Chapter 7

Continental Illinois and "Too Big to Fail"

Introduction

One of the most notable features on the landscape of the banking crises of the 1980s was the crisis involving Continental Illinois National Bank and Trust Company (CINB) in May 1984, which was and still is the largest bank resolution in U.S. history. Although it took place before the banking crises of the decade gathered strength, the Continental episode is noteworthy because it focused attention on important banking policy issues of the period. Among the most significant of these was the effectiveness of supervision: in the wake of the bank's difficulties, some members of Congress questioned whether bank regulators (in this case, the Office of the Comptroller of the Currency in particular) could adequately assess risk within an institution. The economic dislocation such a large bank failure might bring also engendered increased scrutiny of the supervisory process. In addition, Continental was a particularly telling example of the problem that bank regulators faced when attempting to deal with safety-and-soundness issues in an institution that had already been identified as taking excessive risks but whose performance had not yet been seriously compromised.

Continental's size alone made it consequential. Large-bank failures in the 1980s and early 1990s would prove to have serious consequences for the Bank Insurance Fund (BIF). For example, although only 1 percent of failed institutions from 1986 to 1994 had more than $5 billion in assets, those banks made up 37 percent of the total assets of failed institutions and accounted for 23 percent of BIF losses during that period.[1] Moreover, continuing industry consolidation can only serve to make the issues involved in the handling of large-bank failures more significant.[2]

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[1] FDIC, *Failed Bank Cost Analysis 1986–1994* (1995), 12, 32.

[2] At year-end 1984, only 24 commercial banks had more than $10 billion in assets; by year-end 1994, the number was 64. During the same ten-year period, total assets at such banks had risen from $865 billion to $1.94 trillion.

As the nation's seventh-largest bank, Continental forced regulators to recognize not only that very large institutions could fail but also that bank regulators needed to find satisfactory ways to cope with such failures. The methods adopted in the resolution of Continental gave rise to a great deal of controversy, with the debate centering on whether large banks like Continental had to be treated differently from smaller institutions (the policy of differential treatment was soon given the rather inaccurate sobriquet of "too big to fail" [TBTF]). In fully covering all deposits in Continental, the FDIC used a method that contrasted sharply with its continuing use of deposit payoffs in some smaller resolutions. Perceptions of inequity in the treatment of banks depending on their size were brought into even greater relief by the fact that the Continental assistance package was put together soon after the FDIC had implemented a pilot program of "modified payoffs" in which only a proportion of the amount owed to uninsured depositors and other creditors was paid, based on the estimated recovery value of the institution's assets. The FDIC, seeking to encourage depositor discipline, had hoped to expand the modified payoff to all banks regardless of size. However, the Continental assistance package effectively ended the program. At the Senate hearings for his confirmation as FDIC chairman in September 1985, L. William Seidman testified that it was important not to have bank size lead to differential treatment—but he would later write that regulators were largely unsuccessful in remedying the problem.[3] The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) took significant steps toward dealing with TBTF, but since then no very large bank has failed, so the law's effect on how regulators would respond to such a failure has not yet been tested.

Continental's Growth through 1981

The story of Continental Illinois is now well known, but before 1982 few observers would have nominated it as the institution that would become emblematic of TBTF.[4] The bank had long been conservative, but in the mid-1970s its management began to implement a growth strategy focused on commercial lending, explicitly setting out to become one of the nation's largest commercial lenders.[5] By 1981, management had accomplished this and more: Continental was the largest commercial and industrial (C&I) lender in the United States. CINB's emphasis on C&I lending can be seen clearly when it is compared with other money-center banks. Between 1976 and 1981, CINB's C&I lending jumped from ap-

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[3] L. William Seidman, *Full Faith and Credit: The Great S&L Debacle and Other Washington Sagas* (1993), 75–76.

[4] See Irvine Sprague, *Bailout: An Insider's Account of Bank Failures and Rescues* (1986), pt. 4; James P. McCollum, *The Continental Affair: The Rise and Fall of the Continental Illinois Bank* (1987); and William Greider, *Secrets of the Temple: How the Federal Reserve Runs the Country* (1987), chaps. 14 and 17. The discussion here also owes much to FDIC, "Report on Continental Illinois" (unpublished paper), 1985.

[5] U.S. House Committee on Banking, Finance and Urban Affairs, Subcommittee on Financial Institutions Supervision, Regulation and Insurance, *Inquiry into Continental Illinois Corp. and Continental Illinois National Bank: Hearings,* 98th Cong., 2d sess., 1984, 39; and "Continental Illinois Sails into a Calm," *Business Week* (May 14, 1979): 114.

proximately $5 billion to more than $14 billion (180 percent), while its total assets grew from $21.5 billion to $45 billion (110 percent). During the same period, Citibank's C&I lending rose from $7.7 billion to $12.5 billion (62.5 percent), while its total assets rose from $61.5 billion to $105 billion (70 percent). Growth at Continental Illinois substantially outstripped that at institutions such as Chemical Bank, Morgan Guaranty, and its Chicago competitor, the First National Bank of Chicago. (See table 7.1.)

Continental's management, the bank's aggressive growth strategy, and its returns were lauded both by the market and by industry analysts. A 1978 article in *Dun's Review* pronounced the bank one of the top five companies in the nation; an analyst at First Boston Corp. praised Continental, noting that it had "superior management at the top, and its management is very deep"; in 1981, a Salomon Brothers analyst echoed this sentiment, calling Continental "one of the finest money-center banks going."[6] Continental's share price reflected the high opinions of and performance by the bank. In 1979, an article noted that while the stocks of other big banking companies have hardly budged, " . . . Continental's . . . has doubled in price—rising from about $13 to $27 . . . since the end of 1974, compared

Table 7.1

Growth in Assets and Domestic C&I Lending at the Ten Largest U.S. Banks, 1976–1981
($Billions)

	1976			1981			1976–1981	
Bank	Total Assets	Domestic C&I	Domestic C&I as % of Assets	Total Assets	Domestic C&I	Domestic C&I as % of Assets	Asset Growth	Domestic C&I Growth
Bank of America	$72.94	$7.06	9.67	$118.54	$12.10	10.21	62.52%	71.51%
Citibank	61.50	7.71	12.54	104.80	12.54	11.97	70.40	62.57
Chase Manhattan	44.75	9.24	20.66	76.84	10.05	13.07	71.69	8.67
Manufacturers Hanover	30.10	4.43	14.73	54.91	9.46	17.22	82.44	113.39
Morgan Guaranty	28.49	3.07	10.79	53.72	5.61	10.44	88.57	82.43
Chemical Bank	26.08	4.65	17.82	45.11	10.82	23.98	72.94	132.74
Bankers Trust	21.76	3.06	14.04	33.00	5.23	15.84	51.66	71.08
Continental Illinois	**21.44**	**5.09**	**23.74**	**45.15**	**14.27**	**31.61**	**110.56**	**180.42**
First National Bank of Chicago	18.68	4.04	21.61	32.55	5.59	17.16	74.25	38.42
Security Pacific	16.15	2.49	15.43	30.46	5.91	19.38	88.59	136.98

