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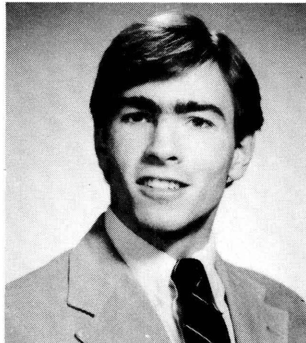
THE CONTINENTAL ILLINOIS BANK FAILURE: HOW DID IT HAPPEN?

by Paul F. DeCain



I. Introduction

"In many regards Continental is the best commercial bank in the country" (Osborne, 1980, p. 173). As this statement by Kenneth West, President of Harris Trust, suggests, many considered Continental Illinois Bank to be one of the finest banks in the country. At the end of 1980, the bank was the leading lender in the U.S. and, according to Duns Review (1978), was one of the five best managed American companies. Yet, by May 11, 1984, this once highly regarded institution was losing money at the rate of $8 billion a day; and by June the Federal Deposit Insurance Corporation had taken over all the major operations of the bank (Forsyth and Kerwin, 1984, p. 15). Essentially, the seventh largest bank in the U.S. had failed.

It is the purpose of this article to analyze the major causes of this very significant bank failure. First, attention will be directed to the immediate cause of the failure, a run on the bank in the spring of 1984. Next, the role of nonperforming loans as a contributing factor to the run on the bank will be discussed. And finally, the ultimate cause of Continental's collapse will be analyzed—the overly-aggressive management strategy adopted in the 1970s.

II. The Run

On May 15, 1984 sixteen major banks, led by Morgan Guarantee, supplied Continental Illinois Bank with a safety net (temporary source of funds) of $4.5 billion (*Wall Street Journal,* May 16, 1984, p. 1). The purpose of the safety net was twofold: first, to allow Continental to meet its daily liquidity needs; and second, to reassure creditors of the safety of their deposits. Shortly thereafter, the Federal Depository Insurance Corporation, along with a group of twenty-five major banks, provided Continental Illinois with a $2 billion capital infusion, for the same purposes noted above (Forsyth and Kerwin, 1984, p. 15). Ever since the collapse of the Oklahoma-based Penn Square Bank in the middle of 1982, Continental, which was linked to Penn Square through the purchase of over $1 billion of Penn Square loans, had been in poor financial condition. But what were the

particular events and conditions which in early 1984 caused the run on Continental's capital and subsequently the biggest bank bailout in U.S. history?

Continental's financial condition at the end of 1983 was extremely depressed. Its fourth quarter earnings had declined by 39%, and its nonperforming loans[1] stood at $1.9 billion (*Wall Street Journal*, January 20, 1984, p. 4). Yet, the bank was still paying its quarterly dividend of 50 cents a share. However, two events occurred in early 1984 which led many creditors of the bank to withdraw their deposits, thus causing a run on capital. On February 14, Moody's lowered Continental's long term debt rating from A-2 to A-3 because of the increased risk of holding Continental debt instruments (*Wall Street Journal*, February 14, 1984, p. 44). On March 16 Continental sold its credit card business to Chemical Bank for $176 million (*Wall Street Journal*, March 16, 1984, p. 7). The effect of the lower rating of Continental's long term debt is obvious: it simply further depressed the market for Continental certificates of deposit (CDs). On the other hand, the significance of the sale of the credit card business is not so obvious. Continental had to meet its quarterly dividend of 50 cents a share or a run on capital would be imminent. Missing a quarterly dividend payment is a significant financial indicator of a company in very bad condition; and in the case of a bank, such an omission could lead to a run on capital. In order to meet this dividend payment, Continental was forced to rely on one-time gains from the sale of assets; hence the sale of the credit card business. The fact that Continental's earnings were so weak that it had to count on capital gains to show a profit and pay out dividends gave a clear indication to creditors of the bank's condition, and no doubt instilled in them a fear for the safety of their deposits. Finally, on April 23 it was reported that nonperforming loans had increased by $400 million from the first of the year to a total of $2.3 billion, or 8% of total loans. The increase was largely due to an influx of $200 million dollars in nonperforming loans from Latin America (*Wall Street Journal*, April 23, 1984, p. 8). Because nonperforming loans are a burden on future profits, this particular increase, which was both untimely and large, further weakened the confidence of creditors in the bank and its financial condition.

