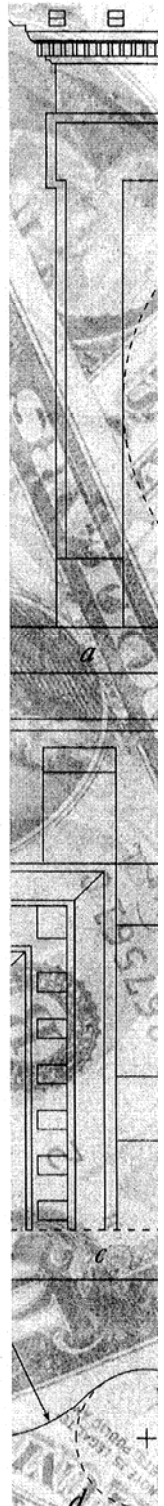


Wharton

Financial Institutions Center

The Collapse of Continental Illinois National Bank and Trust Company:
The Implications for Risk Management and Regulation

The Wharton School
University of Pennsylvania



THE COLLAPSE OF CONTINENTAL ILLINOIS NATIONAL BANK AND TRUST COMPANY: THE IMPLICATIONS FOR RISK MANAGEMENT AND REGULATION¹

The collapse of Continental Illinois National Bank and Trust was a watershed event in modern banking history that holds lessons for both bank risk managers and regulators. It showed how quickly the revelation of credit problems at a well-regarded bank could turn into a liquidity problem that jeopardized not only the survival of the bank itself, but also, in the view of the US regulators, the financial system. It is widely, if controversially, cited as a prime modern example of systemic risk.

The run on Continental was global and began when traders in Tokyo refused to roll-over their inter-bank placements with Continental. By the time markets opened in the US, Continental Illinois was no longer a viable institution. The U.S. authorities improvised a series of increasingly desperate bail-out measures including the guarantee of uninsured depositors and creditors of the bank, but these measures failed to restore confidence in the institution. Continental remains the largest institution ever to have been rescued by the Federal Deposit Insurance Corporation. Indeed, during Congressional testimony surrounding the intervention in Continental, the regulatory authorities admitted that the ten other largest US banks were also “too big to fail.” The ultimate resolution of Continental Illinois – the so-called Continental divide – has become the prototype for numerous good bank/bad bank restructurings around the world.

The collapse of Continental also influenced the redesign of the financial safety net in the United States. Widespread dissatisfaction with the too-big-to-fail doctrine and a series of subsequent bailouts of troubled institutions during the late 1980s and early 1990s led to the regulatory reforms embodied in the Federal Deposit Insurance Improvement Act of 1991. These included attempts to increase market discipline of large banks by creditors and uninsured depositors, to strengthen capital adequacy, and to reduce regulatory discretion to forbear.

The background material for this case was originally submitted by the Comptroller of the Currency, C.T. Conover, to the House Banking Committee four months after the collapse of Continental. As the official with principal supervisory responsibility for Continental, Conover had the awkward task of explaining to Congress why Continental collapsed despite the superb quality of supervision it received. Although the Comptroller’s statement reflects this special perspective, the facts are clearly stated.

¹ These materials were assembled by Richard J. Herring, Jacob Safra Professor of International Banking, The Wharton School, University of Pennsylvania. An earlier version of this case appeared in the New York University Salmon Center Series.

The Collapse of Continental: A Chronology

1976–1981	Rapid growth in assets, specialization in lending to the energy sector and corporate lending more broadly
1981:	Became 6 th largest US bank with \$45.1 billion in assets, 12,000 employees.
July 5, 1982	Failure of Penn Square Bank, run on Continental
1982-1984	Rise in non-performing loans
May 9, 1984	Run begins in Tokyo
May 11, 1984	Borrows \$3.6 billion through Fed discount window
May 14, 1984	16 banks provide Continental with a \$4.5 billion 30-day line of credit
May 17, 1984	Regulators announce unprecedented interim assistance package
September 26, 1984	FDIC implements good/bank bad bank restructuring, effectively nationalizing Continental
1991	FDIC sells last of equity stake in Continental, seven years after collapse

Based on your reflections on the Comptroller's statement below, please formulate answers to the following questions:

1. Why did Continental experience a run in 1982? How did it manage to survive without recourse to official assistance?
2. After the run in 1982, what did Continental do to reduce its vulnerability to a funding shock? What else could it have done?
3. Why was the run in 1984 more devastating?
4. Why did the Federal Deposit Insurance Corporation guarantee all of Continental's creditors against loss? What alternative policy could the authorities have implemented?
5. After the closure of BCCI on July 5, 1991, the United Kingdom experienced a "flight to quality" in which wholesale depositors--and even some retail depositors--shifted their funds from small banks to the largest banks. When the Bank of England tried to enlist the aid of the four largest banks to provide financial support for smaller banks experiencing liquidity problems the clearing banks refused saying "Why should we risk our capital to prop up competitors?" Note how this incident differed from the behavior of large US banks after the collapse of Continental Illinois. What may account for the difference in the behavior of the large UK banks and the large US banks?
6. During the mid-eighties Bank of America was the subject of market rumors that were eerily reminiscent of the Continental episode. Why was Bank of America able to withstand shocks similar to those which destroyed Continental?
7. Bank of America acquired Continental in January 1994. It made two principal arguments about how it could add value to Continental: 1. It could sell a broader range of products to Continental's existing customer base and 2. It could fund Continental Illinois at substantially lower cost. Why did the market find the second argument especially plausible?

Continental Illinois National Bank and Trust Company

Ten-Year Review*

This statement provides a ten-year historical overview of the principal events leading up to the federal rescue of Continental Illinois National Bank and Trust Company. Continental's history, for this purpose, falls naturally into two distinct time periods: the period from 1974 through 1981 when Continental grew rapidly and acquired many loans that ultimately turned into losses, and the period from the beginning of 1982 until July 1984 in the aftermath of the discovery of significant loan problems. The statement reviews the effects of the U.S. economy on the bank, significant actions taken by the bank, and OCC's supervisory involvement. The discussion and accompanying charts relate to the bank and not the bank holding company. Unless otherwise indicated, the peer group referred to in the charts and analysis is composed of eight wholesale money center banks.**

Continental: 1974 - 1981

Located in America's industrial heartland, Continental historically focused on domestic corporate lending. Because state restrictions on branching limited the establishment of a significant retail customer base, corporate lending was a natural area for Continental to emphasize. As the U.S. emerged from the 1974-75 recession, economic growth was strong and many new lending opportunities emerged.

Roger E. Anderson became Chairman and Executive Officer in 1973. He and his new management team set ambitious strategic business goals to make Continental a world class bank. In describing those goals, a bank executive was quoted in a 1980 *Institutional Investor* article:

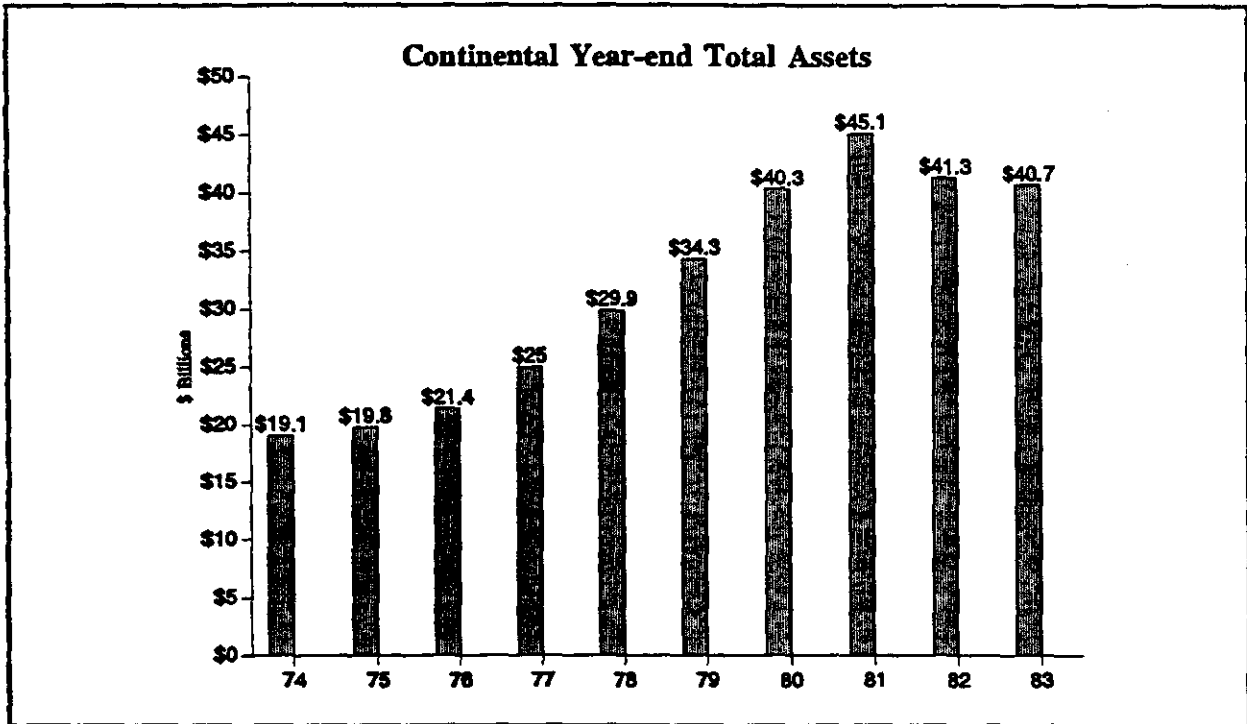
We're a country bank...What we would like to do is demonstrate that a Midwestern country bank can become the most magnificent force in the banking world.

Between 1974 and 1981, Continental's assets grew an average of over 13% per year. Its \$45.1 billion in total assets at year-end made it the sixth largest bank in the nation, up from the eighth largest in 1974.

As illustrated in the second chart following, Continental generally grew faster than other wholesale money center banks during this period.

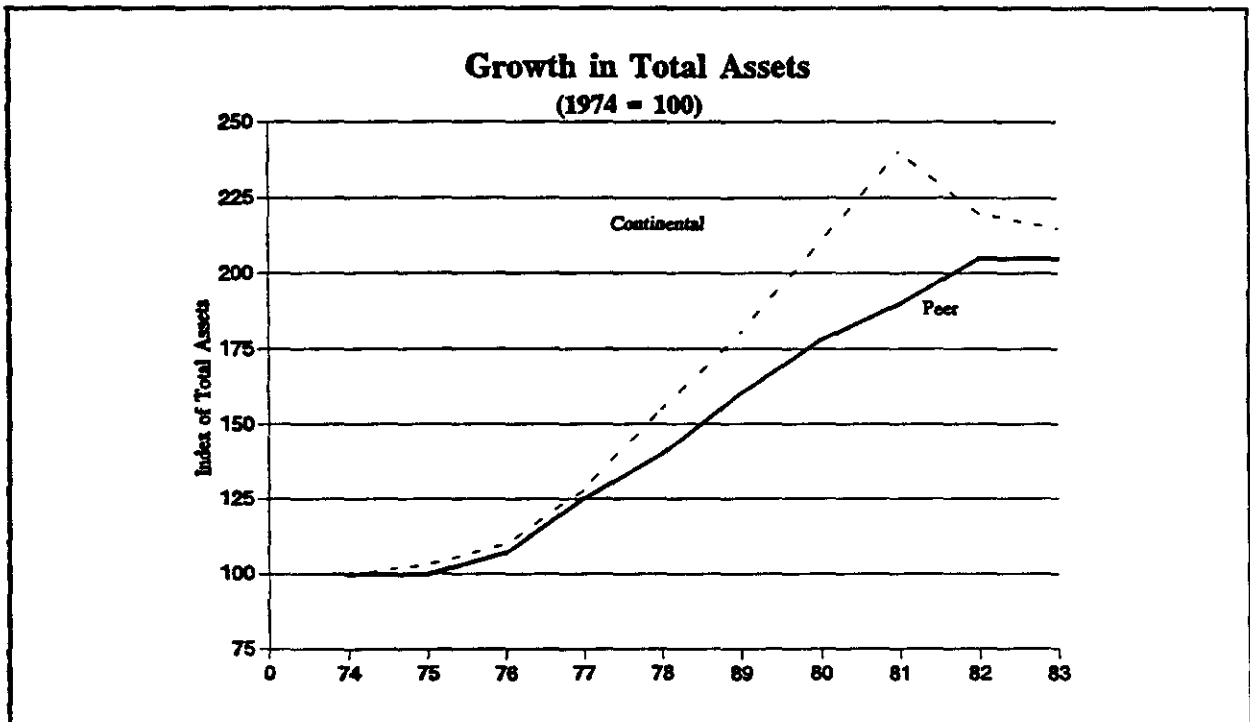
* Appendix to a statement of C.T. Conover, Comptroller of the Currency, before the Committee on Banking, Finance, and Urban Affairs, U.S. House of Representatives.

** The eight wholesale money center banks included in the peer group are Bankers Trust, Chase Manhattan Bank, Citibank, First National Bank of Boston, First National Bank of Chicago, Irving Trust Co., Manufacturers Hanover Trust Co., and Morgan Guaranty Trust Co.



Source: Call Reports

As illustrated in the following chart, Continental generally grew faster than other wholesale money center banks during this period.



