 insured depositors would clearly result in a dramatic and drastic interruption and change in the financial and economic situation in the Philadelphia area. For a certain period of time, the community would lack adequate banking services. It is impossible to predict how long this condition would continue.

An alternative to a payoff would be assistance under Section 13(e) of the FDI Act. In pertinent part, Section 13(e) allows the Corporation to make financial assistance available in order to facilitate the sale of assets of a closed insured bank to and the assumption of its liabilities by another insured bank, whenever in the judgment of the FDIC Board of Directors such assistance will reduce the risk or avert a threatened loss to the Corporation. However, assistance under Section 13(e) presents a significant problem in that, due to the size of the Bank, any purchase and assumption transaction with a single bank in Pennsylvania would raise serious anticompetitive issues.

It is also significant that other banks in the community have agreed to make subordinated loans to the Bank of $25 million. Such financial commitments would indicate the concern that the Bank's competitors have over the impact on the community of the closing of the Bank.

It should be noted that the Corporation has granted assistance under Section 13(e) on only four occasions in the past.

RESOLUTION

WHEREAS, the Federal Deposit Insurance Corporation ("FDIC") has received an application from the Farmers Bank of the State of Delaware (the "Bank"), for assistance under Section 13(c) of the Federal Deposit Insurance Act (12 U.S.C. § 1823(c)); and

WHEREAS, the Board of Directors ("Board") of FDIC has examined the application of the Bank, the statement of the Banking Commissioner of the State of Delaware that the Bank is in danger of closing, the most recent examination reports and financial statements of the Bank, and has reviewed and considered all such other information and documents submitted in connection with or as a result of such application of the Bank; and

WHEREAS, based upon the foregoing and such other matters as it deemed appropriate, the Board has concluded and is of the opinion that, but for the assistance contemplated under the proposed Promissory Note and Security and Pledge Agreement between FDIC and the Bank, which are attached hereto and incorporated herein by reference, the Bank is in danger of closing and that its continued existence is essential to provide adequate banking services in the communities it serves.

NOW THEREFORE, BE IT RESOLVED that, in order to prevent the closing of the Farmers Bank of the State of Delaware, FDIC grant assistance under Section 13(c) of the Federal Deposit Insurance Act by purchasing a promissory note or notes of the Bank, which shall mature on demand and bear interest at the rate of 8 1/2% per annum, which is the rate in effect at the Federal Reserve Bank in Philadelphia on March 15, 1976 for borrowing by individuals, partnerships, and corporations under 12 U.S.C. § 347c, and which shall be secured by certain assets of the Farmers Bank of the State of Delaware having a value at all times of not less than one hundred fifty percent (150%) of the amount of principal and interest then due under the outstanding promissory notes.

BE IT FURTHER RESOLVED that Reford J. Wedel, FDIC Acting General Counsel be and he is hereby authorized to execute on behalf of FDIC said Security and Pledge Agreement, and that the Controller of the Corporation be, and he hereby is authorized, to disburse said sums to the Bank, and that the appropriate officers and employees of FDIC be and are hereby authorized to take such other actions as may be required to carry out the terms, conditions and covenants provided for in the Promissory Note and Security Agreement.

FDIC FEDERAL DEPOSIT INSURANCE CORPORATION

NEWS RELEASE

FOR IMMEDIATE RELEASE PR-37-71 (7-27-71)

Unity Bank and Trust Company, Roxbury, Massachusetts, is to receive a substantial infusion of capital under a plan announced today by Federal and State officials.

Chairman Frank Wille of the Federal Deposit Insurance Corporation announced the inauguration of an assistance program for the benefit of Unity Bank and Trust Company. Under the terms of the assistance program, the FDIC and a number of Massachusetts banks will lend a total of approximately $2,000,000 to the Bank. The loans will be unsecured and subordinated to the claims of depositors and other general creditors of the Bank. Five hundred thousand dollars of the loans are being provided by a group of Massachusetts banks. The banks also will provide management assistance as part of the overall assistance program.

The Board of Directors of the FDIC approved the loan to Unity Bank and Trust Company after it determined that the continued operation of the Bank was necessary to provide adequate banking services to the black community in Roxbury and Dorchester. Deposit accounts in the Bank will continue to be insured by FDIC up to $20,000 per depositor.

The management of Unity Bank and Trust Company will be in the hands of Richard P. Banks, who has been appointed by Freyda P. Koplow, Commissioner of Banks for the Commonwealth of Massachusetts. Mr. Banks, a prominent Boston attorney on leave from his job as Director of Boston Lawyers for Housing, will be assisted by the current directors of Unity Bank and Trust Company, who requested the action taken by Mrs. Koplow and who will continue on as an advisory board to Mr. Banks.

All parties concerned have expressed confidence in the future of Unity Bank and Trust Company and feel that it will continue to provide needed banking services for the black community in Roxbury and Dorchester, as well as serving as a valuable asset to that community.

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FEDERAL DEPOSIT INSURANCE CORPORATION, 550 Seventeenth St. N.W., Washington, D.C. 20429 • 202-389-4221

FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

NEWS RELEASE

FOR IMMEDIATE RELEASE PR-6-72 (1-18-72)

FDIC ANNOUNCES FINANCIAL ASSISTANCE PROGRAM
FOR DETROIT'S BANK OF THE COMMONWEALTH

A financial assistance program designed to help rehabilitate the billion dollar Bank of the Commonwealth (BOC) in Detroit, Michigan, has been approved by the Board of Directors of the Federal Deposit Insurance Corporation (FDIC).

Implementation of the plan is subject to approval of common and preferred shareholders and subordinated capital note holders of the bank. The bank's proxy statements with the proposal are to be mailed today with the vote of the shareholders scheduled for February 28.

The basic features of the rehabilitation plan were jointly developed by the FDIC, the Board of Governors of the Federal Reserve System and the Michigan State Banking Commissioner, and concurred in by the Board of Directors of the bank.

The FDIC action was an expression of confidence that the bank can again become a vigorous competitive force in Michigan's commercial banking structure. The FDIC also pointed out that depositors and general creditors of the bank now have, and under the plan will continue to have, the protection of FDIC deposit insurance plus more than $70 million in capital funds and reserves.

As a prerequisite to FDIC assistance, BOC shareholders are being asked to take the steps necessary to create almost $38 million of undivided profits in order to permit the bank to absorb anticipated future losses on the sale and write-off of certain existing assets which in turn would permit the bank to make

- more -

significant improvements in liquidity and earnings and substantial reductions in short-term borrowings. Existing shareholders would thus bear the existing loss potential in BOC's present asset structure. To replenish the bank's capital as these asset losses are taken, FDIC has agreed to lend Bank of the Commonwealth not more than $60 million in the form of senior capital maturing April 1, 1977, which must be repaid in full before any dividends can be declared on BOC stock and before any redemptions can be made of its outstanding preferred stock. Actual draws on the FDIC commitment are expected to be substantially less than the $60 million authorized, the balance providing a margin of safety for unexpected developments during the five-year rehabilitation period. The FDIC notes would be subordinate to claims of depositors and general creditors, but senior to all of the bank's existing capital securities.

The FDIC is not a tax-supported agency and all its funds are derived from deposit insurance assessments paid by the nation's banks and from income on its accumulated investments. The Federal deposit insurance fund currently exceeds $4.7 billion. FDIC's current yield on this fund is 5.32 percent, and the proposed loans to Bank of the Commonwealth would bear interest at 5.5 percent per annum. In addition, Bank of the Commonwealth has paid a $300,000 commitment fee to FDIC.

Bank of the Commonwealth was organized in 1916, joined the Federal Reserve System in 1953, and at the close of business December 31, 1971, had 57 banking offices in Metropolitan Detroit, with combined deposits of just over $1 billion and total assets of $1.26 billion.

The bank was acquired by the "Parsons Group" in 1964 and became the kingpin of a banking chain that at one time controlled 19 institutions in Michigan, Ohio, Colorado and the District of Columbia. COMAC, one of the Parsons partnerships, held management contracts with Bank of the Commonwealth and most of the other banks in the Group until the summer of 1970. One bank in the group, the Birmingham-Bloomfield Bank, was ordered closed as insolvent by the Michigan State Banking Commissioner in February 1971 (FDIC assisted a new bank to assume 100 percent of its deposit liabilities and is currently liquidating its assets). The 17 other banks in the "Parsons Group" have all been sold over the last two years, most have been recapitalized and nearly all are now in the hands of local community investors.

Bank of the Commonwealth's major problems relate to an unusually large investment in low yielding long-term municipal securities acquired prior to year-end 1969, substantial loan losses, a capitalized deferred income tax benefit account that is now of doubtful value, a lack of liquidity that requires large daily borrowings in the Federal Funds market or from the Federal Reserve System, and a capital structure that effectively prevents a restructuring of assets. As a result of these various problems, Bank of the Commonwealth's total capital funds plus its reserves for possible loan losses declined, between year-end 1969 and year-end 1971, by $16,680,950.

At year-end 1971, BOC had a reserve for possible loan losses of $9,285,121 and an undivided profits account of only $796,931. Its remaining capital funds, consisting of the par value of its common and preferred stock, a capital surplus account of $3,017,658, and the principal amount of its outstanding capital notes, totalled $63,519,654 at year-end 1971, but without a reorganization of the capital structure and the transfer of some of this amount to the bank's undivided profits account, BOC would be unable to take additional securities losses or write-off its capitalized tax benefit account. The rehabilitation plan being presented to the bank's stockholders would accomplish this reorganization and the desired transfer to undivided profits.

With such a transfer to undivided profits, the bank could then sell off much of its municipal securities account at the current market, which is approximately $30 million below book value, write off the tax benefit account, and reduce to normal levels the bank's present daily borrowings. Additional loan losses would be written off against the reserve provided for that purpose or against undivided profits. As these various losses are recognized by the bank, Bank of the Commonwealth would become eligible to draw funds from the FDIC to replenish its capital account.

Under the contract between FDIC and the bank there would be no common stock dividends and no preferred stock dividends or retirements until all of the funds provided by FDIC had been repaid, with interest. If the rehabilitation plan is approved by two-thirds of Bank of the Commonwealth's present capital noteholders, interest payments on and certain redemptions of such notes estimated at not more than $7.7 million in the aggregate, would be permitted prior to the maturity of the FDIC notes.

The Board of Governors of the Federal Reserve System, which regularly examines Bank of the Commonwealth as a State member bank, on January 18, 1972, issued a cease and desist order, of indefinite duration, prohibiting any common and preferred dividends and any redemption of preferred stock, the purpose being to conserve the bank's present capital funds. In addition, the order prohibits any payments of interest on or retirements of the bank's outstanding capital notes, unless the rehabilitation plan, which provides for interim replenishment of capital by the FDIC, goes into effect.

Bank of the Commonwealth paid no common stock dividend in 1971 and only one of four scheduled preferred dividends of $442,998 during 1971. BOC is currently four dividends in arrears on its preferred stock.

In addition to the ban on dividend payments while the FDIC loan is outstanding, the contract also contains a variety of provisions designed to prevent any recurrence of past practices that led to the bank's current problems, including provisions under which (i) new securities purchases, apart from U. S. Government and agency securities, are limited to the top three ratings and maximum maturities of five years, (ii) insider transactions are limited, and (iii) FDIC obtains a veto over the appointment, retention and compensation of top management of the bank. Other provisions state that any loans charged off on the bank's books which become the basis for a draw against the FDIC commitment can be taken over for collection by the FDIC; any mergers or consolidations of BOC require FDIC approval, in addition to other statutory approvals; and special restrictions apply if the bank is acquired by a holding company.

To reduce the FDIC loan which matures, by its terms, on April 1, 1977, an amount equal to the bank's net earnings would be applied annually. During the five-year period of rehabilitation, it is also anticipated that the bank will sell new capital securities to further strengthen the bank's capital funds and to repay any balance remaining on the FDIC loan.

To create an undivided profits account of approximately $38 million, BOC's management is proposing that each of the 4,573,107 shares of common stock outstanding be reduced in par value from $3.29 to 5¢, thereby allowing the transfer of $14.8 million to surplus and reducing the stated value of BOC's common stock to $228,655. In addition, BOC's management is proposing that each of the 304,465 shares of preferred stock outstanding be reduced in par value from $100 to $25, thereby allowing the transfer of an additional $22.8 million to surplus and reducing the stated value of BOC's preferred stock to $7.6 million

(the liquidation rights and redemption provisions applicable to the preferred stock, however, would not be changed, nor would the rate at which preferred dividends accumulate)

With the approval of the Michigan State Banking Commissioner, these amounts can then be transferred to the bank's undivided profits account and be available for the recognition of anticipated securities losses and asset write-offs.

Bank of the Commonwealth's problems began in the last half of the 1960's when management pursued a policy of purchasing an extraordinarily large amount of low-yield, low-quality long term municipal securities whose market value was reduced sharply as prevailing interest rates rose. At year-end 1969, the book value of BOC's investment in municipal securities was $333,382,610.

At the same time the bank was committing itself to and was investing in loans that later proved to be of doubtful quality, had costly management contracts and attorneys fees, paid out substantial dividends and capitalized future tax benefits that might or might not materialize because of the bank's exceptionally large investment in tax free municipals.

The situation came to a head during 1969 when rapidly rising interest rates and extremely tight money conditions forced the bank to seek expensive Eurodollars and other high cost funds in order to meet its commitments.

In the summer of 1970 under pressure from the Michigan State Banking Commissioner and the Board of Governors of the Federal Reserve System, four directors of BOC resigned, COMAC management contracts were discontinued and the undesirable investment and loan policies were brought to an end.

But the bank by then was locked into a low-yield investment position and its loan losses were increasing while its earnings and deposits were declining. It became necessary to borrow daily on the Federal Funds market and from the

Federal Reserve Bank of Chicago. Favorable market conditions since then have enabled BOC to reduce its holdings of municipal securities to $245,990,823 and its short-term borrowings from $349,519,900 at year-end 1969 to $125,244,816 at year-end 1971. The municipal securities remaining in the portfolio, however, continue to be low-yielding (4.87 percent on book at year-end 1971) and of long maturities (22.2 years on average). BOC's earnings and capital position, moreover, continued to decline in 1970 and 1971. Net operating loss was $6,648,139 in 1970 and $4,089,663 in 1971, after making provisions for possible loan losses of $12,900,000 in 1970 and $10,500,000 in 1971. Actual net loan charge-offs were $7,265,365 in 1970 and $13,338,707 in 1971.

Under the FDIC contract, qualifying charges, i.e., charges against the bank's capital accounts for which draws may be made against the FDIC commitment, include write-offs for losses on loans held by the bank on December 1, 1971, losses realized on the sale of municipal securities held by the bank on December 1, 1971, write-off of the future income tax benefit account and such other charges against the capital accounts of the bank as FDIC may agree.

Since December 1, 1971, the bank has written off assets that will enable it to draw $3.8 million against the FDIC commitment once the rehabilitation plan is approved by securities holders. Heavy draws are also anticipated in the first half of 1972 as the balance of the tax benefit account ($9,344,000) is written off and as sale of municipal securities is expedited.

FDIC's overall commitment is limited to $60 million, but there is a $25 million ceiling on the total amount of security losses that can become eligible as qualifying charges. This contrasts with an estimated $30 million in market depreciation at year-end 1971.

The FDIC commitment has been issued under the provisions of Section 13(c) of the FDI Act, which provides for assistance to operating banks when a finding can be made (a) that but for the contemplated assistance the bank is in danger of closing; and (b) that the bank is essential to provide adequate banking service to the community.

This provision, added by the Congress in 1950, was used once before, in 1971, with the purchase of a $1.5 million subordinated capital note by the FDIC to shore up the $10 million deposit Unity Bank and Trust Company, a black-owned and operated bank in the Roxbury-Dorchester section of Boston.

With assets of over $1 billion, the Bank of the Commonwealth is among the 50 largest commercial banks in the United State and by far the largest institution ever to seek FDIC assistance.

The Chase Manhattan Bank, which had loaned $20 million to certain Parsons enterprises, foreclosed on its collateral, consisting of Bank of the Commonwealth securities, in February of 1971 and took effective control of the bank with 39 percent of the common stock and 21 percent of the preferred stock. A Chase executive, John A. Hooper, is Chairman of the Board and Chief Executive Officer of BOC. Under Federal law, Chase may be required to dispose of its holdings in BOC as early as February 1973, two years after acquiring the stock.

The FDIC first began considering an assistance program for the bank at a March 29, 1971, meeting of key staff personnel of the FDIC, the Federal Reserve Board, and the Michigan State Banking Commissioner with representatives of Bank of the Commonwealth and The Chase Manhattan Bank. FDIC was asked to participate in this meeting by the Board of Governors of the Federal Reserve System.

The State of Michigan Banking Department, as chartering agency, is the primary supervisor of Bank of the Commonwealth, while the Federal Reserve Board, because of BOC's membership in the Federal Reserve System, is the bank's Federal supervisor. FDIC insure BOC's deposits, but is not otherwise responsible for BOC's regulation.

During the ensuing months, a variety of assistance proposals were discussed, including the possibility that FDIC might purchase BOC's entire municipal securities account at book -- a proposal which was unacceptable the the FDIC. In late November, a joint State-Federal agency plan was presented to BOC which would require existing stockholders to bear the existing loss potential in BOC and provided for FDIC assistance along the lines upon which agreement was finally reached. When Bank of the Commonwealth and The Chase Manhattan Bank agreed to this approach, negotiations proceeded swiftly.

The FDIC finding that but for the contemplated assistance the bank was in danger of closing was concurred in by the Michigan State Banking Commissioner and the Board of Governors of the Federal Reserve System.

The finding on BOC's essentiality to the community considered BOC's service to the black community in Detroit, BOC's contribution to commercial bank competition in the Detroit area during the 1960's when it provided many innovations that improved the banking climate for the consumer and competitors matched its services, BOC's contribution to commercial bank competition in the Upper Great Lakes Region, and the effect BOC's closing might have had on public confidence in the nation's banking system.

In addition to being concerned with public confidence in the nation's banking system if a billion dollar institution were to close, FDIC carefully considered the alternatives.

If a deposit payoff became necessary, an immediate outlay of about $750 million -- or roughly one-sixth of the total deposit insurance fund accumulated since 1934 -- would be required. If FDIC assistance to another bank were given to enable that bank to assume the deposits of BOC, over $1 billion would have had to be advanced. And if there were an emergency merger with one of the four largest Detroit banks, the already high concentration of banking resources which now exists in Detroit would become even higher.

The FDIC assistance was voted unanimously by its three-man Board of Directors: Frank Wille, Chairman; Irvine H. Sprague, Director; and William B. Camp, Comptroller of the Currency.

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FDIC

FEDERAL DEPOSIT INSURANCE CORPORATION

NEWS RELEASE

FOR IMMEDIATE RELEASE SUNDAY P.M. PR-52-74 (9-8-74)
SEPTEMBER 8, 1974

FDIC MAKES CASH AVAILABLE TO SOUTH CAROLINA BANK CAUGHT IN LIQUIDITY SQUEEZE

To meet a pressing need and to set to rest unfounded rumors that have been circulating about American Bank & Trust, Orangeburg, South Carolina, the Board of Directors of the Federal Deposit Insurance Corporation, the U.S. government agency which insures deposits in virtually all the nation's banks, announced today that it had arranged to provide whatever cash the bank needs to enable it to deal with a short-term liquidity problem.

American Bank & Trust is the sixth largest bank in South Carolina with assets totalling nearly $150 million and deposits of approximately $120 million. It operates 29 offices in 20 communities in South Carolina, in 10 of which American Bank & Trust is the only bank providing commercial bank services.

The FDIC stated that a routine examination of the bank which is still in progress indicates that American Bank & Trust has an excess of assets over liabilities, but confirms that the bank has encountered problems associated with a number of sizeable real estate loans which have become illiquid in the present economic atmosphere.

The FDIC has made its line of credit available after being advised by the Federal Reserve System that its Richmond bank was legally unable to make a similar advance to American Bank & Trust, an FDIC-insured state-chartered bank which does not belong to the Federal Reserve System. The FDIC will continue to monitor the situation closely in conjunction with appropriate state banking officials, the Honorable Grady L. Patterson, Jr., State Treasurer and Chairman, South Carolina Board of Bank Control, and the Honorable Robert C. Cleveland, South Carolina Commissioner of Banking.

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FDIC NEWS RELEASE

FEDERAL DEPOSIT INSURANCE CORPORATION

FOR IMMEDIATE RELEASE PR-24-77 (3-25-77)

FDIC ANNOUNCES AMENDMENTS TO ASSISTANCE PROGRAM FOR FARMERS BANK OF THE STATE OF DELAWARE

Chairman Robert E. Barnett of the Federal Deposit Insurance Corporation today announced that the FDIC Board of Directors and officials of the State of Delaware have reached an agreement to amend the assistance program for the Farmers Bank of the State of Delaware, Dover, Delaware. Consummation of this agreement will take place following required action by the Farmers Bank Commission, which was created to manage the State of Delaware's interest in Farmers Bank, and by the Delaware General Assembly which must adopt a resolution authorizing Governor Pierre S. duPont, IV, to sign the agreement. A resolution is to be presented to the General Assembly on or about April 5, 1977.

The original program was consummated on June 10, 1976, but subsequent developments have led to the need for the present revisions. As 1976 unfolded, it became apparent that the bank had a higher level of severely classified assets than originally estimated, against which it had to establish additional reserves. The effect of this problem on the bank's financial condition was heightened by its accountant's interpretation of certain accounting rules which made the original plan less attractive than contemplated.

The revised assistance package consists of three agreements:

1. The FDIC will cancel the obligation of Farmers Bank to pay any loss which the FDIC may incur on the assets the Corporation purchased from the bank in the 1976 transaction. The Corporation purchased for $32 million bank assets with a book value of $40 million. Originally, the bank agreed to repay the Corporation 40 percent of any loss suffered in collecting the $32 million, with a maximum liability of $8 million. Full repayment was to have been made probably no sooner than 1996 and out of future earnings. The liability of the bank which is being forgiven therefore had a significant contingency nature and a present value substantially less than the $8 million maximum liability.

2. The State of Delaware will immediately transfer to the FDIC $2 million of the $20 million of Farmers Bank 6 percent preferred stock which the State purchased in 1976 as part of its assistance to the bank. Redemptions will be received pro rata by the State and the FDIC.

3. The State of Delaware, which at present is required to maintain its demand deposits in Farmers Bank at a minimum level of $75 million, will forego its previous right to reduce that level to $50 million by early 1978 and will instead maintain the $75 million minimum demand deposit level until the end of 1980.

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The amendments announced today represent a continuation of the principle embodied in the original assistance plan that the FDIC and the State should share in the costs of aid to the bank through a recognition of their mutual interests arising from FDIC's role as insurer of deposits and the State's position as the bank's largest depositor and shareholder. By increasing the bank's income potential and allowing it to remove from its books a significant liability, the program announced today will allow Farmers Bank to continue to be a viable banking entity furnishing essential services to the Delaware economy.

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FDIC

NEWS RELEASE

FOR IMMEDIATE RELEASE PR-21-76 (3-15-76)

FDIC ANNOUNCES FINANCIAL ASSISTANCE PROGRAM FOR FARMERS BANK OF THE STATE OF DELAWARE

Chairman Frank Wille today announced that the Board of Directors of the Federal Deposit Insurance Corporation has approved in principle a rehabilitation program for Farmers Bank of the State of Delaware which the FDIC developed jointly with the State of Delaware and the bank's management. As an integral part of that program, FDIC has agreed to purchase for $32 million in cash inferior assets currently carried on the bank's books in the aggregate amount of $40 million. Should the FDIC fail to realize $32 million in the collection of these assets during the next ten years, the FDIC would be reimbursed by the bank for 40% of the shortfall, up to a maximum of $8 million. The FDIC's commitment is conditioned on favorable action by the State of Delaware and the bank's shareholders on those aspects of the program which require their approval.

