Continental Illinois

What Happened to the Bank?

- Rapid growth strategy: 1975-1981 based on loan growth: in assets held (CGR = 15% 1975-81) and in fees generated by origination; favored stock in sector, recognized as one of the 5 best managed American companies.

- Grew to 6th largest US bank from 8th: One of the best loan loss records in the country; loan approval process decentralized and made easier; increasing share of C&I loan market; heavy focus on energy loans; bank is Wall Street analysts top choice in June 1981.

- 1982 – Penn Square Bank fails – ConIll identified as holding over $1 billion in loans to Penn Square. This occurs after other industrial bankruptcies and collapse of Mexican Peso in 1981 and beginning of the “Third World Debt Crisis.

- ConIll (Illinois is one-branch bank, limiting access to retail depositors) maneuvers to defend itself against “run of bank” (withdrawal of deposits); begins to utilize Euro CD market as principal source of deposits – this became 40% of bank’s entire funding

- High funding costs ate into high loan spreads, making bank on balance less profitable than peer banks. But this was made up by low overhead and noninterest expenses. End 1981 ROA = 236/45,000 = 0.52%

- Feb 1984 – CEO replaced by VChm

- 1984 – Nonperforming loans on ConIll’s books more than triple.

- Sells credit card business to maintain dividend

- May 1984: rumors develop in Tokyo that ConIll is about to file for bankruptcy. Run on foreign deposits begins. OCC issues report denying rumor. Borrows $4 billion from Chicago Fed (1/2 daily funding requirement)

- Announces consortium of 16 major US banks will provide LOC.
FDIC (with Fed and OCC approval) extends FDIC guarantee to “all depositors and general creditors of the bank.” FDIC extends capital infusion of $2 billion

Mid-May 1984. $20 billion in deposits run off.

1 July 1984, Federal officials admit run or deposits has continued and move to take over the bank.

“The Mother of All Restructurings”

Too big to fail – guarantee everything.

Continental divided by FDIC into “good” bank and (a new subsidiary) “bad” bank

FDIC buys bad loans with face value of $3 billion of $2 billion. Commits to buy up to $1.5 billion more bad loans over 3 years at book value

FDIC takes over bank’s debt to Chicago Fed, provides additional $1 billion investment in Preferred Stock convertible into 80% of bank’s common stock.

Conlll management team and Board are replaced by FDIC

Cost of the rescue to the FDIC = $1.7 billion.

By Dec 1990 (6 years later) bank had assets of $27 billion and ranked 27th in US. Now under Thos. Theobald – ex Citibank -- bank has new corporate strategy (to be a “business bank”). Bank went public again and FDIC was able to recover about $800 million of its costs.

Conlll intervention seen as very successful, model for others.

S&L liquidations were to follow. Also further commercial bank failures that forced banks to merge with others instead of being taken over by FDIC
Banks are Hedge Funds

- They are highly leveraged – Basle capital of 8% (10% in US)
- They are “spread traders” (long and short positions)
- They face trading risks as well as credit risks: basis, market (duration), liquidity, operations
- Management determines what investors get to know (write offs, etc)
- Hedge funds are allowed to fail (LTCM); will banks be too?

Bank Regulation Today

- FIREA (1989) – quick intervention
- Basel minimum capital agreements
- Extending deposit insurance is overprotective and expensive
- Repeal of Macfaden Act (more competition, consolidation), Glass Steagal (increase banks’ competitiveness)
- 2002: bankruptcies, third world debt, liquidity concerns (CP after Enron), increasing banking spreads.