Source: Call Reports

Beginning in 1973, Continental embarked on an aggressive assault on selected segments of the banking market. The bank rapidly built up its consumer loan portfolio. A private placement unit was created that secured a foothold in the market by arranging placements of debt for small companies. Its international effort was expanded by structuring syndicated Eurodollar loans, making advances in direct lending to European multinational companies, and becoming active in project financing.

Like most banks, Continental suffered during the collapse of the real estate investment trust industry in the mid-1970s. Continental's management, however, handled this problem well; it recovered from its real estate problems more successfully than most other large banks with similar problems. As a result, Continental continued to remain active in real estate lending throughout the 1970s. Its mortgage and real estate portfolio grew from \$997 million at the end of 1977 to approximately \$2.3 billion at the end of 1979.

Continental emerged from the 1974-75 recession with one of the best loan loss records among its peer group, reflecting management's ability to steer the bank through economic downturns. Financial problems at some of Continental's prime competitors in the late 1970s also provided the bank with a competitive opportunity to increase its market share and become the "premier bank in the Midwest."

OCC's assessment of Continental's management and the bank's performance during the eight examinations conducted by this Office in the 1974-81 period was favorable. The bank was particularly strong as it emerged from the 1974-75 recession. Earnings were rising and the bank's handling of its problem loans following that recession was superior to that of most other wholesale money center banks.

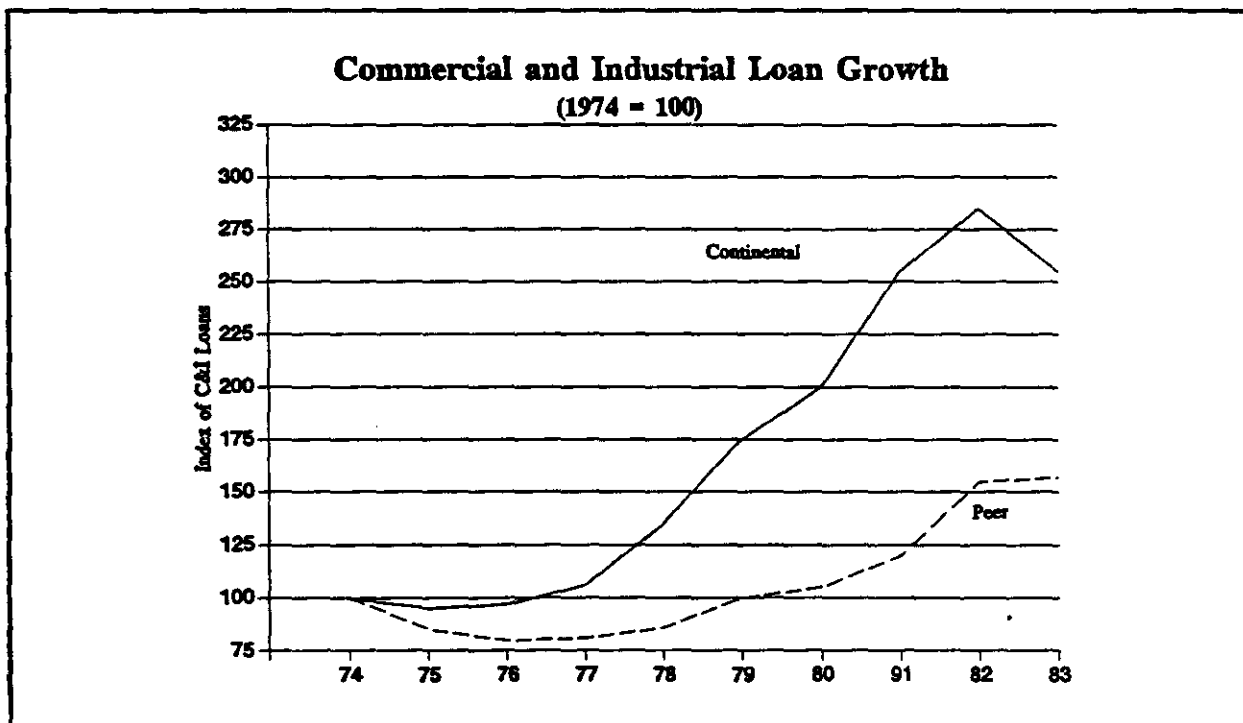
In 1972, the bank expanded individual lending officers' authority and removed the loan approval process from a committee framework. Continental revamped its organization in 1976 and eliminated more of the "red tape" in its lending procedures. Major responsibility was delegated to lending officers in the field, resulting in fewer controls and levels of review, in order to provide lending officers with the flexibility to rapidly take advantage of lending opportunities as they arose. While decentralized lending operations were common among money center and large regional banks, Continental was a leader in this approach. Management believed that this organizational structure would enable Continental to expand its market share and eventually meet its goal of becoming "one of the top three banks lending to corporate America."

In light of Continental's rapid growth, OCC examiners stressed the importance of adequate controls, especially in the loan area. Certain internal control problems within the bank were noted by examiners. In particular, exceptions were noted in the timeliness of putting problem loans on the bank's internal watch list.

In reaction to these criticisms, management implemented new control features, including computer-generated past due reports and a system to track exceptions in the

internal rating process. Given the bank's historical loan loss experience and proven ability to deal with problem situations, supervisory concerns were not of a serious nature.

During the period 1974-81, Continental sought to spur loan growth by courting companies in profitable, although sometimes high risk businesses. Lending officers were encouraged to move fast, offer more innovative packages, and take on more loans. This aggressive lending strategy worked well for the bank; Continental's commercial and industrial (C&I) loans expanded from \$4.9 billion in 1974 to \$14.3 billion in 1981. Moreover, it was able to expand its market share during a period in the late 1970s when many other major U.S. banks experienced declining market shares because of increasing competition from foreign banks, the commercial paper market, and other nontraditional lenders. By adding numerous multinational and middle-market companies that previously did no business with the bank, Continental's share of the domestic C&I loan market rose from 3.9% at the end of 1974 to 4.4% at year-end 1981.

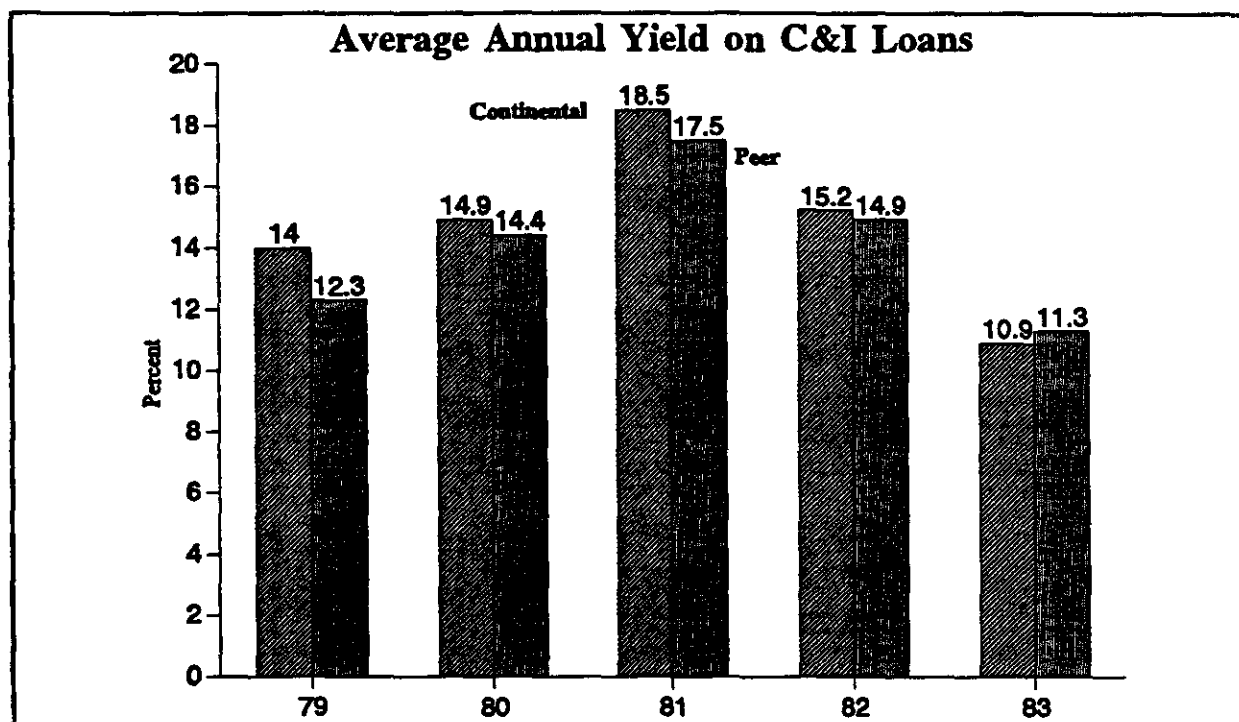


Source: Call Reports, OCC

As part of its corporate expansion, Continental became particularly aggressive in the energy area. The bank created a special oil-lending unit in the early 1950s -- reportedly the first major bank to have petroleum engineers and other energy specialists on staff. The economic consequences of the 1973 oil embargo and the resulting four-fold increase in world oil prices pushed energy self-sufficiency to the forefront of our national goals. A number of actions were taken by various Administrations and Congress following the first embargo and subsequent oil price hikes to both reduce U.S. energy consumption and to

increase domestic production. The Department of Energy, created in 1977, sought to develop ways of encouraging higher investment in U.S. exploration, development, production, and refining capacity. Cultivation of this niche had made Continental a premier energy lending bank and contributed significantly to its rapid, and profitable, expansion.

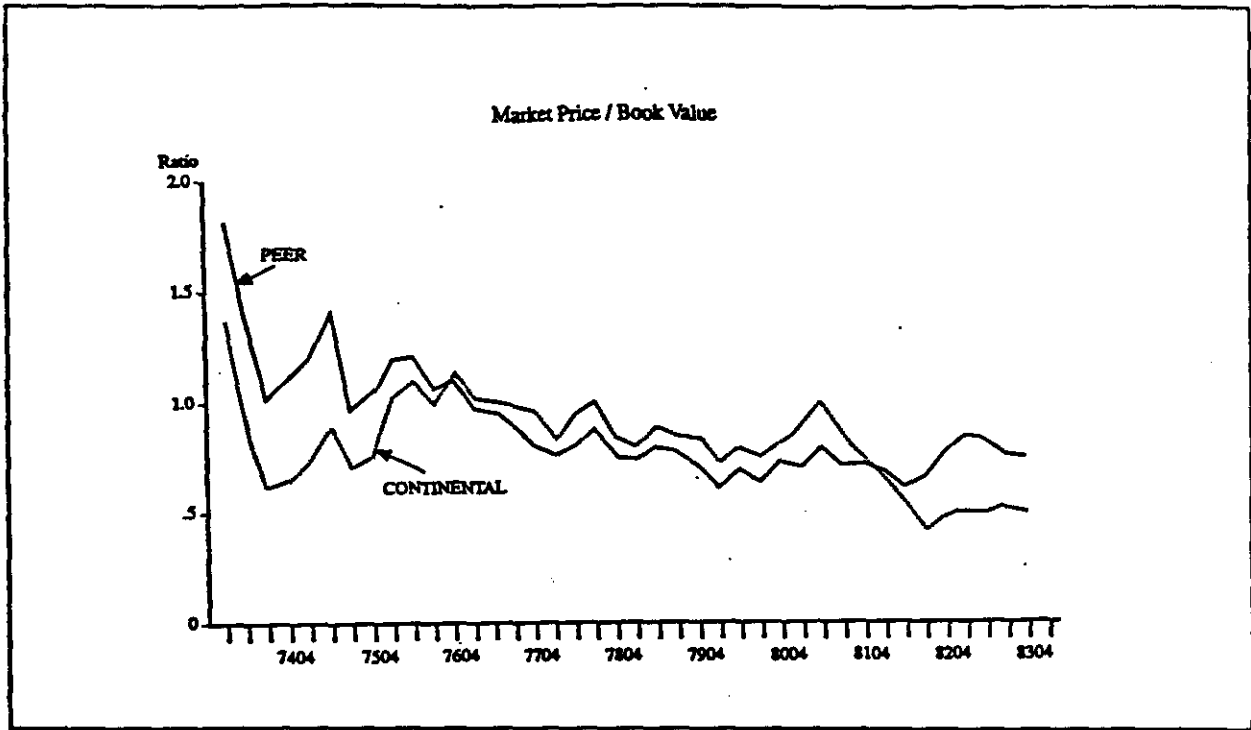
Continental C&I loans, including its energy loans, produced high returns for the bank. Average yields were consistently higher than those of other wholesale money center banks.



Peer group includes only national banks.