Even though the events described above were the leading causes of the run on bank capital by creditors, the size and scope of the run were magnified greatly by the fact that most of Continental's deposits were very large (over $1 million) as well as by the fact that a good portion of Continental's creditors were foreign (over 50%). By law the FDIC is only required to guarantee up to $100,000 of one particular deposit and is not required to guarantee foreign deposits. Thus, a majority of Continental's deposits were uninsured, making the bank exceptionally vulnerable to the massive withdrawals which began in late April. Clearly, the various events and conditions of early 1984 precipitated the run on Continental's capital, while the size of Continental's deposits and the nondomestic character of over 50% of the depositors made the magnitude and scope of the run as large as any since the Great Depression.

And so in May of 1984, the volume of withdrawals began to grow while fewer CDs were rolled over, as first Japanese creditors, then European creditors, and finally U.S. creditors withdrew their deposits. Continental was forced to borrow heavily from the Federal Reserve as it was losing capital at a rate that was nonsustainable. Thus, with Continental and perhaps even the entire banking system at the edge of disaster, the bailout commenced.

III. Nonperforming Loans

Although all of the factors discussed in the previous section were major immediate causes of the run and subsequent bailout of Continental, the most significant long term cause of the deterioration of Continental's financial condition was its enormous accumulation of nonperforming loans. A nonperforming loan is a loan with a high probability of default, one which will most likely lower the level of a bank's future profits. The growth in size of this nonperforming total at Continental from 1982 through

[1]Nonperforming loan—a loan which has not paid interest within 90 days.

1984 was a major cause of the bank's weakening condition and eventual failure.

The $2.3 billion of nonperforming loans as of May 15, 1984 included large portions from several major industries and had a number of similarities and common characteristics. Most of the nonperforming loans fell into one of three categories: energy related loans, real estate loans, and loans to Latin American countries. In order to understand the process by which the bank accumulated this burden, each of these significant segments of the nonperforming total will be briefly examined.

The highest portion of the nonperforming loan total in Continental's loan portfolio were energy-related loans. These were loans to oil and gas producers, oil and gas research companies, oil and gas distributors, and refineries. Since 1953 Continental had been a leader in such lending, and during the late 1970s total energy related loans at the bank grew from $2 billion to $5 billion. In fact, by 1982 they comprised over 15% of Continental's total loans (*Business Week*, July 19, 1982, p. 52). Eventually, a great many of these loans stopped paying interest while some even defaulted.

Continental had acquired a good portion of its energy related "problem" loans from only a few companies. The single major source of such loans originated with the purchase of Penn Square loans in the middle of 1982. Penn Square was an Oklahoma-based bank which in early 1982 had nearly 25% of its loans overdue. Faced with imminent bankruptcy, Penn Square was desperately looking for potential loan purchasers. Because the business "looked so lucrative" (*Business Week*, October 11, 1982, p. 85), Continental bought over $1 billion worth of loans from Penn Square (probably the single most damaging mistake in the bank's history), and over half were written off by the end of 1982. As mentioned, most of these loans were energy related, with loans to two firms—Nucorp Energy Inc. and GHR Energy Corp.—accounting for nearly $250 million of the nonperforming total. All told, energy related nonperforming loans made up over 40% of the $2.3 billion nonperforming total in early 1984 (*Wall Street Journal*, May 16, 1984, p. 1).