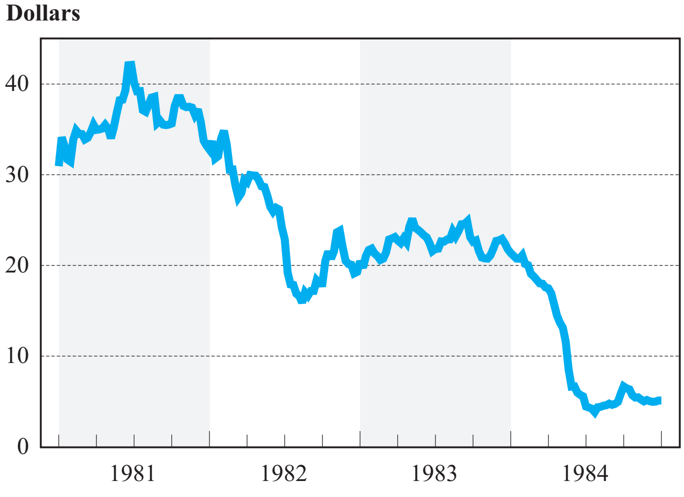
[6] "Here Comes Continental," *Dun's Review* 112, no. 6 (1978): 42–44; and "Banker of the Year," *Euromoney* (October 1981): 134.

with a 10% gain for the average money-center bank."[7] And even as its share price was deteriorating during late 1981 and early 1982 (see figure 7.1), many stock analysts continued to recommend purchase of Continental shares.[8]

It is not surprising that few observers recognized the problems inherent in Continental's rapid growth; most indicators of the bank's financial condition were good, and some were outstanding. For example, for the five-year period from 1977 to 1981, the bank's average return on equity was 14.35 percent, which was second only to Morgan Guaranty (14.83 percent) among other large commercial banks. Over the same period Citibank's average was 13.46 percent, and Continental's cross-town rival First Chicago had an average of only 9.43 percent. Continental's return on average assets was also acceptable, exceeded only by the returns of Security Pacific, Morgan Guaranty, and Citibank (see table 7.2). Continental did have one of the lower equity levels of the large banks, with its average of 3.78 percent putting

Figure 7.1

Continental Illinois Corporation: Average Weekly Share Price, 1981–1984



Source: Dow Jones News/Retrieval.

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[7] "Continental Illinois Sails into a Calm," *Business Week* (May 14, 1979): 114.

[8] See, for example, *Wall Street Transcript* (January 25, 1982), where a Morgan Stanley analyst described Continental as "attractive," and *Keefe Nationwide Bankscan* (March 15, 1982), where market dissatisfaction with Continental was viewed as "a gross overreaction to the year-end increase in the bank's nonperforming assets." Two weeks after this comment, an analyst at the Bank of New York raised his rating on Continental from hold to buy (*Wall Street Transcript* [March 29, 1982]). All of these are cited in FDIC, "Report on Continental Illinois."

Table 7.2
Average Returns and Equity Ratios at the Ten Largest U.S. Banks, 1977–1981

Bank	Average ROA*	Average ROE†	Average Equity/ Assets Ratio
Bank of America	0.50%	13.91%	3.57%
Bankers Trust	0.42	10.84	3.92
Chase Manhattan	0.44	11.04	4.01
Chemical Bank	0.38	10.96	3.52
Citibank	0.59	13.46	4.40
Continental Illinois	**0.54**	**14.35**	**3.78**
First National Bank of Chicago	0.38	9.43	3.99
Manufacturers Hanover	0.45	12.92	3.53
Morgan Guaranty	0.65	14.85	4.37
Security Pacific	0.66	14.31	4.60

*Return on assets is year-end net income divided by year-end assets.

†Return on equity is year-end net income divided by year-end equity.

it seventh out of ten; however, only three banks had ratios significantly over 4 percent. Moreover, asset and loan growth at Continental was at least matched by growth in the bank's equity ratio, which rose from 3.55 percent at year-end 1976 to 4.31 percent at year-end 1982. If there were signs of trouble, that was not obvious from Continental's earnings.

There were, however, two aspects of Continental's financial profile that, with the benefit of hindsight, were indicators of the increased risk the bank took on during its growth period. First, Continental's loans-to-assets ratio increased dramatically—from 57.9 percent in 1977 to 68.8 percent (see appendix, table 7-A.3) by year-end 1981, when it was the highest of the ten banks. This alone suggests that the bank was riskier; the greater the proportion of its portfolio a bank holds in loans, the more exposed the firm is to default risk. Second, although Continental's return on assets was adequate over this period, it hovered at around .51 percent; with a higher percentage of assets in loans, the average loan had to have been earning less at the end of the period than it had been at the beginning, implying that over time, Continental was originating loans with lower interest rates than those on the books in 1978. Given the large increase in interest rates over this same period, such a scenario indicates the bank might have adopted a below-market pricing strategy, a possibility some observers noted at the time.

As this suggests, intimations that Continental's lending style might be overly aggressive had not been altogether lacking. The bank's growth was attributed partly to its "zeal for occasional transactions that carry more than the average amount of risk." One bank officer stated, "We hear that Continental is willing to do just about anything to make a deal."[9] Another observer noted that Continental had "sold the hell out of the corporate market by taking more than the average risks in selected areas."[10] One of the most significant of those areas was the energy sector, where Continental had a long history and the bank could claim a great deal of expertise.[11] Continental's growth was also perceived to stem from aggressive pricing. A published news report stated that when Continental wanted to do business with a corporation badly enough, the bank would offer "a cheap deal . . . the financial officer can't refuse."[12] A Chicago competitor noted in 1981 that "even with a 20% prime they were doing 16% fixed rate loans. I don't know how they do it."[13] But while some were suggesting that the bank's aggressive lending style might be too risky, few thought so before 1982, and Continental's management dismissed such views.[14]

Late in 1981, however, problems were beginning to surface. The bank's second-quarter earnings fell 12 percent, a drop that CEO Roger Anderson explained was largely the result of backing interest rates the wrong way. (It was reported that the fall would have been much greater had the bank not taken some extraordinary gains during the quarter.)[15] In September 1981, Continental's senior vice president in charge of oil and gas dismissed the 1981 drop in oil prices—which would in fact continue steadily— as "just a little blip."[16] In addition, some of Continental's corporate customers began to have severe problems. For example, in the first six months of 1982, Nucorp Energy lost more than $40 million, and Continental held a large portion of the company's debt. Continental had also lent $200 million to the near-bankrupt International Harvester, and one bank analyst suggested that Continental had "taken some bad credit gambles that aren't paying off . . . and it is costing them now."[17] After peaking at approximately 42 in June 1981, Continental's share price declined almost 37 percent during the next year. Many stock analysts believed the reaction was overdone and the downturn in stock price more psychological than fundamental; nevertheless, the increasing volume of nonperforming loans was viewed as at least a short-term

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9 Both of these citations are from "Continental Sails," 114.

10 "On the Offensive," *The Wall Street Journal* (October 15, 1981), 1.

11 See Sanford Rose, "A Well-Heeled Gambler's Half-Hearted Reformation," *American Banker* (August 18, 1981), 4; and Laurel Sorenson, "In the Highflying Field of Energy Finance, Continental Illinois Bank Is Striking It Rich," *The Wall Street Journal* (September 18, 1981), 33.

12 Neil Osborn, "Continental Illinois Shakes Up the Competition," *Institutional Investor* 14, no. 10 (1980): 178–79.

13 "On the Offensive," 1.

14 Sorenson, "Highflying Field," 33.

15 "Banker of the Year," 135; and Sanford Rose, "Will Success Spoil Continental Illinois?" *American Banker* (August 25, 1981), 4.