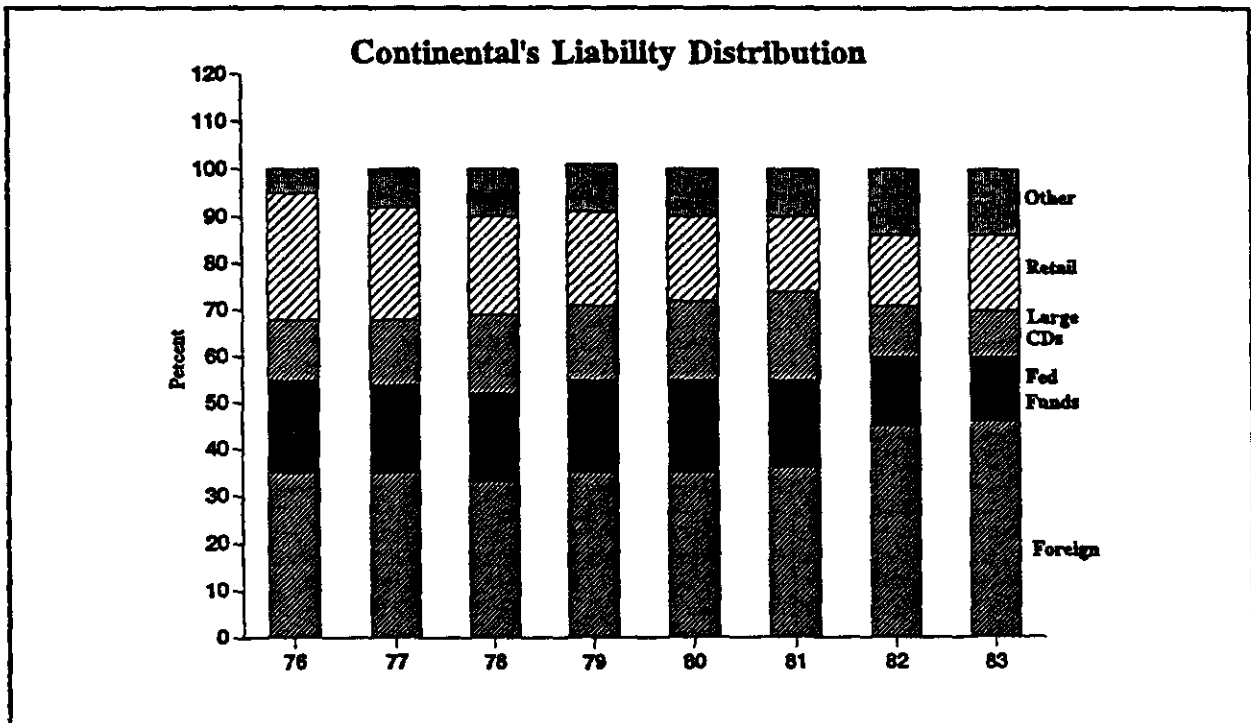
Source: Call Reports

The financial markets reacted favorably to Continental's aggressive growth strategy. In 1978, *Dun's Review* described Continental as one of the five best managed companies in America. Many analysts regarded it as a preeminent wholesale money center bank, citing its stable asset and earnings growth, its excellent record in loan losses, and its expertise in energy lending. Continental Illinois Corporation's ratio of market price to book value, which had lagged behind other money center bank holding companies in the early 1970s, began rising in 1976.



Source: Data Resources, Inc.

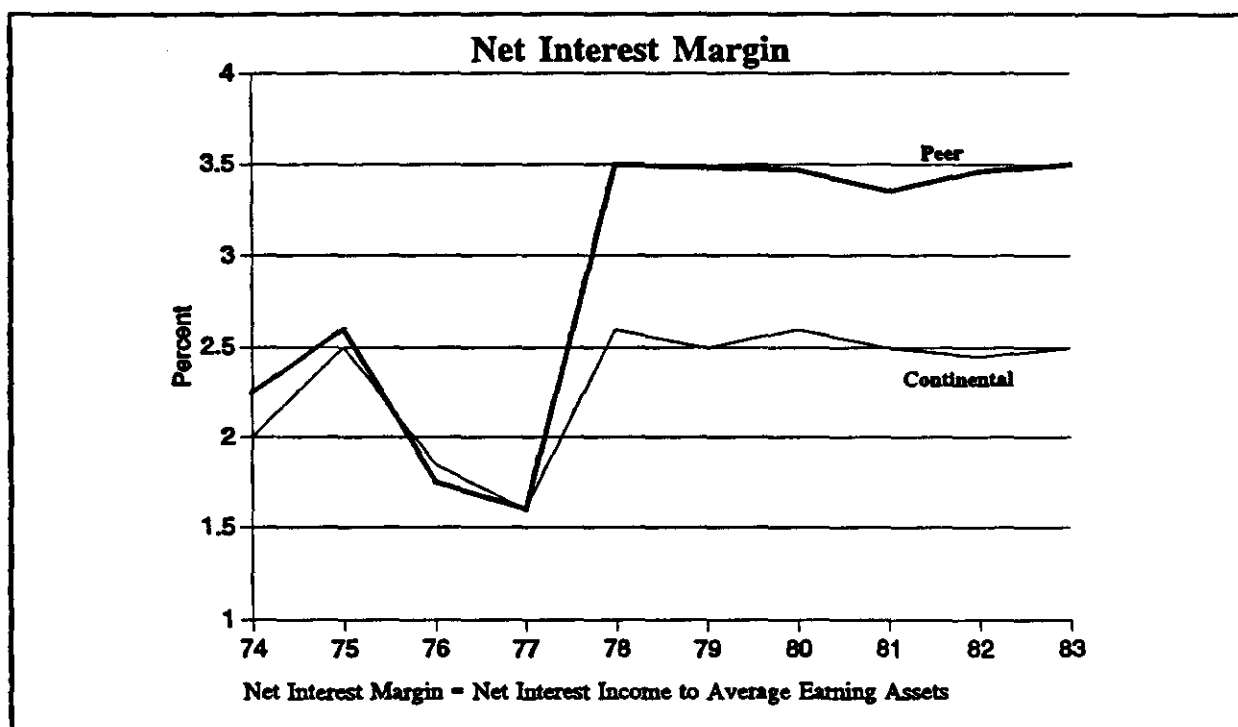
With limited access to retail banking markets and core deposit funding because of restrictive branching statutes in Illinois, Continental funded its rapid growth through purchased wholesale money such as federal funds, negotiable certificates of deposit, and the interbank market. Its reliance on purchased funds, approximately 70% of total liabilities, was much higher than its peer group average.



Source: Call Reports

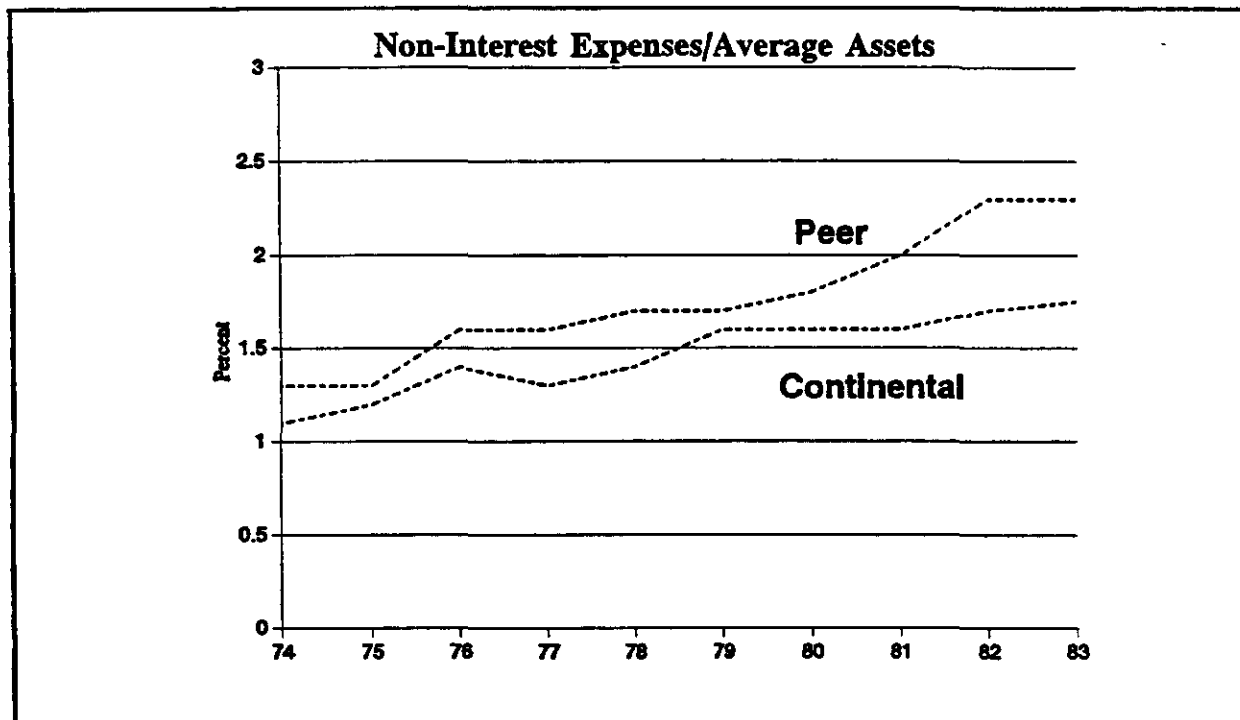
Concerns were raised by OCC examiners in the 1976 examination over the bank's liquidity and its reliance on Fed Funds, foreign deposits, and negotiable CDs. By the time of the summer 1977 examination, Continental had improved its liquidity position and had enhanced its monitoring systems. OCC examiners concluded that the Office's funding and control concerns were being adequately monitored by the bank. The bank was requested, however, to submit quarterly status reports on classified assets over \$4 million and monthly financial statements.

Continental's heavy reliance over this period on purchased money, which had a higher interest cost than retail deposits, offset much of the gain that accrued from Continental's higher loan yields. High funding costs reduced Continental's net interest margin to a level well below its peer group.



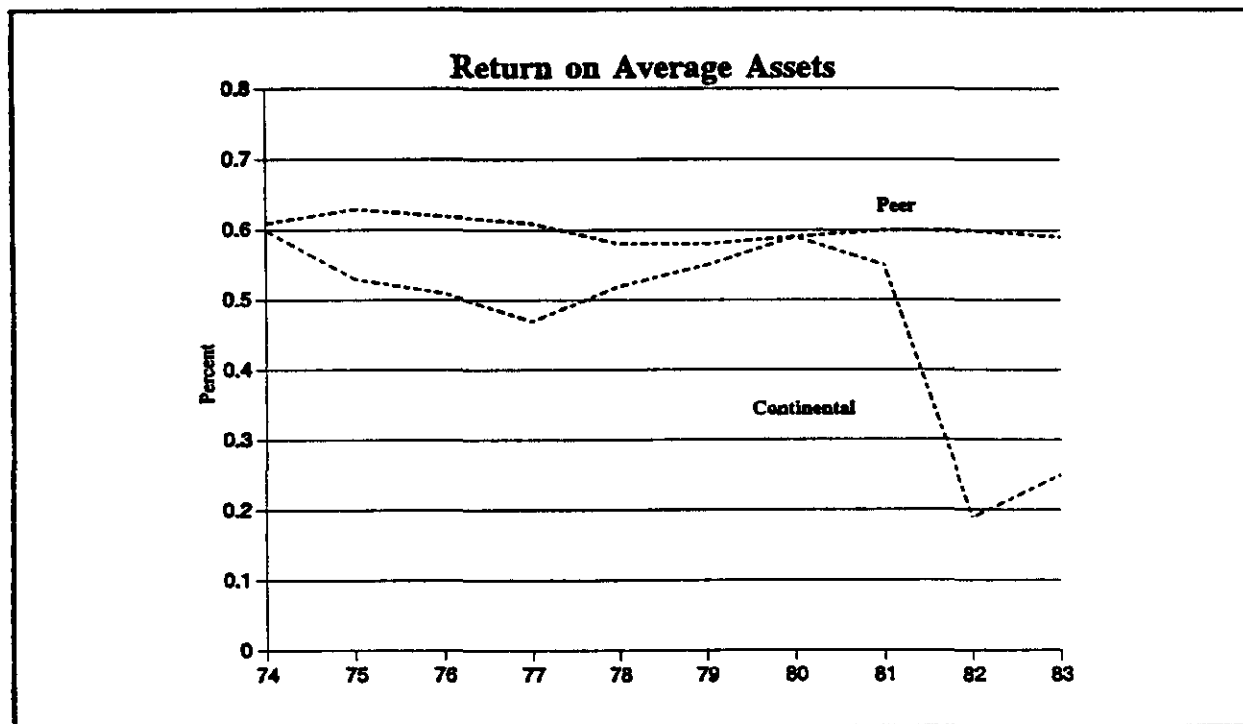
Source: Call Reports

Continental was, nevertheless, able to maintain its superior earnings growth because of low overhead and non-interest expenses. The absence of domestic branches and relatively few foreign branches, compared to other money center banks, held down Continental's overhead expenses and, therefore, compensated for some of its high funding costs. As illustrated in the following chart, Continental's ratio of non-interest expenses to average assets was far below its peer group average.



