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CONTINENTAL ILLINOIS: THE IMPLICATIONS

Address by

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before the

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Association of Bank Holding Companies

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It is truly a pleasure for me to have this opportunity to address this annual meeting of your association. We go back a lot of years together.

I want to focus my remarks today on the situation at Continental Illinois National Bank, explaining why we did what we did and addressing some of the implications for market discipline and deregulation. Our decision to provide interim assistance to Continental has engendered considerable public comment -- some informed and thoughtful, some wide of the mark.

A. What Happened and Why.

Continental had a substantial volume of problem loans and relied heavily on volatile funding sources. Beset by rumors, the bank was unable to meet its daily funding requirements in the markets, and liquidity strains were affecting markets generally. Something had to be done quickly to stabilize the situation. Realistically, we had two options: try to arrange a hasty merger or provide an interim capital infusion. We chose to provide interim capital to give the FDIC, bank management and prospective investors or merger partners the time needed to resolve the bank's difficulties in the most orderly manner possible at the lowest cost to the FDIC. A merger done on such short notice would not have given prospective purchasers an opportunity to evaluate the bank and, thus, would have required substantial FDIC financial involvement to protect against the uncertainties. At the same time, a merger would have had the same effect as the 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.

Since we wanted to stabilize the bank, we put in a very large amount of interim capital -- we felt that we should err on the side of too much rather than too little. We do not expect these funds to remain in Continental beyond the comparatively short period required to develop the permanent solution. It is too early to predict, but it is certainly possible that the permanent solution will not result in any loss to the FDIC.

Incidentally, the FDIC fund has never been stronger. Despite record losses over the past three years in handling bank failures, the fund grew dramatically from $11 billion at the beginning of 1981 to over $16 billion today. The fund is highly liquid (we raised the $1.5 billion for Continental in less than an hour and realized a market gain in the process), and our gross income this year will be in the range of $3 billion. Should the need arise, we have the right to borrow from the U.S. Treasury. We have never needed to use this authority and do not expect to do so, but it's there.

Much ado has been made of our assurance that all depositors and other general creditors of Continental would be protected in any subsequent transaction to permanently resolve the bank's problems. However, by placing $2 billion of interim capital in the bank on top of the bank's $2.3 billion in book capital and reserves, the FDIC was in fact protecting all depositors and other general creditors. Since the purpose of the interim capital was to stabilize the bank's funding sources, 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 judgment. Moreover, the FDIC's purchase of Continental's subordinated debt created the likelihood that a subsequent deposit payoff would be considerably more expensive to the FDIC than arranging a merger, and, as previously noted, a merger would protect all depositors and other general creditors against loss.

Our actions at Continental have several precedents. In 1981, the Greenwich Savings Bank in New York was experiencing a run. The FDIC gave a Continental-type assurance to depositors and other general creditors in order to buy time to arrange an orderly merger. The action was successful. 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.

Some have noted that the FDIC recently tested a modified payoff procedure, whereby depositors over the insurance limit were exposed to the risk of loss, and have questioned why the procedure wasn't employed at Continental. First, Continental had book capital and reserves of $2.3 billion. The bank was experiencing a serious liquidity problem, but its primary supervisor had not declared an insolvency. Without that, no payoff -- modified or otherwise -- could have been done. Second, the modified payoff procedure was introduced by the FDIC on March 16 of this year as a test. We said in our press release that if the procedure proved successful "after a reasonable testing period," we would "provide adequate public notice and substantial lead time" before changing our general procedures for handling bank failures. If we had employed the procedure at Continental, it would have entailed an abrupt change of policy on a massive scale and would have threatened hundreds of small banks which maintained correspondent relationships with Continental, as well as thousands of other businesses around the world. In short, it would not have been responsible under the circumstances, and small banks would have been among the principal victims.