16 Sorenson, "Highflying Field," 33.

17 Greider, *Secrets*, 522; and *The Wall Street Journal* (June 1, 1982), 1.

problem. Yet in March 1982, when Fitch's Investors Service Inc. downgraded six large banks' ratings, Continental retained its AAA rating.[18]

After Penn Square

Optimism about Continental's condition ended abruptly in July 1982, when Penn Square Bank, N.A., in Oklahoma failed.[19] Penn Square had generated billions of dollars in extremely speculative oil and gas exploration loans, many of which were nearly worthless, and Continental had purchased a monumental $1 billion in participations from Penn Square. While Continental and the other "upstream" banks pressed regulators to find a way to prevent a deposit payoff of Penn Square, a course that would also have been preferred by both the Federal Reserve and the OCC, the larger banks involved refused either to inject money into Penn Square or to waive their claims on the bank. The refusal to waive their claims meant that the contingent liabilities the FDIC would have incurred militated against every course except a deposit payoff.[20] Penn Square became the largest bank payoff in the history of the FDIC, and remained so until 1992.[21]

News of Continental's relationship with Penn Square caused great anxiety among investors, and many stock analysts quickly halved earnings estimates and downgraded their opinions on the company.[22] During July the share price had dropped to nearly 16, a 62 percent decline from a year before. The major rating agencies swiftly downgraded the bank's credit and debt ratings. Continental's lending involvement with three of the largest corporate bankruptcies of 1982 helped turn perceptions of the bank increasingly negative. Such perceptions were reinforced by the advent of the less-developed-country (LDC) debt crisis brought on by Mexico's default in August 1982; Continental had significant LDC exposure.[23] The aggressiveness and loan policies that had met with so much praise during the "go-go" years were now seen in a far more critical light. The financial press began to write about faults in the bank's management, internal controls, and loan pricing.[24] CEO Ander-

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[18] Dow Jones New Service: *The Wall Street Journal* combined stories (April 20, 1982). Moody's Investors Service had downgraded Continental's debt rating from AAA to AA in March.

[19] For the story of Penn Square's failure, see Chapter 9; and Phillip L. Zweig, *Belly Up: The Collapse of the Penn Square Bank* (1985).

[20] See Sprague, *Bailout*; and Greider, *Secrets*, 497–500.

[21] Penn Square had $390 million in deposits and $436 million in assets. In 1992, there was a deposit payoff of the Independence Bank of Los Angeles ($548 million in deposits and $536 million in assets). Data are for the quarter before failure.

[22] For example, within a month of Penn Square's failure, revised positions were taken by analysts at Keefe, Bruyette and Woods; Smith Barney Harris Upham and Co.; and Donaldson, Lufkin, Jenrette (FDIC, "Report on Continental Illinois").

[23] See Chapter 5 for a discussion of the LDC debt crisis.

[24] See, for example, "The Stain from Penn Square Keeps Spreading, " *Business Week* (August 2, 1982), available: LEXIS, Library: NEWS, File: BUSWK; "Forgetting the Rules," *Newsweek* (August 2, 1982), available: LEXIS, Library: NEWS, File: NWEEK; and "Continental Illinois' Most Embarrassing Year," *Business Week* (October 11, 1982), available: LEXIS, Library: NEWS, File: BUSWK.

son, while admitting that Continental's system had broken down, defended the bank's lending policies and stated that the bank "had no intention of pulling in its horns."[25]

Analysts' reactions to Continental's statements about its condition were mixed, but during 1983 the stock price did gradually recover into the mid-20s. While Continental furnished an image of a sober institution dealing with its problems, the bank's mistakes had meant a loss of credibility in the domestic money markets. This was particularly significant because Continental had little retail banking business and therefore relatively small amounts of core deposits. The bank's ability to generate retail business was severely circumscribed by the combination of federal banking laws restricting geographic expansion and Illinois law strictly requiring unit banking in the state.[26] In 1977 core deposits made up 30 percent of total deposits; by 1981 they had declined to just under 20 percent. (See appendix, table 7-A.1.) Instead, the bank relied on fed funds and large CDs. In addition, management favored issuing shorter-term, more volatile but less-expensive instruments rather than longer-term ones that were both more stable and more expensive. Continental therefore continually needed to roll over large volumes of deposits and search for new sources of funds, but the loss of confidence due to Penn Square meant the bank had to pay substantially higher rates on its CDs. Within three weeks of Penn Square's failure, Continental removed itself from the list of top-graded banks whose CDs traded interchangeably in the secondary markets. Unable to fund its domestic operations adequately from domestic markets, Continental increasingly turned to foreign money markets (at higher rates). Its dependence on these funds would figure significantly in the bank's crisis in 1984.[27]

During the first half of 1983 Continental's situation appeared to have stabilized somewhat, but the bank's recovery was far from certain. Although the bank apparently had made efforts to tighten its internal controls and lending procedures, its nonperforming loans continued to mount. Earnings were bolstered by a series of extraordinary gains, while operating earnings declined. One reporter noted an example of gallows humor among bank employees: "[The only] difference between Continental and the Titanic is that the Titanic had a band."[28] Many institutional investors were deserting the ship, including major shareholders such as U.S. Steel & Carnegie Pensions and Mathers & Co. (a Chicago-based

[25] McCollum, *Continental Affair*, 248.

[26] Concerning federal law, see the discussion in Chapter 2 on the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. Until after the Continental open-bank assistance, Illinois law prohibited branching, only permitting one "facility" within 1,500 feet and another within 3,500 yards of the main banking premises (Conference of State Bank Supervisors, *A Profile of State-Chartered Banking* [1977], 98; and ibid. [1986], 86).

[27] FDIC, "Report on Continental Illinois," 7–12.

[28] A. F. Ehrbar, "Toil and Trouble and Continental Illinois," *Fortune* (February 7, 1983), available: LEXIS, Library: BUSFIN, File: FORTUN.

money management firm), both of which sold their entire stock positions.[29] The first-quarter 1984 results confirmed Continental's troubles: nonperforming loans increased $400 million to a record $2.3 billion, with more than half the increase coming from Latin American loans; if not for the sale of its profitable credit card business to Chemical for $157 million, Continental would have reported a loss for the quarter. This news prompted Moody's to announce yet another review of its debt ratings on Continental.[30] By the end of April, Continental's share price had sunk from a post–Penn Square high of 26 in September 1983 to less than 14.

The Bank Run and Government Assistance

The deterioration in Continental's condition and earnings, coupled with its reliance on the Eurodollar market for funding, helped make the bank vulnerable to the high-speed electronic bank run that took place in May 1984. Among the factors that caused the run to start and made stopping it difficult, rumor was prominent. On May 9, Reuters asked Continental to comment on rumors that the bank was on the road to bankruptcy; the bank condemned the story as "totally preposterous." In addition, stories circulated that a Japanese bank was interested in acquiring Continental, or that the OCC had asked other banks and securities firms to assist Continental.[31] Anxious overseas depositors began to shift their deposits away from Continental, and it was reported that Chicago's Board of Trade Clearing House had done the same. In an effort to calm the situation, the Comptroller of the Currency, departing from the OCC's policy of not commenting on individual banks, took the extraordinary step of issuing a statement denying the agency had sought assistance for Continental and noting that the OCC was unaware "of any significant changes in the bank's operations, as reflected in its published financial statements, that would serve as the basis" for rumors about Continental.[32] The run, however, continued, and by Friday May 11, Continental had had to borrow $3.6 billion at the Federal Reserve's discount window to make up for its lost deposits.[33] During the following weekend Continental attempted to solve its problems by

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[29] Lynn Brenner, "Chicago Giant's Top Holder Isn't Fazed: Batterymarch Financial Management Still Owns 2 Million Shares," *American Banker* (May 23, 1984), 3.