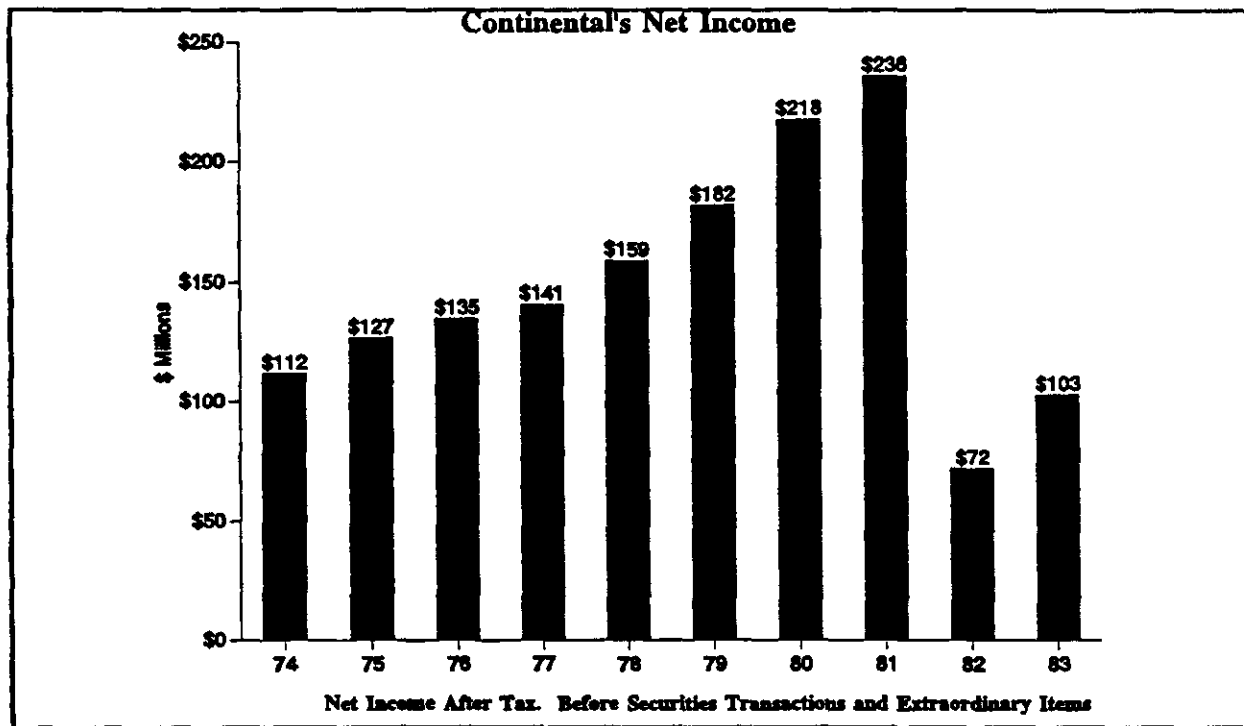
Source: Call Reports

As a consequence, through 1980 Continental was able to achieve one of the best and most consistent performance records among money center banks. Its ROA was consistently above the average of other wholesale money center banks.



Source: Call Reports

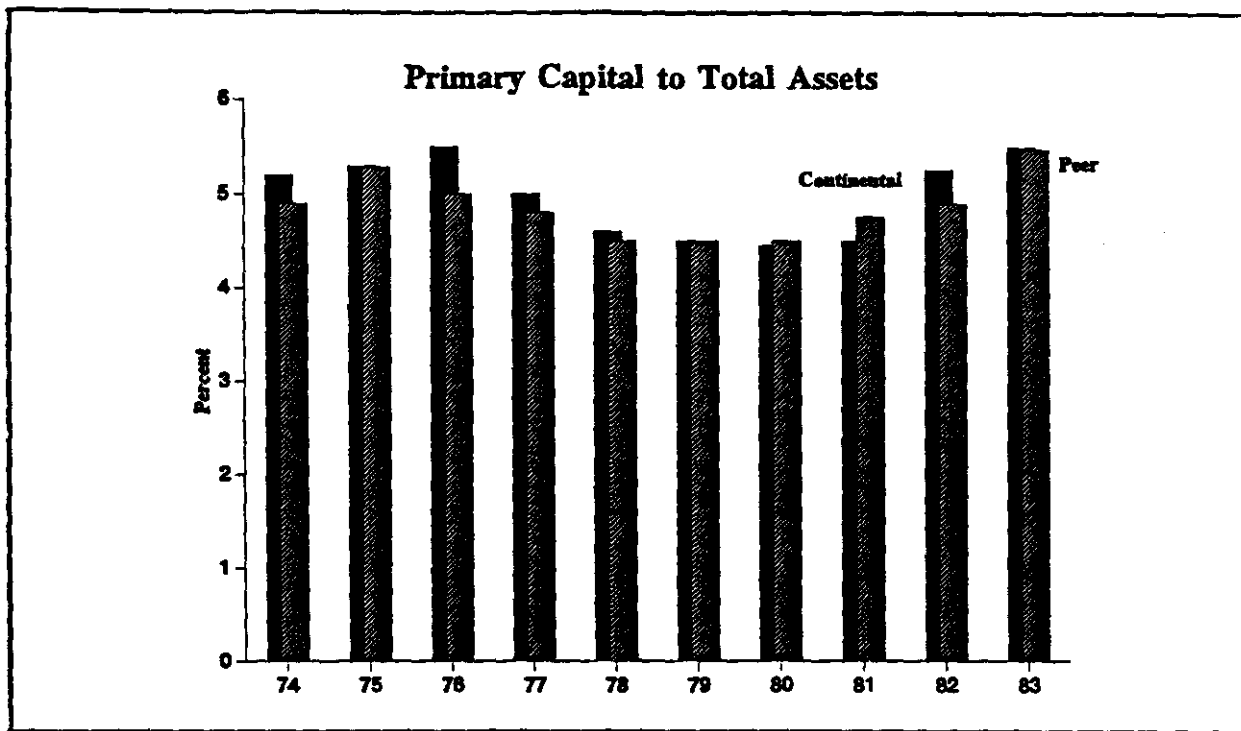
The bank showed record earnings while its assets grew to a high of \$45.1 billion in 1981. As shown in the following chart, net income rose rapidly before peaking at \$236 million at year-end 1981.



Source: Call Reports

As noted earlier, in the examinations conducted by this Office in the 1974-1981 period, Continental's overall condition was found to be good and it generally compared well with other multinational banks under our supervision. In addition to liquidity and internal controls, our concerns during this time period centered on capital adequacy and asset quality.

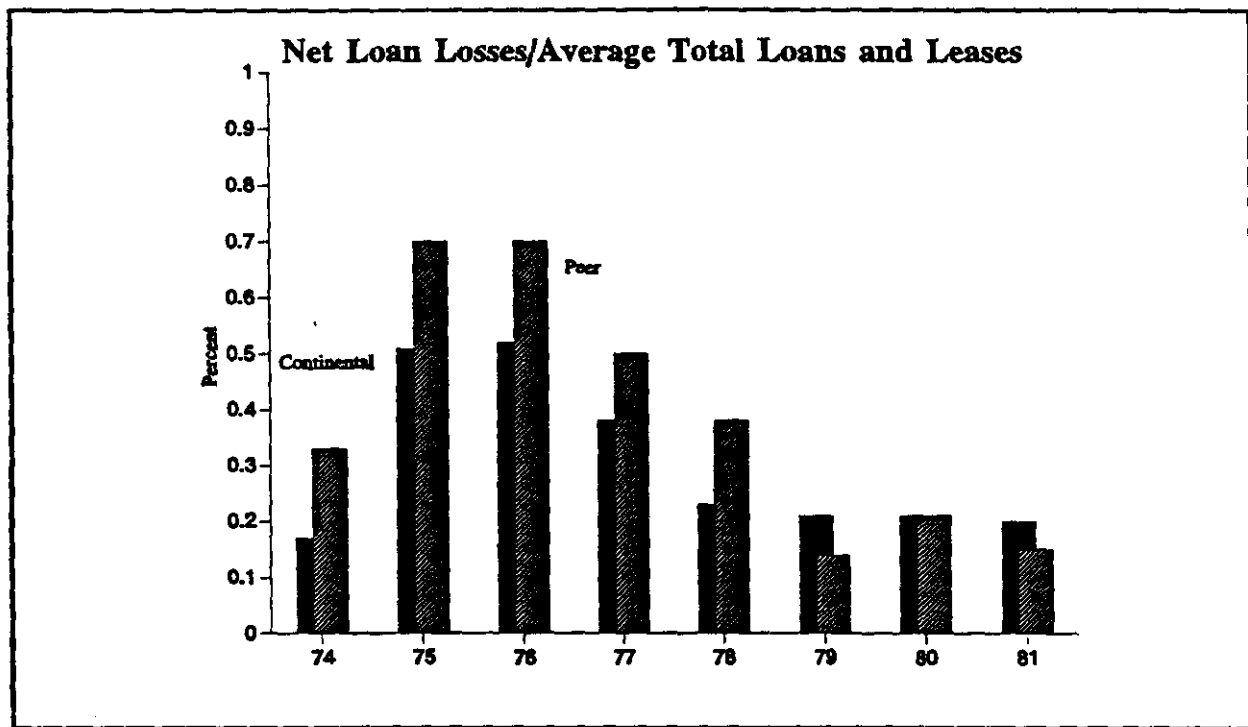
While Continental's capital to asset ratio compared favorably to other money center banks, OCC examiners expressed concern throughout the late 1970s about the bank's ability to generate sufficient capital to keep pace with its rapid expansion.



Source: Call Reports

During the 1976 examination, the Office pointed out that, unlike most other large national banks, Continental had no definite capital growth plan. As a result, the bank prepared a three year capital plan and took immediate measures to increase capital, including cutting the size of its 1976 dividends to the holding company, by \$15 million, to \$45.6 million. In addition, the bank holding company issued debt and used the proceeds to inject \$62 million into the bank's surplus account. Despite these efforts, capital failed to keep pace with asset growth and continued to decline through 1980.

Continental had an excellent loan loss experience, with one of the lowest percentages of nonperforming assets and net loan losses in the industry. Asset quality, which was a major concern at most money center banks in the 1975-1976 period, showed steady improvement at Continental throughout the late 1970s. Its classified assets decreased dramatically following the recession, demonstrating management's ability to deal effectively with problem assets. By the end of 1977, Continental had classified assets representing 86% of gross capital, down from 121% of capital the previous year. In the 1975-1977 period, Continental's ratio of net loan losses to average total loans and leases was 25% lower than the average of other wholesale money center banks.



Source: Call Reports

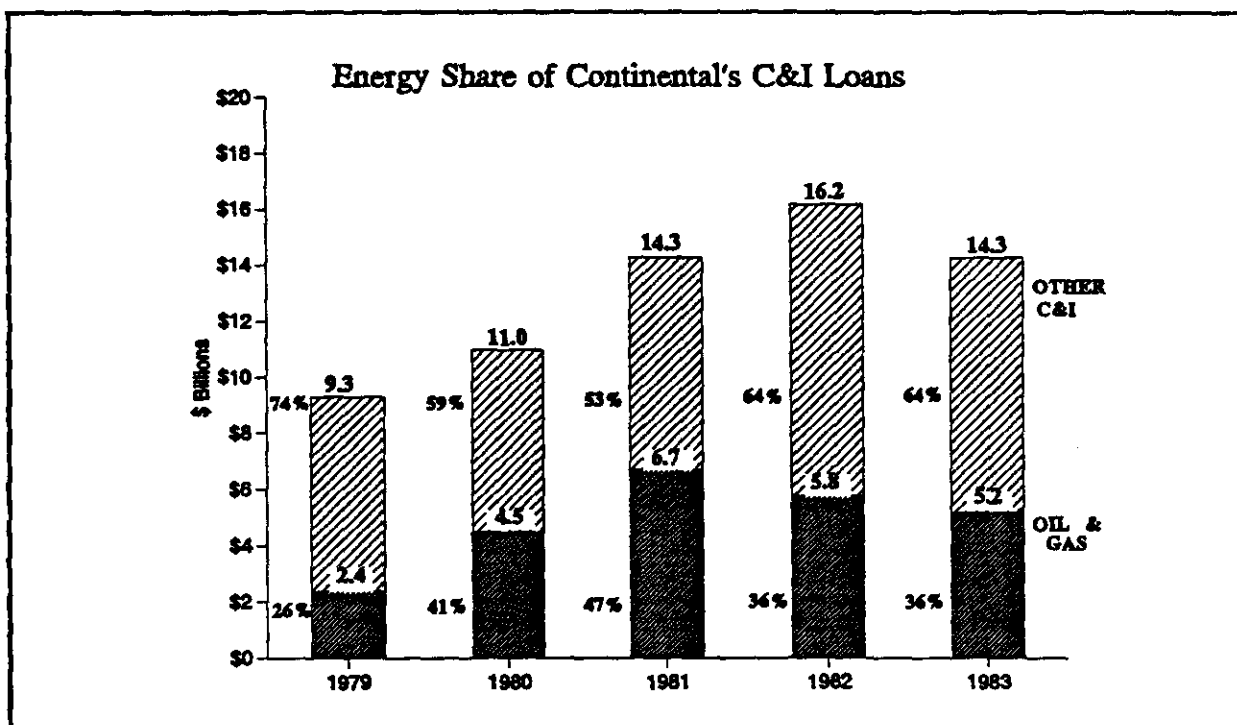
OCC's 1979 examination of Continental noted continuing improvement in asset quality. Classified assets had declined from 86% to 80% of gross capital funds. Liquidity was also considered adequate at this time. Some problems, however, were noted in the bank's internal credit review system. Deficiencies were cited in the identification and rating of problem loans and the completeness of credit files. In light of the bank's rapid asset growth, OCC examiners once again emphasized the importance of building a strong capital base.

Similar conclusions were drawn during the 1980 examination. Liquidity was still considered acceptable. Asset quality continued to improve; classified assets as a percent of gross capital funds declined to 61%. Management was encouraged to perform some type of on-site review of information submitted to the loan review committee, such as periodic visits to foreign offices and other loan origination sites. Although not keeping pace with asset growth, capital was considered adequate. The bank was thought to have sufficient capability to meet external pressures and to fund projected growth.