The plan, which further contemplates that the FDIC will provide any necessary short-term liquidity to the bank on a secured basis over the next three weeks, includes the following additional components:

1. The State of Delaware will subscribe to a $20 million issue of the bank's preferred stock.

2. The State of Delaware will continue to use the bank as its sole depository and will maintain an average daily balance of $40 million in its demand deposit accounts at the bank. The present arrangement is an average daily balance of $20 million.

3. The bank will reduce its operating expenses exclusive of interest expense and provision for loan losses by at least $2.3 million by the end of 1977.

4. No dividends will be paid on common stock of the bank until all amounts required to be paid to the FDIC on account of losses, if any, realized in the assets FDIC is purchasing have been reserved or paid.

5. The bank's management, and its operating and investment policies, will be subject to review and approval by the FDIC throughout the period of the bank's contingent financial obligation to the FDIC.

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Farmers Bank of the State of Delaware, a $370 million-deposit institution, is 49% owned by the State of Delaware and is the sole depository of State funds under Delaware law. In mid-1975, it was the second largest commercial bank in Delaware and held approximately 22.5% of total commercial bank deposits in that State.

The FDIC commitment is being issued under the provisions of Section 13(c) of the Federal Deposit Insurance Act, which authorizes certain types of financial assistance to open and operating banks when the FDIC Board finds (a) that but for the contemplated assistance the bank is in danger of closing, and (b) that the continued operation of the bank is essential to provide adequate banking service in the community. This provision, added by Congress in 1950, was also the basis for presently outstanding FDIC aid to Detroit's Bank of the Commonwealth and Boston's Unity Bank and Trust Company.

In addition to considering the requirements for direct financial assistance under Section 13(c), FDIC carefully considered the alternatives. If a deposit payoff had become necessary, an immediate FDIC outlay estimated at approximately $220 million would have been required to pay off insured depositors up to the statutory ceiling (now generally $40,000). Uninsured depositors, primarily the State of Delaware and its school districts, would have been caused significant inconvenience, delay and likely loss in recovering their deposits. If FDIC assistance had to be given to another sound bank to enable that bank to assume all of Farmers Bank's deposits, considerably more than $32 million in cash would have had to be advanced by FDIC.

The FDIC does not believe its loss, if any, on the assets to be purchased under the plan announced today will exceed the loss it would have experienced had there been either a deposit payoff or a takeover of Farmers Bank with FDIC assistance by a healthy bank.

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Joint News Release

Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board

FOR IMMEDIATE RELEASE PR-42-80 (4-28-80)

REGULATORS ANNOUNCE JOINT BANK-FDIC
ASSISTANCE TO FIRST PENNSYLVANIA BANK

A $500-million assistance package designed to assure the viability and continued strength of First Pennsylvania Bank, N.A., to be provided jointly by the Federal Deposit Insurance Corporation and a group of banks, including many of the nation's largest, was announced today.

Details of the package, which has been agreed to in principle by the FDIC and the assisting banks, were revealed at a news conference by the FDIC, the Federal Reserve and the Comptroller of the Currency.

Assistance to the Philadelphia bank is in the form of five-year subordinated debt which will enable the bank to strengthen its capital account, improve operating performance and continue its service to the community. Present stockholder equity potentially will be diluted substantially by warrants to be issued by the bank's holding company, First Pennsylvania Corporation, for purchase of holding company stock.

First Pennsylvania Corporation announced today in Philadelphia that in addition to the five-year subordinated loan to the bank, the private banking industry has agreed to provide a continuing funding commitment of $1 billion in lines of credit. The Federal Reserve indicated that the Federal Reserve discount window also will be available as appropriate.

FDIC Chairman Irvine H. Sprague said:

"This assistance package represents a unique cooperative effort between the FDIC and the banking industry. It is designed to serve the public interest by enabling the nation's 23rd largest bank to maintain its service to the community and to facilitate the bank's early return to full financial health."

Sprague was joined in announcing the assistance agreement by the two other members of the FDIC Board of Directors, William M. Isaac and Comptroller of the Currency John G. Heimann, and by Federal Reserve Governor J. Charles Partee. The transaction was approved unanimously by the FDIC Board.

First Pennsylvania Bank is a successor to the first private bank in the United States established in 1782. It has $5.3 billion in deposits, $8.4 billion in assets, and 574,000 deposit accounts in 69 domestic offices, including 40 branches in Philadelphia County. The bank also operates branches in the U.S. Virgin Islands, London and Nassau.

The bank's Board of Directors formally applied last Friday for assistance under Section 13(c) of the Federal Deposit Insurance Act, which authorizes the FDIC to provide direct assistance to assure adequate banking services in a community.

First Pennsylvania Bank's difficulties began with a large number of non-performing loans originated primarily in the late 1960s and early 1970s. Although the bank has made substantial progress in resolving this situation, residual problems remain. Beginning in 1976, the bank used short-term money market liabilities to make large-scale purchases of long-term, fixed-rate U.S. Government securities. The cost of funds to support these securities rose sharply as interest rates climbed, contributing to operating losses. Sale of any substantial portion of these securities would have required the bank to recognize extraordinary losses caused by the securities' depreciated value in a high interest rate environment. The combination of these factors created a problem of confidence among some of the bank's customary sources of deposits and other funds, forcing the bank to seek unusual amounts of credit from the discount window of the Federal Reserve Bank of Philadelphia.

The assistance package announced today is expected to restore confidence in the long-term health and profitability of First Pennsylvania Bank. The package will:

1. provide the bank with substantial financing that is subordinate to depositors and other general creditors;

2. improve the earnings position of the bank by making financing available at a subsidized interest rate;

3. reduce the bank's reliance on high-cost funding and enhance future earnings by enabling the bank to sell a substantial portion of its securities portfolio in the near-term; and

4. strengthen the capital position of the bank through its improved earnings and, potentially, through an infusion of equity from exercise of warrants to purchase holding company stock.

The $500-million assistance package includes $325 million from the FDIC, with no interest payable the first year and interest at 125 percent of the FDIC investment portfolio yield for the next four years. At the current portfolio yield of 8.54 percent, the interest rate would be 10.67 percent. The FDIC loan will be subordinate to the assistance from the banks but senior to First Pennsylvania Bank's existing subordinated debtholders and stockholders.

The assisting banks' participation totals $175 million, including $25 million from Philadelphia banks, also for five years at a reserve-adjusted one-year certificate of deposit rate, established annually. The loans from the assisting banks will be subordinate to depositors and other general creditors, but senior to other subordinated creditors, including the FDIC.

Principal on the loans is due at the end of five years and may be prepaid. All payments are to be shared pro rata by the FDIC and the assisting banks.

As part of the package, First Pennsylvania Corporation will issue pro rata to the FDIC and the assisting banks warrants to purchase 20 million shares of its common stock at $3 per share. The exercise price is 50 percent of the average daily closing prices of the holding company's stock from March 17, 1980, to April 15, 1980, the

30 days immediately preceding initiation of discussions between FDIC and First Pennsylvania Bank. The warrants have a seven-year life and any proceeds from their exercise must be invested by the holding company as equity in the bank. As of March 11, 1980, the holding company had 15,605,996 common shares outstanding, plus certain other warrants and options.

FDIC assistance, including the issuance of the warrants, will be submitted for ratification by the shareholders of First Pennsylvania Corporation at a meeting to be held in May.

FDIC General Counsel Frank L. Skillern, Jr., commented that in reaching its decision, the FDIC Board reviewed the bank's application, the most recent financial statements of the holding company and the bank and all subsidiaries, as well as other records and documents pertaining to the financial condition of the bank. In addition, the Board reviewed reports from the Comptroller of the Currency and the Board of Governors of the Federal Reserve System on the condition of First Pennsylvania Bank and First Pennsylvania Corporation, respectively.

Based on its own review and these reports, the FDIC Board determined to provide assistance. The Board concluded that a healthy First Pennsylvania Bank is essential for a variety of reasons to the provision of adequate banking services in the community. The support of the Philadelphia banking community and of major banks throughout the nation was considered. The Board also considered the fact that the bank is the largest in Philadelphia and the second largest in Pennsylvania and provides certain unique services to the community.

Among factors considered by the FDIC Board were the following:

* The bank has 19 percent of the retail market and 40 branches in Philadelphia, and the bank plays a vital role in delivering necessary financial services to the community, including significant services to minority and low-income residents of the inner city.

* First Pennsylvania is one of the leading providers of consumer credit in its area, with more than 270,000 consumer loans and credit card customers having total outstanding balances of $425 million.

* First Pennsylvania provides computer and other services to 196 banks in the Third Federal Reserve District. The bank also is the second largest of all banks servicing the credit union industry. Of the 71 credit unions serviced by First Pennsylvania, 58 are located in the Philadelphia area.

* First Pennsylvania is a significant lender to the city of Philadelphia and the Philadelphia School District. Combined loans to both entities total $20 million.

* The bank has about 2,000 borrowers serviced by its small business unit, with total outstanding balances of $80 million.

* The bank is heavily involved in construction and land loans in the Delaware Valley market; at present, it has more than $100 million in commitments to local builders.

* The bank has a permanent mortgage portfolio in the Delaware Valley of $223 million, and its commercial lending in the region is about $500 million plus unfunded commitments of $500 million.

Conditions of the FDIC loan to First Pennsylvania include requirements that (a) the bank sell sufficient securities to recognize a $75 million loss this year; (b) $55 million in proceeds from the sale and liquidation of finance and mortgage company subsidiaries of the holding company be used to increase bank equity; (c) the bank dispose of or reconstitute the affairs of its securities dealer subsidiary; (d) no dividends be paid by the bank or the holding company without FDIC approval; (e) detailed reports on the bank's plans and objectives be provided to the FDIC for approval; (f) all directors and principal officers of the bank and the holding company serve subject to FDIC's review and their compensation be subject to FDIC approval; and (g) a number of other operating restraints and reporting requirements apply.

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THE FOLLOWING BANKS ARE PARTICIPATING IN THE ASSISTANCE PACKAGE ANNOUNCED TODAY:

Ameritrust Company
Cleveland, Ohio

Bank of America
San Francisco, California

Bankers Trust Company
New York, New York

Chemical Bank
New York, New York

Citibank, N.A.
New York, New York

Continental Bank
Philadelphia, Pennsylvania

Continental Illinois National Bank and Trust Company of Chicago
Chicago, Illinois

Crocker National Bank
Los Angeles, California

Girard Bank
Philadelphia, Pennsylvania

Marine Midland Bank
New York, New York

Manufacturers Hanover Trust Company
New York, New York

Morgan Guaranty Trust Company
New York, New York

North Carolina National Bank
Charlotte, North Carolina

Philadelphia National Bank
Philadelphia, Pennsylvania

Provident National Bank
Bryn Mawr, Pennsylvania

Republic National Bank of Dallas
Dallas, Texas

Security Pacific National Bank
Los Angeles, California

The Chase Manhattan Bank, N.A.
New York, New York

The Fidelity Bank
Philadelphia, Pennsylvania

The First National Bank of Chicago
Chicago, Illinois

The Philadelphia Savings Fund Society
Ardmore, Pennsylvania

Wells Fargo Bank, N.A.
San Francisco, California

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Chairman St Germain. I think it would be also important to have your staff and my staff see to it that those memoranda are sent to individual members of the subcommittee as well, because it may be a period of time before the record of these hearings is printed and I think it might be interesting reading for them. If they don't want to read them they don't have to, but at least we will provide them.

Mr. Carper.

Mr. Carper. Thank you, Mr. Chairman.

I recall the testimony I think of Mr. Conover last month. I don't recall what he said but I think the essence was that in this country we can't let a major bank like Continental Illinois fail, but having said that we should endeavor to revise the banking system so we can let a major bank like that fail in the future without creating real chaos in our own banking community.

Do you concur with that as a reasonable objective?

Mr. Isaac. I think it is a reasonable objective. We have got to treat large and small banks alike. We have got to find a means to do that.

Mr. Carper. How would you have us between the Congress, the executive branch, the regulators, how would you go about having us accomplish that goal?

Mr. Isaac. We have to decide as a matter of policy in this country whether we want to have any depositor discipline or not. If we do the FDIC can be directed to go less disruptive ways than a straight payoff for having some depositor discipline. It would take time. If we want depositor discipline we can develop it and it can be less disruptive than a straight payoff. A modified payoff is a step in that direction. Another possibility is to handle all bank failures by way of merger and try to get discipline through the suppliers of capital.

The problem I have is that the Congress has been giving us mixed signals. In 1980, in the Monetary Control Act, the Congress raised the deposit insurance limit to the $100,000 over the objections of the FDIC. The FDIC did not want it done and Congress did it.

In 1982, early 1982, the Congress——

Chairman St Germain. Excuse me. Were you at that conference?

Mr. Isaac. No. In 1980?

Chairman St Germain. Yes.

Mr. Isaac. No.

Chairman St Germain. Who was representing you at that time? Was it one of the other Board members?

Mr. Isaac. Mr. Sprague was Chairman.

Chairman St Germain. I think I recall his being there and frankly, I thought that jump was much too high at the time, but the Senate insisted. It was one of the things we had to compromise on and I agreed with the FDIC at that time. I thought it was a mistake.

Mr. Carper. I have to return to the floor. I will ask unanimous consent to submit further questions in writing.

Again thank you for your presence here.

Mr. Isaac. Could I complete the answer, Mr. Chairman?

In 1982, I think it was in March, the Congress passed a full faith and credit resolution backing the FDIC and the FSLIC with full faith and credit——

Chairman ST GERMAIN. That was done for the same reason——

Mr. ISAAC. Over the FDIC's strenuous objection, and I was there then.

Chairman ST GERMAIN. That was done for the same reason I guess that Todd Conover on May 10 said that Continental was in great shape. People were panicking, and we were asked by the industry to please do something.

Mr. ISAAC. By the thrift industry, not by the banking industry, and FDIC was strenuously opposed to it.

Then in 1982 in the Garn-St Germain bill we received a net worth certificate program over the FDIC's objections.

Then this year the Senate just passed a bill that ties our hands on dealing with one of the most pervasive problems in the banking system today, fully insured broker funds. The bill would take away our authority to deal with troubled institutions that are dealing in brokers funds. The bill also extends the net worth program and expands it to include shareholder owned commercial banks, over the FDIC's objections.

Chairman ST GERMAIN. I want you to relax. That bill is not before us.

Mr. ISAAC. I hope not, Mr. Chairman.

Chairman ST GERMAIN. You have our word.

Mr. ISAAC. You have been very supportive on a lot of these issues, including the brokered deposit issue. When you take that record and then I come in here and we are criticized for keeping what could have been a serious crisis under control, I have to wonder what does Congress want the agencies to do? In light of all these resolutions and laws that have been passed, what does Congress want the agencies to do? Do you want discipline or don't you want discipline and if you do, how do you want it? I will follow your lead.

Chairman ST GERMAIN. Mr. Barnard.

Mr. BARNARD. Mr. Isaac, in determining the classification of a bank or the stability of a bank, there is a lot of concern and attention given to the assets structure of the bank. Am I wrong there?

Mr. ISAAC. Could you repeat it please?

Mr. BARNARD. In examining a bank and determining the strength of a bank, there is a lot of consideration given to the asset structure of the bank, the quality of loans——

Mr. ISAAC. Yes.

Mr. BARNARD. Quality of the investment and so forth.

Mr. ISAAC. Yes.

Mr. BARNARD. How much attention is given to the characteristic of its liabilities and what it is doing with those liabilities? I mean, for example, its deposits, whether it is long term, short term, or whether they are paying too much money above market rates.

How much consideration does the FDIC, and if you can comment on the other regulators, how much consideration do they give to the liability side of the ledger?

Mr. ISAAC. A fair amount. It used to be you didn't give any because the liability structure was rather mandated by law, the rates and maturities and everything; but today that is receiving a fair amount of review and consideration.

Mr. BARNARD. What do you do about it? How do you correct the problem?

Mr. ISAAC. If you see a lot of exposure, for example, to interest rate swings in the bank because of the way they structured their liabilities, you would bring, if it were a bad enough situation, a cease and desist action and order them to change their liability structure.

Mr. BARNARD. For example, let's say that in examining the ABC National Bank, you find out that they had offices in Hong Kong and Tokyo and London and Stockholm and Geneva, actually serving as procurement offices for deposits, and they were paying 100 to 200 basis points more than the market. What would you do in that situation?

Mr. ISAAC. Depends. We are now subscribing to listing services showing banks that pay high rates because it helps point us to problem banks. We send lists out to our regional offices to the banks paying the highest rates, and we ask them to be in those banks on a very regular basis to determine what they are doing with the money so that if we start seeing abuses, we can move very quickly.

That is one thing that is occurring. If the bank is already a known problem, and is at the leading edge of the market in paying rates, we suggest that they ought not to be at the leading edge, they ought not to be trying to grow, they ought to be trying to shrink in size.

Mr. BARNARD. Was this the situation in the Continental Bank?

Mr. ISAAC. I don't know anything about what was done in Continental.

Mr. BARNARD. Was that a condition, though, in the Continental Bank? Now that you are in the Continental—working with it—do you find that they have a liability structure that is paying far beyond the market?

Mr. ISAAC. I don't know what is happening right now. I know there was a period following Penn Square, and perhaps through this summer, where Continental was having to pay a premium to get funding. It wasn't because they were trying to grow, for example, this summer they were shrinking. But they were simply having to pay a premium because of the concerns of what followed Penn Square.

In that circumstance, you don't have an objection to their paying a premium because they need to get the funds. It is not for growth, not to put new loans out.

Mr. BARNARD. What about brokered deposits that Continental has? Was that a problem at Continental?

Mr. ISAAC. I honestly don't know to what extent Continental's deposits were brokered. I suspect it was a fairly small proportion of their deposits.

Mr. BARNARD. Are the regulators looking at brokered funds a little differently now than they did at one time?

Mr. ISAAC. With more alarm.

Mr. BARNARD. Why? Can you explain why? Maybe you don't want to explain, but I would take note that the Home Loan Bank

Board is prescribing that $1 billion in brokered funds be infused in the FCA.

Mr. ISAAC. I understand that. We were asked by Continental this summer when its problems were well known and they were having all the funding problems, we were asked by them if we would write a letter encouraging the brokerage firms to raise a few billion in fully insured brokered funds for Continental so the bank would be able to reduce its reliance on the Fed.

We declined to provide that letter.

Mr. BARNARD. Do you still feel that brokered funds carte blanche, regardless of the management of the bank, capital adequacy of the bank, is wrong, is bad?

Mr. ISAAC. Brokered funds in a good bank I don't have any problem with whatsoever. The problem is that when you have full insurance on brokered funds, the funds don't go to good banks, they go to the banks that pay the highest interest rates. We have $8.5 billion in fully insured brokered funds in troubled FDIC insured banks. That is half of the Federal Deposit Insurance Fund, and is up from $6.5 billion at year end 1983.

Mr. BARNARD. Couldn't they be in trouble for the same reason, for just arbitrarily paying more for deposits?

Mr. ISAAC. It is much harder. Say you have a bank in Sioux City, IA, and please anybody in Iowa, I don't know of any such——

Mr. BARNARD. He is from Iowa, but——

Mr. ISAAC. I don't know of any such bank, it is hypothetical, but it is much harder for a bank in Sioux City, IA, by simply paying a higher rate to attract a tremendous amount of funds in order to grow at the pace it can grow if it can turn to a deposit broker that has a nationwide network to go out and vacuum up these funds and ship them off to institutions that are willing to pay up by a quarter or a half.

There is a tremendous potential for brokered funds to be abused, and they are being abused.

Mr. BARNARD. This is where I find inconsistency in my own philosophy. One, we are finding today that the factor of essentiality should be flexible, but yet the idea of brokered funds should be inflexible. We ought to outlaw them——

Mr. ISAAC. Not at all. What the FDIC is saying is that the placement of brokered funds should be done in reliance on market forces, not on the existence of 100 percent deposit insurance guarantee. If Merrill Lynch or any other broker wants to place money in bank "*x*", they can put as much in there as they want, and it is not going to give me a problem so long as there isn't a full FDIC guarantee on it—so long as Merrill Lynch or Dean Whittier or whoever is going to have to make a credit judgment about that institution, not just place it in the institution paying the highest rates.

Mr. BARNARD. That is a matter that I am sure Congress will be addressing.

I would like to just move into another little area. I understand—and I believe you admit this in your testimony—that the infusion of capital in Continental was somewhat irregular, in other words, it moved through the holding company, as opposed to the bank, and you didn't want to do it that way. The Fed didn't want to do it that way, and the Comptroller didn't want to do it that way.

But the peculiarities of the debentures was that they had to do it that way. I guess that is true, right?

Mr. ISAAC. The last statement is true, I am not sure that everybody you named didn't want to do it that way.

Mr. BARNARD. You didn't want to do that?

Mr. ISAAC. I didn't want to do it that way.

Mr. BARNARD. I think Mr. Conover said he didn't want to do it that way.

At what point in time would you feel that FDIC would sell those preferred shares?

Mr. ISAAC. At what point do you think we might sell them?

Mr. BARNARD. Yes.

Mr. ISAAC. It will depend on a whole host of factors. I will give you an estimate. It is going to be a range.

I would say realistically you are probably talking about 2 to 3 years, on the short side, to 5 years, on the long side.

Mr. BARNARD. What conditions will be there that would prompt you to sell them?

Mr. ISAAC. We need to have the bank have a solid track record for a period of time, demonstrating that it is profitable. We need to get the funding restored so it is totally self-sufficient.

That is basically it. Then it is going to depend on market conditions.

Mr. BARNARD. Let me ask you a question then. Would you characterize First Pennsylvania as a healthy financial institution?

Mr. ISAAC. I don't comment on the health of individual institutions.

Mr. BARNARD. Why is it——

Mr. ISAAC. Except the ones in which we have a major stake.

Mr. BARNARD. Why does the FDIC continue to exercise this degree of control over a healthy commercial bank?

Mr. ISAAC. We don't exercise any control. We have made a decision for the time being that——

Mr. BARNARD. What is that decision based on?

Mr. ISAAC. Two factors, one, we have an option to hold those warrants which we bargained for that runs until 1992, I think. I don't think we should feel a great deal of pressure to dispose of them just because the bank wishes to get the FDIC's warrant and——

Mr. BARNARD. But if you——

Mr. ISAAC. Let me continue, if I might.

Second, those warrants were issued to the FDIC originally with a couple of purposes in mind, one was to see that there was some price to be paid by the shareholders in this transaction. Also and very importantly, we wanted the warrants to be used as a way to infuse new capital in that bank. First Pennsylvania came to us a year or so ago with a proposal to buy half our warrants to support a convertible preferred stock offering which would enhance the capital of the bank. The FDIC readilly agreed to that after some negotiations over price.

This year they came to us and said "We don't have any capital enhancement plans, we are just tired of you holding our warrants, why don't you get rid of them?" We said "That is very interesting."

Mr. BARNARD. Why do you want to hold onto them?

Mr. ISAAC. Because if we are going to get rid of them, I want it to be done in connection with a transaction, and I think our entire board feels this way, that enhances the bank's capital.

Mr. BARNARD. What is the bank's capital?

Mr. ISAAC. I don't know. It is probably in the vicinity of—I don't know.

Mr. BARNARD. You believe it was around 7 percent?

Mr. ISAAC. Perhaps.

Mr. BARNARD. Isn't that pretty high for a regional bank?

Mr. ISAAC. I will not discuss the adequacy of their capital.

Mr. BARNARD. Well, the point I am trying to make is that it looks to me that when the FDIC gets control, they want to keep control.