[30] *The Wall Street Journal* (May 2, 1984), 41.

[31] See Jeff Bailey and Jeffrey Zaslow, "Continental Illinois Securities Plummet amid Rumors Firm's Plight Is Worsening," *The Wall Street Journal* (May 11, 1984), 3; Robert A Bennett, "Continental Fighting Rumors," *The New York Times* (May 11, 1984), sec. 4, p. 1; and Sprague, *Bailout*, 152–53.

[32] For the text of the OCC press release, see U.S. House, *Inquiry,* 285. It was noted that the last time the government had made such a statement had been in 1974, ten years earlier; the bank was Franklin National, and it later failed (*The Wall Street Journal* [May 21, 1984], 3).

[33] " 'Smart Money Bank': What Went Wrong," *The New York Times* (May 18, 1984), sec. 4, p. 15.

creating a $4.5 billion loan package provided by 16 banks, but this proved insufficient to stop the run; Continental's domestic correspondent banks also began to withdraw funds from the bank.

As the situation continued to deteriorate, bank regulators were faced with a potential crisis that might envelop the entire banking system. The run had to be stopped, and so the three bank regulatory agencies decided to provide a $2 billion assistance package to Continental: the FDIC provided $1.5 billion, and participated an additional $500 million to a group of commercial banks. The capital infusion was in the form of interest-bearing subordinated notes at a variable rate 100 basis points higher than that on one-year Treasury bills. The Federal Reserve stated that it would meet any liquidity needs Continental might have, and a group of 24 major U.S. banks agreed to provide more than $5.3 billion in funding on an unsecured basis while a permanent solution was sought. In what was perhaps the most controversial move by the regulators, the FDIC promised to protect all of Continental's depositors and other general creditors, regardless of the $100,000 limit on deposit insurance. The assistance package was to remain in place while the regulators searched for a permanent solution to Continental's problems.[34]

The regulators spent two months searching for a suitable and willing merger partner for Continental, but none could be found. Moreover, the temporary assistance package had not ended deposit outflows from Continental. In July the bank regulators agreed on a complex and controversial resolution. The plan consisted of the FDIC's purchase from the bank of $4.5 billion in bad loans. These troubled loans would then be managed for the FDIC by the bank under a servicing contract. The structure of the loan transfer involved a charge-off to the bank of $1 billion, but the permanent assistance plan also infused $1 billion in capital into the bank through the FDIC's acquisition of preferred stock in Continental Illinois Corporation (CIC), which the holding company was required to downstream to the bank as equity. The FDIC wanted to place the new capital directly into the bank but was prevented from doing so by outstanding indenture agreements with the holding company.[35] The bank also continued to receive liquidity support from the Federal Reserve, and the funding facility that had been provided by a group of U.S. commercial banks remained in place. Finally, the permanent assistance plan removed Continental's top management and board of direc-

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[34] See OCC, FDIC and FRB, Joint News Release (May 17, 1984).

[35] Placing the capital in the holding company was controversial because holding company bondholders were protected, but no other avenue to effect the resolution could be found. See John Riley, "Inside the Bailout: Continental Leaves a Wide Wake," *National Law Journal* (October 22, 1984): 29. Continental's shareholders were substantially wiped out, though they did have the prospect of some return, depending on the losses the FDIC incurred under the agreement.

tors and put John Swearingen and William Ogden in place as executive officers of CIC and CINB, respectively.[36] In September Continental's shareholders approved the plan.[37]

Policy Implications: Supervision

Continental continued in existence, though as a substantially different entity, but both the need for intervention as well as the character of the intervention highlighted several important policy debates. Even if one did not take issue with the regulators' permanent solution (and many did), the effectiveness of the OCC's supervisory activities before the Continental assistance plan remained open to question. There was little doubt that the bank's management had embarked on a growth strategy built on decentralized credit evaluation unconstrained by any adequate system of internal controls and that the bank had relied on volatile funds. But how well had the responsible bank regulators assessed Continental's situation, and should they have been more assertive in requiring the bank to change its lending and other high-risk practices?

A staff report of the House Banking Subcommittee in 1985 expressed reservations about both the OCC's and the Federal Reserve's supervision of Continental. Among its criticisms, the report found that the OCC failed to take "decisive action" to slow the bank's growth or increase its equity-to-assets ratio before 1983 and failed to require Continental to remedy known problems in its loan management system before 1982. The report also held that despite the OCC's awareness of Continental's growing concentrations in oil and gas, the agency did not "consistently and forcefully" point out potential dangers to management, and that OCC examination reports in general were too ambiguous to provide a clear message to the bank about its problems. The OCC's sampling technique for loan evaluation was also thought to be insufficient in the case of Continental because it relied too much on the bank's own internal controls, which in this case were themselves woefully deficient. The report criticized the Federal Reserve on the grounds that although its supervision of the holding company identified potential risks from the reliance on volatile funding, the agency did not communicate these warnings consistently over time. The report also noted that the

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36 See OCC, FDIC, FRB, "Permanent Assistance Program for Continental Illinois National Bank and Trust Company," PR-87-84 (July 26, 1984).

37 As of 1997, the estimated cost to the FDIC of resolving Continental is approximately $1.1 billion. At this writing, a small number of assets are still to be disposed of, but are not expected to change the final cost significantly. Although many criticized the Continental resolution, the FDIC's estimated cost was considerably smaller than the costs for First Republicbank Corp. ($3.77 billion) and MCorp-Dallas ($2.85 billion). Moreover, if one considers estimated losses as a percentage of assets, Continental (3.27 percent) ranks behind Texas American Bancshares (22.67 percent), MCorp (18.12 percent), First Republic (11.69 percent), First City Bancorporation [its 1988 failure] (9.55 percent), New Hampshire Savings Bank (9.55 percent), Goldome Federal Savings Bank (9.24 percent), CrossLand Federal Savings (7.50 percent), and Bank of New England Corp. (3.40 percent). These percentages are calculated using asset size either at the time of closure or at the time of the assistance transaction, whichever is applicable.

Federal Reserve's continuing approval of the holding company's applications to expand its activities—despite numerous examinations containing critiques of the bank's capitalization, asset quality, and funding—"may have conveyed to CIC and the public that the Federal Reserve basically approved of the operating and financial characteristics" of both the holding company and the bank.[38]

C. T. Conover, the Comptroller of the Currency, noted in his testimony before Congress in 1984 that the OCC had considered whether the agency ought to have taken action as early as 1976 to stop Continental from implementing its growth strategy. Conover said he believed that this would have been inappropriate but that the OCC could have placed "more emphasis on . . . evaluation and criticism of Continental's overall management processes."[39] This issue touches on a central quandary that bank regulators faced. On the one hand, as Federal Reserve Board General Counsel Michael Bradfield noted, "The real failure of supervision [was that] . . . nobody did anything about Continental in the late seventies and early eighties," but on the other hand, as Federal Reserve Board Governor Charles Partee pointed out, "To impose prudential restraints is meddlesome and it restricts profits. If the banking system is expanding rapidly, if they can show they're making good money by the new business, for us to try to be too tough with them, to hold them back, is just not going to be acceptable."[40]

A different situation obtained, however, after Penn Square had made Continental's shortcomings obvious. Conover noted that in 1983, at the OCC's direction, Continental had entered into a formal agreement with the agency requiring the bank to deal with problems in asset and liability management, loan administration, and funding. Continental's plan called for a reduction in assets and a more conservative lending policy. The OCC believed that management and organizational changes to help recovery were being implemented but that economic conditions, such as rising interest rates and a continuing decline in the energy sector, made the plan's goals unachievable. This further deterioration was noted in the 1983 OCC examination of Continental, when the bank's composite CAMEL rating slipped to a 4.[41] The bank's decline continued, and Conover stated that at that point there was little the regulators could have done to increase market confidence in the bank in a manner that would have changed the outcome in May 1984.