In its response to the 1980 examination, Continental management indicated that, although they believed the bank's present internal credit review system had been successful, some type of on-site review might be appropriate, particularly in light of the bank's expansion. Accordingly, management had been exploring various methods of accomplishing this shift in a cost-effective manner. An experimental field review was subsequently conducted.

During the 1981 examination, the OCC placed special emphasis on the review of Continental's energy and real estate lending, since the bank was targeting these areas for additional growth. Continental's energy portfolio nearly doubled between 1979 and 1980 and increased by an additional 50% the following year. By 1981, energy loans represented 20% of Continental's total loans and leases and 47% of its total C&I loans. With energy prices skyrocketing and drilling and exploration activity booming, Continental was well-positioned to meet the burgeoning credit demands for development of energy sources.

Continental historically had made loans to energy producers that were secured by "proven reserves" or by properties surrounded by producing wells that were almost guaranteed to produce oil and gas. As part of management's intensified commitment to energy lending in the late 1970s, the bank had begun expanding its energy portfolio, including making loans secured by leases on undeveloped properties with uncertain production potential. The bank also became particularly aggressive in extending loans to small, independent drillers and refiners.



Source: OCC

In 1981, Continental had over \$6.7 billion in oil and gas loans outstanding. Despite this high commitment to a single sector of the economy, Continental's management felt confident about the strength of the energy industry and its knowledge of specific oil fields and companies. Losses from Continental's energy loans had consistently averaged less than half the net loan losses from its non-energy loans. According to Gerald Bergman, former head of Continental's Special Industries lending department, the bank was simply

demonstrating "a reasonable way to leverage [its] expertise in the oil industry" (*American Banker*, August 25, 1981).

While conducting the 1981 examination, which used information as of April 30, 1981, OCC examiners noted a significant level of participations from Penn Square that were backed up by standby letters of credit. Recognizing that the amount of these loans was large in comparison with Penn Square's size, additional time was spent examining them. The OCC's review determined that these standby letters of credit were issued by banks other than Penn Square, including several money center banks, alleviating our concerns. Moreover, since the energy industry still appeared strong and the energy loans were continuing to perform, we saw no cause for concern at that time. In all, only two oil and gas loans, totaling \$85 million were classified. Neither loan had been purchased from Penn Square.

As part of the 1981 examination, OCC examiners sampled new account relationships, in particular, and devoted further efforts to judging the quality of the credit rating system. Classified assets as a percent of gross capital had increased from 61% at the previous examination to 67%. The trend, which was also noted at other large banks, however, was attributed by OCC examiners to deteriorating economic conditions rather than a relaxation of credit standards.

OCC examiners again reviewed Continental's internal loan review systems during the 1981 examination. Although examiners did classify several loans for which watch loan reports had not been prepared, each of these loans had been internally rated in accordance with bank policy. Neither the dollar amount nor the number of these loans was considered significant. However, it was noted that approximately 375 loans, totaling \$2.4 billion, had not been reviewed by the bank's rating committee within one year; 55 of these had not been reviewed within two years. Management was aware of these exceptions and was in the process of reassessing its loan review system.

Continental's quality and consistency of earnings were considered good at the time of the 1981 examination. Examiners noted that a program of holding down dividends had resulted in a steady source of capital augmentation, but that capital still needed to be brought in line with asset growth. Liquidity was considered sufficient to meet any external pressures. Suitable systems for managing funding and rate sensitivity were found to be in place.

In response to the 1981 examination, Continental's management indicated that they did not feel there was a problem with the loan portfolio quality, in light of the economic environment at that time. In fact, management expressed surprise that more difficulty had not surfaced, given the prolonged period of record high interest rates and the state of the economy. Nevertheless, they stated that close, continued attention would be provided to the quality of the portfolio. Management further stated that the issue of loans not being reviewed on schedule for rating purposes was receiving attention and that improvement was expected.

Through most of 1981, the majority of Wall Street analysts believed that Continental would continue to experience superior growth due to its position as a prime lender to the energy industry, its potential for improved return on assets, and its record of loan losses. The *Wall Street Transcript* gave its silver runner-up award for outstanding money center bank CEOs to Roger Anderson in June of 1981. Bank analysts strongly supported the selection, with one analyst noting:

I give Continental credit for doing what they do best, and that is lending money. They've been able to pick out certain niches. I'm continually amazed by their reception as energy lenders. They positioned themselves well early on, and they have been reaping the benefits of that. I used to be skeptical that they could manage their costs when things slowed down, but they've shown me recently that they've done a good job of managing people and costs and pushing employees toward productive areas.

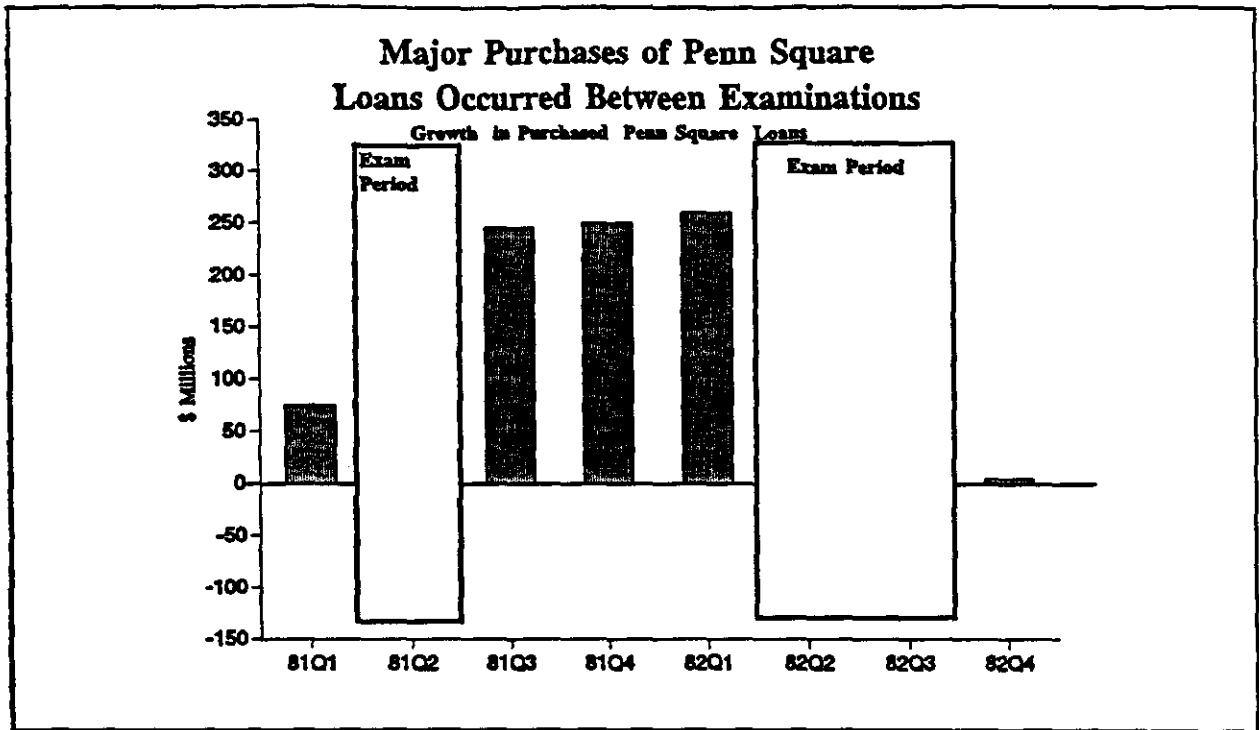
Another analyst commented that:

With Continental possessing one of the best loan loss records among money center banks, one can assume it is carrying the same credit standards into the current period of economic weakness as it did in the prior period and will not suffer large loans losses.

Continental: January 1982 - July 1984

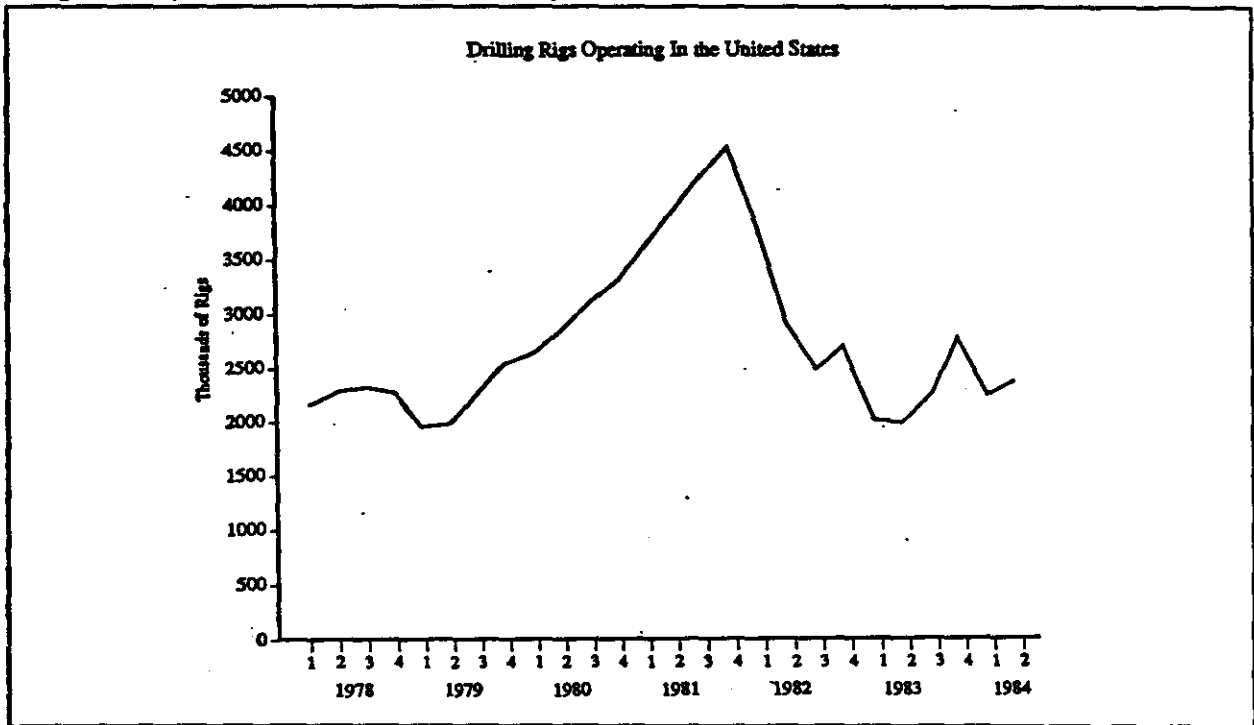
To fully understand the demise of Continental, it is first necessary to review the history of Penn Square Bank's involvement with Continental. Penn Square was one of the most aggressive lenders in one of the hottest energy drilling areas of the country. Because its loan generating ability exceeded its legal lending limit as well as its funding ability, Penn Square would originate loans and then sell them to other banks, including Continental and Seattle First National Bank.

Although Continental began purchasing loans from Penn Square as early as 1978, significant growth in loan purchases did not occur until the beginning of 1981. For example, as of the end of 1980, Continental had purchased energy loans from Penn Square totaling only \$167 million. By the conclusion of this Office's 1981 examination of Continental in August, loans purchased from Penn Square were in excess of \$500 million. From that time period until the start of the 1982 examination, another \$600 million in participations from Penn Square loans were booked at Continental, bringing the total amount to \$1.1 billion. At their peak in the Spring of 1982, Penn Square loans represented 3% of Continental's total loans and leases and 17% of its total oil and gas loan portfolio.



Source: OCC

In a quarterly visit with Continental management in March of 1982, prior to the general examination, OCC examiners discussed the general health of the energy industry. Since the end of 1981, the energy industry, as represented in the following chart showing drilling activity, had declined significantly.



Source: Standard & Poor's

In spite of this decline, bank officials said they felt comfortable with their expertise in the energy area and planned to continue to stress it. Notwithstanding the thorough review of the energy portfolio in the 1981 examination, the intervening decline in the oil and gas industry made energy a principal focus of the OCC's 1982 examination scheduled to begin in May. At the request of the examiner-in-charge of the Continental examination, an energy lending specialist from the OCC's Southwestern District was assigned to assist in the 1982 examination of Continental.

Our concerns became serious when OCC examiners at Penn Square learned that Continental had purchased a significant quantity of bad loans from Penn Square. An examination of Continental was underway and OCC examiners in that bank were immediately informed of irregularities in the Penn Square loans.

The OCC responded to this in a number of ways. After informing Continental's management in June of the serious condition of Penn Square and its implications for Continental's loan portfolio, the OCC extended its examination through November and worked closely with Continental's internal auditors and independent accountants to assess the damage. On July 5, 1982, Penn Square bank failed.

Continental's serious condition prompted the OCC to direct a number of corrective measures, which were immediately initiated by the bank. The OCC informed management in August of its intention to formalize these directives by placing the bank under a Formal Agreement, enforceable under the cease and desist authority of 12 U.S.C. 1818. The Comptroller and his staff met several times with senior management and board members over the next few months to discuss the bank's condition and the impending Agreement.