Mr. ISAAC. That is not true. We have no control——

Mr. BARNARD. We are talking about preferred stock of the Continental——

Mr. ISAAC. We used to have a considerable amount of control over First Pennsylvania. They couldn't give a promotion or raise or anything else. All that is gone. We have only the warrants. They don't have voting power attached to them. First Pennsylvania's management thinks we are a nuisance waiting in the wings, but we do not exercise control.

Mr. BARNARD. You don't think there is a question as to when a regulator, Mr. Isaac, or an insurer should be of stock or warrants of a bank? If a bank is a healthy bank and its capital is adequate, why would you want to keep holding onto the warrants, just because——

Mr. ISAAC. I just said——

Mr. BARNARD. The other banks that have bought these warrants, haven't they sold theirs?

Mr. ISAAC. Mr. Barnard, frankly I don't know why we are sitting here discussing First Pennsylvania.

Mr. BARNARD. I will tell you why, because the fact is you are owning preferred stock in Continental, and I want to know what has Continental got to do for you to ever sell that? Is the FDIC going to get into the business of owning banks across the country?

Mr. ISAAC. No.

Mr. BARNARD. That is what you are telling me.

Mr. ISAAC. The FDIC, because of a transaction that First Pennsylvania initiated, wound up with some warrants, First Pennsylvania wanted a bailout. They got a bailout. We got some warrants. The purposes of the warrants were two: One, to enhance the equity of the bank through the exercise of the warrants; and, two, to cause some discipline for the shareholders in that transaction.

The bank——

Mr. BARNARD. Wait, we have already gone through that.

Mr. ISAAC. There was another purpose, and that was to make up for the subsidized nature of the loan by giving the FDIC the profit potential on the warrants. Now the bank has come to us with a proposal to sell the warrants—I don't know, they have done it a couple times in the past year. We allowed them to have back half the warrants a year or so ago, because it enhanced the capital of the bank.

Now, they have come to us with a proposal that does not enhance the bank's capital, and asked us to sell just to be nice, I guess.

Mr. BARNARD. You don't want to be nice?

Mr. ISAAC. No.

Mr. BARNARD. Well, I will tell you——

Mr. ISAAC. I don't want these transactions to be particularly pleasant for the banks.

Mr. BARNARD. It was none of this committee's business what you did a couple years ago.

Mr. ISAAC. Sorry.

Mr. BARNARD. I got the impression from what you said a moment ago that it was none of this committee's business what you did. I say this to you, that it is not the purpose of the FDIC to arbitrarily and without reason have ownership in banks.

Mr. ISAAC. Mr. Barnard, if I implied that it is not the committees business to review what we have done, I sincerely apologize for that.

Mr. BARNARD. I accept that.

Mr. ISAAC. I tried to say I don't see the point of why we are discussing the private affairs of First Pennsylvania Bank. You were asking me about what I think——

Mr. BARNARD. It is not private. I agree with Mr. Vento; it is public. They have made a public request of the FDIC to accommodate.

Mr. ISAAC. It wasn't public, but I guess it is now.

Mr. BARNARD. Well, I know it was public.

Mr. ISAAC. There was a private application to the FDIC.

Mr. BARNARD. It has been in the newspapers.

You don't call that "public"?

Mr. ISAAC. It is not in the newspapers, because the FDIC put it in there.

Mr. BARNARD. I didn't say who put it in there. But it is public.

But still, Mr. Chairman, I just think that we have got a serious situation here. When a bank—when they have been successful, when they have been successful in infusing capital and monitoring the bank's operation until it becomes a good bank, and a good, viable bank with good capital ratios, and they still want to hold on to ownership, it doesn't make sense, to me. I don't know; maybe you understand it better than I do.

But the question I want to know is, what kind of state has Continental got to be in before you decide to sell the preferred stock?

Mr. ISAAC. We have a great incentive to dispose of our stock in Continental as rapidly as we can. For one thing, we have laid out a fair amount of money, and the biggest chunk of it is in convertible preferred stock that does not pay dividends. Every day we hold that stock costs us money, unlike the warrants in First Pennsylvania where we have no money laid out. So we have a very great financial incentive.

Plus, I think Continental will be a much stronger bank once it has returned to the marketplace. We don't have any control over First Pennsylvania. First Pennsylvania is a private bank. We don't have any voting control. We don't have any management say-so over that institution.

In Continental, we need to get ride of our position as quickly as possible and make it again a truly private sector bank.

Mr. BARNARD. I think that you really are getting into a serious conflict of interest in a situation like that, which I hope you would reconsider.

Mr. ISAAC. If you are making the point that the FDIC ought not to be in the business of owning banks, I couldn't agree more.

Mr. BARNARD. Well, I wish you would explain to me what you have just been saying, because you are saying that what it warrants is a form of ownership.

Am I wrong?

Mr. ISAAC. Yes. Yes, you are wrong.

Mr. BARNARD. What is it, then?

Mr. ISAAC. It is not a form of ownership. It is a potential. It is a potential to convert into ownership.

Mr. BARNARD. You are just seizing on a technicality, as far as that goes.

Chairman ST GERMAIN. Excuse me.

What you are saying is, if I own a substantial number of warrants, you don't think if I went to the board and said, hey, it would be nice if you put Doug Barnard on your board, you don't think they would react? If he decides to exercise those warrants, he will have a little control, so we might as well go along and put this hotshot Doug Barnard on the board—you don't think that is conceivable

Mr. ISAAC. I don't know whether they would or not.

Chairman ST GERMAIN. But what Mr. Barnard is getting at is there is some clout involved.

Mr. ISAAC. No. The FDIC has not used those warrants for that purpose at all.

Chairman ST GERMAIN. But the potential is there?

Mr. ISAAC. Maybe that is what has the bank nervous; I don't know.

Chairman ST GERMAIN. Well, that is what Mr. Barnard is saying.

Mr. ISAAC. Or the existing management of the bank may be nervous about it.

Chairman ST GERMAIN. That is what Mr. Barnard is saying.

Right?

Mr. BARNARD. Exactly right.

Chairman ST GERMAIN. OK.

Mr. ISAAC. I am not nervous about it.

Mr. BARNARD. I don't see how you can expect to be an owner and regulator at the same time. I just think that is inconsistent.

Mr. ISAAC. We are not the primary supervisor of First Pennsylvania or Continental.

Mr. BARNARD. You are the primary insurer.

Mr. ISAAC. We don't exercise primary jurisdiction.

Chairman ST GERMAIN. Are you the primary supervisor of Continental?

Mr. ISAAC. No.

Chairman ST GERMAIN. Of course, not. But you are in control of Continental.

Mr. ISAAC. Our lawyers would argue with that.

Chairman St Germain. You have 80 percent of the stock, haven't you?

Mr. Isaac. No.

Chairman St Germain. My good friend?

Mr. Isaac. No. We have the right to have 80 percent of the stock.

Chairman St Germain. You don't—you mean to tell me that if Mr. Ogden—and who is the other one?——

Mr. Isaac. Swearingen.

Chairman St Germain. Swearingen—if you see they are not doing good, and, my goodness gracious, things are not going the way they should, you mean to tell me you can't decide you are going to replace them with Doug Barnard?

Mr. Isaac. Swearingen and Ogden?

Chairman St Germain. Yes.

Mr. Isaac. We have already made it clear—not because we hold the convertible feature in our stock but because it is part of the assistance agreement—that we have the right to veto members of the board of directors. We have signed resignations and we intend to accept a number of those resignations.

Chairman St Germain. Therefore, in other words, you control that bank. You could change the management.

Mr. Isaac. We have a certain amount of say so in the selection of directors at Continental, but the reason why we have it is not because we have shares of preferred stock that are convertible into common, but because in a separate part of our arrangement we negotiated that. It doesn't flow from the shares, the convertible preferred shares; nor does it flow from the warrants in First Pennsylvania.

We used to have detailed control over First Pennsylvania under the assistance agreement, not because of the warrants but because of the assistance agreement, and then once they paid the loan back we canceled all that, and we still have the warrants.

Chairman St Germain. Would you explain something for those of us present and those who are observing? A few moments ago you said to Mr. Barnard that in the case of Continental that preferred stock is costing us, in your words, costing us money.

What do you mean by that?

Mr. Isaac. Just that on the convertible preferred, I think the amount of it is $720 million in convertible preferred, is not earning.

Chairman St Germain. Noninterest bearing?

Mr. Isaac. Right.

If the bank starts paying dividends again, we will get dividends on it. But——

Chairman St Germain. Just tell me what you meant when you said it is costing us money.

Mr. Isaac. It is costing us money.

Chairman St Germain. How?

Mr. Isaac. We are not getting income on $720 million.

Chairman St Germain. And that would be invested otherwise, that is part of the insurance fund.

Mr. Isaac. Exactly.

Chairman St Germain. Which ordinarily, if it were not tied up where it is, having purchased that convertible preferred, that money would be invested by the FDIC somewhere to earn money.

Mr. Isaac. And let's, for the sake of discussion, say it is 10 percent. So it is costing us $72 million a year to have that convertible preferred. So there is a real economic incentive to the FDIC to get out of it.

Mr. Barnard. So, therefore, these warrants that you are holding, you consider that as an investment like you would buy a Treasury bill or bond?

Mr. Isaac. Of course. First Pennsylvania entered into this transaction as consenting adults, and they knew the purpose of the warrants.

Mr. Barnard. Let me ask this question: Don't you think the fact that you all still hold the warrants is a cloud on the bank?

Mr. Isaac. No.

Chairman St Germain. The time of the gentleman has expired. I would like you to meet Congressman Bruce Vento from Minnesota.

Mr. Isaac. We have met earlier.

Mr. Vento. Mr. Chairman, I was interested in this regulatory role.

I think you put your finger on it, Mr. Isaac. I think all of us—I think obviously—I thought the reason you were in Continental with the interest that you have was that you have some equity to protect in terms of protection of the funds. This role of saying that really we are not controlling this, we are not exercising our options, you damn well better exercise your options with the billions of dollars of equity that you have standing there by virtue of the fund, don't you?

Mr. Isaac. We found that doesn't work out very well. In First Pennsylvania, for example, we had those kinds of clauses. Every time they wanted to buy a teller machine almost they had to come and ask permission from us. And when they wanted to give their people a raise or hire some new person, it required our approval.

Mr. Vento. Are you saying you are just along for the ride?

Mr. Isaac. Not at all. Bill Ogden and John Swearingen are two of the most successful business people in the world, and they were selected to head up that institution. They are in the process of selecting a new board of directors which will be satisfactory to the FDIC, and we think the best way for us to deal with this situation is to—as any other major shareholder would do—is make sure we have got the very best directors and management. But we shouldn't be involved in running this bank day to day. It can't be done that way.

Mr. Vento. I know. But you know the message that is coming through from the Comptroller, and to some extent from you, and I don't fault you for it; I just think it is the size of the institution you got there, a $42 billion institution. It has been cut down to a different size—maybe my figures are wrong—down to $25 billion or something.

But the point is, we can't seem to cut through, you know, some of the size here in terms of our regulators. If you didn't have this communication between the happenings at Penn Square and what happened at Continental Illinois National Bank—there wasn't communication at the Comptroller's Office; and I don't know what the communication is—but we can't seem to cut through the problems that were occurring at these large institutions. That is to say, we find in these institutions a credit culture that seems to be completely without function, without statistical backup in terms of this.

I am concerned about the size, the inability. In other words, you are answering questions of Mr. Patman that the Comptroller couldn't answer for me with respect to foreign loans and foreign assets and foreign deposits, and what the impact is. These are fundamental.

I don't know if you bought any foreign loans. I suspect you did not buy foreign loans in the category or group that you purchased at this particular time.

I don't have any special hangup with foreign loans except that I think it is a question that we ought to be looking at. We ought to be asking questions about it because of the problems with the LDC's, and so forth.

So I am concerned about the inability to cut through this sort of morass and simply the tremendous faith that you placed in a couple of corporate executives that you put at the head of this institution; and the fact that you put the Federal Reserve Board—the FDIC put the money into this institution, and commitment in, as they have.

I don't know what the answer is. But I feel just a little uneasy about that.

Did you find problems in terms of communication as to the status of this institution that were similar to those that have been testified to by the Comptroller of the Currency, and the regulatory structure that he has? Did you find problems with getting information or inconsistencies in the information, Mr. Isaac?

Mr. ISAAC. No.

Mr. VENTO. You found no inconsistencies in it? You had no problems? In other words, if the Comptroller's Office was not made aware of their regulatory role and the impact of what was happening in Penn Square on Continental Illinois National Bank, you didn't find that to be a problem? You didn't have those types of inconsistencies occur?

Mr. ISAAC. I thought you were talking about Continental; not Penn Square.

Mr. VENTO. I am talking about both, and the interrelationship between them, and the fact that within even the Comptroller's Office they had problems communicating with the different——

Mr. ISAAC. In Continental, nobody was aware of the problems prior to Penn Square—not the public generally, not the FDIC, and I don't believe the Comptroller's Office. Since Penn Square, we have been in close communication with the Comptroller's Office on Continental, and I don't feel there have been any communication problems.

Mr. VENTO. I have a problem. One of the things you talked about, for instance, is an insurance differential in terms of being a possible solution in the future.

Isn't there a problem with trying to do a rating on different loans and different size institutions with regard to such an issue, or insurance differential?

Mr. ISAAC. That is a problem. But we have proposed a system for doing it that I think is pretty good, at least as an initial step.

Mr. VENTO. Do you feel any—I think the real question that Mr. Barnard is asking is: How long will it be before Continental Illinois is standing on its own and has paid back the resources; and what will it ultimately cost the FDIC?

What is your projection?

Mr. ISAAC. OK. That is an issue I was hoping somebody would finally ask me, because I must admit I was in the back of the room being very frustrated by the statements that the FDIC had not done any kind of a cost analysis; didn't have any idea what it was doing.

The Congressional Budget Office estimates that the FDIC might lose as much as $3.8 billion in Continental.

You say, why didn't we come up with a number in May and do the form we do on $20 million banks? It is because we couldn't physically do it. We didn't know enough about the condition of the bank to do it with any precision. You couldn't even do it today with a great deal of precision. But it is pretty easy to imagine that the FDIC, if it had paid off the insured deposits of $3.2 billion, would have lost—pick a number—$500 million. That is pretty easy to imagine.

For one thing, we would have laid out $3.2 billion, which would cost $350 million or $400 million a year in lost income until we got it back. So it is pretty easy to imagine that a deposit payoff in Continental would have cost the FDIC, let's say, a half-billion dollars.

Now, we got the problem of these other banks, and however many it was, I don't for a minute think it would have cost as little as $18 million, or whatever that number was this morning.

Mr. VENTO. $58 million.

Mr. ISAAC. $58 million, I don't think for a minute it would have been that inexpensive. Then you have got the problem of whatever else that set off in the banking system and prevented you from being able to control. But just——

Chairman ST GERMAIN. Could I interrupt for half a second because you just said—did you say you didn't have the capacity to figure out how much it would have cost to do a payout on Continental?

Mr. ISAAC. Not with any precision, not in that time in May when we were trying to deal with it. We could do what I just did. We could make that kind of judgment back then.

Mr. VENTO. Let me interject this, and I don't mean to interrupt your train of thought, but in doing the calculation, you are assuming a certain return on the assets, in other words, you are assuming 100 percent return on the loan assets and only calculating the interest charge. In other words, you are low balling the figure in terms of the insurance?

Mr. ISAAC. It may have cost more than I am giving you.

Mr. VENTO. You are just saying it would be the interest charge in terms of paying that off and that you could recover a lot through the long portfolio, a significant amount?

Mr. ISAAC. What is this deal going to cost us? The so-called study of the CBO makes a couple of fatal errors. It is extremely pessimistic on loan collections. These loans have a $5.1 billion face value, and we bought them for $3.5 billion. You already have a 30-percent discount on the loans. I think the CBO projected on some scenarios we would collect only 20 to 25 cents on the dollar on the $5.1 billion in face value. Second, the CBO report doesn't consider the time value of money at all. If we spend $3.8 billion 5 years from now, that is not the equivalent of $3.8 billion spent today. They don't factor that in at all.

Second, their most optimistic projection on how much we could sell our shares for was something like $6 or $7 a share. A few days ago the stock was already selling for that amount and that was the CBO projection for 5 years from now.

We bought that stock for $4.50 per share, giving the FDIC a $2.50 per share paper profit as of a couple of days ago on our stock interest in Continental—That is a $400 million paper profit since July 26.

Chairman ST GERMAIN. Would that same profit accrue to the stockholders of Continental who were stockholders prior to May 1984?

Mr. ISAAC. No, because their remaining shares are subject to being taken over by FDIC if we lose enough money under the purchase arrangement.

Chairman ST GERMAIN. What was the high on Continental within the last 12 months?

Mr. ISAAC. I don't know.

Chairman ST GERMAIN. Fifteen or sixteen?

Mr. ISAAC. It strikes me——

Chairman ST GERMAIN. My staff tells me it was 22. The low was 2⅞, so those stockholders, as of now, have gone from 2⅞ to 7?

Mr. ISAAC. No.

Chairman ST GERMAIN. What do you mean, no?

Mr. ISAAC. It is the clean stock that is selling for seven.

Chairman ST GERMAIN. What is the dirty stock selling for?

Mr. ISAAC. Less than that. I think it is four-something.

Chairman ST GERMAIN. OK.

Mr. ISAAC. Because the market is estimating on its own.

Chairman ST GERMAIN. How many shares of that are out there?

Mr. ISAAC. Forty million.

Chairman ST GERMAIN. Forty million—so that has gone up about a point, 2⅞ to 4. Thank you.

Mr. ISAAC. Let me give a hypothetical on what could happen in Continental and I am not predicting it will. We will try to make some estimates after we get a better reading on the problem loans. Let's assume that the FDIC loses $800 million under the loan purchase arrangement. In other words, instead of getting back our $3.5 billion, we get back $800 million less than that. That would mean—I want to repeat again, so nobody gets it wrong in the press, that is not a prediction—that would mean that the old shareholders of Continental would have no more stock interest. The FDIC would have 200 million shares of Continental. An $800 million loss on the loans is not an optimistic projection.

Let's make another assumption. Let's assume that Continental starts earning, and does so for the next 5 years, 75 basis points on assets. That is optimistic, but not wildly so when you consider that the bank will not be paying income taxes because of the large tax loss carryforward. It is very optimistic, but not out of the question. If you assume those kinds of earnings for the next 5 years, book value at the end of the 5-year period will be between $13 and $14 per share. Let's call it $13.50 for the sake of discussion. Assume that the FDIC is able to sell the stock for book value—optimistic, but Continental now is selling at book value. The FDIC sells 200 million shares 5 years from now at $13.50. That is $2.7 billion. You have $300 million, roughly, in market rate preferred stock that we invested in. Let's assume that we sell that for the $300 million we have in it which we should be able to. Now we have $3 billion in our coffers. I just said that we lost $800 million on the problem loans.

Mr. VENTO. Lost the interest.

Mr. ISAAC. I was assuming lost interest because that is entered into our cost calculation. Second, we have a billion dollar investment in the bank. That is $1.8 million. Now, let's pick up that $72 million a year we have in lost income on the convertible preferred stock for 5 years, that is $350 million. We have $1 billion plus $800 million, plus $350 million in lost income, that is $2.1 billion. The net profit to the FDIC in 5 years would be $900 million.

I am not predicting it. I certainly wouldn't stake my career on it. I am telling you it is not out of the question—not anywhere near as far out of the question as those CBO projections of a $3.8 billion loss.

Mr. VENTO. That is assuming that that money would have been earning interest at the same rate, whatever the investment that you have?

Mr. ISAAC. I think I just factored it all in.

Mr. VENTO. I appreciate the opportunity and the explanation. I am concerned about this that the size of institutions really puts them—does not give us the ability to do the job that we are expected to do, and I am persistent and I recognize your acknowledgement of the same, but I think it is something that we have to deal with.

Mr. ISAAC. Could I add something? At the time—and I really say this for the chairman's benefit as well—at the time we were handling Continental in May, things were moving very, very fast. Our staff estimated to me that maybe we would lose $1 billion if we did this deal, worst case, maybe we would make $1 billion, best case.

The midpoint of that is zero, or break-even. In a payoff as I said earlier, we were facing a sure half a billion loss, a sure half a billion loss, and Lord only knows how much beyond that.

Mr. VENTO. I think you have to factor that in against the impact that these types of policies have in the overall regulatory scheme of things and whether or not that we really solve the problem here. I think there are some relative values in terms of the overall policy. If the only thing you look at is protecting your funds and don't worry about structure of banks or market discipline, I suppose you can justify a whole host of actions that otherwise would not be justified. That is, of course, I think some thing that we want to look at very carefully as we proceed.

Mr. ISAAC. I concur. We cannot let cost drive these transactions to the exclusion of everything else, no question.

Mr. VENTO. Thank you, Mr. Chairman.

Mr. PATMAN. Mr. Chairman.

Chairman ST GERMAIN. Mr. Patman?

Mr. PATMAN. Thank you, Mr. Chairman.

Mr. Isaac, if I understood your testimony earlier, you don't have any written memoranda evidence on these charges nor on these rewards, nor on what the transactions are going to be. Have you got something in your files that shows that you might make a billion or lose a billion?

Mr. ISAAC. No.

Mr. PATMAN. You mean you were talking about billions of dollars, hundreds of millions and you didn't make any memoranda evidencing that?

Mr. ISAAC. They are a lot of memoranda in our files and the committee's staff has had an opportunity to review every one of them. We have opened up the file drawers to the staff and said, "Here it is." In terms of trying to make a precise estimate of what the FDIC might gain or lose, first of all, it is going to depend tremendously on how well those loans are collected, and you can make all sorts of different assumptions on that. We want the time to study that because when we announce our forecast loan collections it is going to affect the price of the tainted shares of Continental, the ones that are subject to being taken over if we lose enough money. That is going to drive the price of those shares up or down and I don't want to start handing out numbers on that until I have a great deal of confidence in those numbers.

Mr. PATMAN. That is not your response to keep the market up for those shares.

Mr. ISAAC. No, it is not. I don't care about that.

Mr. PATMAN. Let's worry about what is good for the Government and what is good for the taxpayers of this country.

Mr. ISAAC. I am saying those shares will be traded based upon what those shareholders expect to be able to get out of those shares. If the losses under the loan purchase arrangement are a certain magnitude, $800 million, the shareholders will lose their entire investment. I don't want to make any kind of projection on what those loan losses might be and thus what those shares are worth until I know the projection is right and has been thought out and even then it will likely be wrong.

Chairman ST GERMAIN. Mr. Patman, would you yield?

Mr. Isaac, absent the finding of essentiality in this case, let's hypothesize. If there were no finding of essentiality, and really let's face it, essentiality is great because it makes things so much easier, but absent that, wouldn't you have had to project immediately what the recovery would have been in order to make a determination as to what you might do?

Mr. ISAAC. If we had had to make a cost finding, we would have done it.

Chairman ST GERMAIN. Are you telling us that you won't make that prediction at this point, that you are going to wait a year——

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Mr. ISAAC. No.

Chairman ST GERMAIN. Let me read something from the May 17 memo that, in view of what you said to Mr. Vento and what you are saying now, is rather confusing. This is a memo to the Board from Mr. Shumway, Subject: Continental National Bank. "Against this background, division of bank supervision believes that there are sufficient facts to determine that Continental is in danger of closing." You know, we keep being told that it was never insolvent or what have you, but this is the bank supervision saying it was in danger of closing on May 17.

Mr. ISAAC. From a liquidity standpoint, it was.

Chairman ST GERMAIN. "We have determined the amount of services to facilitate a merger consolidation or the sale of the assets and assumption of the liabilities of Continental is an amount in excess of that amount reasonably necessary to save the cost of liquidating, including paying the insured accounts of Continental." Then they say that they think it is essential to save the bank. So the Division of Bank Supervision, on May 17, made a determination that it would be cheaper to liquidate and pay the insured accounts.

