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"The banking system is completely safe." (interview with William Isaac)

Q Mr. Isaac, reports of banks in trouble--such as the **Continental Illinois National Bank & Trust** Company in Chicago--and a record pace of bank failures around the U.S. have rattled a lot of bank customers. How safe is their money?

A I would hope that our actions over the past week, in particular, and over the past two or three years in handling a comparatively large number of bank failures in an orderly way demonstrate to the public that the banking system is completely safe. We have in place the mechanisms to take care of any problems, large or small, that might arise.

Q Just what are these "mechanisms," as you call them?

A The Federal Reserve, the nation's central bank, is available to provide liquidity to the system.

The Federal Deposit Insurance Corporation is normally called upon when a bank's troubles go beyond a straightforward liquidity problem--for example, if the bank is insolvent. In that case, we would handle the bank failure in an orderly way. On occasion, the FDIC has found it necessary to step in when there was a liquidity demand that was so large that we felt that it would be desirable to stabilize the situation in the bank.

Q Is that essentially what happened in the Continental case?

A Yes. We stepped in and provided a large infusion of interim capital in order to give us the time to assess the condition of the bank and give prospective purchasers and investors an opportunity to review the bank. At the same time, we provided assurances to the bank's depositors and other general creditors that they would be protected.

These actions by the FDIC are not unprecedented. In 1981 we gave similar assurance to depositors in the Greenwich Savings Bank in New York. Last year we made a capital injection in First National Bank of Midland, Tex., and United Southern

Bank of Nashville, Tenn. In the case of Continental, there are simply more zeros behind the numbers.

After we have had an opportunity to conduct our review, one very real possibility is that **Continental Illinois** will be merged into another institution. The merger will protect depositors and other general creditors of the bank but will not necessarily protect shareholders of the parent holding company.

Q Is your strategy to protect depositors and force stockholders and management, if necessary, to take their lumps?

A We have no responsibility to protect stockholders. We almost invariably sue management, boards of directors, accounting firms and others who are involved in a bank failure to try to collect damages for their negligent acts or other forms of misconduct.

Q Can current policies of the government be construed to mean that it would not allow a big bank to fail?

A Certainly we're not saying that a big bank cannot fail. What we are saying is that bank failures will be handled in a way that protects the public and maintains stability in the system.

In the foreseeable future, there are two realistic alternatives for handling a larger-bank failure: One is a merger into another institution, and the other is a capital infusion.

Q Why couldn't you just shut down a big bank like Continental and pay off the insured depositors?

A That simply is not a practical solution to this kind of problem. Continental has approximately 3 billion dollars in insured deposits. It has another 37 billion dollars in uninsured liabilities. The FDIC could have quite easily written out the check for 3 billion, but the closing of the bank and the refusal to honor 37 billion dollars' worth of claims would undoubtedly have had major consequences in financial markets. That kind of solution could have jeopardized individuals and businesses around the country, including a number of smaller banks.

Q Is there a danger that Continental's troubles and the other bank failures could undermine the whole U.S. banking system?

A We will not allow widespread instability in the system. We will take whatever steps are necessary to prevent that. The fact is the 33 banks that have failed this year were seriously mismanaged. They are not the norm for the industry. Roughly 90 percent of the 14,700 banks in this country are rated 1 or 2 on our rating system. That means they are good banks. We have a small percentage of the banks on our problem-bank list--roughly 4 or 5 percent. Even they, for the most

part, are not in serious danger of failing.

Only a small number of banks fail each year. Even though the number is higher than normal right now, it is still less than one half of 1 percent of all banks. I don't know of another industry that comes close to being that safe.

Q Does the FDIC have the resources to handle these problem banks?

A Without question. The insurance fund stands at 16 billion dollars right now. I might add that not one penny of this is taxpayers' money. This money comes from the premiums paid by insured banks.

We also have the right to borrow from the Treasury should the need ever arise. We have never needed to do that, and, frankly, I can't see a reasonable scenario ahead of us that would require that.