Continental moved quickly to determine the extent of its exposure in loans originated by Penn Square, to get a fix on the size of the loan loss provision necessary for the second quarter, and to stabilize funding. OCC examiners also reviewed all of the loans Continental had purchased from Penn Square and evaluated their effect on Continental's loan portfolio and provision for loan losses. Our examiners had numerous meetings with Continental's Board of Directors to discuss the bank's provision for loan losses and its recovery effort.

OCC's 1982 examination determined that many of the loans purchased from Penn Square, particularly in the months just prior to Penn Square's failure, had failed to meet Continental's typical energy-lending standards. Many were also poorly documented and were, therefore, not being internally rated in a timely manner. Accordingly, increasing numbers of these loans appeared on Continental's late rating reports. In addition, numerous loans had appeared on Continental's internally-generated collateral exception report. The reliability of Continental's internal reporting systems, however, had been spotty in previous years. As a consequence, officers in the Special Industries Division who were purchasing the loans from Penn Square were able to persuade senior lending officers to disregard the internal reports. Early internal warning signals were, therefore, largely ignored.

During the office's 1982 examination, OCC examiners also learned that a team of internal auditors had been sent twice in 1981 by Executive Vice President Bergman, head of Continental's Special Industries Group, to review the Penn Square loans Continental was purchasing. The auditors' report on their first visit in September 1981 noted several items that they felt merited "special attention," including: incomplete and inaccurate records, questionable security interests, and a high level of loans to parties related to Penn Square. The Special Litigation Report of the Board of Directors issued in 1984 concluded that this audit report, although submitted to Bergman, was not seen by senior Continental management prior to the collapse of Penn Square.

The written report of the bank auditors' findings of their second visit to Penn Square in December 1981 expressed concern with loans secured by Penn Square -- issued standby letters of credit (representing approximately one-third of that bank's equity), questionable lien positions, and several loans in which the bank had purchased more than Penn Square's current outstanding balance. This audit also uncovered \$565,000 in personal loans from Penn Square to John R. Lytle, manager of Continental's Mid-Continent Division of the Oil and Gas Group, and the officer responsible for acquiring the Penn Square loans.

The Special Litigation Report once again indicated that while senior Continental management did receive news of these loans to Mr. Lytle, they once again did not receive the full auditors' report from the December review of the Penn Square lending operations. No action was taken by Continental to remove or discipline Mr. Lytle until May of 1982.

In July of 1982, following the collapse of Penn Square, Continental sent a staff of experienced energy lenders to Oklahoma City to review Penn Square's records and assess the dimensions of the problem. Each of the loans Continental purchased from Penn Square were reviewed during the first two weeks of July. After analyzing the probable risk associated with each credit, senior Continental officers recommended an addition to loan loss reserves of \$220 million. This Office, as well as the bank's accounting firm of Ernst & Whinney, reviewed this figure and concluded that it was supported by the information available at that time. This figure was then published on July 21 along with a full statement of Continental's second-quarter results.

Continental auditors, supported by accountants from Ernst & Whinney, remained in Oklahoma City reconciling Continental's records with Penn Square data, assisting in the Penn Square portfolio assessment program, and preparing the loan workouts. OCC examiners also reviewed in late August and early September each loan purchased from Penn Square and discussed their findings with senior Continental management before release of third quarter earnings. That review resulted in an additional \$81 million being added to the bank's provision for loan losses in the third quarter, as reported in Continental Illinois Corporation's October 14 press release. The holding company also indicated that its nonperforming assets had reached \$2 billion as of September 30, 1982, up \$700 million from the previous quarter.

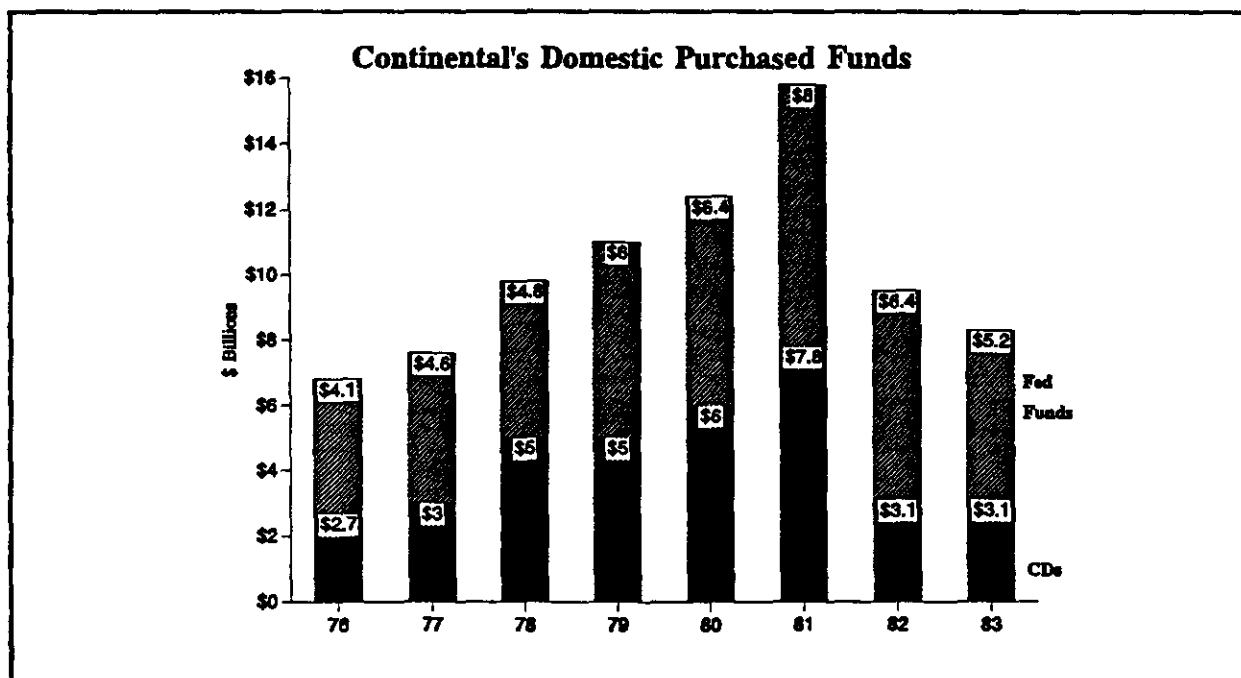
Simultaneously with the credit review, Continental undertook an extensive review of the people involved in the Penn Square relationship and the lending policies, procedures, and practices which might have contributed to the crisis. In its first phase, an independent

review committee appointed by Continental's Board of Directors recommended a series of major staff changes beginning with the July 14 suspension of John R. Lytle. Mr. Lytle was permanently released from the bank on August 30. Resignations and early retirements, including those of Executive Vice President Bergman and his superior, Executive Vice President George Baker, soon followed. In addition, various other bank personnel were reassigned.

In its second phase, the internal review committee assessed bank policy and recommended:

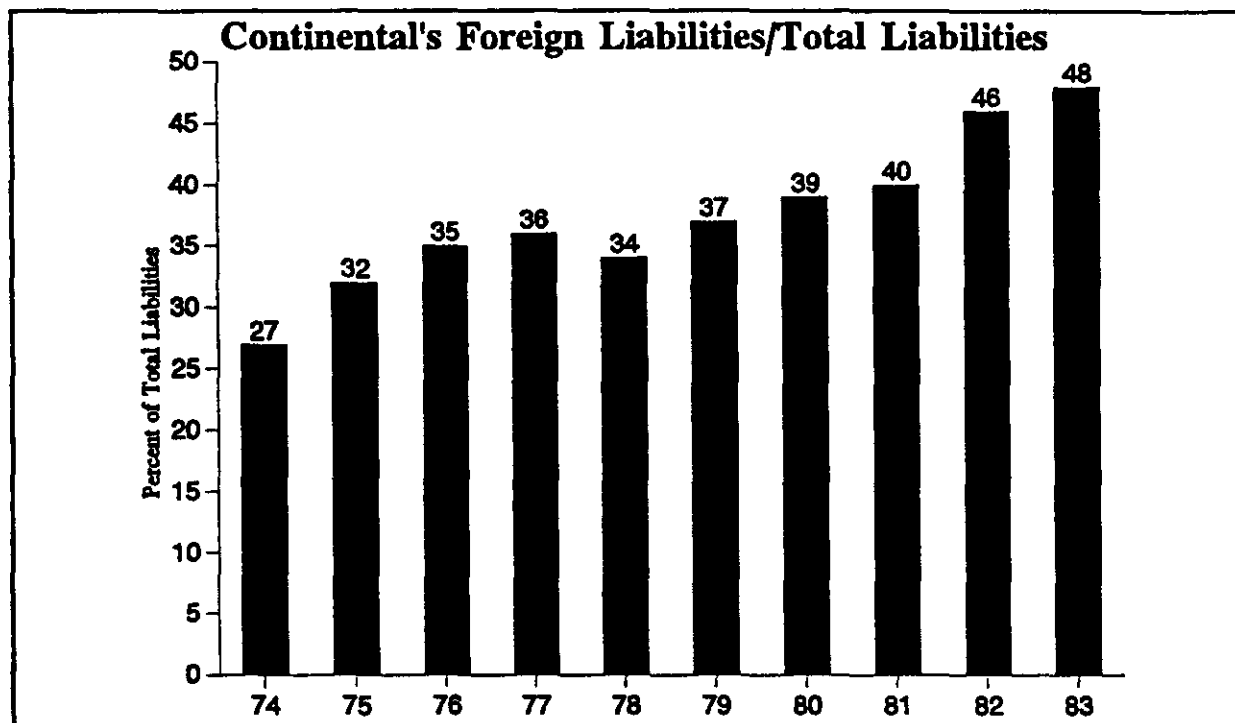
- codification of bank lending policies and procedures;
- enhancement of secured lending and related support systems;
- improvement in cooperation between loan operations and the line;
- revision of loan operations activity to improve its reliability and productivity; and
- formulation of a Credit Risk Evaluation Division, as had been recommended by the OCC, to strengthen the bank's credit rating system and enhance credit risk identification, evaluation, reporting, and monitoring.

Following the Penn Square collapse, the domestic money market's confidence in Continental was seriously weakened. The bank's access to the Fed Funds and domestic CD markets quickly dried up. As illustrated below, Continental lost 40% of its purchased domestic funding in 1982.



Source: Call Reports

Continental moved quickly to stabilize and restore its funding. Meetings were held with major funds providers, rating agencies, and members of the financial community. Public disclosures were periodically issued to correct misinformation. In the fall of 1982, liquid assets were sold or allowed to mature. As the domestic funds market dried up, Continental shifted to the European interbank market for funding. Foreign liabilities soon began to approach 50% of the bank's total liability structure.

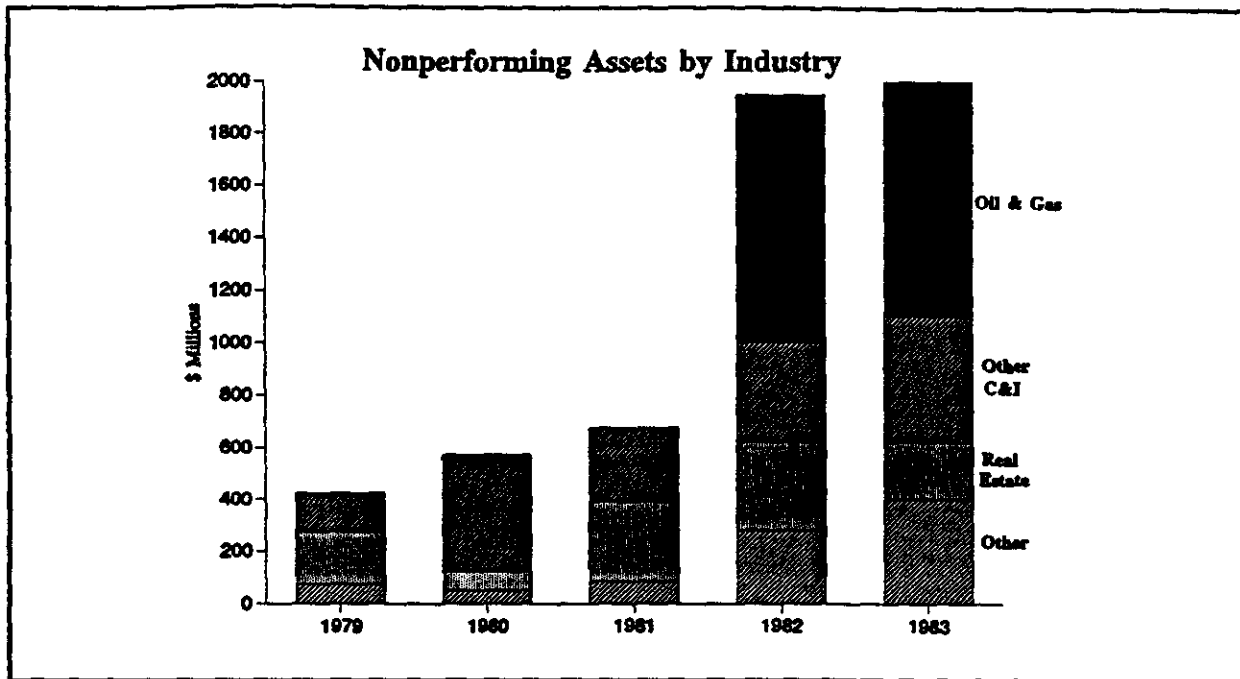


Source: Call Reports

Continental's parent holding company maintained its \$0.50 per share dividend on common stock in August 1982. While the dividend may not have been merited by the earnings level, holding company management felt it was a necessary step in attempting to restore the confidence of the financial markets and to raising capital in the marketplace.