Mr. ISAAC. I am aware of that memo because I read it yesterday for the first time. That memo was written in Washington by our legal staff. The Board was in New York at the time trying to put this deal together. The Board meeting was held in New York and that memo was drafted in Washington. None of the Board members saw it before the Board meeting. I didn't read it or see it until yesterday because I felt I should before I came up here and got asked questions about it.

That statement in there is simply wrong. If you look at the minutes of the Board meeting that was held on May 17, you will find a statement in the minutes by me that, though we were relying on the essentiality test, if we had to make a cost finding I had no doubt that we could justify it on a cost basis.

Chairman ST GERMAIN. You could?

Mr. ISAAC. Could.

Chairman ST GERMAIN. So the Division of Bank Supervision therefore was wrong?

Mr. ISAAC. It was actually a memo drafted in the Legal Division, and that statement is simply wrong. Whoever drafted it didn't know the deal, because nobody knew the deal except the few of us who were in New York.

Chairman ST GERMAIN. You didn't know the deal at that point?

Mr. ISAAC. I knew what we were doing.

Chairman ST GERMAIN. Did you know what you were going to do on May 17?

Mr. ISAAC. I am saying that I knew on May 17 what I expected. Let me back up.

As I said earlier, it is easy to imagine a $500 million cost figure on a deposit payoff. If you look at the deposit payoff cost calculation that our Division of Bank Supervision does on a $20 million bank, there is nothing in that calculation that takes into account the cost of funds. It doesn't consider that when you pay off insured depositors, that you have laid out a bunch of money and you are not getting interest on it.

Moreover, if they had done this kind of calculation in Continental based on what the classifications of the loans were at that time, the cost of a deposit payoff would have been grossly understated, because the loan classifications ultimately, a month or two later, were revised and made much more severe. The bank was required to charge off a billion dollars or so.

Chairman St Germain. You are discussing classification. You are talking about the potential recovery; isn't that correct? The eventual potential recovery that you say now you want to wait until next year to give an estimate on?

Mr. Isaac. To estimate.

Chairman St Germain. When you talk about lost interest, there is a little lost interest going the route that you have gone, as well.

Mr. Isaac. I just described that and tossed it into the example I gave.

Chairman St Germain. That occurs in either instance.

Mr. Isaac. Right.

Chairman St Germain. Mr. Patman, thank you for yielding.

Mr. Patman. Mr. Isaac, then the first judgment you make is whether or not there is a test of essentiality met. Is that true? Or do you first check on whether or not it is more cost effective to provide a capital infusion or a merger partner? Which judgment do you make first in deciding whether or not a bank is to survive?

Mr. Isaac. When the typical bank comes to us, the bank regulator comes in and says this bank is insolvent.

Mr. Patman. Let's go to any of the top 11 largest banks.

Mr. Isaac. There is no point in talking about those.

Mr. Patman. They are going to be saved because they meet the test of essentiality?

Mr. Isaac. I didn't say that.

Mr. Patman. Well, I am asking you then.

Mr. Isaac. I would not make a prediction on that.

Mr. Patman. You wouldn't?

Mr. Isaac. No.

Mr. Patman. You think there may be one of those 11 banks that would not meet that test, and therefore would not be saved?

Mr. Isaac. I didn't say that, either.

Mr. Patman. Think about it for a minute.

Mr. Isaac. I have thought about it a lot.

Mr. Patman. Can you imagine some circumstances under which they would not be saved?

Mr. Isaac. I am not going to make a prediction.

Mr. Patman. I am asking if you can think of any circumstances under which they would not be saved.

Mr. Isaac. I don't think it would be appropriate for me to make a prediction.

Mr. Patman. We are all concerned that you are letting these large depositors in Seminole, TX receive only 55 percent of their excess over $100,000; and yet, you are taking the Federal Government and putting it into Continental Illinois and giving all those depositors all of their moneys back.

Mr. Isaac. Right. And in Seminole, TX, the alternative in that case would have been to give them nothing over $100,000. We did a modified payoff and gave them initially, I think, 55 cents on the dollar. I suspect they may get more as we collect on the assets.

The alternative in that case would have been a straight payoff because of the massive uncertainties involved.

Mr. PATMAN. Well, you aren't saying that some of these other large banks will not be saved, possibly?

Mr. ISAAC. I am simply not addressing the question.

Mr. PATMAN. Well, the problem is that some of the depositors in this Nation may get the idea that the only way they can really safely place a deposit of over $100,000 is in one of the large money center banks, such as Continental Illinois, or one of the other banks, based on a precedent they conceive that you have established of paying off all the deposits in that one bank.

Mr. ISAAC. That is a very serious perception problem, and it has existed for some time, because in 1972 the FDIC did a capital infusion in Bank of Commonwealth, because in 1973 we did a merger transaction in San Diego, because in 1974 we did one in Franklin, because in 1980 we provided capital infusion to First Pennsylvania, and now we have provided capital infusion in Continental. Yes, there is a serious perception problem, in that regard.

When I came to the FDIC in 1978, the conventional wisdom was that the FDIC would never pay off insured accounts in a bank over $100 million in size—it would always take care of the depositors in full if the bank was larger than that. Penn Square crossed them up, and now they have raised their level——

Chairman ST GERMAIN. Whose wisdom? Is that on the street or within the FDIC?

Mr. ISAAC. Probably both.

Chairman ST GERMAIN. Seriously.

Mr. ISAAC. I think there was a perception in the FDIC among the staff, that the board would never have the courage to do that in a bank of over $100 million in size. And it was surely the conventional wisdom on the street.

Penn Square crossed them up. Now they think the limit is higher, but don't know how much higher. Most people think there is a limit, and that is something that the Congress and the FDIC and the other regulators need to concern themselves with, because it is not fair to have that perception out there.

Mr. PATMAN. I agree.

You have established the principle that some banks are too big to fail?

Mr. ISAAC. I haven't made any predictions.

Mr. PATMAN. You do agree that some banks are too big to fail, don't you?

Mr. ISAAC. I didn't address that question.

Chairman ST GERMAIN. You answered that question affirmatively on May 17, 1984.

Mr. ISAAC. Some people have interpreted it that way.

Chairman ST GERMAIN. How else would you interpret it?

Mr. ISAAC. That the FDIC——

Chairman ST GERMAIN. You know, actions speak louder than words.

Mr. ISAAC [continuing]. Put together the most cost-effective transaction it could put together.

Chairman St Germain. You don't have any facts to demonstrate that.

Mr. Isaac. I just gave you——

Chairman St Germain. Off-the-top-of-your-head generalizations.

Mr. Isaac. Those are not any more off the top of my head than the CBO studies.

Chairman St Germain. Admit it, Mr. Isaac, when you stepped in and what you did—Mr. Patman, would you yield to me?

Mr. Patman. I yielded to you my prior 5 minutes.

Chairman St Germain. Listen to this. I will answer the question you asked him.

And I repeat, yes, you made a determination that you are not going to let big banks fail. Mr. Conover said the same. You may say, no, that is not the case. But the fact of the matter is that when you took the action that you took on May 17, and subsequent actions, that was the decision you made. And you, I am sure, are looking to us hopefully so that we can discuss this matter and decide and determine once and for all whether or not we are going to have altered plans, or if are we going to continue to go this way.

So now, transcript of a meeting of the Board of Directors of the Federal Deposit Insurance Corporation, closed to public observation, May 17, 1984—is there anything wrong with my reading this?

Mr. Isaac. I don't know. I would like to take a look at it before you do, if I could, Mr. Chairman.

Chairman St Germain. I don't think there is, but you might want to take a look.

Mr. Wylie. Isn't the point, Mr. Chairman, that we made a decision that this one big bank wouldn't fail; that you haven't made a decision at all with respect to others?

Mr. Isaac. I made a decision about what to do with Continental Illinois.

Chairman St Germain. The decision is made because of, and on the basis of, its size. And if we look at the resolution that was finally adopted, we find that they go into the number of employees that would lose their jobs, the other banks that would be accepted—ad nauseam. But, in reality, it is because it was so big and they feared the repercussions. Mr. Conover testified to that. It is in the resolution.

Mr. Wylie. That determination, I think, would be made on a case-by-case basis.

Chairman St Germain. That is true. Somebody runs a red light—and I am not saying that you did that here—someone runs a red light; they violated the law. And each time somebody runs that red light, it is case by case true, and it is still a violation of the law.

Have you had an opportunity to take a look——

Mr. Isaac. Yes.

I have no objection to that.

Chairman St Germain. I didn't think you would.

Mr. Isaac. I can never be sure what our Board may have said.

Chairman St Germain. It is usually very difficult.

May 1984, closed to public observation, the transcript of the meeting of the Board: "At 7:30 a.m., on May 17, 1984, the Board of Directors of the Federal Deposit Insurance Corporation met in the

FDIC New York regional office located at 345 Park Avenue, 21st floor, New York, NY, to consider a certain matter which it voted pursuant to subsections * * * "—I ask unanimous consent to put it in the record—to consider in a meeting closed to public observation. That is the Sunshine Act.

William M. Isaac, Chairman of the Board; Irvine H. Sprague, Director; C.T. Conover; all the Board members; Margaret Egginton, Deputy to the Chairman; and highly skilled people from the Legal Division; Open Bank Regulation and Supervision were there. Mr. Shumway was not there because he was writing that memo in Washington.

Mr. ISAAC. I think Shumway was there.

Chairman ST GERMAIN. Why didn't he tell you about the memo?

Mr. ISAAC. Shumway didn't see the memo then, either.

Chairman ST GERMAIN. Well, it is from him to you. It is dated May 17.

Mr. ISAAC. It was prepared at a lower staff level. Mr. Shumway came back to Washington later and——

Chairman ST GERMAIN. Joe Shelby was there and you had a lot of other people. Chairman Isaac presided at the meeting—now, the exciting part. Chairman Isaac, this is a special meeting—we are finished with all the little numbers and letters—"This is a special meeting of the Board of Directors. I make the Sunshine motion. [I move that the Board of Directors determine that Corporation business requires its consideration of the matter which is to be the subject of the meeting on less than seven days' notice to the public; that no earlier notice of the meeting was practicable; that the public interest does not require consideration of the matter which is to be the subject of the meeting in a meeting open to public observation; and that the matter may be considered in a closed meeting by authority of subsections (c)(8), (c)(9)(A)(ii) and (c)(9)(B) of the 'Government in the Sunshine Act' (5 U.S.C. 552b(c)(8), (c)(9)(A)(ii), and (c)(9)(B)).]

"Director Sprague: I'll second.

"Director Conover: I agree."

Now, you know——

Mr. ISAAC. Could you repeat that? [Laughter.]

Chairman ST GERMAIN. I think what you said was "I make the Sunshine motion," and then they type it in for you. I don't think you even said that.

Mr. ISAAC. Precisely.

Chairman ST GERMAIN. OK.

Chairman Isaac, "The purpose of the meeting is to consider the purchase of $2 billion in subordinated notes from Continental Illinois National Bank and Trust Company of Chicago pursuant to Section 13(c)(2) of our act."

That is the related section, you were right on.

"I have a letter from the Comptroller of the Currency stating that the bank is having severe problems with respect to its funding. It says, 'If the bank's ability to obtain funding continues to deteriorate, the bank may become unable to meet its obligations as they become due.' It is apparent that we must do something and do something quickly. We have arranged for this subordinated loan transaction. We are considering possibly selling off part of the subordinated loan to some of the major banks around the country."

And that was indeed done certainly for $500 million.

Mr. ISAAC. It was in negotiation at that time.

Chairman ST GERMAIN. "It is not clear at this point whether that will be done or not. The loan is payable on a demand basis, but it is our intention to allow the loan to stay outstanding for a period of time of probably several months in order to work out a permanent solution to the bank's problem. I have a resolution which authorizes us to enter into this transaction. I think it authorizes Paul Fritts or me to sign, is that correct?"

Page 2, "Mr. Jones: Among others, yes.

"Chairman Isaac: "Among others.

"Mr. Jones: It also authorizes you to make demand, when the time comes, to make the demand without a further Board meeting.

"Chairman Isaac: Okay and the resolution that I would ask the Board to adopt makes a determination that continued operation of the bank is essential to provide adequate banking services in the community, that the granting of assistance is in the best interest of the public and the depositors of the bank, and that the granting of assistance will prevent the closing of the bank until a merger, consolidation, or other solution to the bank's problems may be arranged."

Sounds to me like boiler plate language, am I correct? That is what you call the boiler plate, in other words, that is the standard language of the motion for this purpose?

Mr. ISAAC. Well, I——

Chairman ST GERMAIN. You look quizzical.

Mr. WYLIE. You have only referred to one bank so far.

Chairman ST GERMAIN. Are you an attorney, Chalmers?

Mr. WYLIE. Yes.

Chairman ST GERMAIN. You know the formal language, the boiler plate? That is what I am saying.

Mr. WYLIE. But this so far only talks about Continental.

Chairman ST GERMAIN. Who said it talked about anything else?

Mr. ISAAC. Most of what you said is standard, to take care of legal requirements.

Chairman ST GERMAIN. That is what I mean, to take care of legal things. That is all I am saying.

Mr. ISAAC. All the standard things.

Chairman ST GERMAIN. Then you say, "We don't have anything"—I don't think this is standard—"We don't have anything at this point to verify it, but I would also say that I think this is probably the least cost alternative for us at the moment, to go forward with this subordinated note arrangement, "and—then the interruption."

Maybe, I am thinking, Mr. Conover is going to say, "Well, shouldn't we have some information to verify it?" But I am disappointed. It says, "Director Conover: Bill, I have an objection to one part of the resolution, and that is that I think that the calling of the demand note ought to be done through a Board meeting. I would prefer that that—" then Mr. Isaac, a very nice gentleman, says, "I don't have any problem with that at all."

Mr. Jones says, "That can be removed."

"Chairman Isaac: In any event, what I was saying is that I think this transaction is probably the least costly alternative for the FDIC, although we don't have a document to demonstrate that. But, by coming in here on this interim subordinated loan basis, we will give ourselves the maximum amount of time or a considerably longer period of time in order to make a sensible permanent arrangement, which will minimize our cost. So we could probably do it based on either the essentiality finding"—aha—"or a cost test," which was never performed I guess. "I move that we adopt the resolution with the change that Todd suggested."

So, therefore, I am still wondering whether we do it on the basis of an essentiality finding or a cost test.

Mr. ISAAC. Excuse me, we clearly did it on the essentiality finding. I only said that based upon the information that I had, I felt that a cost test, had we wanted to do a cost test, and had some time, we could have easily satisfied a cost test. That is all that said.

But we didn't have the time. There was no need to do it because the lawyers told us the essentiality test would suffice. Therefore, we didn't do a cost test. That is exactly what I have said all afternoon.

Chairman ST GERMAIN. Again, I am just reading your words. I can't—all I have is the words, the transcript of the meeting.

Mr. ISAAC. OK.

Chairman ST GERMAIN. And it says no cost test was performed.

Mr. ISAAC. Exactly.

Chairman ST GERMAIN. At this point, you have not made the decision, May 17, you say in your own words here——

Mr. ISAAC. We were making the decision right then. We had a resolution before us.

Chairman ST GERMAIN. We could probably—the resolution is for the subordinated note transaction. That is all.

Mr. ISAAC. That is right.

Chairman ST GERMAIN. We could probably do it based on either the essentiality finding or a cost test.

Mr. ISAAC. Precisely.

Chairman ST GERMAIN. You don't make up your mind.

Mr. ISAAC. No, the resolution says we were doing it on the essentiality finding.

Chairman ST GERMAIN. With the suggested change.

Mr. ISAAC. It says that.

Chairman ST GERMAIN. You adopt it with the change. The resolution you ask the Board to adopt makes the finding that continued operation of the bank is essential. We agreed that was the boiler plate language.

Mr. ISAAC. I didn't say that was boiler plate.

Chairman ST GERMAIN. That it is standard language to cover the legal requirements is what you said.

Mr. WYLIE. No, he said it was central, Mr. Chairman.

Mr. ISAAC. I thought you were asking——

Chairman ST GERMAIN. Chalmers, could I question him, then if you want to question him, you may.

Mr. WYLIE. All right.

Chairman ST GERMAIN. Thanks.

Mr. ISAAC. You characterize that as boiler plate, that particular language. All I said was that most of what you have been reading so far is——

Chairman ST GERMAIN. Is the standard legal language.

Mr. ISAAC. To take care of——

Chairman ST GERMAIN. And I said it was boiler plate, you didn't.

Mr. ISAAC. To take care of a legal requirement. The legal requirement is you make a cost finding or essentiality finding. I stated clearly we were making an essentiality finding, not a cost finding, although if we needed to, I felt we could do a cost finding.

Chairman ST GERMAIN. Mr. Isaac, on what did you base your essentiality finding on May 17?

Mr. ISAAC. That is in the Shumway memo.

Chairman ST GERMAIN. Which memo?

Mr. ISAAC. The memo of May 17.

Chairman ST GERMAIN. You hadn't seen it on May 17.

Mr. ISAAC. I knew the facts discussed in it.

Chairman ST GERMAIN. You didn't see it until yesterday.

Mr. ISAAC. You don't think our Board would have acted without having considered the facts.

Chairman ST GERMAIN. Let me just finish, in any event, what I was saying. You say, so we could probably do it based on essentiality.

"I move that we adopt the resolution with the change that Todd suggested."

I tell you the discussion here is inspiring.

"Director Sprague: I'll second the motion.

"Director Conover: I concur."

"Whereupon, at 7:35 a.m., the meeting was adjourned."

Five minutes and a decision was made on it, that it was essential, based on a memo that was in Washington that Mr. Shumway had not seen, and none of the Board had seen, and——

Mr. ISAAC. The Board——

Chairman ST GERMAIN. Let me finish—based on a memo that was in Washington that no one had seen, not even Mr. Shumway who was there who had it prepared. It took 5 minutes to do this, and I guess a decision was made at that point. Was the decision made on May 10 or 17 to save the bank at all costs?

Mr. ISAAC. In my mind, the decision as to how we should proceed was made on May 10.

Chairman ST GERMAIN. By that, I mean that it wasn't a liquidation and payout, but rather the bank would be saved?

Mr. ISAAC. In my mind—I say May 10, perhaps it was May 11 or thereabouts—I made a decision based upon everything I knew——

Chairman ST GERMAIN. And you felt that Continental was——

Mr. ISAAC. For myself. For myself.

Chairman ST GERMAIN. OK. You felt Continental was essential?

Mr. ISAAC. I felt that it was essential that we do this transaction, yes, that Continental was essential.

Chairman ST GERMAIN. How could you reach——

Mr. ISAAC. I also felt it could be justified on a cost basis.

Chairman ST GERMAIN. Pardon?

Mr. ISAAC. I also felt on May 10 or 11 that we could justify it on a cost basis.

Chairman ST GERMAIN. You got a lot of people working down there you ought to get rid of. Why should they work the numbers on cost basis if you can do it, without a cost analysis?

Mr. ISAAC. I said I wanted to explain something, and I think I should——

Chairman ST GERMAIN. OK

Mr. ISAAC [continuing]. About why I reached this judgment about costs at the time.

I think it was in April or so of 1983, that Seattle First got into serious difficulty with its funding, and it started to experience a run. I don't remember the numbers, but it strikes me it was getting up in the magnitude of $1 billion run on that institution.

Dick Cooley, head of Seattle First, came in to see me and said "Can the FDIC render any assistance?"

I said, "Not on a long-term basis, unless, No. 1, shareholders are exposed to a total loss; and, No. 2, we go through some kind of a process to expose this institution to the marketplace, so we can see if anybody wants to buy it and how much FDIC assistance they want and the like."

"What we will do for you, if you have a funding, if you can't get this funding problem settled down, is enter into a subordinated loan arrangement on a demand basis to buy you the time to work out a longer term solution. We will come in on a demand basis with a subordinated loan."

We entered into that arrangement. Our lawyers went to Seattle, the documents were signed over that weekend and were brought back to FDIC. Our Board did not authorize them, and we did not execute them at the FDIC, but the documents were all done and signed and authorized by the Seattle First board of directors. I told Cooley: "Dick, don't ask for this money"—I think we were talking in the range of a $250 million to $500 million interim subordinated loan—"Don't ask for this money unless you absolutely need it. Don't tell me to implement this unless you absolutely need it because once you do, your bank's fate is in the FDIC's hands, not yours. Don't take this step unless you need to, but have it in place in case we do need to."

I felt it was in the FDIC's best interest to have that in place because I felt that it would allow for orderly transaction, which would minimize our exposure to loss. I didn't want to have to handle the failure of Seattle First over a weekend if I didn't have to. We have used that kind of technique in other situations, such as the Greenwich Savings Bank and the like, to buy time to do something in an orderly way.

In those other cases, it worked quite well. In the case of Seattle First, it worked better than I could have imagined because we never needed to trigger it. The run started to settle down, and the Bank of America purchased Seattle First without any FDIC involvement whatsoever.

That is exactly the technique employed at Continental, and that was what we decided to do on May 10 or 11, when we met and discussed it. I suggested we go in with interim money if we needed to do so. On May 10 or 11, it was not yet clear we needed to. It was pretty bad, but it wasn't that bad yet.

I said, "If we need to go in, if we can't get this run settled down short of FDIC involvement, the FDIC will go in with an interim demand subordinated note ranging anywhere from $1 billion to $2 billion." We left the amount open because we were not sure just how much we felt would be needed to settle down the run.

What were the options that weekend? Close it down for 2 months and try to arrange a deposit payoff—for a bank that had book equity and reserves of $2.2 billion?

Do a merger with some big bank, sight unseen over that weekend? We would have had to find some bank to buy Continental, sight unseen. Imagine the guarantees they would have required from FDIC for that deal.

Those were the two options we had that weekend, or to let the run continue to the point where we had nobody involved in that bank except the Federal Reserve.

Chairman St Germain. OK. So what you are saying——

Mr. Isaac. We stepped in to stabilize it so we could take the time to do a sensible transaction. I had no doubt that stabilizing that bank that weekend and giving the time we needed to do a sensible transaction was going to save us money. I have no doubt it, in fact, did save us money.

In Seattle First, it saved us from any expenditure.

Chairman St Germain. Seattle First, nobody knew about it except you and Cooley?

Mr. Isaac. About what? About the potential subordinated note? It never had to be implemented.

Chairman St Germain. That is what I mean. Isn't that the case?

Mr. Isaac. The bank obviously knew about it, and the FDIC and the other regulators knew about it, but the public didn't know because it was not implemented.

Chairman St Germain. Not the public.

Mr. Isaac. It was never executed.

Chairman St Germain. Right.

Mr. Isaac. It never needed to.

Chairman St Germain. Exactly.

Mr. Isaac. The run stopped without it.

Chairman St Germain. Let's go back to Continental on this. You were asked by Mr. Patman if you would let a big bank fail. As we go along here, it becomes obvious you made a finding without a memo on May 17 of essentiality, and I think it was an easy one for you to make because the thing was so big that you realized that repercussions, as recited in the resolution——

Mr. Isaac. If I could correct the record, I made a finding without that document in my hand. I certainly was in possession of all the facts that are discussed in it.

Chairman St Germain. Exactly.

Mr. Isaac. Except the one erroneous fact.

Chairman St Germain. You were in possession of the facts, and those facts are that Continental was a $40 billion institution that had correspondent relationships with many banks, both here and abroad, and that there were many loans and lines of credit involved, and that if Continental were not saved, you found it essential because of the adverse effect it would have on the economy of many areas, particularly throughout the Midwest; isn't that a fact?

Mr. ISAAC. In my mind, the cost considerations—we relied on the essentiality test, but in my mind, the cost considerations were every bit as important, if not more so.