Q There are a record 675 banks on the FDIC's "problem" list. Is sloppy management the main reason why this number is so high?

A It's basically management mistakes that have caused these banks to get in trouble--but I would add that you always see a rise in the number of banks on the problem list when you have turbulence in the economy.

Q You mean the last recession--

A Well, it's not just the last recession.

We had a decade or more of excessive inflation during the 1960s and 1970s. Banks and bank customers began to make decisions based upon the assumption that that inflation was going to continue.

For example, an oil driller wants funding for exploration. At the time, crude oil is selling for \$30 a barrel. Everybody believes that oil prices are going to go to \$60 a barrel, so the deal gets financed. But that kind of loan is not viable in the absence of inflation.

Then we had a period of very high interest rates in 1979 and 1980. The people who got hurt first and hardest were marginal businesses and the banks that took the higher risks. Following that, we experienced a fairly deep recession.

We believe the current recovery will significantly reduce the number of problems. But we must get interest rates under better control.

Q Many banks are pressing for more powers to expand their business. Do you think that the banks are strong enough to handle deregulation?

A Yes. Furthermore, they don't have a choice. If we are going to maintain strength in the financial system, we are going to have to give banks an opportun-

ity to earn money by offering a broader range of financial services, such as investment banking or life insurance. This will help offset the cost of liability-side deregulation.

We've forced banks to pay market rates of interest for their deposits. We have not given banks adequate ways to earn the money to offset those liability costs.

Q Will all of that be good for consumers?

A The big winner is going to be the American public. First, it will result in a stronger financial system, and, second, it will create a more competitive financial system, offering a broader range of services.

Q Do you mean that interest rates would come down?

A More-competitive prices, no question.

Q Congress is trying to decide whether to give banks more powers. Will the Continental episode cause Congress to vote against deregulation or postpone the decision?

A It shouldn't, but it might. We were having a great deal of difficulty getting a consensus in Congress on how to proceed with deregulation.

Unfortunately, the Continental episode might make it more difficult to achieve that consensus--for all the wrong reasons. The fact is that the Continental situation demonstrates some of the flaws in excessive reliance on regulatory restraints.

Q What kinds of flaws?

A One of Continental's problems is that it was dependent on volatile funding sources. Why was it so dependent on volatile funding sources? In part because Illinois law does not allow the bank to branch. Unlike most major banks around the country, Continental was not able to develop a strong local-depositor base. If it wanted to grow, it couldn't go out and establish branches in the suburbs of Chicago and elsewhere around the city; it had to buy the funds in national money markets.

Second, even in view of its present plight, Continental is severely limited in its choice of merger partners. Continental wants to talk merger, but under our restrictive laws the bank is limited in its choice of voluntary merger partners to in-state firms and foreign banks. The FDIC can arrange an interstate involuntary merger, but the bank cannot unless Illinois changes its law.

My point is that the regulatory system has helped exacerbate the problems. I'm not saying it caused the problems. The fact is that Continental's management made some very serious mistakes and has no one to blame but itself. But the regulatory

climate in which they were operating helped nudge them in the direction they went.

Q What's next for **Continental Illinois**?

A The liquidity problem has been alleviated; in fact, funding is starting to come back. However, in the near term, a permanent resolution of the bank's problems must be arranged.

The No. 1 problem right now is obtaining additional permanent capital. That could be arranged by way of a merger or by having a group of investors acquire a substantial amount of stock in the institution.

William Isaac. (portrait)

Bank failures. (graph)

----- INDEX REFERENCES -----

COMPANY: CONTINENTAL ILLINOIS **CORP**; FEDERAL DEPOSIT INSURANCE **CORP**

NEWS SUBJECT: (Banking Risk (1BA09); Mergers & Acquisitions (1ME39); Economic Policy & Policymakers (1EC69); Economics & Trade (1EC26); Corporate Groups & Ownership (1X009))

INDUSTRY: (Banking (1BA20); Major Central Banks (1MA01); Bank Operations (1BA31); Federal Reserve (1FE99); Financial Services (1FI37); Financial Services Regulatory (1FI03))

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