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38 U.S. House Committee on Banking, Finance and Urban Affairs, Subcommittee on Financial Institutions Supervision, Regulation and Insurance, *Continental Illinois National Bank: Report of an Inquiry into Its Federal Supervision and Assistance, Staff Report*, 99th Cong., 1st sess., 1985, 7–10.

39 U.S. House, *Inquiry*, 212–13.

40 Cited in Greider, *Secrets*, 524–25.

41 The CAMEL rating system refers to capital, assets, management, earnings, and liquidity. In addition to a rating for each of these individual or "component" categories, an overall or "composite" rating is given for the condition of the bank. Banks are assigned ratings between 1 and 5, with 5 being the worst rating a bank can receive. See Chapter 12 for a detailed explanation of CAMEL ratings.

The Comptroller noted that removing the bank's top management following Penn Square was viewed as unnecessary—management was perceived as capable and had put a program in place to correct problems within the bank; moreover, the officers directly responsible for Continental's Penn Square difficulties had been removed. Forcing Continental to cease dividend payments was another option, but the bank's management and board of directors felt the dividend was crucial to regaining market confidence, and in any case the amount of money involved would not have added appreciably to the bank's capital. Conover stated that after mid-1982 "there was nothing more that we could have done to speed Continental's recovery."[42]

A later account by William Greider, however, suggests that the regulators did informally attempt to do more after Penn Square but believed it inadvisable to impose a formal action, such as a cease-and-desist order. According to Greider, in 1982 Federal Reserve Board Chairman Paul Volcker advised Continental's directors to make changes in both management and lending policy, but the directors refused. FDIC Chairman William Isaac remembered that "when Volcker and Conover presented their recommendations to the Continental Illinois directors, . . . the directors said to them: 'Well, this will be the end of the bank and you will be to blame.' " Isaac noted that it would have been difficult for a regulator to proceed in the face of the directors' refusal. "It takes real gumption for a regulator to sit there and say, 'I'll take the responsibility. . .' We're talking about one of the biggest banks in the world. No one knows what will happen." Michael Bradfield made the same point about any Federal Reserve attempt to deny a bank access to the discount window as a way of forcing its hand, noting that "the consequences of refusing to supply liquidity support to a bank are too severe." It appears, therefore, that in 1982 regulators believed more should have been done but were unwilling openly to require the removal of Continental's top management or take other formal actions, such as demanding a dividend cut. However, it also seems likely that, as Bradfield noted, by the time Penn Square failed, the damage had already been done.[43]

Policy Implications: "Too Big to Fail"

Just as Continental's supervision had raised fundamental questions about regulatory policy, so did the bank's resolution. Some critics objected simply to the notion of a government agency's acquiring 80 percent ownership in a bank—the word "nationalization"

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42 U.S. House, *Inquiry*, 211.

43 Greider, *Secrets*, 522–25. William Isaac noted that "what should have been done right away was the board of directors should have fired the management, brought in strong management from outside, taken a huge loan write-off and eliminated its dividend to stockholders. They might have failed anyway, but . . . there was a substantial chance they could [have] survive[d]" (Greider, *Secrets*, 522).

was often invoked to describe the assistance package.[44] Others objected to the methods adopted in this case: the combination of the FDIC guarantee of protection to all depositors and creditors, the apparent possibility that Continental shareholders might retain some of their investment, and the protection of CIC's bondholders. Overarching all of these issues and far outlasting the immediate aftermath was the question of whether certain banks were "too big to fail." If they were, then the obvious corollary was that most banks were not, and this pointed up what many believed to be a significant inequity in the deposit insurance system.[45]

Until 1950, the FDIC had basically had two options in dealing with failed and failing banks: close the institution and pay off the insured depositors, or arrange for the bank's acquisition. After 1950, a third option was available if the FDIC Board of Directors deemed a bank "essential" to its community: keep a failing bank open through direct infusion of funds (as was done with Continental).[46] Also after 1950, and until the passage of the Federal Deposit Insurance Corporation Improvement Act of 1991, the FDIC operated under a cost test for determining which method to use: it was required to estimate the cost of a payoff and liquidation as the standard of comparison, and could adopt an alternative resolution if the alternative was expected to be less costly than the standard. But the FDIC was also allowed to use an alternative method under the essentiality provision, and the statutory language was sufficiently general to provide the FDIC with discretion to extend essentiality beyond local economic dislocation (as was done with Continental).[47] When essentiality was invoked, cost considerations could be ignored. In practice, most larger bank failures were handled by purchase-and-assumption (P&A) transactions rather than payoffs, and the

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[44] Bank analyst David Cates, however, noted at the time that the fact that the FDIC shares would have voting rights only after they were sold indicated the FDIC wanted to return the bank to the private sector as soon as possible, so nationalization was not the most accurate term to describe the assistance package ("All Debits, No Credits: A Hard Look at the Government's Takeover of Continental Illinois," *Barron's* [July 30, 1984]: 6).

[45] There was a correlation between bank size and resolution method. During the period 1986–91, for example, the average asset size of institutions that were resolved by insured-deposit payoff and liquidation was approximately $65 million, whereas the average asset size of institutions that were resolved through either acquisition or open-bank assistance, both of which meant uninsured depositors were protected, was about $200 million (FDIC, *Failed Bank Cost Analysis 1986–1995* [1996], 11).

[46] See §13(c)(1) of the Federal Deposit Insurance (FDI) Act, 12 U.S. Code §1823(c)(1). When this change was made to the law, the FDIC noted that it was "the intent of the Corporation to exercise this authority sparingly" (FDIC, *Annual Report* [1950], 6); and indeed, it was not invoked until 1970, and since then has been used relatively infrequently.

[47] See the FDI Act, §13(c). For a discussion of the history of the essentiality issue, see Henry Cohen, "Federal Deposit Insurance Corporation Assistance to an Insured Bank on the Ground That the Bank Is Essential in Its Community," Congressional Research Service, Library of Congress (October 1984), 8. Cohen notes that before Continental, essentiality had been used five times, all of them between 1971 and 1980: Unity Bank and Trust (Boston, MA 1971), the Bank of the Commonwealth (Detroit, MI 1972), the American Bank and Trust Company (Orangeburg, SC 1974), the Farmers Bank of the State of Delaware (Wilmington, DE 1976), and First Pennsylvania Bank, NA (Philadelphia, PA 1980).

uninsured depositors were protected.[48] The FDIC recognized the inequities of its practice, but also desired to minimize local economic disruptions. Thus it often selected a resolution method that protected all deposits even with smaller banks if allowed under the cost test.[49] Overall, the FDIC weighed the particular circumstances in deciding on failure-resolution methods, and for the most part this meant that when uninsured depositors suffered losses, it was in smaller institutions—a practice that created incentives for depositors to place large deposits in larger banks, and that fueled concern over TBTF.