Chairman ST GERMAIN. But you never did, not you, but your staff that ordinarily would have worked the numbers didn't do it, because you didn't have to in view of the fact you had the essentiality finding.

Mr. ISAAC. We didn't do it formally; that is correct.

Chairman ST GERMAIN. So essentiality was relatively easy for you in your own mind without the Shumway memo of May 17 that was in Washington. You could reach a finding of essentiality because at this meeting on May 17, you just said it was essential and there was no discussion with Mr. Sprague, Mr. Conover, or any staff?

Mr. ISAAC. They had all been briefed; they knew what the facts were. We didn't need to discuss why it was essential.

Chairman ST GERMAIN. Why was it essential?

Mr. ISAAC. I just went through a whole litany a few hours ago.

Chairman ST GERMAIN. Yes; primarily because of its size.

Mr. ISAAC. Its size, yes, and its position in the market, what other alternatives were available—a whole host of factors that go into that decision.

Chairman ST GERMAIN. What other alternatives were available?

Mr. ISAAC. Sure; if we could have, for example, easily arranged the disposition of Continental in some other fashion.

Chairman ST GERMAIN. Through a merger or acquisition?

Mr. ISAAC. Yes, acquisition. We probably would have gone that route.

Chairman ST GERMAIN. All right. But the fact of the matter is—let me put it to you this way, are you going to deny—I have a lot of respect for you—are you going to deny it was easy to make a finding of essentiality in the case of Continental because of its size alone—and sent all the other items that you ordinarily have to go through?

Mr. ISAAC. If you——

Chairman ST GERMAIN. Wasn't it an easy determination to make?

Mr. ISAAC. I am not sure I understand exactly the point of the questioning, but let me——

Chairman ST GERMAIN. It is not the point of the question, Mr. Isaac, it is just the question. You are trying to figure out what I am going to come up with next.

Mr. ISAAC. No, no, I wouldn't ever do that.

Chairman ST GERMAIN. But you are trying.

Mr. ISAAC. Let me say a couple things. One, it was extremely easy to make the decisions that had to be made in Continental because it was very clear from my point of view what had to be done, what needed to be done, what should be done.

Now, if you are asking me——

Chairman ST GERMAIN. But in order to do that, you had to first make a finding of essentiality.

Mr. ISAAC. If you are asking me if it's more difficult to make a decision to pay off the insured depositors in a large bank that has a massive amount of uninsured deposits and could have an extremely disruptive impact over a wide area, including the entire banking system, if you are asking me if it is easier to decide not to do a deposit payoff in that situation, the answer is "yes."

That is one of the problems that we—and I hope the Congress will help us with it—have to come to grips with.

Chairman St Germain. OK. By the same token, isn't it easier to make a finding of essentiality when the bank is as large as Continental than it is for the case of the smaller bank?

Mr. Isaac. Well, I think that flows from the consequences.

Chairman St Germain. I agree. I just want to make sure. That is what I have been trying to get at all this time.

Mr. Isaac. Although we have made essential findings in the cases of smaller banks.

Chairman St Germain. Exactly, but I am saying it is much easier——

Mr. Isaac. I think it is a much clearer case that Continental is essential than First Pennsylvania, and it was much clearer that First Pennsylvania was essential than the Farmers Bank.

Chairman St Germain. Now, all this time I have——

Mr. Carper. Thank you. That is because your account wasn't in the Farmers Bank. [Laughter.]

Chairman St Germain. I like that one.

Mr. Patman said to you, and this is when I asked him to yield, he said: "One of the reasons you wouldn't let this fail is because it is so big." "Frankly," you said, "no." I said that was answered by the facts, the facts being that this bank was found to be essential without too much difficulty.

Mr. Isaac. I don't recall Mr. Patman ever asking me that question or me responding in that way. If you are asking me was it hard to let Continental just flat out fail because it was so big and had all these uninsured claims, yes, it was hard to do that. I thought Mr. Patman was asking me to make some prediction about what we would do with any other——

Chairman St Germain. With other big banks the size of Continental or larger, yes.

Mr. Patman. Well, Mr. Chairman, if I may state my question at this point, you made a judgment that Continental was too big to fail.

Mr. Isaac. No.

Mr. Patman. Isn't that true?

Mr. Isaac. No; I made the judgment——

Mr. Patman. Too big a bank to fail?

Mr. Isaac. I made the judgment that it would be cost effective, No. 1, to handle Continental the way we did, and, number——

Mr. Patman. That was irrelevant, though, that was irrelevant because you first——

Mr. Isaac. It wasn't irrelevant to me.

Mr. Patman. You determined it was essential. It was not essential to your decision.

Mr. Isaac. Cost was not the legal test we relied on, but that very much was the factor in my behavior.

Now, I made, No. 1, a judgment that it was cost effective to handle Continental the way we did and, No. 2, that the consequences of handling it some other way would have been more severe than I cared to take responsibility for.

Mr. PATMAN. Let's take that viewpoint of it. Why don't you just say the impact of the failure of so large a bank was too great and that met the test of essentiality as far as you were concerned?

Mr. ISAAC. What I will say is the impact of paying off insured deposit accounts in Continental at that time could have been catastrophic.

Mr. PATMAN. And you would say the same thing about any other large bank?

Mr. ISAAC. No; I did not say that. I will not say that.

Mr. PATMAN. But if faced with the stark reality of another bank failing with the same impact as the failure of Continental would have had or resulted in, you would do the same thing, isn't that true, and reach the same conclusion?

Mr. ISAAC. I am not going to speculate on that. I was dealing with a specific problem——

Mr. PATMAN. It would be unfair to——

Mr. ISAAC. At a specific time.

Mr. PATMAN. If you run into another bank whose impact failure, the impact of which would be——

Mr. ISAAC. If you are telling me that if——

Mr. PATMAN. Excuse me——

Mr. ISAAC. If I get an identical set of circumstances, will I act in the same way? Yes, I will. That is true.

Mr. PATMAN. If you get another bank about to fail that will cause the same impact that the Continental failure would have caused, you would do the same thing?

Mr. ISAAC. Depending on what other options I had at the time.

Mr. PATMAN. If you had the same options?

Mr. ISAAC. That is an identical situation. If you have an identical situation, I would act the same way because I am satisfied with what we did.

Mr. PATMAN. How small a bank—what is the dividing line between the banks and the impacts of their failure, between those that meet the test of essentiality because the impact of their failure is too large and those that do not meet the test of essentiality because they are, their failure is not large——

Mr. ISAAC. The dividing line is somewhere in the area of $10 or $15 million in size—not billion, million because that was the size of Unity Bank and Trust in Boston where we made an essentiality finding. So apparently the FDIC Board is willing to 60 down to $10 or $15 million in size. I don't know whether it would go lower.

Mr. PATMAN. So a person who is serving as the trustee in placing the bonds would not be a reasonably prudent person if he puts those amounts in excess of $100,000 in a bank with less than $15 million?

Mr. ISAAC. $10 or $15 million is what the Board did in Unity. That is the smallest bank we have made an essentiality finding on. There are——

Chairman ST GERMAIN. What is the next smallest?

Mr. ISAAC. The next one, I don't know. I would guess it would probably be the American Bank in South Carolina.

Mr. PATMAN. Do you see the problem that people have in wondering what your decision is going to be the next time and how to protect themselves and be prudent investors?

Mr. ISAAC. Sure, I think there is a perception that big banks are safer for uninsured depositors than smaller banks. And I think that that is something that we have got to deal with. We have got to change that perception, and we have offered some suggestions on how we might do that.

Mr. PATMAN. What safeguards does the Congress have or the public have in having the right decision made on this? Who makes the decision, you and two or three others? What safeguards are there? What appeals are there?

Mr. ISAAC. We have to act within our statutory authority and Congress has pretty clearly spelled out what it is. We cannot abuse our discretion. We have to act in good faith or whatever standard the courts apply. I don't believe the FDIC has exceeded its statutory authority, and I haven't heard any suggestion that it has abused its discretion or misused it.

Mr. PATMAN. Will you provide us with any objective test you can think of that the committee or the Congress, or anyone else, could apply to banks of various sizes in determining which banks would be likely subject to being bailed out as Continental Illinois was bailed out, as opposed to what happened in Seminole?

Mr. ISAAC. We have a policy statement on that score, which I would be happy to provide, which talks about the circumstances under which we are willing to go in on some kind of an open bank basis. That is our enunciated policy in a public policy statement.

Mr. PATMAN. Now, you bailed out a holding company as well as a bank, did you not?

Mr. ISAAC. I object to the use of the term "bailout". But, yes, we went through the holding company.

Mr. PATMAN. And the holding company was engaged in other enterprises besides banking, was it not, insurance and other things?

Mr. ISAAC. It had some limited financially related activities. I don't know about insurance. I think they had some leasing activity and I don't know what else.

Mr. PATMAN. So you have used the FDIC funds to assist the holding company that was engaged in enterprises other than banking, is that not true?

Mr. ISAAC. Well, I don't think they were engaged in anything in the holding company that the bank could not have engaged in directly.

Mr. PATMAN. Did you have any reticence or hesitancy on your own part about getting involved in bailing out a holding company?

Mr. ISAAC. I had a great deal of——

Mr. PATMAN. Or participating in that?

Mr. ISAAC. I did not want to do the transaction the way we did it. I would have given almost anything to do it some other way.

Mr. PATMAN. Specifically because it was a holding company?

Mr. ISAAC. Yes; that was the issue.

Mr. PATMAN. That was a critical issue in your mind?

Mr. ISAAC. I don't know about a critical issue but it was an important issue. We were trying to structure this deal in a way so we didn't have to go into the holding company, but there were a number of loan indenture agreements outstanding in the holding company that made it impossible to structure a sensible transaction any other way.

In the case of Continental, this was largely a philosophical issue. It wasn't a substantive issue because if you had attributed no value to the holding company's holdings in the bank and valued it at zero, the holding company had assets roughly equal to its liabilities. So the holding company creditors probably wouldn't have lost much, if anything, no matter how we did it.

Moreover, when we decided we were going to assist the bank we were making the holding company creditors safe no matter how we did it because the primary asset was the bank.

So this is largely an academic issue, but it is an important issue if you apply it to other situations in the future. We have to think about giving somebody the authority to override or ban those kinds of covenants in the future so they don't get in the way of assisting a bank directely..

Mr. PATMAN. As a matter of fact, the holding company could have been structured in such a way that the bank could have failed entirely and the bank have all the liabilities and the holding company just walk away from it with its other assets and not be injured except by the loss of that asset it had in the bank, is that true?

Mr. ISAAC. Yes. In the case of Continental, it probably would have gone into a formal bankruptcy proceeding, but the creditors would have come out close to even—little or no loss if the bank had simply folded up.

Mr. PATMAN. Thank you, Mr. Isaac.

Chairman ST GERMAIN. Mr. Isaac, to say that the holding company gimmick was academic—you know, I think it was rather important. I think Paul Volcker was very concerned about preserving the holding company and I will ask him about it when he comes to spend a little time with us.

Mr. ISAAC. I didn't mean to say it was not an important issue. It was an important issue. I am saying in this case the holding company creditors were going to come out okay no matter what was done.

Chairman ST GERMAIN. But the bond holders were a different story?

Mr. ISAAC. No.

Chairman ST GERMAIN. The covenant that they had in there was pretty good for them, wasn't it, and you are concerned about that same covenant being insured in the future.

Mr. ISAAC. I am more concerned about the future. But in this situation those creditors weren't going to lose much of anything no matter what happened.

Chairman ST GERMAIN. Mr. Carper.

Mr. CARPER. Picking up on the line of questioning I started earlier, I was reviewing a comment Mr. Conover had made about the desirability of reworking our financial system so that a major bank like a Continental Illinois could fail without bringing down the banking system and I asked you to give an idea of what you thought were appropriate steps to accomplish that goal.

I would like you to pick up on these and I am looking for specific ideas for us to consider as legislators as we look toward the next Congress.

Mr. ISAAC. Right now we have an administrative problem because the FDIC, candidly, does not have the capacity administratively right now to payoff on a very, very large bank like Continental in a short period of time. With 850,000 accounts, it would take about a month or more to pay off the insured depositors. That is too long. In a small bank that has maybe 10,000 accounts, you are talking about over the weekend and the checks are available on Monday. So administratively, we have a lot we need to do.

Mr. CARPER. What I am looking for——

Mr. ISAAC. I am giving too complete an answer, I am sure, but let me get to what I think the Congress needs to focus on. The big problem in a large bank payoff is not getting people the insured money, assuming we can solve the administrative problems, but dealing with the ripple effects from the losses by uninsured depositors.

That is a major problem. Continental's uninsured creditors, holding $30 billion in claims, wouldn't collect their money for years and years. That is a problem we have to figure out how to solve.

The FDIC was developing and testing earlier this spring the modified payoff for just that reason. It is easier to handle a larger failure through a modified payoff than it is through a straight payoff.

So one thing Congress needs to do is tell us, if you have an opinion, whether you want any depositor discipline in the system. Do you want people over $100,000 to lose any money? Everything Congress has been telling us for the past five years or more has been, no, we don't want discipline.

Congress watched us do BOC in 1972, San Diego in 1973, and Franklin in 1974, and First Pennsylvania in 1980. Congress never objected to the way the deposit insurance system was being used to provide 100 percent deposit insurance coverage for banks, particularly big ones. Then in 1980 we got the increase in the deposit insurance limit of $100,000 over the FDIC objections, the full faith and credit resolution in 1982, and the net worth program over the FDIC's objections.

Congress needs to tell us whether it wants depositor discipline in the system. If so, I think we can find a way that wouldn't be disruptive.

An alternative we have suggested is forget about depositor discipline, do mergers and make depositors whole. But if you are going to do that, we think you need another kind of discipline and we have suggested as an alternative that we raise the capital level in banks from the current 6 percent over time to say 9 percent, allowing the additional 3 percent to be satisfied by subordinated debt.

A well run bank will be able to go into the market and get subordinated debt at not much of a premium above the CD rate. A bank that is sufficiently poorly run will not be able to get the money and thus it won't be able to grow.

You get your discipline that way. That is an alternative and we can go that route if it is the sense of the Congress.

Another thing you can do that would give us some ability to have discipline in the system is give us the authority to have risk-related premiums.

Mr. CARPER. Could you spend a minute talking about your request along those lines?

Mr. ISAAC. The FDIC has pending before the Congress a bill which would authorize the FDIC to charge poorly run banks a higher premium than the well run banks. It would mean no additional revenue to us, a break-even proposition.

We charge all banks one-twelfth of 1 percent and then we deduct our losses and expenses for the year and give them a rebate of 60 percent of the balance. We have requested the authority to create three categories of banks, normal-risk banks, high-risk banks, and very high-risk banks.

Approximately 15 percent of the banks would fall into the high-risk or very high-risk category. We have spelled out the tests we would use at least initially. They are objective.

A very high-risk bank would not get any assessment rebate from the FDIC. A high-risk bank would get one-half the normal rebate.

The remaining banks would get the full rebate plus what those other banks forfeited, so that we would provide a financial incentive for banks to do the right thing.

Mr. CARPER. That seems like a logical recommendation. What are the objections to it?

Mr. ISAAC. Maybe somebody from the committee can help me on why it is not moving. Last spring, I attended the ABA Leadership Conference; 300 or 400 bankers from around the country voted unanimously to endorse our proposal.

If it is satisfactory to the ABA and to the FDIC, why isn't it law? I don't know.

Mr. CARPER. Thank you for your testimony today.

Mr. ISAAC. These are very important issues we are talking about. I appreciate it.

Chairman ST GERMAIN. Mr. Wylie.

Mr. WYLIE. Thank you very much, Mr. Chairman.

I think that we have more than adequately covered the subject today.

Chairman ST GERMAIN. Almost.

Mr. WYLIE. Almost?

All right. Well, I would say in spite of some gear shifting we do have a very good record, at least from my standpoint. You said that the essentiality determination was based on some facts except for one erroneous fact and I thought at the time maybe we could call that a nonfact fact.

Mr. ISAAC. OK.

Mr. WYLIE. Well, I think you have done an excellent job, Mr. Chairman, and your testimony has been very, very elucidating at least to this Member. I was not here when you first came on, unfortunately, but I understand you made reference to a staff report which has been made a part of the record, which was referred to earlier by two staff members earlier in the day. Rather than take more time right now, Mr. Chairman, and I will not ask any more questions, I have sent a letter to Chairman Isaac asking him to respond to the staff report.

I think it would be beneficial to have that for the record and I would like to ask unanimous consent to put his answer to my letter into the record when it arrives.

Chairman ST GERMAIN. Reserving the right to object. It might well be that we will want Mr. Isaac to come up and in living color deliver his reply to his letter and commenting because, I think, that that would be very, very essential.

I will be happy to enter it into the record, but we will enter it into the record with Mr. Isaac here present so that we can discuss and analyze his reply.

Mr. WYLIE. That is fine with me.

Chairman ST GERMAIN. Because we enjoy having Mr. Isaac.

Mr. ISAAC. Mr. Chairman, could we take a vote on that?

Chairman ST GERMAIN. Somewhat like the May 17 meeting.

Mr. WYLIE. Mr. Chairman, may I suggest that when the letter comes up I will show it to you and if you think it is appropriate to put it in the record, we will put it in the record. If you would rather have Mr. Isaac introduce it in living color, that will be fine.

Chairman ST GERMAIN. Is there objection? The Chair hears none.

[The correspondence of Chairman St Germain and Congressman Wylie referred to above and Chairman Isaac's response to the committee staff study "Continental Illinois National Bank Failure and Its Potential Impact on Correspondent Banks" follows:]

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

NINETY-EIGHTH CONGRESS

2129 RAYBURN HOUSE OFFICE BUILDING

WASHINGTON, D.C. 20515

October 16, 1984

The Honorable Fernand J. St Germain
Chairman
Committee on Banking, Finance and Urban Affairs
2129 Rayburn House Office Building
Washington, D. C. 20515

Dear Mr. Chairman:

Transmitted herewith is FDIC Chairman Bill Isaac's response to the Committee staff study, "Continental Illinois National Bank Failure and Its Potential Impact on Correspondent Banks."

As we discussed during the hearing, I respectfully request that the enclosed correspondence be included at the end of the official hearing record for October 4.

Thank you for your consideration.

Sincerely,

Chalmers Wylie

CHALMERS P. WYLIE
Ranking Member

CPW:gwd

Enclosures

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

NINETY-EIGHTH CONGRESS

2129 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, D.C. 20515

October 4, 1984

The Honorable William M. Isaac
Chairman
Federal Deposit Insurance Corporation
550 17th Street, N. W., Room 6052
Washington, D. C. 20429

Dear Mr. Chairman:

Enclosed is a copy of the staff report, "Continental Illinois National Bank Failure and Its Potential Impact on Correspondent Banks," which was presented by staff today to the Subcommittee on Financial Institutions.

Once you have had an opportunity to study this staff report in depth, I would greatly appreciate receiving your formal comments about its contents for inclusion in the official hearing record.

Sincerely,

CHALMERS P. WYLIE
Ranking Member

CPW:gwd

Enclosure

FDIC
Federal Deposit Insurance Corporation
Washington, DC 20429

Office of the Chairman

October 12, 1984

Years of Confidence 1933 - 1983

Honorable Chalmers P. Wylie
Ranking Minority Member
Committee on Banking, Finance and
Urban Affairs
House of Representatives
2129 Rayburn House Office Building
Washington, D.C. 20515

Dear Chalmers:

You have requested the FDIC's comments on a report prepared by the Committee's staff entitled, "Continental Illinois National Bank Failure and Its Potential Impact on Correspondent Banks."

The report focuses on two memoranda from Robert V. Shumway, Director of the FDIC's Division of Bank Supervision. Mr. Shumway had the memoranda prepared in June at my request because I wanted written verification of the information I had been given orally around May 10 regarding the exposure a large number of small banks had in Continental. The memoranda show that some 2,300 banks had approximately $6 billion deposited in Continental as of April 30, 1984. Sixty-six of these banks had more than the amount of their capital in Continental, while another 113 had exposure ranging from 50 percent to 100 percent of their capital funds.

The Committee's staff report does not contest the validity of these data, but it alleges that the FDIC, intentionally or through ignorance, misused the data to project the failure of 66 to 179 small banks had the FDIC handled Continental through a payoff of insured depositors. More specifically, the staff report "reveals" that a portion of the $6 billion was insured and thus would not have been lost and that there would have ultimately been a 70 percent or so recovery on the uninsured portion.

The FDIC does not dispute the report's "revelation" regarding either the insured portion of the deposits or the uninsured portion. The observations are obviously correct, and the FDIC has never made any representation to the contrary in any public or private forum.

Assuming that each of the 2,300 banks had at least $100,000 in Continental (which would produce the highest possible total for the insured deposits), insured deposits would have been $230 million. That would have meant that uninsured deposits would have totalled slightly under $5.8 billion. Applying the Committee staff's 30 percent loss estimate to the $5.8 billion, the 2,300 banks would have lost approximately $1.7 billion -- a fair amount of money by any standard.

Honorable Chalmers P. Wylie
October 12, 1984
Page 2

The FDIC has never contended or implied that a substantial number of the 2,300 banks would have failed as a result of direct losses if Continental had been liquidated. The FDIC has said on several occasions that a significant number of these banks would have suffered a severe financial blow and that they were among the principal beneficiaries of the Continental rescue effort. It seems indisputable that a loss of $1.7 billion would have been a severe financial blow, particularly to the 179 banks with exposure greater than 50 percent of their capital. It also seems a fair assumption that those banks were more than a little bit pleased to have been spared the experience.

The FDIC does not know, nor does the Committee's staff know, how many of the banks would have failed as a result of direct losses in Continental. That would require a thorough analysis of the condition of each bank in order to gauge its ability to absorb the losses. However, I believe the number of small-bank failures as a direct result of losses in Continental, disregarding all of the ripple effects, would have been fewer than 25.

The FDIC did not base its decision to rescue Continental on the fact that 2,300 small banks would have otherwise lost $1.7 billion or that 25 or so might have failed. The decision was certainly influenced by these considerations, but other factors weighed even more heavily.

If the FDIC and the other regulators had closed Continental -- a bank that was not then and is not now insolvent -- in response to a liquidity crisis, and had liquidated the institution, the consequences might well have been catastrophic. The viability of other banks and thrifts throughout the nation and even the world would likely have been called into question. Approximately 850,000 insured depositors would have had $3.0 billion frozen for a month or longer while the FDIC prepared their checks. Over $30 billion in uninsured funds would have been tied up for years awaiting the liquidation of assets and the settlement of litigation. And in the end, the FDIC would almost certainly have lost more money than under the rescue package. Indeed, as I pointed out at last week's hearing, it is possible that the FDIC will earn a profit from the Continental rescue effort.

We appreciate this opportunity to set the record straight on the Committee's staff report. Please let me know if we can be of any further assistance.

Respectfully,

William M. Isaac
Chairman

Chairman ST GERMAIN. Now, Mr. Isaac, Thursday, May 10, 1984, Mr. Volcker and Mr. Isaac and Mr. Conover, I think, had a little meeting. And at that May 10 meeting, I think you said that a decision was made not to do a payout and there was a general discussion of possible interim assistance terms, is that accurate?

Mr. ISAAC. I didn't hear the last part of your——

Chairman ST GERMAIN. The decision was made not to do a payout and there was a general discussion of possible interim assistance terms.

Mr. ISAAC. There was a discussion of possible interim solutions. I don't recall any decision being made at that time not to do a payout.

Chairman ST GERMAIN. I say a general discussion of possible——

Mr. ISAAC. What I was objecting to is the first half, that I don't recall any decision being made not to do a payoff. That group, for one thing, had no decisionmaking authority.