There were several reasons for Continental's large number of energy loans. During the late 1970s and early 1980s Continental operated on the assumption that the demand for oil (and its price) would continue to rise as it had throughout the early and mid-1970s. As John Reading, a Senior Vice President at Continental, stated, "We're dealing with a commodity which is scarce and going to get scarcer" (*Business Week*, July 19, 1982, p. 52). Had the demand for and price of oil continued to rise, many of Continental's borrowers would have been able to compete in the oil and gas market, and a good many of Continental's energy loans would probably not have gone "sour." However, with the weakening of OPEC in the early 1980s, the price per barrel of oil stabilized at about $32.00 and the once "scarce commodity" suddenly became abundant. Subsequently, many of the energy companies to which Continental had loaned began to falter. These were largely companies which were developed in anticipation of a continual rise in oil prices and which simply could not offer their oil and gas at the stabilized price. One after another of these companies folded, as Continental realized how devastating its stand on energy lending in the 1970s would be to the bank's very existence in the 1980s.

Although it is well known that energy loans were at the heart of Continental's loan problem, it is not as well recognized that Continental's real estate lending to construction companies and developers also contributed greatly to its difficulties. In fact, Continental's real estate loans had grown rapidly from 1977 to 1981 and at the beginning of 1982 comprised fully 12% of its loan portfolio. To the chagrin of Continental's loan officers, nearly 33% of its total 1982 nonperforming loans were real estate loans (*Business Week*, October 11, 1982, p. 82). Several of the more notable nonperforming loans to real estate businesses included ones to Mclean Gardens (a 720-unit condominium development outside Washington, DC), a Florida luxury condominium development, and a Chicago developer called American Invesco (*Business Week*, October 11, 1982, p. 82). Together these three loans contributed over $400 million to Continental's nonperforming loan total.

As in the case of the energy loans, there were several reasons for Continental's disastrous experience with real estate lending. During the period from 1978 to 1982, the value of new construction in the U.S. fell from an annual level of $181 billion to $150 billion while the number of new housing starts over the same period declined from 2,036,000 to 1,072,000 (*Statistical Abstract 1984,* p. 736). The entire real estate business in the U.S. was suffering severely during the late 1970s and early 1980s, and those real estate companies to which Continental had loaned fared no differently. The declines in the construction and development fields were primarily a result of rapidly rising interest rates—from 11.75% in 1978 to 21.50% in 1980 (*Statistical Abstract,* 1984, p. 736). These high rates made debt (a necessity in the real estate business) very expensive and in turn forced many builders and developers to fold. To an already very dangerous level of nonperforming loans was thus added a substantial volume of "bad" real estate loans.

The third type of loans which contributed notably to Continental's nonperforming total were those to developing countries—in particular, loans to Latin America. By the end of 1983 Continental had outstanding loans of $476 million to Brazil, $699 million to Mexico, $436 million to Venezuela and still more to other Latin American developing countries (*Wall Street Journal,* May 16, 1984, p. 1). The reasons why so many of these loans defaulted in the early 1980's are directly related to the recent international debt crises. The oil price shocks of 1974–1980 added a total of $260 billion to the total import costs of oil-importing developing countries from 1973 to 1982. Interest rates, which rose rapidly during 1981 and 1982, added a further $40 billion to the debt servicing costs of developing countries. Furthermore, the global recession of 1981–82 cost developing countries an estimated additional $100 billion in foregone exports (Cline, 1984, p. 12). Finally, the oil producing developing countries (particularly Mexico and Venezuela) were greatly weakened by the oil and gas glut and consequent price stabilization of the early 1980s.

All in all, these external shocks (coupled with domestic problems[2]) seriously worsened the financial and economic conditions of a great many Latin American developing countries (Cline, 1984, p. 12). Consequently, a high proportion of the loans made available to developing countries by such banks as Continental soon turned into nonperforming loans as these countries experienced difficulties making their interest payments.

IV. Management Strategy

The question "why did Continental Bank fail?" has yet to be answered in full. Undoubtedly, the run on Continental's capital in early 1984 was the immediate cause of the bank's failure. Furthermore, the large amount of nonperforming loans which Continental had accumulated was a direct (though longer run) cause of the bank's failure, creating as it did a financially weakened bank which was extremely vulnerable to a run on capital. Yet, neither the run nor the nonperforming total was the ultimate cause of Continental's downfall. In any corporation, success or failure is ultimately attributable to management, and Continental is no exception. Specifically, Continental's downfall can be traced to the management goals and techniques which guided the corporation during the 1970s and early 1980s.