As has been noted, however, TBTF was an inaccurate term: "too big to liquidate" would have been more appropriate. Large banks did fail during the period, with shareholders losing their investments and managements being removed. In significant ways, Continental "failed." But as one regulator observed, the banking agencies were "reluctant to tolerate the sudden and uncontrolled failure of large institutions and therefore generally opt[ed] for managed shrinkage, merger, or recapitalization."[50] There were several reasons for adopting such an attitude, the most important of which was "systemic risk." This rubric covered "potential spillover effects leading to widespread depositor runs, impairment of public confidence in the broader financial system, or serious disruptions in domestic and international payment and settlement systems."[51] In addition to systemic risk, the logistical difficulties and potential expense of liquidating a large bank also contributed to regulatory reluctance to close such a bank and pay off insured depositors. Moreover, liquidation would mean tying up uninsured depositors' funds during the lengthy proceedings, a situation that could have a very disruptive effect on a bank's community.[52] For all these reasons combined, the larger the bank, the more likely it was that bank regulators would look for alternatives to closing the bank and paying off the insured depositors.

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[48] In a P&A, all deposits and other nonsubordinated liabilities of the failed bank are assumed by another institution. Even without the too-big-to-fail policy, it is likely that large banks would have been resolved more often through P&As than through deposit payoffs because they had greater franchise value and marketability. The latter may have stemmed from large banks'(1) greater flexibility in seeking new markets and offering new product lines, (2) location in states where the absence of restrictions on geographic expansion meant a greater number of qualified bidders, and (3) earlier resolution action (to the extent that disclosure requirements applicable to publicly traded companies alerted regulators to problems at an earlier stage).

[49] FDIC, "Systemic Risk (Too Big to Fail)" (unpublished paper), 1995.

[50] E. Gerald Corrigan, "A Perspective on Recent Financial Disruptions," Federal Reserve Bank of New York *Quarterly Review* 14, no. 4 (winter 1989–90): 12.

[51] Statement of John P. LaWare, U.S. House Committee on Banking, Finance and Urban Affairs, Subcommittee on Economic Stabilization, *Economic Implications of the "Too Big to Fail" Policy: Hearing,* 102d Cong., 1st sess., 1991, 113. Cited in Charles Moyer and Robert E. Lamy, "'Too big to fail': Rationale, Consequences and Alternatives," *Business Economics* 27, no. 3 (1992): 21.

[52] Ibid. For other discussions of TBTF, see Walker F. Todd, "An Insider's View of the Political Economy of the Too Big to Fail Doctrine," working paper 9017, Federal Reserve Bank of Cleveland, 1990; and Robert L. Hetzel, "Too Big to Fail: Origins, Consequences, and Outlook," Federal Reserve Bank of Richmond *Economic Review* 77, no. 6 (November/December 1991): 6ff.

Regulators had another concern besides inequity and local economic disruption. They and industry observers worried that the perception of de facto 100 percent deposit insurance for many banks led depositors to believe they needed to devote little if any attention to where they placed their money, a situation that could induce some banks to take excessive risks. But some commentators thought moves to increase depositor discipline flew in the face of "too big to fail"; the issue of depositor discipline therefore became attached to the TBTF debate. During the early 1980s, the FDIC did seek ways to increase market discipline as a means of controlling inordinate risk taking. A solution proposed in 1983 was the creation of the so-called modified payoff. In such a resolution, insured depositors' claims would be settled as they always had been. Rather than being made whole, however, other claimants would receive a proportion of their money based on an estimate of the total value of bank assets that would have been recovered in a liquidation. The agency expected that both the insured-deposit settlement and the "advance" could be handled by transfer to an operating institution.[53] The FDIC began to experiment with the method in 1983 and used it in 13 resolutions in 1983–84, most of which took place in March and April 1984, just before the Continental assistance package was put in place.[54] The experiments had been viewed as possibly leading to regular use of the method, but the Continental assistance package effectively ended the modified payoff as a means to instill market discipline.[55] Almost a year after Continental, the FDIC sought public comment on the possible use of modified payoffs in all resolutions, but it did not pursue the policy at that time.[56]

With regard to Continental Illinois, the regulators' greatest concern was systemic risk, and therefore handling Continental through a payoff and liquidation was simply not considered a viable option. Continental had an extensive network of correspondent banks, almost 2,300 of which had funds invested in Continental; more than 42 percent of those banks had invested funds in excess of $100,000, with a total investment of almost $6 billion. The FDIC determined that 66 of these banks, with total assets of almost $5 billion, had more than 100 percent of their equity capital invested in Continental and that an additional 113 banks with total assets of more than $12 billion had between 50 and 100 percent of their equity capital invested.

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[53] FDIC, *Deposit Insurance in a Changing Environment* (1983), III-4-5. See also William Isaac, address before the Management Conference of the National Council of Savings Institutions (FDIC PR-92-83, December 6, 1983).

[54] See Eugenie D. Short, "FDIC Settlement Practices and the Size of Failed Banks," Federal Reserve Bank of Dallas *Economic Review* (March 1985): 19.

[55] FDIC, *Mandate for Change: Restructuring the Banking Industry* (1987), 112. For the reaction of a depositor (after the Continental assistance package) at a bank resolved through the modified payoff, see Pam Belluck, "Continental Illinois Rescue May Doom FDIC Plan to Share the Insurance Risk," *National Journal* (August 11, 1984), available: LEXIS, Library: BANKING, File: NTLJNL.

[56] *Federal Register* 50 (May 6, 1985): 19088.

The House Banking Committee staff found that this analysis—inasmuch as it did not take into account either the $100,000 payment on insured deposits or the banks' likely recovery from the disposition of Continental's assets—overstated the true exposure of the creditor institutions and thus the numbers of correspondent banks that fell into the above-mentioned categories. In reply, FDIC Chairman William Isaac noted that the FDIC had never suggested that all these banks would fail but that these small banks would probably have lost more than $1 billion and that such losses would have led to a number of failures. In addition, the assets involved would have been frozen while the bank was liquidated, and liquidation is a protracted process.[57]

The potential impact on the correspondent banks was not the only problem. Regulators were afraid of ripple effects on other large institutions that were perceived to be in vulnerable financial condition, banks such as First Chicago, Manufacturers Hanover, and Bank of America. The financial markets' worry about such banks was amply demonstrated just a week after the Continental assistance package was announced, when rumors about funding difficulties at Manufacturers Hanover caused its share price to drop 11 percent in one day, with other major banks' shares falling as a result.[58] Regulators feared that if Continental were allowed to close, a series of large institutions might be next; given this perception, open-bank assistance under the "essentiality" clause was viewed as the only viable option.[59]

The Continental assistance package sharpened the public's focus on TBTF, and not only because the bank's size ensured notoriety. C. T. Conover's statement before Congress that regulators would be unable to do a deposit payoff of the 11 largest banks seemed an explicit confirmation that large banks were inherently treated differently from smaller ones.[60] Even if this appeared to codify TBTF, it should be noted that many of the characteristics of Continental's resolution most relevant to TBTF were not unique to Continental. The FDIC had assisted a large bank before: only four years earlier, it had provided assistance in the form of a $325 million loan to First Pennsylvania, a $9 billion institution. Nor was the controversial guarantee that all depositors would be protected a novelty: the FDIC had made the same promise in the case of Greenwich Savings Bank in 1982.[61] Except for the FDIC's

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[57] U.S. House, *Inquiry*, 435–36, 444–45, 471–73.

[58] Greider, *Secrets*, 626–27, 632–33.

[59] For FDIC memos on FDI Act §13(c)(2) assistance under the essentiality provision, see U.S. House, *Inquiry*, 522–25. Stanley C. Silverberg notes that another factor militated against a deposit payoff in the case of Continental: that "the FDIC did not have the system and capability to pay off Continental's depositors in a reasonable time period and without looking incompetent." See volume 2 of this study.