Chairman ST GERMAIN. Maybe not statutorial but as a practical matter that is a pretty high powered group, Volcker, Isaac, and Conover. You have the creme de la creme there. Let's go to May 10 through May 15, the Japanese and the European markets dry up, CD's aren't being rolled over; is that not correct?

Mr. ISAAC. On what date?

Chairman ST GERMAIN. Between May 10 and May 15.

Mr. ISAAC. The money continued to run—it had started before May 10.

Chairman ST GERMAIN. It continued to happen, particularly to Japanese and Euruopean investors. Then we get to May 15, Tuesday, sounds like an exciting day. In your meeting—Mr. Sprague—is that Mr. Corrigan——

Mr. ISAAC. I know Mr. Corrigan.

Chairman ST GERMAIN. He was present at that meeting.

Mr. ISAAC. Where, when?

Chairman ST GERMAIN. On May 15, Tuesday.

Mr. ISAAC. I don't know. I only saw Gerry Corrigan once or twice during the whole period and I don't recall it in a meeting.

Chairman ST GERMAIN. Let me try to refresh your memory. Mr. Sprague, Mr. Corrigan, Pres Martin in and out, and Mr. Volcker and Mr. Isaac and at that meeting, as I say, Pres Martin was popping in and out, but Mr. Corrigan was there.

That is rather intriguing——

Mr. ISAAC. I will tell you what happened. Some time during that period Mr. Corrigan was on his way to Boston to attend a funeral of one of the Federal Reserve officers. He came through Washington to pick up another person from the Federal Reserve who was going on to Boston with him, and so he may very well have been in town.

Mr. Corrigan, if he was involved in any of this, I didn't see him much. I recall him being through on one occasion because of that funeral but I don't recall anything else.

Chairman ST GERMAIN. We will have to check the tape to see, but you were at the meeting, Mr. Volcker, I guess, had a few conversations with Lou Preston. Lou Preston, is he with Morgan Guarantee or Chemical?

Mr. ISAAC. Lou Preston is with Morgan.

Chairman St Germain. I think Mr. Preston is sort of lead man trying to get the participation of the other banks with the FDIC on that $500 million.

Mr. Isaac. Morgan led the safety net group.

Chairman St Germain. And Mr. Volcker between cigar puffs was in contact with Mr. Preston during that meeting. But at that particular meeting the decision was reaffirmed May 10 that there wouldn't be a payout—my information was that that meeting was made rather clear.

Mr. Isaac. What day of the week is that?

Chairman St Germain. Tuesday.

Mr. Isaac. I don't even recall such a meeting on that day because it strikes me that on Tuesday——

Chairman St Germain. It was a 9 o'clock meeting at the Fed.

Mr. Isaac. In the morning?

Chairman St Germain. Yes.

Mr. Isaac. I don't know what the purpose of that was. I think a more important meeting occurred that day in Don Regan's office, Secretary Regan.

Chairman St Germain. Tell us about that one.

Mr. Isaac. I already have in materials submitted, but I will repeat it.

Chairman St Germain. His request was——

Mr. Isaac. It was for the purpose of informing him of the situation and also explaining to him the solution that was proposed. The participants in the meeting as far as I know were Chairman Volcker, Comptroller Conover, myself, Deputy Secretary McNamar, and I am not sure who else, if anybody else.

We explained to the Secretary what the situation was at Continental and what the proposed solution was regarding the FDIC's subordinated debt infusion, the Secretary suggested that, in his judgment, it would be a stronger, more reassuring package if we had private sector participation and, therefore, maybe we ought to trim back the FDIC's involvement from $2 billion to $1½ billion and ask the safety net banks to come in for half a billion dollars. It was agreed that was a good suggestion and that we would carry that out the next day in New York at a meeting.

Chairman St Germain. OK. And then early June was when the Chemical and some other banks came in and looked at Continental to determine whether or not they would be interested in a merger or acquisition, is that accurate?

Mr. Isaac. It may have been early June. I would be surprised if it weren't in late May.

Chairman St Germain. Between June 11 and June 15, the decisions were coming in to you that there were no takers.

Mr. Isaac. I wouldn't state it that way. I think some people said no, we are not interested, period. Others said, oh, we are not interested unless there is enough money in it.

Chairman St Germain. All right. And then June 20 and 22, we have the Shumway memos in response to the June 6 memos and I ask unanimous consent to put them in the record and also unanimous consent to put the June 6 memo in the record.

Without objection, so ordered.

26

June 6, 1984

MEMORANDUM TO: A. David Meadows
Associate Director

FROM: Robert V. Shumway, Director
Division of Bank Supervision

SUBJECT: Continental Illinois

This documents a conversation I had this morning with Chuck Collier. I asked him to obtain the following information about Continental Illinois for the Chairman:

1. Data showing the exposure the downstream correspondent banks had in Continental at about the time the assistance package was put in place. This probably includes, as a minimum, correspondent bank accounts exceeding $100M plus unsecured Fed funds as a percentage of capital. This information is needed by June 11 at the latest.

2. Data showing the structure of the holding company debt and who holds both the holding company debt and holding company preferred stock, if any.

3. Data showing the bank's funding sources and maturity structure at the time of the Penn Square closing and at the time of the assistance package. It has been alleged that Continental either could not or chose not to properly diversify its funding sources after Penn Square.

cc: Mr. Collier

DBS:AMS:GNUnthank:co:6/19/84
cc: Mr. Shumway
Mr. Meadows
Mr. Collier
Mr. D. Cooke
Date File

June 20, 1984

MEMORANDUM TO: Chairman Isaac

FROM: Robert V. Shumway, Director
Division of Bank Supervision

SUBJECT: Exposure of Downstream Correspondent Banks to Continental Illinois

Approximately 2,299 banks had funds invested in Continental as of April 30, 1984. Of these, 976 had funds in excess of $100,000 invested. Included in the funding figures are demand and time balances (both domestic and offshore) due from Continental and unsecured Federal funds sold to Continental. The total of the deposit balances and Federal funds was then calculated as a percentage of the correspondent bank's equity capital accounts as of December 31, 1983. No adjustment was made for FDIC insurance coverage. In all, 66 banks had more than 100% of their capital in funds at Continental and another 113 had between 50% and 100% of their capital in funds at Continental. A recap of the total number of banks, their total assets and the states where located follows.

More than 100% of equity capital invested in Continental:

State	Number of Banks	Total Assets (000 omitted)
Illinois	54	$ 3,835,160
Nine other states	12	978,512
	66	$ 4,813,672

50% to 100% of equity capital invested in Continental:

State	Number of Banks	Total Assets (000 omitted)
Illinois	70	$ 7,879,906
Iowa	11	534,418
Indiana	10	781,810
Wisconsin	10	622,977
Eight other states	12	2,485,740
Total between 50%-100%	113	$12,304,851
GRAND TOTAL	179	$17,118,523

APPENDIX

CMY

DBS/AMS/GNUnthank:cw:co:6/22/84
cc: Mr. Shumway
Mr. Meadows
Mr. Collier
Mr. D. Cooke
Date File

June 22, 1984

MEMORANDUM TO: Chairman Isaac

FROM: Robert V. Shumway, Director
Division of Bank Supervision

SUBJECT: Exposure of Correspondent Banks to Continental Illinois

In response to your request for further information regarding the correspondent banks, the following is offered.

Of the 2,299 banks which had funds invested in Continental as of April 30, 1984, only 976 had total funds in excess of $100,000 invested in the bank. In order to expedite the process, only those 976 banks and their investment or deposit balances were entered into the FDIC computer. This allowed the computer to total the assets of the 976 banks and also to calculate the correspondent bank's exposure to Continental as a percentage of the correspondent bank's equity capital account. It should be noted that the total exposure of the 1,323 banks which were not entered into the computer is estimated at somewhere under $25 million. The following totals relate only to the 976 banks, each of which has a total exposure in excess of $100,000 at Continental; however, these 976 banks represent more than 99% of the funding provided to Continental by correspondent banks as of April 30, 1984.

Total Number of Banks:	976
Total DDA Balances	$ 668,161,000
Total Time Balances	2,925,354,000
Total Unsecured Federal Funds	2,362,660,000
Total Exposure of 976 Banks	5,956,175,000
Total Assets of the 976 Banks	$1,300,542,112,000

Chairman ST GERMAIN. On July 26, the final assistance package was announced and that, I imagine, is a pretty close to accurate scenario, right, of the meetings, et cetera?

Mr. ISAAC. Rather sketchy, but yes.

Chairman ST GERMAIN. If there are a lot of meetings I don't know about, I would love to have you tell me.

Mr. ISAAC. There were a lot of meetings, continuous meetings throughout this period.

Chairman ST GERMAIN. Leading up to the July 26 package. Let me recap the factors in Shumway's memo when he determined that Continental was an essential bank. First, he said Continental had correspondent relationships with hundreds of banks.

Then he said it has significant commercial and industrial loans, loans to other financial institutions, and relationships with exchange.

Third, Continental made a significant role in international and domestic money marks and, fourth, it was a major provider of savings and deposit services in the market area.

Now, does that sound precisely correct, Mr. Isaac?

Mr. ISAAC. You are reading the memo. I have to assume it is.

Chairman ST GERMAIN. I am summarizing his memo and using the points that he used to determine——

Mr. ISAAC. I didn't hear you say anything that was——

Chairman ST GERMAIN. Distressing?

Mr. ISAAC. No.

Chairman ST GERMAIN. OK. Would you say that Citibank is a major provider of correspondent banking service, commercial industrial loans? Is that an accurate statement?

Mr. ISAAC. As far as I know they are.

Chairman ST GERMAIN. And is not Citibank a major participant in international and domestic money markets, and a provider of household and governmental banking services?

Mr. ISAAC. Yes. I think.

Chairman ST GERMAIN. And is Citibank, therefore, not essential under your definition and under the criteria for reaching a finding of essentiality?

Mr. ISAAC. That would depend on the circumstances existing at the time I had to deal with it, God forbid.

Chairman ST GERMAIN. You mean that wouldn't be enough to make a finding of essentiality?

Mr. ISAAC. I think what always enters into a decision as to essentiality is what are your options at the time and what are the conditions in the financial system at the time and how will this affect a lot of other institutions, individuals, and businesses.

Those are all things that weigh in on a decision about essentiality.

Chairman ST GERMAIN. Well, now, let's say that the time was yesterday.

Mr. ISAAC. What was yesterday?

Chairman ST GERMAIN. You asked what the conditions were at the time, so let's use yesterday's conditions.

Mr. ISAAC. You are trying to get me to make an essentiality finding on Citibank and I cannot. First of all, I am not the FDIC Board. I am just a little old member of it.

Chairman ST GERMAIN. Such humility.

Mr. ISAAC. Sometimes you stretch.

Chairman ST GERMAIN. Did you ever work in a garment factory?

Mr. ISAAC. A garment factory?

Chairman ST GERMAIN. Yes.

Mr. ISAAC. I have worked in about every other kind of factory.

Chairman ST GERMAIN. In my part of the country, we had a lot of garment factories and I worked there and they sent me for the sky hook and once they sent me to get the cloth stretcher. When I looked at the Philadelphia resolution, I said, my God, maybe this is a cloth stretcher. Seriously speaking, starting from May 10 to July 26, in that period of time, if the bank involved had been with the same proportionate problems, had been Citibank intead of Continental, wouldn't you have had to make a finding of essentiality?

Mr. ISAAC. I would say, as I did in response to Mr. Patman, if you give me virtually identical facts, I would make the same decisions because I think the decisions that were made—I thought at the time they were correct and I still think they were correct.

Chairman ST GERMAIN. There is a certain inevitability in life as well as at the FDIC. And the inevitability at this point in our history, with the prestatutory requirements and the powers conferred upon you, is that had Citibank been the bank in trouble in May of this year, starting May 10 of this year, given the same nonperforming loans, bad loans, money running out, et cetera, then you would have had to make a finding of essentiality, would you not?

Mr. ISAAC. If you give me virtually identical points——

Chairman ST GERMAIN. Just changing the numbers to comply, so it would be virtually the same facts. Whom are we kidding? It is not the amount. The finding of essentiality, Mr. Isaac, does not take into account or consideration—you need not under essentiality come up with a finding that it is cheaper to keep the thing afloat than it is to do a payout; is that not a fact?

Mr. ISAAC. You do not need to make a cost finding; that is correct.

Chairman ST GERMAIN. Correct. So you keep saying, given the same facts—I am asking you about essentiality.

Mr. ISAAC. And I am telling you that I considered very much, in my own mind, the cost aspects of it.

Chairman ST GERMAIN. But with essentiality you do not need to consider cost aspects.

Mr. ISAAC. I didn't need to——

Chairman ST GERMAIN. You did it because you felt like doing it, but no one asked you to do it and you are not required to do it.

Mr. ISAAC. I feel like I have always got to consider my fiduciary duty to protect that fund.

Chairman ST GERMAIN. But if essentiality is there, you haven't an alternative because the statute governs.

Mr. ISAAC. No; nothing says we have to make an essentiality finding. It says we may. If the cost would have been significantly cheaper to go some other way, then you probably wouldn't make an essentiality finding.

If you had another viable option, and it was cheaper, you wouldn't——

Chairman ST GERMAIN. Given the same facts, except for proportions, you would have to find Citibank essential? Yes—you don't agree?

Mr. ISAAC. I guess the only way to say it is that there was nothing magical about the name Continental. If you had changed the nameplate and put another bank's name in there and the facts were roughly the same, we probably would have reacted in a similar fashion.

But change it to a different time or change the options or change any other material fact and you may not get the same result.

Chairman ST GERMAIN. Therefore, you don't need any legislation, you don't want any changes, so that if Citibank were to end up in the same situation Continental was in, Bank of America, Chase Manhattan, Manufacturers Hanover, J.P. Morgan, Security Pacific, Bankers Trust, First Chicago, Wells Fargo, you don't want any changes whatsoever, you want no legislative or statutory exchanges, no discussions of differentiation in policy, you can handle it? You are going to play semantics?

Mr. ISAAC. I hope that is not what I am conveying. I am sorry if I did.

What I tried to do, what I have spent much of the afternoon talking about, is the necessity of a change in our laws to try to deal with this issue of big bank versus small bank.

Chairman ST GERMAIN. Well, if you want change you have to help those who would assist you in changing. In order to assist us to assist you, we have to be a little forthright here.

Mr. ISAAC. The only thing I have declined to do, Mr. Chairman, is to make what I would consider a mistake by telling you this bank, this bank and this bank are not going to be permitted to fail. I think that would be a mistake for a lot of good reasons and I won't make that mistake.

If you are telling me there is a problem in handling large bank failures and that we ought to be trying to deal with that in a way so that large and small bank failures can be treated in a similar fashion, I couldn't agree more.

Chairman ST GERMAIN. That being the case, I will say that as of the present time, you take the list of the 20 or 30 largest banks in this country—what was the ranking of Continental?

Mr. ISAAC. Eight at the time, I think.

Mr. PATMAN. It started out at six, 2 years ago.

Chairman ST GERMAIN. The fact of the matter is that even at Continental the level is not where we end up. We have to go far beyond that to the list of large banks in this country.

Our exposure at this point in time is rather dramatic and that is why we have to address this problem. That is what I was trying to get from you, Mr. Isaac—the fact that if we don't make some policy decisions, if we don't make what statutory changes are necessary, then we could possibly have some rocky days ahead and we want to avoid that.

Mr. ISAAC. I agree with you, sir. I think we need to make some policy changes. The only thing I didn't want to do was to compound the situation by trying to identify banks.

Chairman ST GERMAIN. I am not trying to identify banks that are in trouble.

Mr. ISAAC. Not banks that are trouble—I don't want——

Chairman ST GERMAIN. I was not implying or inferring in any way, shape, manner or fashion that there were problems with any of these. I was just using them as examples of the fact that we have to address this.

If we don't, we have a lot of biggies out there.

Mr. ISAAC. I didn't want to identify banks by name and say these banks are failproof. That would be a mistake. I don't want to do that.

Chairman ST GERMAIN. In other words, it has gone from $100 million to $500 million, we know that. Penn Square was $500 million?

Mr. ISAAC. If you look at the historical record, the FDIC has never done a deposit payoff in a bank over $500 million in size.

Chairman ST GERMAIN. And that was reasonable in the case of Penn Square?

Mr. ISAAC. Yes. It used to be we had never done it in a bank over $100 million.

Mr. PATMAN. Mr. Chairman, is that not then their policy that they will not do a payout on a bank above $500 million?

Mr. ISAAC. It is not. I am glad you asked so I could clarify that.

Chairman ST GERMAIN. Do you have further questions?

Mr. PATMAN. I would like Mr. Isaac to provide us with his guidelines as to what banks will be subject, based on strictly size, subject to payout and which ones will not, which ones will be subject to merger and which ones will not, which ones will be subject——

Mr. ISAAC. As much as I would like to give the committee some guidance on that, I am afraid I can't. What I can do, Mr. Patman, is send over something that would explain what our policies are.

Mr. PATMAN. Could you provide information that would be useful to the financial markets in relation to which banks will be permitted to fail and which will not?

Mr. ISAAC. I don't think I could tell them anything they haven't already figured out.

Mr. PATMAN. I think they have figured it out all right.

Chairman ST GERMAIN. Mr. Isaac, I think not really for the record, but for the future, since we appear to be drawing the curtain on this wonderful episode at an early hour, I think it would be wonderful if you perhaps had some extra time this evening, if you were to put your thinking cap on, I am sure you have already done it, but to start sharing with us some of your thoughts as to how we should resolve this dilemma, and I say it is a dilemma. I hope that you agree with me on this that it is a dilemma as to where, is it $100 million, $500 million, or can anybody fail?

We have got to address it, we must. So we would be very pleased and grateful and indebted to you if you would share your thoughts with us on this. There is no one little thing that is going to help us. We have a number of things to do.

You know, I am with you—I have made statements to the effect that as far as depositors insurance is concerned, we have to address that problem and I intend to. We shall work on it. Our problem is that it is not all that smooth.

If we thought it was, we would have to put it on a tree or make it a branch of a tree. We will work with you on it.

Mr. ISAAC. Mr. Chairman, you have always been very supportive of the kinds of reforms we are looking for and we appreciate that. I hope this hearing has helped spotlight some of the issues.

Chairman ST GERMAIN. I think the hearing has been very, very productive in that members now have a better grasp of what your problems are and those of your coregulators when it comes to facing a situation such as you have faced in Continental.

They will now have a better understanding of what definitions of essentiality are and how costs are arrived at. I think putting it all together, including the staff report, seriously, is going to be helpful to all of us, and it is something perhaps we should have done before.

It is just that you just can't get around to everything you should be doing. So it has been a very productive hearing, a helpful one. We hope that you are more happy than you were when you arrived. I hope you have enjoyed it. I hope that when you retire to Kentucky 20 years from now you will look back upon this day with fascination.

The subcommittee stands in recess.

[Whereupon, at 5:35 p.m. the subcommittee adjourned, subject to the call of the Chair.]

[The following statements were received by the subcommittee for inclusion in the record:]

39-133 O—84——39

FDIC REFORM IN THE LIGHT OF THE CONTINENTAL ILLINOIS EXPERIENCE:

A STATEMENT OF VIEWS, WITH POLICY RECOMMENDATIONS

by

Albert Gailord Hart
Professor Emeritus of Economics
Columbia University

Draft of 8 September 1984, looking toward hearing of House Banking Committee, 18 September.

Contents

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CONTRESC A.G.Hart 8 September 1984

FDIC REFORM IN THE LIGHT OF THE CONTINENTAL ILLINOIS EXPERIENCE

by

Albert Gailord Hart
Professor Emeritus of Economics, Columbia University

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The House Commitee on Banking shows great wisdom in calling for a review of the Continental Illinois experience at this time. This disconcerting episode highlights pervasive weaknesses in our banking system, and in our system of deposit insurance and bank supervision, and shows the urgency of a reform of FDIC.

Symptoms of bank debility

It is fashionable to picture Continental as "unique" in the banking world. It is true that Continental was unusual in its lack of a network of potentially valuable "retail" branches. But Continental was unusual also in a way that offsets the first--its low exposure (as major banks go) in the problem area of loans to Third World countries.

Many of the weaknesses displayed by Continental are all too likely to be found in other major banks. I would cite in particular:

a) Instability of the deposit base. Instead of relying for funds on a body of "customers" who have a sense of mutual interest with the bank, major banks have come to rely upon faceless money-market sources for 75% to 90% of their funds. Was Continental's 90% reliance that much more of a weakness than 80% at some other bank?

b) Setting "profit targets", for the various divisions of the bank, which can be reached only by continuous favorable outcomes from risky placements of funds.

c) "Aggressiveness" in seeking loan opportunities.

d) Undue reliance on the judgment of others (often of people with a vested interest in acceptance of the loan, and without adequate documentation) as to the quality of loans. The prevalence in recent years of loan syndications suggests that other banks have probably placed large amounts with the same borrowers with whom Continental has had trouble.

e) Lack of reliable internal signaling mechanisms to flag weak spots in the portfolio for special attention. It is ominous that Continental seems to have treated junior officers who pointed out such weak spots as obnoxious "whistle-blowers" rather than as guardians of the bank.

As Chairman St. Germain remarked in a recent interview, in case of another challenge to a major bank, "the next step you'll see is the FDIC coming to Congress in order to boost its reserves." In view of the above symptoms, and also of the untenability of the position of many overseas debtors whose loans are on the books of major banks, it would be very imprudent to rest public policy on the assumption that no other major banks will be challenged in the visible future.

Shortcomings of FDIC and Federal Reserve responses

The way in which FDIC and the Federal Reserve have handled the Continental Illinois "rescue" unfortunately confirms the suspicion that we have at present no good way to handle a crisis at a large bank. In particular:

o The supervisors as much as tell us that they cannot spot dangerous weaknesses in bank assets in time to set a merger proposal in motion before the situation becomes critical.

Besides, the inducements FDIC can offer a merger partner hinge on FDIC's absorption at face value of doubtful assets. And FDIC neither possesses nor should possess authority to absorb such assets from banks which still function as going concerns. Thus merger-in-advance is not an available option for FDIC policy.

- To throw a major bank into receivership (letting holders of uninsured deposits wait for the payoff the bank's assets will ultimately yield) can produce serious disruption in the economy. Would-be borrowers must start over with loan negotiations at some other bank. Employees, suppliers and creditors of these would-be borrowers, as well as of the holders of frozen uninsured deposits, may be crippled by failure to realize receipts on which they had counted.

  Accordingly, we must I think agree that FDIC was right to make a strenuous effort to avert closure-and-payout at Continental, and should continue to avoid this "solution" if further major banks are challenged.

- A last-minute merger (such as was attempted for Continental) must be expected to fail in the case of any challenged large bank, because:

  - even after absorption of bad assets by FDIC, the amount of new capital that must be injected to give the combined bank a decent capital/liaties ratio is more than the potential acquiring bank can mobilize on short notice; and

  - if the potential acquiring bank did have access to such an amount of capital, there would be safer and more profitable uses for it.

- If as with Continental a bank closing is averted by guaranteeing all depositors large and small, and injecting FDIC capital (in a position senior to the equity of original stockholders but junior to all deposits), the bank is essentially nationalized. It cannot then be put back into the private sector without somehow bribing private parties to accept it.

- Federal Reserve involvement makes it hard to avoid a general easing of commercial bank reserve positions (whether or not this is desirable in the economic situation), and engages the Federal Reserve in long-term financing guaranteed by FDIC -- essentially, a siphoning across of Fed funds to reduce the apparent amount of FDIC commitment.

We must conclude that to avoid both economic disruption and perhaps irreversible nationalization, FDIC needs a revision both of its powers and its mandate for dealing with challenges to large banks.