B. <u>The Implications for Market Discipline.</u>

Our actions at Continental have raised questions about whether the FDIC will be able to continue its efforts to achieve a greater degree of market discipline in the banking system -- specifically, whether the modified payoff concept remains viable. The testing phase of our modified payoff procedure ended before the Continental assistance package was

announced (it was used in 8 out of 22 failures since March 16). We plan to evaluate the results and consult with bankers and others before deciding how to proceed. If we do go ahead, we will provide adequate public notice as promised in our press release of March 16. In the meantime, we may use modified payoffs when our normal procedures (e.g., our statutory cost test) would call for a straight payoff (indeed, in most of the 8 cases to date, a straight payoff would have been indicated due to the existence of large contingent claims or the lack of bids).

The need for market discipline is growing, not diminishing. It's 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.

In addition to fostering needed discipline, the modified payoff approach represents an attempt by the FDIC to develop a system for handling bank failures of all sizes in a more even-handed fashion. Prior to the modified payoff, the FDIC had but two options for handling a failure: (1) make all creditors whole through a merger or capital infusion or (2) do a straight payoff whereby all creditors over the insurance limit typically must wait for years to receive their money. A straight payoff would be extremely disruptive in a large bank and has never been used in one. About 25 percent of smaller bank failures have been handled as straight payoffs due to lack of bidders or to the existence of significant contingent claims. The modified payoff is designed to alleviate the adverse impact of a payoff and make it possible to handle failures of all sizes in an equitable manner. However, as noted previously, we believe we should give adequate public notice of our intentions before changing our general procedures for handling bank failures. This would encourage and provide the time for development of a private insurance system to cover the deposits at well-run banks in excess of the $100,000 FDIC limit. A delayed effective date would also give some of the weaker banks an opportunity to correct their problems.

Some have questioned, quite legitimately, whether seeking discipline through depositors by using modified payoffs is the best approach. In our deposit insurance study submitted to the Congress last year, we suggested an alternative that would encourage discipline through the suppliers of capital to banks, specifically subordinated debt holders. The federal banking agencies currently require equity capital in the 5-to-6-percent range for a well-run bank. We could raise the minimum standard to the 8-to-9-percent range, but allow the additional amount to be satisfied with subordinated debt. A well-run bank would be able to attract subordinated debt at a comparatively modest cost above the CD rate. A marginal bank would pay a premium or perhaps not even be able to issue the debt. While we believe this system could be nearly as effective as the modified payoff procedure in maintaining discipline and might be less disruptive in financial markets, the industry has thus far indicated its preference for the modified payoff approach. We have also

suggested other supplemental measures such as risk-based premiums and curtailment of the insurance coverage for deposits made by financial institutions and federal government agencies.

How all of this will sort itself out is not clear at this time. What is clear is that additional measures to enhance discipline in the financial system are absolutely essential if we wish to maintain a strong, private banking system.

C. The Implications for Deregulation.

The final issue I will touch on is deregulation. It's ironic that foes of deregulation are attempting to use the Continental episode to bolster their case. In my 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 liability costs. When banks try to raise service charges to help cover their increased expenses, they are roundly criticized. Banks like 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. Even now, in its current plight, Continental's choices of partners for a voluntary merger are severely limited by restrictive laws.

This is not to argue that Continental would not have gotten into difficulty had the regulatory climate been more benign. Continental's management made serious mistakes and has no one to blame but itself. But the regulatory environment did not give the bank very many attractive alternatives to following the high-risk path it chose.

The Administration has been attempting, with the support of Senator Garn and others, for more than two years to get Congress to enact a sensible banking-deregulation package. The proposals would greatly strengthen our nation's financial system, while offering the American public a broader range of convenient financial services at more competitive prices. The FDIC has been urging Congress to include in the package some long-overdue and essential reforms to the deposit insurance system.

We have maintained from the beginning that, in view of marketplace developments, the choice is not between deregulation and regulation. Liability-side deregulation is an accomplished fact -- it cannot be reversed. The only choice is between orderly deregulation and unplanned, helter-skelter deregulation. We are getting a good dose of the latter and I, for one, don't like what I see. Congress should seize this unique opportunity to take control by enacting much needed, comprehensive reforms.

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