[60] While noting that he would have preferred it to be otherwise, Conover admitted there was then no mechanism for treating large and small banks "in a consistent way that is fair to them," and he essentially agreed that the regulators could not allow any of the money-center banks to be liquidated in a payoff as they might allow smaller institutions to be (U.S. House, *Inquiry*, 299–300).

[61] See Chapter 6.

involvement as primary shareholder in the resurrected bank, the steps taken in the Continental assistance package were not really unprecedented.

TBTF after Continental

Despite reservations on the part of both regulators and industry about whether TBTF should be used, it remained in place into the 1990s, when its most famous exemplar was the resolution of three banking subsidiaries of the Bank of New England Corporation (BNEC), with total assets (at the time of failure) of $21.9 billion, in January 1991.[62] Although questions about unfairness and depositor discipline remained, the increasingly parlous state of the Bank Insurance Fund and the attendant increases in deposit insurance premiums made the issue more urgent, and attempts to restrict the policy formed an important part of the debate over FDICIA. Some members of Congress wanted to prohibit the government from protecting uninsured depositors altogether, but most regulators as well as many legislators, though wanting to limit the application of TBTF, favored retaining regulatory flexibility to deal with the relatively rare problem of systemic risk.[63] All depositors in some large banks would need to be protected, Federal Reserve Board Chairman Alan Greenspan noted, "in the interests of macroeconomic stability," but there would "also be circumstances in which large banks fail with losses to uninsured depositors but without undue disruption to financial markets."[64]

FDICIA as enacted essentially took this road, attempting to place limits on regulatory activities associated with TBTF but still leaving regulators the ability to invoke it under certain circumstances.[65] FDIC resolutions were now required to proceed according to a "least-cost" test, which would mean that uninsured depositors would often have to bear losses. The FDIC was prohibited from protecting any uninsured deposits or nondeposit bank debts in cases in which such action would increase losses to the insurance fund. One important effect of the least-cost provision was that the FDIC would not be able to grant open-bank assistance unless that course would be less costly than a closed-bank resolution; thus FDICIA limited the discretion the agency had exercised under the old cost test and essentiality provisions of the FDI Act. These changes have had a significant effect on the protection of

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[62] TBTF, specifically defined as the invocation of the essentiality clause with regard to an institution, was actually used only three times between the resolutions of Continental and BNEC. The other cases were First National Bank and Trust Company of Oklahoma City ($1.6 billion in assets) in 1986, First Republicbank of Dallas ($32.2 billion in assets) in 1988, and MCorp of Houston ($15.7 billion) in 1989 (assets are as of time of failure). See U.S. House, *Economic Implications*, 83. For a discussion of BNEC, see Chapter 10.

[63] See *BNA's Banking Report,* 56, no. 18 (May 6, 1991): 853ff., and no. 19 (May 13, 1991): 910ff. See also statements by L. William Seidman, Robert Clarke, and John LaWare, U.S. House, *Economic Implications*.

[64] *Congressional Quarterly* (May 11, 1991): 1174.

[65] For a discussion of the post-FDICIA period, see Larry D. Wall, "Too-big-to-fail after FDICIA," Federal Reserve Bank of Atlanta *Economic Review* 78, no. 1 (January/February 1993): 1–14.

uninsured depositors. From 1986 through 1991, 19 percent of bank failure and assistance transactions resulted in the nonprotection of uninsured depositors. From 1992 through 1994, the figure rose to 62 percent. On the basis of total assets, the average percentage of uninsured depositors suffering a loss was 12.3 percent from 1986 through 1991, but from 1992 through 1994 it increased to 65 percent.[66]

The law made an exception to the least-cost requirement in cases of systemic risk, but provided for a specific decision-making process to increase governmental accountability and limit the application of the exception. At least two-thirds of both the FDIC Board of Directors and the Board of Governors of the Federal Reserve must recommend that an exception be made, and this recommendation must then be acted upon by the secretary of the treasury in consultation with the president.[67] The General Accounting Office then reviews any such actions taken and reports its findings to Congress. In addition, FDICIA establishes a relationship between a bank's capitalization and the Federal Reserve's ability to provide assistance through the discount window: for critically undercapitalized banks, the Federal Reserve has to demand repayment within no more than five days, and if that limit is violated the Federal Reserve is liable for increased costs to the FDIC. As one economist who has recently examined FDICIA notes, the law clearly moves toward the elimination of TBTF as an operating principle and it gives the accountable agencies political incentives to avoid resorting to the systemic-risk exception. He concludes by observing that "although FDICIA does not ban the too-big-to-fail doctrine, it has substantially reduced the likelihood of future large bank bailouts."[68]

Conclusion

The crisis at Continental Illinois highlighted concerns about both large-bank supervision and large-bank failure and resolution. Given the regulators' anxiety about Continental's correspondent banks and their worries about overall systemic risk, it was very unlikely they would have pursued a course different from the one taken in 1984. Regulatory options were further limited by Continental's peculiar characteristics: although very large, it had proportionately few core deposits, no retail branches, and little franchise value. The Continental assistance package brought debate over TBTF to the fore, and although regulators would have preferred otherwise (a preference that did not mean regulators had a solution to

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[66] FDIC, *Failed Bank Cost Analysis* (1996), 10–11.

[67] If the systemic-risk exception is invoked, the FDIC must "expeditiously" recover the loss to the appropriate insurance fund through one or more special assessments on the members of the insurance fund of which the relevant institution is a member. (The assessment is to be equal to the product of an assessment rate established by the FDIC and "the amount of each member's average total assets during the semiannual period, minus the sum of the amount of the member's average total tangible equity and the amount of the member's average total subordinated debt.") See Public Law 102-242, §141(a).

[68] Wall, "Too-big-to-fail after FDICIA," 11.

put in its place), TBTF essentially remained in place until addressed by law in 1991.[69] Nevertheless, after Continental there were some significant changes as the banking agencies acquired greater experience with large-bank failures. For example, regulators were given more flexibility, which allowed them to deal with large-bank failures more efficiently. The most important addition to the regulatory arsenal was the bridge-bank authority granted by Congress in 1987.[70] Moreover, without addressing TBTF directly, by the late 1980s regulators were no longer, in L. William Seidman's words, " as solicitous of the interests of the bank's owners and bondholders" as they had been in the case of Continental. This changed policy had partly evolved by the time of the First City Bancorporation assistance in 1988, and was clearly evident in the case of First Republic, also in 1988, when FDIC money was channeled directly into the banking subsidiaries and not into the holding company.[71] By the early 1990s, many of the issues surrounding TBTF had been addressed under FDICIA, but the problem of systemic risk remains, as does the question of how regulators would respond today to a dilemma similar to the one they confronted in May 1984.

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[69] One effort to try to get beyond TBTF was described by Seidman, who noted that E. Gerald Corrigan, president of the Federal Reserve Bank of New York, proposed that regulators use a policy of "constructive ambiguity" to prevent any institution or its depositors from being certain they would be protected under TBTF. Seidman stated that although regulators agreed to follow such a course, "the markets knew that the largest institutions would always be known as too big to fail" (Seidman, *Full Faith and Credit*, 150).

[70] See the section on CEBA in Chapter 2.

[71] Seidman, *Full Faith and Credit*, 143–54.