Dangers of delay in FDIC reform

Unless the powers and mandate of FDIC are reformed before the next serious challenge to a major bank, it is all too likely that we will find ourselves committed to full US guarantee of all deposits large and small. It is ominous that when the Continental situation became acute, the authorities apparently pulled out of a desk drawer a predesigned arrangement ("needing only to have a few blanks filled in") which included such a guarantee for the bank affected. We must presume that this predesign was not laid out without serious thought, and represented the best arrangement the authorities saw as feasible under the existing powers and mandate.

If some other major bank comes under challenge and the same treatment is applied, the public's expectations will be shaped in such a way that nobody would dare propose refusal of a guarantee thereafter. The authorities made a great effort to persuade the public that the guarantee in the case of Continental was a special arrangement to fit the "unique" situation. Such an assertion will scarcely work a second time-- particularly if no steps have been taken to provide an alternative procedure for later use.

Risk-exposure of large depositors as an element in "market discipline"

When federal deposit insurance was first enacted, in the New Deal period, skeptics expressed fears that imprudent banking practices would be freed from market discipline because depositors insured against loss would feel no need to move funds away from a bank that was imprudently managed. This worry was discounted on the ground that only small depositors were given full protection, while the bulk of deposits were in the uninsured portion of large accounts. Since it would be large rather than small depositors who had access to information that would reveal imprudent management of a bank, it was argued, this incentive for prudent management would not really be impaired.

An explicit or implicit full guarantee of large deposits plainly cancels out the argument just stated. It is true, of course, that in the Continental case top management and stockholders have suffered heavily, so that the precedent of Continental does not entirely wipe out penalties for imprudence. On the other hand, the banking authorities have gone to great lengths to further a cover-up of imprudence at large commercial banks-- especially of imprudent lending to Third World debtors. Debt service has been "paid" chiefly by arranging purportedly new loans for the purpose. In substance, banks have been encouraged to treat as "current income" sums which (if they are *ever* paid) will be paid *after* the previously-outstanding principal is settled-- and then probably in dollars eroded by intervening inflation. The authorities have even promised publicly (and in disregard of their legal mandate) that overseas loans will not be "critized" at banks which comply with IMF urgings to increase overseas exposure. The International Lending Supervision Act enacted by the Congress in November 1983 has up to now been effectively nullified.

The sort of imprudence represented by the shaky overseas loans is costly to society, and could have been obviated if bankers had faced their responsibilities. Banks have a major role in the capital market-- sifting loan applications, eliminating those which are unsound, and making short-term placements of capital where it will be most productive. Incidentally, sound banking not only protects those who provide funds to the bank, but also protects borrowers against walking into a trap. A loan applicant is supposed to be warned off in case the proposed use of loan proceeds is unlikely to enhance his earning power enough to pay off the loan and leave him better off than if he had not borrowed.

The capital poured into Third World countries by our bankers would have been much more productive if used elsewhere in the world, where productive opportunities were richer-- or if guided into neglected productive uses in the borrowing countries. Our bankers turned off their lending skills whenever the loan applicant was a "sovereign". In consequence capital was wasted on an enormous scale in overseas financing of:

- facilities that could not be effectively used for lack of markets, of trained manpower, or of materials;

- overpricing of new facilities;

- balance-of-payments deficits that reflected inadequate adjustment to the oil shocks, failures of agricultural policy and the like;

- fiscal deficits that reflected failure to tax rich Third World citizens who had enormous ability to pay;

- capital exports by Third World citizens who preferred acquisition of assets in the industrial world to investment in their own countries; and even

- provision of funds so placed in the Third World economy in question as to be accessible for looting by officials engaged in feathering their personal nests.

The damage was compounded by using bank loans (purporting to be of short or medium term) to finance projects which if worth while should have been financed on long term. [This last complaint lies also against many intra-US loans.]

In its 1983 report entitled DEPOSIT INSURANCE IN A CHANGING WORLD, FDIC argues that discipline through vigilance of large depositors could be replaced by requiring banks to meet a stiff requirement (10%?) for the ratio of capital to unsubordinated liabilities, using long-term subordinated debt to supplement stockholder equity. With such a safeguard, it was argued, incentives for prudent management could be intensified even with a full guarantee of large deposits, through the vigilance of those to whom the subordinated-debt securities must be sold. But it is hard to believe the banking authorities would have the fortitude to enforce a sufficiently large and rapid expansion of bank capital -- let alone to put meaning into it by forcing banks to squeeze the water out of their overvalued assets.

Reliance for discipline on the vigilance of large depositors exposed to risk has major advantages. In the first place, the needed risk-exposure is already provided by the deposit-insurance ceiling. And in the second place, the large depositors in any given bank are to a considerable extent other banks, and thus particularly well equipped to evaluate the bank's pattern of operations. Under the subordinated-debt pattern, on the other hand, the added capital would have to come from non-bankers unless (over the banking system as a whole) this capital were to be fictitious, with interbank debt pretending to be bank capital.

Unless large depositors are at risk, furthermore, the outcome of any challenge to a major bank (as with Continental) is likely to be that there is no way to keep the bank in operation without putting it into public ownership. Perhaps there are political systems under which public-sector banks will be fully responsive to market discipline; but if there are, the US system is not one of them. If any substantial part of the US banking system were nationalized, the temptation to call upon banks for grants-disguised-as-loans would be irresistible.

> [Incidentally, the combination of nationalized banking with a balanced-budget amendment would be really poisonous: to use the banks as a way to get expenditures off budget would render the budget entirely meaningless!]

Inadequacy of proposals for "risk-related FDIC premiums"

I agree with the proponents of "risk-related" premiums for deposit insurance that it would be appropriate to revise the premium structure so as to reflect the intensity of the risks which different patterns of banking impose on FDIC. But I do not see how such a change in premium-structure can have any strong effect on banking practice, for a very simple reason: the cost represented by such premiums is so trifling in relation to total costs of lending that premium-differentials will have only a barely-perceptible effect on incentives for choosing patterns of bank operation.

This pessimistic opinion would have to be revised if the premium-rates charged were enormously increased. They would then take on the characteristics of a p e n a l t y t a x on various types of operation. For example, a case could be made for imposing a substantial penalty (perhaps of the order of 2% or 3% per annum) upon the use of funding from "faceless" and thus presumptively unstable sources, with much lower premiums upon deposits from "customers" who have continuing and many-sided relationships with the bank. The resulting differential in interest rates could induce large depositors to choose banks where they would be steady customers, and stabilize their balances at those banks.

It would be more straight-forward, however, to apply such penalties through the structure of reserve requirements (continuing as at present to pay zero interest upon reserve deposits). Today, the reserve-requirement structure actually discriminates in favor of destabilizing types of bank liability. But this is not the result of some immutable law of nature, but of policy decisions (legislative and administrative) about reserve requirements, and these requirements could be restructured.

It is generally accepted that the effect of reserve requirements is essentially that of a tax (levied upon banks but presumably large shifted to users of banks) equal to interest on the potential lending power represented by the reserves. There is some tendency to think of such a tax as inherently evil. But there is a solid "principle of economics" to the effect that a tax helps the market structure reflect social costs and benefits when the object of the tax (like pollution) is one that carries "adverse externalities". Clearly, such adverse externalities attach to forms of fund-holding that destabilize the banking system, so that a differential tax would be appropriate. Conceivably the public or the regulatory agencies will perversely refuse to impose such a tax in the form of a reserve requirement but be willing to impose it in the form of an insurance premium. Only in this case would I be willing to recommend FDIC-premium differentials strong enough really to affect banking operations.

My proposals for policy changes

I propose that the powers and mandate of FDIC should be changed so as to fulfil the following purposes in case of chalgenges to major banks:

- o Maintain continuity in the flow of inter-customer payments and in bank lending.
- o Maintain the vigilance of holders of claims upon a bank to enforce prudent banking through market discipline.
- o Provide an automatic mechanism to keep challenged banks in the private sector, avoiding "socialization of losses" and the temptation to politicize the placement of bank funds.

To fulfil these objectives, and to clean up the risky situation where hundreds of billions of claims not now regarded as part of the money supply can be instantly monetized at the will of the holders, it is desirable also to reform the structure of reserve requirements and the rules applying to quasi-banking institutions. But to keep a sharp focus on FDIC, I leave these problems aside.

The main changes I would urge in the system of deposit insurance are as follows:

a) As suggested recently by Chairman St. Germain, reduce the deposit-insurance ceiling from $100,000 to a figure such as $40,000. This will probably solve the problem of "brokered deposits" over which FDIC is understandably so worried, and will increase the cushion of uninsured deposits which is available to protect FDIC from "socializing losses".

b) Authorize and direct FDIC to intervene when large banks are challenged by imposing a c o n s e r v a t o r s h i p rather than by promoting a merger or throwing the challenged bank into receivership. The role of conservator should be assigned to experienced bankers of the calibre of those invited to take over Continental.

c) Authorize and direct the conservator to proceed as follows:

- Keep continuously available all insured deposits, but freeze a sufficient proportion of uninsured deposits to assure that FDIC will not become the effective owner of the bank.

- Follow through on pending loan applications and on new applications from established customers. [It might be desirable to rule out needless loan extensions for such purposes as corporate mergers, "leveraged buyouts", and "greenmail".]

- To minimize financial disruption, grant uninsured depositors an automatic line of credit (like that many individuals have in connection with "no-bounce" checking accounts) up the amount of their uninsured transaction-account balances.

- Transform into preferred stock the frozen uninsured deposits.

It will be noted that this design will not induce panic among large depositors as would a threat to throw all challenged major banks into receivership. The large depositor is exposed to an inconvenience, but not to a catastrophe. He may find that part of his claim gets transformed into preferred stock, but not that it will be wiped out.

I would claim as a major advantage of this design the fact that it would protect prudently-managed banks against being wiped off the map by mere adverse rumors. The conservatorship will maintain the ability of the bank to take care of its steady customers. It will not be necessary to sell off the bank's assets suddenly at distress prices. Thus going-concern value can be preserved. If under the conservatorship it turns out that in fact the bank's assets were not over-valued, the preferred stock can be paid off, and the original owners are back in business at the old stand. If the bank's assets have been so far overvalued that the common-stock equity goes negative or turns out to be grossly inadequate, the preferred stockholders become the effective owners. In either case, a functioning bank remains in the private sector.

Emergency versus deferred legislation

If it were feasible, a good time to put in place legislation for FDIC reform along the lines I suggest would be today. But if wishes were horses, we would have a terrific over-supply of riding animals! While I would contend that my proposals above would provide considerable security if enacted immediately, there can be no pretense that to formulate such proposals for a hearing is the same thing as to offer a matured legislative draft ready for enactment. Allowance must be made for the jammed legislative calendar, for the need to give skeptics who share authority time to feel their way into unfamiliar proposals, and for the danger that to get up steam for very quick action it might prove unavoidable to use scare tactics which could be damaging in themselves.

I would urge that to put in form for enactment a "failsafe" system of the sort I am recommending is a much more urgent task than (for instance) to continue the wrangle as to whether banks should be empowered to be active in the insurance business. I infer that your Committee would do well to assign enough staff talent to this problem to get on top of it in a matter of weeks, and that members of the Committee would do well to study the problem to the point where they could rapidly evaluate staff reports if the problem became acute. But its place on the Committee's agenda for active work should in my judgment be the opening of the 1985 Congressional session-- now only about 100 days away.

It is not impossible that challenges to major US banks could erupt suddenly. There may well be financial fireworks when the military regime in Brazil is succeeded by a civilian government a few weeks hence. US financial markets (and the world market for the US dollar) are jumpy, and may take a course that can intensify the over-indebtedness of a number of important corporate debtors within the United States. If the adjourned crisis of the savings industry again becomes acute, as seems fairly likely, troubles may spread to banks. In case of any such development during the next few months, ability of your Committee to announce well-developed plans for dealing with deposit insurance may be needed to protect against a financial panic.

The most recent major items of financial news are somewhat reassuring. In particular, the announcement that Mexico is arriving at a compromise with the banks (entailing extension of maturities, a long grace period and graduated schedule of principal payments for the greater part of Mexican debts) promises at least a breathing spell. The Argentine authorities also have been talking as if they aimed to avoid any breach of relations with creditor banks.

We must remember, however, that the willingness and ability of overseas debtors to accept agreements that come anywhere near saftisfying the US bankers are not unconditional. If we get into a fresh process of rapid inflation w i t h o u t any sharp rise in nominal interest rates, of course, the real value of these debts will be eroded, and they will cease to be enormous relative to the debtors' resources. [That is, we will be retrospectively turning purported loans into grants!]

But if we avoid substantial inflation, debtors will be able to live with the revised contracts only if the floating rates they are agreeing to turn out to be much lower than present or recent rates. Such an improvement of interest rates will hinge on rapid and substantial improvement of the US fiscal position. Failing this, debtors will be in deep trouble again unless their interest charges can be capped well below LIBOR-- which will entail great pain for US creditor banks.

As has been pointed out by numerous authoritative critics (notably by Mr. George Champion), our banks have for years been eroded by imprudent practices, and their real position disguised by "creative accounting". Given this situation, the general overindebtedness of US corporations and holders of real estate, and the still-rickety external loans, we need a major effort to restore soundness to our debt structure in general and to banks in particular. Moderating the risks of this adjustment (which is already overdue and should surely be taken as a major national effort starting in 1985) requires early installation of a fail-safe structure for deposit insurance.

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William N. Lane III
Chairman
President

October 19, 1984

The Honorable Fernand J. St Germain
Chairman
Subcommittee on Financial Institutions
Supervision, Regulation and Insurance
Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

I have been following with great interest the recent deliberations of your Subcommittee with respect to the Continental Illinois Bank rescue. I strongly believe that the manner in which the Continental Illinois rescue was implemented by the FDIC combined with the statements of the Comptroller of the Currency and the FDIC Chairman before your Subcommittee have caused a significant competitive imbalance between money center banks and smaller banks with respect to their ability to attract and keep deposits over $100,000. The over $100,000 deposit customer now believes his or her account is fully protected by the U.S. Government if the account is maintained in a money center bank, but that it is not so protected if the account is maintained in a smaller bank. The development of this competitive imbalance is of great concern to the Lane banking group.

We have prepared the enclosed statement urging appropriate changes in the deposit insurance system to alleviate this current unfairness. I respectfully request that the statement be made a part of the Subcommittee's record regarding Continental Illinois.

Sincerely,

William N. Lane, III
Chairman of the Board

STATEMENT OF THE LANE BANKS
SUBMITTED TO
THE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION AND INSURANCE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES

October 19, 1984

This statement is presented on behalf of the Lane Banking Group located in Chicago, Illinois which consists of four medium size banks with total assets in excess of $1.5 billion. It is intended to present a new perspective with respect to some of the issues raised in the current hearings by the Subcommittee regarding the Continental Illinois Bank, particularly as such issues relate to the present disparity of treatment under Federal policies and regulations between small to mid-size banks compared to large money center institutions.

We respectfully submit that the disparity in regulatory treatment between the small to mid-size banks and large money center banks already noted in this hearing should be examined in the light of the following factors:

(1) The manner in which the Continental Illinois "rescue" was handled (i.e., protecting all depositors and general creditors), combined with the statements of the Comptroller and the FDIC Chairman before the Subcommittee, have convinced the market place that deposits, no matter how

large, in a money center bank are backed by the full faith and credit of the United States and thus in fact have *de facto* unlimited Federal Deposit Insurance.

(2) Mid-size banks, such as the Lane Banks, compete with money center banks for commerical loan business and large depositors in metropolitan market areas such as Chicago. There is absolutely no way that a small to mid-size bank, no matter how good its management, nor how large its capital, can compete for deposits over $100,000 on a equal basis with those large banks unless there are some significant changes made in the deposit insurance system that will convince the market place that deposits can be safely maintained at the small to mid-size bank with a reasonable level of Federal protection.

(3) Since money center banks now have all deposits insured, all other banks are at a competitive pricing disadvantage for the over $100,000 depositor. The over $100,000 depositor is sophisticated and will insist on being compensated for the higher risk he assumes placing his deposit in other than a money center bank because of the lack of equal insurance.

(4) A potential solution to the "disparity issue" between large and mid-size banks competing for deposits is deposit insurance reform including an increase in coverage.

Fair and even handed banking legislation should take into account the inequities noted above.

The Comptroller in his prepared statement before the

Subcommittee pointed out that most U.S. banks weathered the economic difficulities of recent years with impressive results, although he acknowledged that all banks have felt the impact of economic factors in the deregulated era. He further pointed out that bad loans and loan losses in the commercial area were rising faster at the large banks than they were at the medium size regional banks. This is a tribute to the type of prudent banking found in the majority of mid-size banks.

Despite this relatively good performance by the regional banks, these banks are losing their ability to compete with money center banks to attract new over $100,000 deposit customers or even retain customers they have served for years due to the current disparity in deposit insurance protection. In his testimony before the Subcommittee, FDIC Chairman Isaac recognized this disparity between the protection of depositors in different size banks. We strongly concur with his observation.

The over $100,000 depositor or potential depositor in a small to mid-size bank, whether an individual, or small or medium size corporation, must pause and consider the prudence of a large deposit in other than a money center bank. This is particularly true wherever there may be a fiduciary duty involved. Why should the deposit insurance system be administered in a way that adversely affects the well run small to mid-size bank vis-a-vis the money center bank? We are particularly concerned that the Congress

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and the FDIC may fail to take appropriate action soon, and consequently the small to mid-size bank will be severely handicapped in its ability to grow and meet the lending needs of its customers and community.

In view of the "disparity issue" and the competitive problem faced by small to mid-size banks competing for depositors of over $100,000, we urge the Subcommittee to consider the concept, which has received little, if any, public discussion, of increasing the ceiling on FDIC insurance at banks of all sizes. For example, if the deposit insurance limit for each account was raised to one million dollars, this would give many large depositors in smaller banks protection equivalent to the deposit protection they would receive in a money center bank.

The net increase in the risk exposure to the FDIC fund from such extended coverage would not be nearly as great as it might first appear since, without such extended coverage, there will be substantial transfers of large deposits from mid-size to large banks where there is *de facto* unlimited insurance and thus the increase in risk to the FDIC fund will occur anyway. Also, a one million dollar FDIC protection would give market discipline a chance to work, if it is going to, for the small to mid-size bank with respect to attracting deposits over that amount. In addition, the increased cost, if any, to the FDIC fund of this change could be minimized or eliminated by the use of risk related premiums.

We recognize that the poorly run bank that has abused interest rate deregulation, prudent lending standards and the current $100,000 insurance level through brokered deposits might find it easier to continue to abuse the insurance system if the coverage is extended. One answer to this abuse is risk related premiums and the additional enforcement tools requested by the FDIC which would help bring increased regulatory effectiveness and additional competitive fairness to the system.

With respect to the suggestion of increased capital that has come forth from these congressional hearings, it should be noted that increased capital does not deal with the disparity created by full and complete deposit insurance protection for depositors in money center banks compared to the $100,000 limit for other banks. The large depositor, regardless of new capital requirements and regardless of the amount of subordinated debt in a mid-size bank, would still decide not to take a chance on the small to mid-size bank when unlimited coverage is available at the money center bank.

In addition, this new capital requirement would add another severe layer of unfairness. Small to mid-size banks do not have the same access to the capital markets enjoyed by the larger banks. They would have a much more difficult and costly time selling subordinated debt. It also would appear that additional capital requirements address a symptom and not the problem of abused prudent lending standards and mismanagement found in poorly run banks. Again, it is suggested that the solution to the problem of the above noted abuses would be uniform increased regulatory effectiveness and more competitive fairness within the system. For the above reasons, we strongly oppose increased capital as a suggested solution.

In conclusion, we urge the Congress and the FDIC to eliminate the current disparity so that the small to mid-size bank will be able to compete and grow, serving its customers and community.

Thank you for the opportunity to present this statment. I would welcome the chance to expand on the statement if the Subcommittee should think it desirable.

WILLIAM N. LANE, III
Chairman of the Board

Lake View Trust & Savings Bank
Northwest National Bank of Chicago
Northbrook Trust & Savings Bank
Pioneer Bank & Trust Company

UNITED STATES GENERAL ACCOUNTING OFFICE

Washington, D.C.

FOR RELEASE

December 14, 1984

STATEMENT FOR THE RECORD

BY THE

COMPTROLLER GENERAL OF THE

UNITED STATES

SUBMITTED TO THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS SUPERVISION, REGULATION AND INSURANCE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

UNITED STATES HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Committee:

I am pleased to present our views on the recent federal rescue of the Continental Illinois National Bank and Trust Company. The General Accounting Office has performed evaluations of federal regulatory oversight of the financial services industry for the past 10 years. As a result we have followed the Continental Illinois development with great interest.

The financial services industry is changing very rapidly. Much of the work that we plan to undertake in the financial institutions and markets area during the next 4 years is designed to assist the Congress in sorting out the implications of the bewildering number of industry developments for the future stability of our financial system. We also hope to contribute to deliberations over the design of alternative regulatory structures and approaches that will better cope with today's financial services industry environment.

My statement is comprised of two parts. I will first compare the way federal regulators handled the near failure of Continental Illinois with the handling of certain of the major federal rescues of nonfinancial organizations during the 1970s. In the second part of my statement, I will discuss the important questions that the bank's rescue raises about the future of our system of deposit insurance, bank regulation and supervision.

COMPARISON OF CONTINENTAL'S HANDLING WITH THE LARGE NONFINANCIAL CORPORATE AND MUNICIPAL RESCUES OF THE 1970s

There has been much discussion in the public press about the lack of opportunity for congressional involvement in decisions associated with the federal rescue of the Continental Illinois National Bank. Continental's handling has been contrasted with the Chrysler situation and certain of the other financial rescues of the 1970s. It has been noted that Chrysler was provided financial assistance only after intense congressional scrutiny and debate. This may be contrasted with discussions indicating that the Continental Illinois rescue was done behind closed doors by the bank regulators.

In March of this year GAO issued a report entitled "Guidelines For Rescuing Large Failing Firms and Municipalities."[1] This report provided the Congress with guidance that should be

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1/ Guidelines for Rescuing Large Failing Firms and Municipalities (GAO/GGD-84-34, March 29, 1984).

considered if the need arises in the future to assist a major failing nonfinancial firm or municipality. These guidelines were developed on the basis of past GAO experience as a member of the boards administering the Chrysler and Conrail programs and as an oversight agency of the Congress in the New York City and Lockheed programs.

The Chrysler, Conrail, New York City and Lockheed programs were all handled on an ad hoc basis. Each program evolved somewhat differently because of the peculiarities of each situation. The purpose of our work was to learn what we could from these experiences and provide the Congress with guidance that would help assure that any future rescues of this sort took advantage of our past experience.

In contrast, for bank crises, an established system for performing financial rescues has existed for many years and has been used extensively in the past. This system includes the lender of last resort role played by the Federal Reserve. It also includes an industry financed deposit insurance fund which, through various means, attempts to minimize the adverse effects of bank failures or near failures.

The guidelines contained in our report may be broadly divided into two areas.

--First, they describe considerations to weigh in assessing the nature of the situation, reaching conclusions about whether a rescue will serve the national interest, and how the rescue package should be structured.

--Second, the guidelines specify ways in which the elements of the rescue package should help assure that (1) risks are shared between the federal government and the assisted organization, (2) the program is properly overseen, (3) the government's financial interest in the firm is adequately secured, and (4) the government is adequately compensated for the risks that it assumes.

I would like to explore how the Continental Illinois rescue relates to those two categories of guidelines.