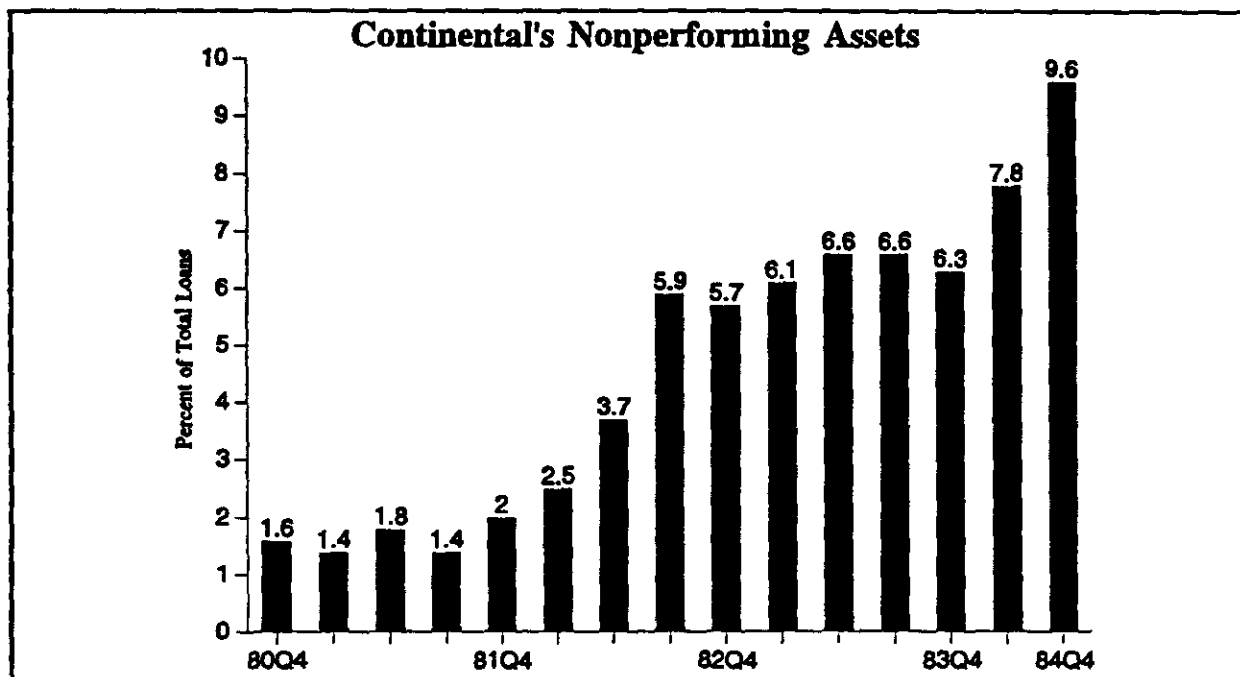
Despite these actions, Continental's condition deteriorated throughout 1982. Many of its energy loans that had performed well and been extremely profitable in the 1970s and well into 1981 were now serious collection problems.

Nonperforming assets at the holding company level, which totaled \$653 million at the end of 1981, grew to \$844 million at the end of the first quarter of 1982. While most of these nonperforming assets were concentrated in real estate loans and nonenergy-related corporate loans through the first quarter of 1982, this changed dramatically in the following quarters when a number of energy loans were nonperforming. By the end of 1982, close to half (over \$900 million) of Continental's nonperforming assets were energy-related.



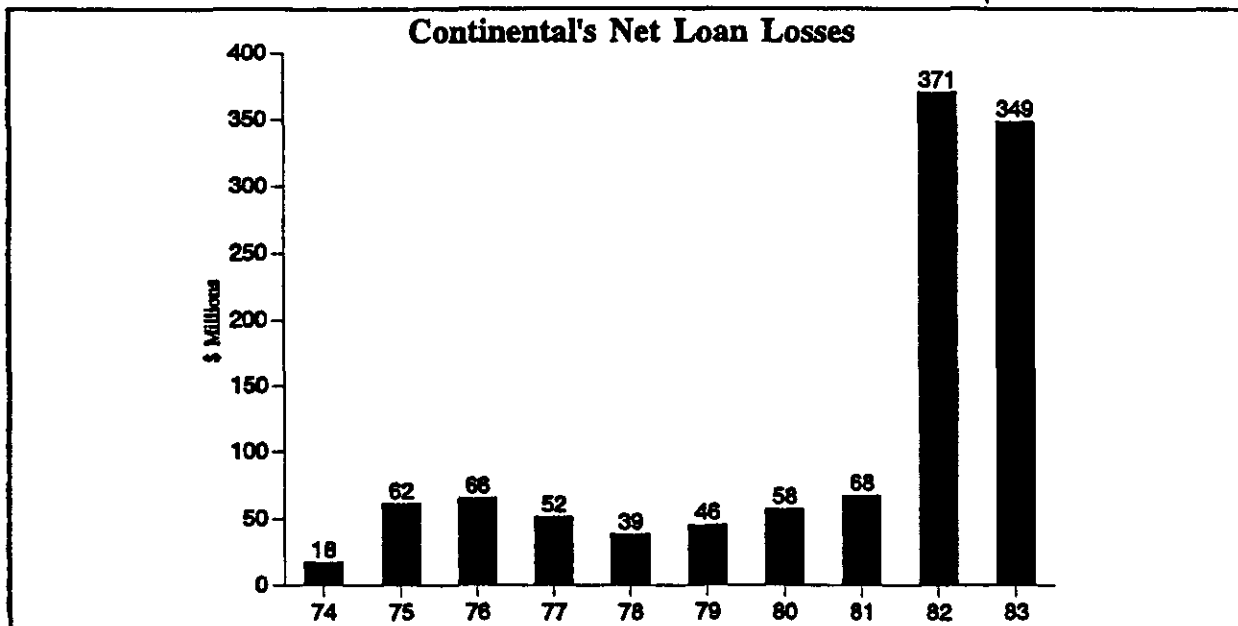
Source: OCC

In all, \$1.2 billion in nonperforming assets were added in 1982, bringing them up to nearly 6% of the total loan portfolio.



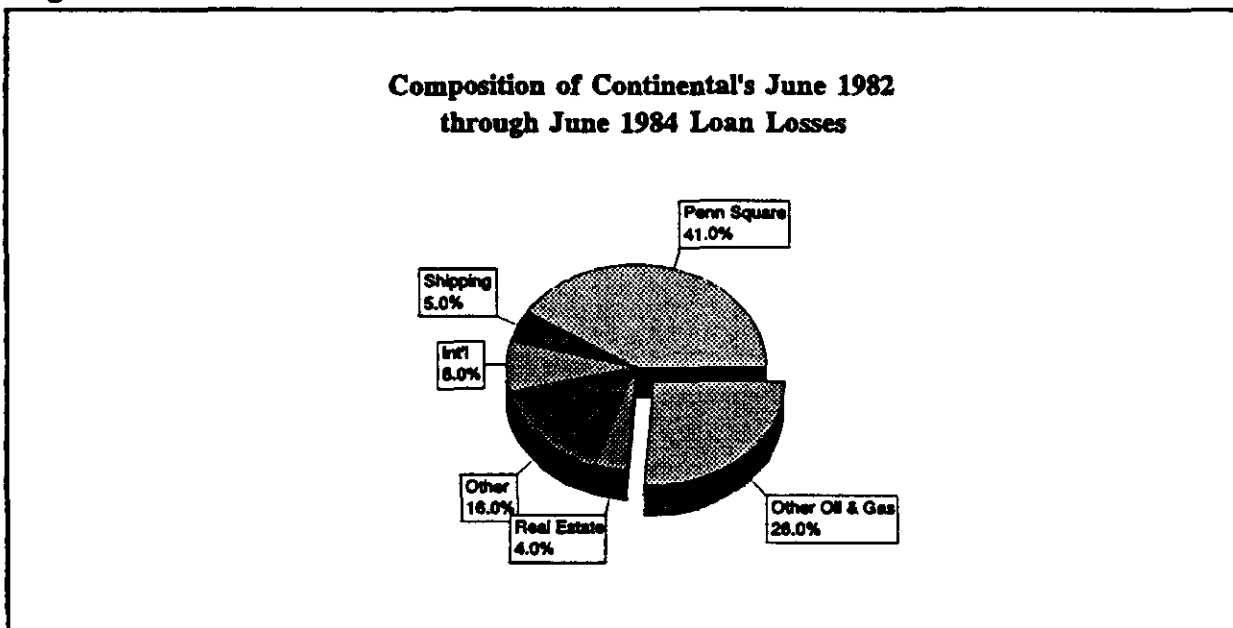
Source: OCC

Continental's net loan losses reached \$371 million by December 1982, nearly a five-fold increase over the previous year's losses. Despite an improving economy in 1983, many of Continental's borrowers continued to experience difficulties and Continental's losses remained high.



Source: Call Reports

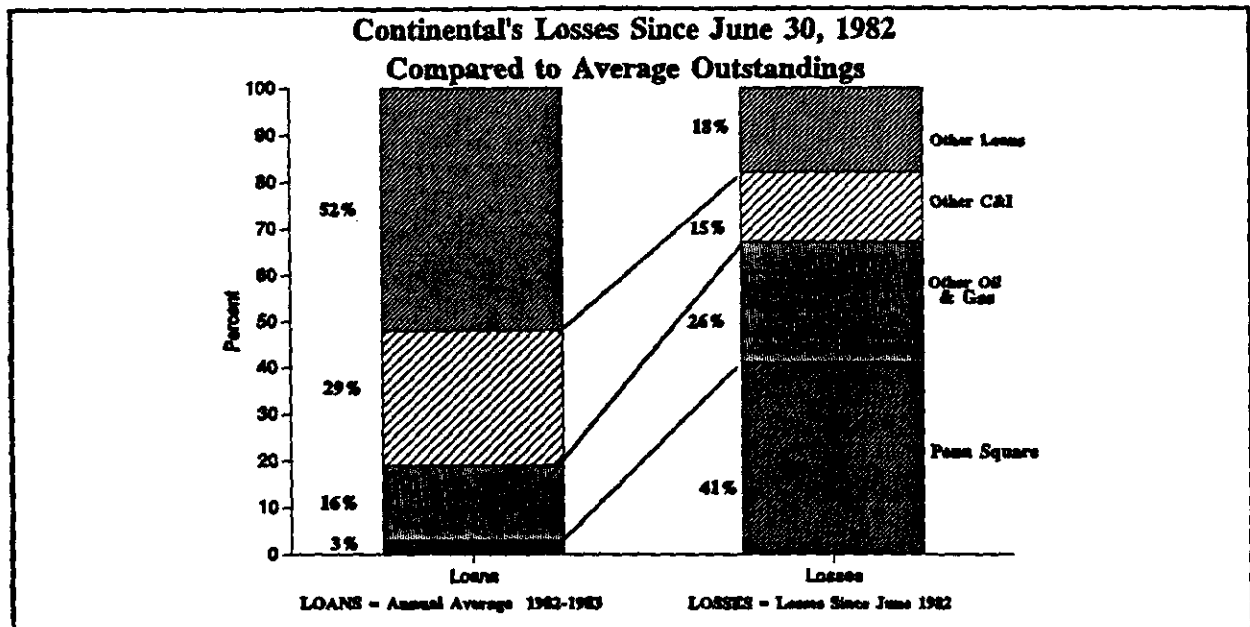
Energy-related loans represented a disproportionate share of Continental's loan losses. While oil and gas loans comprised approximately 20% of Continental's average total loan portfolio in 1982 and 1983, they represented approximately 67% of its June 1982 through June 1984 loan losses.



Note: OCC estimate based on a review of losses in excess of \$2 million per loan taken between June 30, 1982 and June 30, 1984.