Appendix

Table 7-A.1
Continental Illinois National Bank and Trust: Consolidated Statement of Condition, 1977–1983
($Millions)

	1977	1978	1979	1980	1981	1982	1983
ASSETS							
Interest-Bearing Deposits	$ 3906	$ 738	$ 3883	$ 4016	$ 4992	$ 1819	$ 3483
Securities	2759	2635	2896	2817	2482	3009	2175
Loans and Leases	14462	17489	21871	25725	31071	32185	30103
Selected Loan Categories							
Commercial Loans	5618	7120	9339	10980	14272	16183	14350
Real Estate Loans	555	869	1645	1926	2584	3092	3284
Foreign Office Loans	3672	4376	5502	7310	8337	7287	6640
LESS: Reserve for Loan Losses	154	173	191	225	265	364	368
Fed Funds and Reverse Repos	183	362	308	416	494	434	665
Total Earning Assets	**21157**	**24050**	**28769**	**32749**	**38774**	**37083**	**36059**
Cash and Due from Banks	2740	3904	3337	4359	2512	2189	2559
Other Assets	1078	1984	2188	3179	3860	2028	2052
Total Assets	**24975**	**29938**	**34294**	**40287**	**45156**	**41300**	**40670**
LIABILITIES							
Core Deposits	5581	6009	6254	6242	5822	6404	6595
Large Time Deposits	4525	6117	6260	7371	9174	6234	6836
Foreign Office Deposits	8337	8767	11222	13497	14884	15741	16442
Fed Funds and Repos	4403	5152	5914	7257	7886	5893	4811
Other Borrowings	256	1151	1247	1475	1917	3340	2041
Other Liabilities	772	1516	1997	3901	3685	1652	1905
Total Liabilities	**23874**	**28712**	**32934**	**38743**	**43370**	**39521**	**38839**
Total Equity Capital	1102	1226	1360	1544	1776	1779	1831
Total Liabilities and Capital	**24975**	**29938**	**34294**	**40287**	**45146**	**41300**	**40670**
Average Total Assets	$22892	$26359	$32035	$37846	$42320	$44084	$39020

Table 7-A.2
Continental Illinois National Bank and Trust: Consolidated Statement of Income, 1977–1983
($Millions)

	1977	1978	1979	1980	1981	1982	1983
INTEREST INCOME							
Interest on Deposits	$ 217	$ 293	$ 430	$ 615	$ 722	$ 487	$ 209
Securities Income	162	165	199	253	253	223	183
Interest and Fees on Loans and Leases	1012	1469	2346	3315	4661	4585	3404
Interest on Fed Funds and Reverse Repos	12	39	62	66	81	46	28
Total Interest Income	**1402**	**1967**	**3036**	**4248**	**5716**	**5342**	**3825**
INTEREST EXPENSE							
Interest on Large Time Deposits	183	335	495	692	1138	880	324
Interest on Other Deposits (incl. Foreign)	495	703	1233	1668	2178	2323	1932
Interest on Fed Funds and Repos	255	398	676	1041	1390	1054	508
Interest on Other Borrowings	17	28	72	132	224	229	234
Total Interest Expense	**951**	**1465**	**2475**	**3532**	**4929**	**4485**	**2998**
NET INTEREST INCOME	451	502	561	716	787	856	827
OPERATING INCOME							
Non-Interest Income	115	149	188	234	284	306	359
Overhead Expense	310	374	451	539	605	648	691
Provision for Loan Losses	52	57	65	91	114	477	359
Pre-Tax Operating Income	**205**	**221**	**233**	**320**	**352**	**38**	**137**
Income Taxes (Credit)	64	62	51	101	116	(34)	34
NET OPERATING INCOME	141	159	182	218	236	72	103
Securities Gains (Losses)	(2)	(1)	2	1	(5)	(2)	1
NET INCOME	139	158	184	219	231	70	104
Dividends Upstreamed	50	34	50	30	0	62	50

Table 7-A.3.

Continental Illinois National Bank and Trust: Financial Ratios, 1977–1983

	1977	1978	1979	1980	1981	1982	1983
Ratio to Total Assets of:							
ASSETS							
Interest-Bearing Deposits	15.64	12.49	11.32	9.97	11.06	4.40	8.56
Securities	11.05	8.80	8.44	6.99	5.50	7.29	5.35
Loans and Leases	57.91	58.42	63.78	63.85	68.81	77.93	74.02
Selected Loan Categories							
Commercial Loans	22.49	23.78	27.23	27.25	31.61	39.18	35.28
Real Estate Loans	2.22	2.90	4.80	4.78	5.72	7.49	8.07
Foreign Office Loans	14.70	14.62	16.04	18.14	18.46	17.64	16.33
LESS: Reserve for Loan Losses	0.62	0.58	0.56	0.56	0.59	0.88	0.90
Fed Funds and Reverse Repos	0.73	1.21	0.90	1.03	1.09	1.05	1.64
LIABILITIES							
Core Deposits	22.35	20.07	18.24	15.49	12.89	15.51	16.22
Large Time Deposits	18.12	20.43	18.25	18.30	20.32	15.09	16.81
Foreign Office Deposits	33.38	29.28	32.72	33.50	32.96	38.11	40.43
Fed Funds and Repos	17.63	17.21	17.24	18.01	17.46	14.27	11.83
Other Borrowings	1.03	3.84	3.64	3.66	4.25	8.09	5.02
Other Liabilities	3.09	5.06	5.82	9.68	8.16	4.00	4.68
Total Liabilities	95.59	95.90	96.03	96.17	96.04	95.69	95.50
Total Equity Capital	**4.41**	**4.10**	**3.97**	**3.83**	**3.93**	**4.31**	**4.50**
Ratio to Total Average Assets of:							
INTEREST INCOME							
Interest on Deposits	0.95	1.11	1.34	1.63	1.71	1.10	0.54
Securities Income	0.71	0.63	0.62	0.67	0.60	0.51	0.47
Interest and Fees on Loans and Leases	4.42	5.57	7.32	8.76	11.01	10.40	8.72
Interest on Fed Funds and Reverse Repos	0.05	0.15	0.19	0.17	0.19	0.10	0.07
Total Interest Income	6.12	7.46	9.48	11.22	13.51	12.12	9.80
INTEREST EXPENSE							
Interest on Large Time Deposits	0.80	1.27	1.55	1.83	2.69	2.00	0.83
Interest on Other Deposits (incl. Foreign)	2.16	2.67	3.85	4.41	5.15	5.27	4.95
Interest on Fed Funds and Repos	1.11	1.51	2.11	2.75	3.28	2.39	1.30
Interest on Other Borrowings	0.07	0.11	0.22	0.35	0.53	0.52	0.60
Total Interest Expense	4.15	5.56	7.73	9.33	11.65	10.17	7.68
NET INTEREST INCOME (NIM)	**1.97**	**1.90**	**1.75**	**1.89**	**1.86**	**1.94**	**2.12**
OPERATING INCOME							
Non-Interest Income	0.50	0.57	0.59	0.62	0.67	0.69	0.92
Overhead Expense	1.35	1.42	1.41	1.42	1.43	1.47	1.77
Provision for Loan Losses	0.23	0.22	0.20	0.24	0.27	1.08	0.92
Pre-Tax Operating Income	0.90	0.84	0.73	0.85	0.83	0.09	0.35
Income Taxes (Credit)	0.28	0.24	0.16	0.27	0.27	-0.08	0.09
NET OPERATING INCOME	**0.62**	**0.60**	**0.57**	**0.58**	**0.56**	**0.16**	**0.26**
Return on Assets (ROA)	**0.61**	**0.60**	**0.57**	**0.58**	**0.55**	**0.16**	**0.27**
Return on Equity (ROE)	**12.61**	**12.89**	**13.53**	**14.18**	**13.01**	**3.93**	**5.68**