GENERAL DECISIONS ABOUT THE RESCUE

In the cases we reviewed in our report, there was extensive congressional involvement in deciding whether to provide financial assistance for the rescue and, if so, designing the broad elements of the rescue package. In Continental's case, congressional involvement in deciding the bank's fate was impractical at the time of the crisis. Immediate action had to be taken to arrest the run-off of deposits from the institution. Otherwise, the bank would have collapsed quickly. It was also believed that the potential cost of not responding rapidly was a broader financial crisis whose dimensions and duration were uncertain. Though the spillover effects were not precisely known, those making the decisions did not want to find out what the actual effects might have been.

This same type of quick response is not necessarily required in the case of a failing nonfinancial organization. For example, in Chrysler's case, two months of congressional deliberation and debate followed the initial proposal to save the corporation. The predominant reason for the difference in the speed of the required response lies in the behavior of creditors in the two cases. Chrysler's creditors faced the difficult choice between calling delinquent loans (taking their chances on being made whole in a bankruptcy court), or fore-bearing on Chrysler's overdue debt in the hope that the situation would improve. They chose to carry the corporation through an uncertain period. Furthermore, creditors are not as crucial to the funding of a large manufacturing corporation as they are to banking. In Continental's case "creditors," who are the lifeblood of a banking institution's funding, had a much easier choice. Depositors could simply withdraw their funds and put them in a safer place. Holders of the bank's short-term debt could simply fail to roll the paper over when it matured. And, in Continental's case virtually all debt was very short-term in nature. Thus, Continental's depositors and creditors had no incentive to continue their relationship with the bank when uncertainty arose over its soundness. And they could eliminate their relationship with the bank quickly.

In addition to this fundamental difference, the repercussions of a major banking collapse can differ from those that would have resulted from some of the situations we reviewed in our report. In Chrysler's as well as Lockheed's case it was believed that repercussions would spread beyond the company and were of sufficient magnitude to warrant federal aid. But those effects were fairly predictable and bounded in their duration and magnitude. On the other hand, in New York City's case repercussions from its financial collapse were believed to be potentially very widespread but not entirely certain. Uncertainty over the spillover consequences were one of the major reasons for the provision of aid to the city, first by the state of New York and later by the federal government.

Like the New York City case, responsible officials believed that the cost of not acting quickly in Continental's case was a potential rapid spread of the crisis to other financial institutions. This could have occurred either through direct transmission of financial effects as a result of interbank relationships or through a general deterioration of confidence in the banking system. It is not possible to determine whether a Continental collapse would have had repercussions that would have stabilized or become explosive.

The need for immediate action to address Continental's problems does not mean that decisions about the nature of the problem, its national interest implications, and the appropriate design of the rescue package were not made at all. As I indicated, 50 years ago the Congress created a system that delegates responsibility for making these determinations to the bank regulatory agencies.

PROTECTING THE GOVERNMENT'S FINANCIAL INTEREST

Next, let me turn to a comparison of how well the elements of the Continental rescue conform with our report's guidance on steps that need to be taken to protect the government's interest.

Risk Sharing

In our report we suggest that concessions should be sought from any group with a direct or indirect financial interest in the survival of the benefiting organization. These concessions should result in a public/private sector sharing of risk and financing, provide for a reasonably fair allocation of sacrifice, and also create a set of incentives on the part of participants to help assure the success of the program.

In Chrysler's case concessions were sought and obtained from employees, creditors, stockholders, management, suppliers, state and local governments, dealerships and foreign governments. These concessions served two purposes. First, those from employees and suppliers and, to some extent, from creditors were sought to signficantly reduce the company's cost of operations and lower its breakeven point. The other concessions were intended to provide additional sources of badly needed financing. In Continental's case, excessive operating costs were not the problem. Thus, cost restructuring was not the solution and concessions from employees and suppliers would have been inconsequential and time consuming to obtain. Furthermore, there was not so much a need for new money financing at the time of the crisis as there was a need to stabilize existing normal funding sources. And, in order to accomplish this objective it was necessary to guarantee the safety of uninsured depositor and general creditor funding. Concessions from these funding sources were out of the question given the choices they had for protecting the safety of their funds. Even with the guarantee, not all funding sources returned to the bank. In this regard, there is some question whether the FDIC could have better communicated its intentions to guarantee the safety of funding, particularly to the bond rating services. After the statements were made regarding federal backing of the bank, the holding company's credit rating was downgraded. This development may have deterred some institutional investors from returning to the bank. One major rating service upgraded the holding company's credit ratings on November 13.

Stockholders of the bank were required to make concessions. Moreover, unlike the situations we reviewed in our report, Continental's stockholders may ultimately lose their entire existing investment even if the the bank survives. In Chrysler's and Lockheed's case no dividends were paid while federal financial assistance was provided, but the ultimate value of existing equity participation was dependent on the success of the program. In creating Conrail, there were no federal stipulations requiring concessions by stockholders of the bankrupt railroads.

While Continental's stockholders' current investment may eventually be worthless, several points are worth noting.

--During the week following the beginning of the deposit run-off, the bank's stock traded at prices that were not drastically below those existing when the run began. Therefore, there was an opportunity for stockholders to liquidate their investment without incurring enormous losses relative to prices that existed when the bank's position deteriorated in the spring. And, based on the volume of trading in the week following the beginning of the run, some of Continental's stockholders clearly chose to liquidate their positions.

--Current shareholders have the opportunity to participate in the potential success of the program by providing up to $240 million of new capital. This opportunity is not unusual in regulator supervised assistance packages to failing banks. Stockholders are frequently asked to provide new capital as a condition for keeping a troubled bank open.

--Though Continental was technically solvent at the time of the rescue, it was treated in much the same way as insolvent banks have been treated in the past. The handling of insolvent banks is far more analogous to a corporate liquidation than a reorganization under the bankruptcy laws. In a reorganization, debt is restructured, certain assets may be sold to raise cash, and certain other agreements may be reached to reduce costs and improve the financial viability of the firm. In banking, opportunities for cost or financial restructuring do not exist to the extent they do for nonfinancial corporations. And, like a corporate liquidation, equity owners of a bank stand behind all other parties with claims on the organization and they generally do not recoup their investment. In Continental's case we have the mixed result in which the bank was not actually liquidated but stockholders may ultimately lose their entire investment. Short of a means of handling insolvent banks that more closely resembles a Chapter 11 bankruptcy reorganization, it is unclear how bank stockholders could be treated any differently in future crisis situations.

Program Oversight

Our guidelines call for submission of forward-looking plans by the organization as well as government approval of major new contracts. The purpose of these guidelines is to impose on management the discipline of setting realistic goals and making explicit all assumptions about achieving viability. If plans are realistic, they provide a basis for tracking progress. The report's guidelines also call for avoidance by the government in the day-to-day management of the organization.

The terms of the Continental rescue package largely conform with this requirement. The bank must develop plans to restructure itself through a liquidation of assets on a scheduled basis. The Federal Reserve is to monitor progress toward achievement of semi-annual targeted asset levels. In addition, the holding company must inform the Federal Reserve of any proposals to acquire assets representing more than 5 percent of its total capital. The FDIC has indicated that it does not intend to become involved in the day-to-day management of the bank though it did reserve the right to replace certain members of the Board of Directors. On December 3, Continental announced that 9 of its current 14 non-employee directors (all of whom were elected prior to 1980) will not stand for re-election at the Bank's annual meeting next April. This action was said to be requested by the FDIC. Two of the other outside directors will have resigned before that time.

Collateral and Security Interest

Our report's guidelines call for assuring that the government's financial interest is secure through adequate collateralization of its investment and subordination of all other claims to the government's.

Since the permanent assistance package provides that the FDIC and Federal Reserve stand ready to provide whatever support is necessary to maintain the viability of the bank should the steps taken to date prove insufficient, the question of the government's standing in the event of a liquidation may be largely irrelevant. The question is really one of the size of the government's commitment. That commitment will depend on the amount of liquidation proceeds from the loans that the FDIC acquired in exchange for its investment of $4.5 billion and the proceeds from a sale of 200 million shares of Continental Illinois common stock potentially available to the FDIC. At this time it is not possible to be certain that this arrangement adequately secures the government's investment. This is similar to the Chrysler situation in which there was never a certainty that the company's pledged assets were sufficient to secure the government's $1.2 billion exposure in the event the company failed.

The above considerations notwithstanding, it is important to point out that the FDIC expects to take "losses" on bank failures. Indeed, this is the purpose of the industry financed insurance fund that is administered by the federal government. If there were never an expectation of losses from payouts on bank failures, there would be reason to question the need for the insurance fund.

There is reason to be concerned over the standing of the general creditors of the bank's holding company that resulted from the design of the rescue. Apparently, in this specific case, federal regulators were left little choice but to infuse assistance through the holding company. This had the effect of placing the holding company's general creditors in a senior position relative to the government with respect to claims on assets. The protective covenants associated with holding company debt prevented a restructuring of the bank's capital. Furthermore, much of the holding company's debt was in the form of bearer bonds. It would therefore have been infeasible to promptly obtain debt holder approval for a financial restructuring of the bank. It is not clear how we can insure that this result does not occur in the future.

Risk Compensation

The federal government should require compensation for the risk that it assumes in large scale financial rescues. Our guidelines suggest that risk compensation should create incentives on the part of program beneficiaries to return to financial health as quickly as possible but not be so onerous that it undermines the chances of survival. We also suggest that this compensation should provide for government participation in the financial success of the borrower.

Unlike the Chrysler, New York City, and Lockheed programs, there are no fees accruing to the government from the FDIC

$4.5 billion combination loan and preferred stock purchase. On the other hand, the Federal Reserve's continuing liquidity support does carry a penalty rate of sorts amounting to nearly 3 percentage points over the discount rate. The package's provisions also provide for federal participation in the potential success of the bank. In much the same way as stock warrants allowed the government to participate in Chrysler's recovery, the equity participation of the government in the bank provides similar potential opportunities.

CONCLUSIONS FROM THE COMPARISION

My overall conclusion from the comparison of the rescue package that was structured to prevent the failure of the Continental Illinois National Bank and Trust Company is that it conforms with the guidelines contained in our report, where possible. But there are important instances of nonconformance resulting from two main factors. First, a system has been in place for 50 years that delegates responsibility for handling banking emergencies to the bank regulatory agencies. This system was established because, among other things, there was a recognition of the need for quick action and the impracticality of congressional involvement at times of banking crises. Second, due largely to the nature of banking and the system within which it is regulated, once a decision was made to keep Continental open, options associated with risk sharing and protecting the government's financial interest were severely limited.

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Assuming we were not prepared to let Continental fail, I believe that the regulators had to respond quickly. Congressional involvement at the time of the crisis would have been impractical. However, I also believe that now that the situation has stabilized, the time is appropriate for intense congressional scrutiny of how the system dealt with the Continental crisis and what the events imply for the adequacy of our deposit insurance system and the way our banking system is structured, supervised, and regulated.

IMPLICATIONS OF THE RESCUE FOR THE FUTURE OF BANK REGULATION

With the above in mind, I would like to turn now to the second part of my statement and present our views on the broader ramifications of the Continental Illinois rescue. I will first discuss the nature of the precedent set by the rescue. As a result of the rescue, attention has been focused on the reality that there are two classes of banking institutions in this country that are treated quite differently when problems arise. On the assumption that few are totally satisfied with that reality, I then discuss four avenues through which regulatory reform might take place. My objective in this regard is to highlight the difficult choices that will have to be made in reaching a concensus on the configuration of a more equitable and efficient system of bank regulation.

THE EQUITY OF CURRENT BANKING REGULATION

The rescue package that was put together for Continental Illinois was unprecedented in its size as well as in the degree of support that the government has indicated it will provide the bank in the event that steps already taken prove insufficient. The Continental result has many of the aspects of FDIC's purchase and assumption transactions of the past in which most or all of the claims of uninsured depositors and general creditors have been satisfied. However, it does represent significant further movement down a road whose ultimate destination is worrisome. Continental's uninsured depositors and general creditors may have had reason to believe that they would be defacto insured, but there was no certainty that this would be true in every case. For example, in the Penn Square case and in the modified payoff experiment early in 1984, uninsured depositors were not totally covered and these situations could have elevated the concern of Continental's funding sources when rumors of the bank's problems began circulating in May.

If our banking system structure has changed to the point where we cannot afford to let any of the largest banks in this country fail, then we have altered the philosophy for which our system of deposit insurance and liquidity support was established 50 years ago. Deposit insurance was created to avert system-wide bank runs. There was a clear recognition in the 1930s that individual banks would continue to fail. But with a system of deposit insurance and liquidity support for the banking system in general, it was believed that the spillover effects from those failures could be contained.

Today, our banking system contains institutions which have become so large and have established so many financial relationships with other participants in the financial services industry that the threat of a single large bank failure is perceived by regulators as equivalent to system-wide instability.

The Continental Illinois situation underscores the widely held belief that there are two classes of banking institutions in this country: those that we cannot afford to let fail and those whose failure has little effect on system-wide stability. Yet, the system's regulatory rules of the game have been largely the same for both types of institutions. Should this continue to be the case or should we begin thinking about instituting a regulatory quid pro quo for the different protections afforded the two classes of banking institutions? Have we reached the point where for our very large banks, we need to redefine the types of business actions that, from a regulatory perspective, are strictly private? For these very large banks, is special regulatory intervention necessary because of their potential to seriously affect the public interest?

AVENUES OF REFORM

The implications of these considerations are potentially far reaching and require that we come to grips with the various economic and regulatory factors affecting contemporary banking practices. At a minimum we need to explore approaches through four avenues of change to our banking regulatory system. These include:

--changes to our system of deposit insurance in light of its seeming expanded coverage.

--changes in our system of bank examination and supervision to better assure that existing procedures are adhered to, and revisions to existing regulatory procedures and rules regarding when supervisory actions may be taken as well as the nature of the actions.

--changes to disclosure requirements that would better enable depositors and general creditors to evaluate the condition of banks and their management, and

--changes to standards of capital adequacy.

It is important to realize that choices for change within these avenues are not mutually exclusive, nor do we intend this list to be necessarily exhaustive. Changes in one area could affect the need for changes in another. For example, deposit insurance serves as an inexpensive substitute for capital in helping assure the safety of deposits. Furthermore, bank supervision, if done well, can be viewed as a means of limiting the risk associated with a given level of insurance coverage.

The range of choices for establishing a more appropriate regulatory relationship is very broad. Even with the best objective analysis, choices about change will still involve complex value judgments that will generate disagreements based on different perceptions of fairness. Nevertheless, let me elaborate on some of the considerations associated with each of the avenues of reform.

Deposit Insurance

There are three fundamental issues that the Continental Illinois case raises with regard to deposit insurance.

--Should we explicitly broaden the coverage of deposit insurance to cover large depositors in order to prevent runs on large banks?

--If we do broaden the coverage, who should pay for it?

--Regardless of coverage, should insurance be priced to more closely conform with variations in risks assumed by different banking institutions?

As I indicated, broadening coverage of deposit insurance to all uninsured depositors and general creditors is not so drastic an action as it might first seem. Many of FDIC's past purchase and assumption transactions have accomplished this result. One option that would fall short of full coverage would be to fully insure all demand type savings and transactions accounts but to severely limit coverage of time deposits. In this way the size of bank runs might be limited when problems are initially experienced and there might be sufficient time to reach solutions that would eliminate the incentive to withdraw time deposits when they mature. While this option has some appeal it also has drawbacks. It might encourage excessive reliance on very short-term funding and increase interest rate risk. It also might not prevent withdrawal of money market certificate type savings accounts despite the interest penalty associated with premature withdrawal.

If coverage is expanded, the question becomes: who should pay for the increased risks assumed by the government? There are two points worth noting with regard to this issue.

--If the bank supervision and examination processes were sufficiently rigorous that banks were merged or liquidated at the precise time when the value of the assets was exactly equal to the value of the liabilities, the current level of insurance premiums would be more than adequate to cover all deposits and other borrowings of banks. The problem is that this rarely occurs. In general, and largely as a matter of policy, liquidated or merged banks have been insolvent for some time prior to the actual declaration of insolvency. Thus, the risks faced by the government from de jure or de facto coverage of all uninsured depositors and general creditors are a function of both the inherent riskiness of a bank's operations and the policy of not liquidating banks at the exact moment they become insolvent.

--Assuming that the delay policy will not be changed, should large banks pay for the assumption of additional coverage that the government might consider assuming? Most of the exposure from coverage of uninsured deposits rests in large banking institutions. Should we raise premiums paid by the large banks because of this increased exposure or make other provisions for industry provision of funds for large bank problem situations through contingent assessments? Should we, for example, institute a system of interest bearing deposits with the FDIC that resembles the arrangement for the deposit of funds by credit unions with the National Credit Union Share Insurance Fund? The fact of the matter is large banks pay more now in relation to the level of insured deposits because premiums are levied against all domestic deposits, not just insured deposits. On the other hand, total exposure is a function of all deposits and other liabilities including foreign deposits which are found mainly in our large banking institutions; foreign deposits are not insured and are not subject to insurance premiums. If it is our intention to guarantee foreign deposits in the future, then an insurance assessment should be levied against these deposits as well.

Is deposit insurance appropriately priced? Answers to this question depend on what we want the deposit insurance premium structure to accomplish. Many people believe that deposit insurance premiums are structured in such a way that they encourage banks to take risks that they would not take in the absence of deposit insurance. Do we want the level of premium collections structured in such a way that the fund will be adequate to cover the full range of bank failure outcomes that the insurance fund might face? Most people agree that it is not possible to actuarially estimate reasonable worst case scenarios of fund exposure. Despite the bank failures of the 1980s, FDIC's fund has grown. On the other hand, deposit insurance is inexpensive relative to rates of return that banks must earn to attract capital. Should we price deposit insurance so that its cost more closely conforms to the cost of attracting equity capital? What would we do if this built up a very large fund?

Should deposit insurance premiums vary with the riskiness of a bank's operations? Answers to this question depend on whether we believe deposit insurance should serve as a deterrent to excessive risk taking and if so, whether it can be priced to provide an effective deterrent. Can we be confident about the capability of the bank regulators (or anyone else) to accurately assess the riskiness of a bank's decisions when those decisions are made? If we cannot, then increasing the level of premiums or varying them according to the riskiness of a bank or class of banks would occur on an after the fact basis. And, if this is the case, higher premiums should be more appropriately viewed as punitive, not preventive. The question then becomes whether this is desirable from the standpoint of the strength of the banking system. If not, we need to ask ourselves whether there might be a better set of deterrent alternatives.

Bank Supervision

Concerns have been expressed about the quality of the regulatory supervision and examination of Continental Illinois. Is it enough to expect that closer adherence to examination procedures will reduce the probability of similar future situations? If better supervision is not enough, should we consider increasing the regulators' abilities to impose their recommendations on bank management or changing the circumstances under which binding recommendations can be made? When, and under what circumstances might more intrusive supervision come into play--when banks are first classified as problem banks? How can this be reconciled with the fact that most of the banks on problem lists do not fail and eventually come off those lists without highly intrusive supervision? Is it reasonable to expect bank examiners to possess the extraordinary foresight that closer supervision would imply?

Ultimately, in the area of bank supervision the question is: can we be satisfied that, at least for large banks, the public interest ramifications of their private business decisions warrant more direct and intrusive supervision? If so, what should be the nature of that supervision?

Increased Disclosure

Would increased disclosure of banks' financial condition result in more informed decisions by depositors and creditors regarding placement of funds? Is there any reason to believe that release of more financial information would enable the public to make better decisions than bank examiners about the relative riskiness of a bank? Some would argue that those with money at stake do make better decisions, but the point is certainly debatable. Assuming that decisions about risk are made equally well by both parties, is it reasonable to expect the public to impose more discipline on a bank than bank examiners are equipped to do?

Assuming increased disclosure did result in a more informed public, might it not simply result in a better delineation of risks and returns among which choices could be made just as they are in today's financial markets? Some investors are comfortable with high risk-return tradeoffs; others are not. If funds continue to flow to high risk institutions at premium rates would that not increase the riskiness of those institutions? On the other hand, if disclosures were made that had the effect of seriously undermining confidence in a bank (as opposed to simply having the effect of raising rates a bank must pay to attract depositors), would a bank run result? What if this occurred at a large bank? How can these considerations be reconciled with the de facto or de jure extension of insurance to all depositors and general creditors?

Capital Adequacy

Are banks adequately capitalized? Capital serves to buttress a bank against insolvency during periods of depressed earnings. But capital cannot be expected to be sufficient to protect a bank against the consequences of a run-off of deposits. Insulation against bank runs is dependent on the liquidity of bank assets and the maturity composition of liabilities. Considerations regarding capital adequacy are also complicated by the fact that increasing capital requires increasing earnings to pay for the attracted capital. If increased earnings are accomplished through acceptance of increased risks, a given bank would be no less vulnerable to insolvency at a higher capital asset ratio than at a lower ratio.

As I indicated, deposit insurance can be viewed as an inexpensive substitute for capital. If there were no deposit insurance or if its coverage were significantly reduced, it is interesting to contemplate the level of, and return on, investment that would be required to attract permanent capital to the banking industry.

Should we be satisfied with our current definition of capital adequacy? Is a capital/asset ratio of, say, 6 percent an accurate measure of the financial cushion in view of the questionable means by which many of a bank's assets are valued? For example, is any measure of capital adequacy meaningful that does not take into account the contingent liabilities resulting from the growth in off-balance sheet transactions such as standby letters of credit and recourse loan sales? Should we define capital adequacy as a percentage of deposits which are not so subject to judgmental measurement as assets? Another option would be for regulators to consider more systematically the market as well as book value of all assets in the course of supervisory examinations to gain a greater appreciation of the ability of an institution to withstand a sustained erosion in earnings or a run-off of deposits. This would also enable examiners to better identify circumstances under which a bank truly becomes insolvent.

CONCLUSIONS ON THE IMPLICATIONS OF THE CONTINENTAL ILLINOIS RESCUE

I have tried to highlight some of the difficult choices that we face in deciding how to design our system of deposit insurance, bank supervision, and regulation. Each has pitfalls. And, because of this we need to be very careful about changing a system that has worked reasonably well even during the current difficult period. I suspect that some of the problems that Continental has demonstrated can be dealt with by more vigorous adherence to existing examination procedures. I suspect that others must eventually be dealt with through changes within the four avenues I have outlined. Whether these changes imply continuation of a two-tiered regulatory system is uncertain; but we need to begin seeking the answers.

Further analysis will be helpful in answering some of the questions that are raised by the Continental situation. For example, is banking becoming riskier? Are large banks riskier than small banks? What effect has interest rate deregulation had on the risks faced by the banking system? What are the potential risks of expanding product offering powers beyond those currently allowed banks? We do not have good answers to these questions.

In addition to seeking these answers we need to decide what combination of changes are necessary (if any are necessary) that best mutually satisfy the objectives of fairness, efficiency, and confidence in our banking system. In order to decide we must know the relative advantages and disadvantages of each and the extent to which changes in one area mitigate against or reinforce the need for changes in another.

Even with answers to these questions, it will still be necessary to make value judgments about where we draw the boundaries of regulatory intervention into private decisions versus those that truly affect the public interest. The important thing about the deliberative process we should go through is that the more answers we have about changes in the nature of banking risk and the interrelationship among and pitfalls of the various avenues through which reform can take place, the more limited will be the number of decisions that will rest on value judgments or misinformation.

We in GAO are currently pursuing many of the questions that the Continental Illinois situation raises. We expect to issue a report on the deposit insurance system this spring. We expect to point out more specifically than I have done today where more information is needed, indicate some of the tradeoffs associated with the major proposals to reform the system, and provide the Congress with an agenda it may wish to follow in pursuing a solution to the problems we perceive. We also are in the process of implementing a series of studies which will help provide answers to the changing nature of banking risks and the reasons for and relative importance of changes in various types of risks. We also plan to assess the extent to which increased product offering freedoms might affect the riskiness of the banking sector of our financial system. It is our hope that this work will contribute to resolution of many of the questions that situations like Continental Illinois raise.