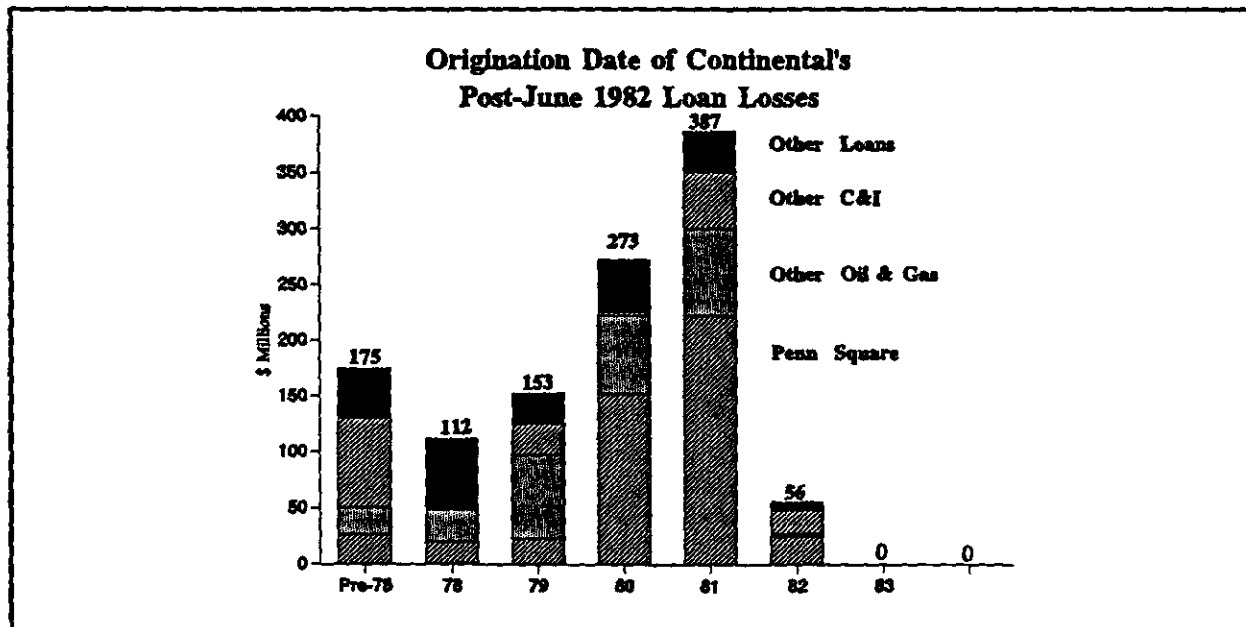
Source: OCC

Most of Continental's oil and gas loan losses were a direct result of its purchase of loans from Penn Square. Although loans purchased from Penn Square averaged less than 3% of Continental's total loans over the past 2 1/2 years, they accounted for 41% of the bank's losses between June 1982 and June 1984. Penn Square loans have thus far resulted in nearly \$500 million in loan losses for Continental.



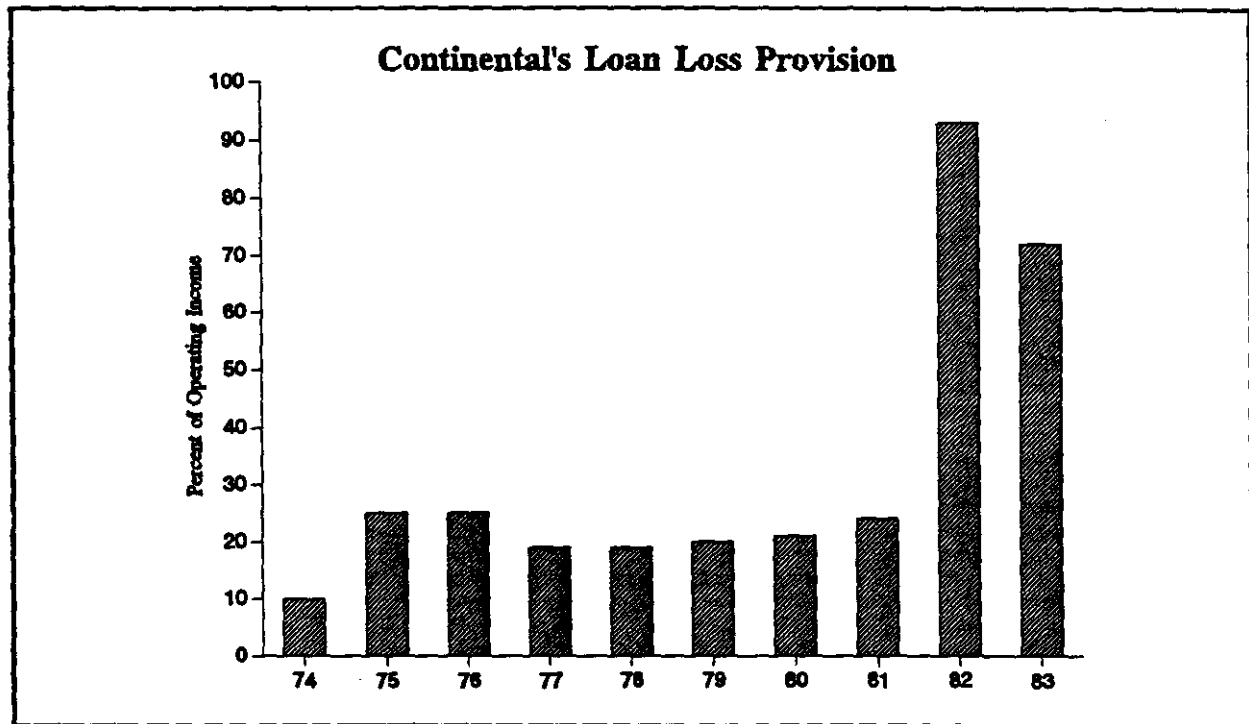
Source: OCC

As illustrated in the following chart, most of Continental's loan losses since June 1982, including those purchased from Penn Square, were from Loans that originated in 1980 and 1981.



Source: OCC

These loan quality problems caused Continental's earnings to collapse. The bank's provision for loan losses consumed 93% of its 1982 operating income, reaching \$476.8 million. Resulting net income fell from \$236 million in 1981 to \$72 million at year-end 1982.



Source: Call Reports

The collapse of Penn Square and the energy industry forced Continental's management in 1982 to reassess the bank's overall direction. Continental's Credit Risk Evaluation Division, which had been created at the urging of the OCC in the fall of 1982, was strengthened in early 1983 to provide improved risk evaluation and to report regularly to the Board of Directors and senior bank management. The Division also monitored the effectiveness of Continental's early warning credit quality systems and served as an important check on corporate lending activities.

The Formal Agreement, signed on March 14, 1983, primarily covered asset and liability management, loan administration, and funding. It required the bank to continue to implement and maintain stronger policies and procedures designed to improve performance. In addition to quarterly progress reports regarding compliance with the terms of the Agreement, Continental was also required to report periodically to this Office on its criticized assets, funding, and earnings.

In April 1983, OCC examiners visited Continental to review the first quarter financial results. nonperforming assets, at \$2.02 billion, were higher than anticipated by the bank, but market acceptance had improved and premiums on funding instruments had declined.

Continental submitted the first quarterly compliance report required by the Formal Agreement to this office in May 1983. It indicated that appropriate actions required by the Agreement were being taken by the bank.

Continental's 1983 recovery plan called for a reduction in assets and staff and a more conservative lending policy. Two executive officers, David Taylor and Edward Bottum, were appointed to Continental's Board of Directors in August of 1983. Immediately after their appointment, they instituted key management and organizational changes to further lay the groundwork for recovery. External market conditions during the second half of 1983, however, slowed Continental's recovery. Increasing interest rates squeezed net interest margins. Loan demand was weak. Nonperforming energy loans rose further as the energy industry continued to decline.

The general sentiment of bank analysts toward Continental in 1982 was negative following Penn Square. It had become apparent to bank analysts by early 1983 that Penn Square wasn't Continental's only problem. Few analysts felt that Continental stock had any short-term turnaround potential. Robert Albertson of Smith, Barney, Harris, Upham & Co. in the March 28, 1983 *Wall Street Transcript* summarized these opinions:

Continental Illinois' problems are something that, in retrospect, we perhaps should have been better prepared for than we were. Recognizing how fast they grew should have alerted us to the fact that at least the potential for unusual problems was definitely there... The most disconcerting thing about [Continental's difficulties] is the fact that the worst hit occurred in its principal area of expertise. Therefore, I have to remain uncertain as to where Continental will be going in the near term.

The 1983 examination of the bank's condition as of June 30, focused on energy and real estate credit, overseas exposure, funding, earnings, capital adequacy, and compliance with the Formal Agreement. The overall condition of the bank had further deteriorated since the 1982 examination. Asset quality and earnings remained poor. Capital was adequate on a ratio basis, but under pressure due to asset and earnings problems. Funding had improved, but was still acutely sensitive to poor performance and other negative developments. The bank was found to be in compliance with the provisions of the Formal Agreement. Following completion of the examination in December 1983, the Comptroller and senior OCC staff met with Continental's Board of Directors on January 23, 1984 to discuss these findings.

A revised recovery plan for 1984 called for a further reduction in assets, enhanced capital-raising efforts, and a reduction in non-interest expenses and staff. Non-essential businesses, such as real estate and the bank's credit card operation, would be sold to improve capital and refocus the bank on wholesale banking. Merger alternatives would be

pursued with the assistance of Goldman, Sachs & Co. which had been retained in September 1983. Plans were also accelerated to transfer additional responsibilities to Taylor and Bottum.

On January 31, 1984, OCC staff met with Continental's Vice Chairman and its Controller to review the bank's 1983 performance, the 1984 recovery plan, and contingency planning. Part of the discussion concerned the bank's own strategy for a "good bank/bad bank" separation, similar to that eventually provided for in the long-term assistance program.

David Taylor replaced Roger Anderson as Continental's CEO in February of 1984 and Edward Bottum was elected President. External events in the first quarter of 1984, however, produced further problems for this new management team. Asset quality continued to deteriorate and Continental recorded an operating loss for the first quarter of 1984.

Continental's condition as of March 31, 1984 remained poor. An OCC examination begun March 19 and targeted at asset quality and funding, concluded that continued operating losses and funding problems could be anticipated unless the bank's contingency plan to sell nonperforming assets was successful. Details of this plan were not, however, available at the close of the examination on April 20.

The Comptroller and his staff met with Continental's Chairman/CEO and President on May 2 to discuss the bank's dividend policy and contingency plan for selling nonperforming assets. It was the Comptroller's conclusion following the meeting that our approval of the payment of the bank's second quarter dividend to the holding company, in part, depended on the successful implementation of the provisions contained in the contingency plan, specifically the sale of nonperforming assets.

Later that month, market confidence in Continental slipped even further as rumors about the bank's impending bankruptcy were fueled by two erroneous press reports on May 8 that concerned the purchase of or investment in the bank. From that point on, the Office was in constant contact with the bank and other bank regulatory agencies, particularly the FDIC. On May 10, the OCC issued a news release stating that the Office had not requested assistance for or even discussed Continental with any bank or securities firm and that the Office was unaware of any significant changes in the bank's operations that would serve as the basis for rumors concerning the bank's fate.

OCC examiners established an onsite presence in Continental's trading rooms in Chicago and London on May 10 to more closely monitor the bank's rapidly deteriorating funding situation. Initial reports from OCC examiners indicated that major providers of overnight and term funds were failing to renew their holdings of the liabilities of the bank and Continental Illinois Corp. The bank was forced to prepay the deposits in Eurodollar and domestic markets and seek replacement of the CD funding in the domestic market. Because other funding sources were not available, the bank resorted to borrowings from the Federal Reserve Bank of Chicago.

From May 12 - 14, a safety net of 16 banks put together a \$4.5 million line of credit for Continental. But, by May 15, the safety net began to unwind due to a heightened lack of confidence. The Comptroller and staff held meetings on May 16 and 17 with Continental, other money center banks, and regulatory agencies in Chicago, New York, and Washington to consider alternatives. These meetings resulted in the formation of the "temporary assistance package".

Under the temporary assistance plan publicly announced on May 17, Continental received a \$2 billion subordinated loan for the period necessary to develop permanent sources of funds. The loan was evidenced by a demand subordinated note; \$1.5 billion was provided by the FDIC, with the balance provided by a group of seven major U.S. banks. In addition, a consortium of 28 banks provided Continental with a \$5.5 billion standby line of credit. By virtue of this capital injection, the FDIC in effect provided assurance that Continental's would not be resolved through a pay-off of insured depositors. It, therefore, also provided assurance that the funds of all depositors, both insured and uninsured, were thereby fully protected.

During the next two months, the regulators held meetings with both domestic and foreign financial institutions and other parties interested in merging with or investing in Continental. It became apparent fairly early on in these discussions, however, that it would be difficult to arrange a completely private sector solution. Furthermore, proposed private sector/government-assisted transactions were likely to be too costly to the FDIC.

The regulators' efforts were, therefore, directed toward devising a permanent solution to Continental's problems that was not dependent on private sector investment. Small working groups comprised of representatives from all three bank regulatory agencies met on a daily basis to develop and refine a long-term solution. At the same time, a search began to find new management for the bank. The Comptroller and other senior officials met at least weekly with the FDIC to discuss planning details; telephone contact between the principals occurred frequently.

Continental's financial situation, while stable for most of June, began to deteriorate again in July. Despite FDIC assurance, there was unease about just how the FDIC "assurances" would be honored if Continental failed. As a result, many large depositors began to again withdraw their funds as they matured.

During the 60 days after the erroneous press reports, Continental's deposits, Fed Funds, and repos had fallen nearly \$10 billion. By July, Continental had borrowed \$4 billion from 28 banks, another \$3.55 billion from the Federal Reserve Bank of Chicago, and \$2 billion more from the FDIC and the seven banks holding subordinated notes.

Throughout this period, OCC held several meetings with senior bank management and with various members of the bank's Board of Directors. Numerous meetings were held internally to analyze and refine the proposed plan. Intensive monitoring of the bank's

funding continued and a joint OCC/FDIC review of the loan portfolio was conducted.

The long-term solution, announced on July 26 and subject to shareholder approval on September 26, is intended to restore Continental to health and allow it to continue to serve its marketplace without interruption. It entailed two key elements: top management changes and substantial assistance.

The solution will result in the creation of a smaller and more viable Continental. Management has been removed, and shareholders have incurred substantial losses. At the same time, major disruption to the financial system has been avoided. Upon implementation of the long-term solution, Continental will be well-capitalized and have stronger assets and management. It will be returned to private ownership at the earliest possible date.