Continental's management strategy from the middle 1970s to early 1980s can best be described as "extremely aggressive." Before Roger Anderson took over as Chief Executive Officer in 1973, Continental Bank rested in the shadow of First Chicago Bank in Chicago and was known as an undramatic, conservative, and fairly "colorless" institution. In fact, it has been said that there was a time when the way to "get ahead" at Continental was to turn down loan proposals (Osborne, 1980, p. 173). Clearly, this kind of atmosphere was not conducive to high growth. But when Roger Anderson assumed control as Chairman in 1973, the bank embarked on a series of aggressive assaults on various segments of the banking market. Under

[2]These domestic problems included the exodus of capital in Mexico and Venezuela caused by overvalued exchange rates and inadequate domestic interest rates.

Anderson's leadership, Continental's outstanding loan total almost doubled from 1973 to 1979 (from $4.9 billion to $9.6 billion) while the bank expanded its market share by 40% (Osborne, 1980, p. 173). Furthermore, from 1978 to 1981 Continental's loan portfolio grew by 22%, compared to an average growth of 14% at such other major banks as Irving Trust, Chase Manhattan, and Chemical Bank. Over the same period the bank's leverage increased dramatically, with asset growth of 82% and equity growth of 69% (*Business Week*, July 19, 1982, p. 52). Anderson's goals for Continental were ambitious ones and were intended to point Continental in the direction of massive growth and expansion. These goals included Continental becoming one of the top three lenders in the U.S., a goal which eventually led Continental to make many loans which were simply too risky. For example, in 1977 Continental loaned $35 million to Pillsbury Co. by offering an interest rate of 9.375%, which at the time was 105 basis points below the second best bid of 10.425%. In 1978 Gamble-Skogmo Corporation had enjoyed little success in searching for funds because of a significant amount of subordinated debt and a recent downgrading in its credit rating on its senior notes. Nonetheless, Continental offered the corporation a $5 million loan and a line of credit of $10 million at 9.5%, almost a full percentage point below the market rate (*Business Week*, May 14, 1979, p. 114). In 1981, Continental's exposure at AM International was gradually being reduced as the company appeared to be headed for bankruptcy. But in that year Richard Black took over as CEO at AM International. Shortly afterward, Executive Vice President George Baker at Continental, believing that Black would turn the paralyzed company around, authorized that still more money be loaned to AM International (*Business Week*, October 11, 1982, p. 82). In the words of one observer, "Continental was willing to offer whatever rate or terms were necessary to swing a deal" (*Business Week*, May 14, 1979, p. 114). The goal of becoming one of the top three lending institutions in the country was only one of many which Continental strived to achieve, but it demonstrates the lengths to which management was willing to go to accomplish this objective.

In addition to pursuing a risky lending policy, Continental's management structure during the 1970s was highly decentralized. Anderson's staff was given a remarkably free hand while lending officers had major powers and very few controls placed upon them. According to *Business Week* (October 1982, p. 82) "The mandate came from the top—how you went about dealing with the mandate was more or less your own business." Lending requirements at Continental were also very relaxed: only two senior officers were needed to commit the bank to loan to its legal limit, 10% of capital. In contrast, at Manufacturer's Hanover all loans had to be approved by one of the top three officers of the bank, and at First Boston loans exceeding $1 million had to be approved by a committee of senior officers. Although many bad loans were made in the 1970s because the bank was far too aggressive and ambitious, many other bad loans were made simply because of the lack of credit "quality control." As one ex-loan officer at the bank stated, "In the years I was there, I never had a loan proposal turned down" (Osborne, 1980, p. 174). Examples of this lack of credit quality control include the request of Litton Industries for a $40 million loan in 1978; it took just seven minutes for the loan officer to come up with an affirmative reply. To cite yet another example, Continental became a major lender to a firm known as Energy Cooperative after First Chicago and Harris Trust had refused to grant additional credit. According to *Business Week*, "Continental was accepting less quality credits for increased market share" (May 14, 1979, p. 115).

In general, a corporation's growth or decline is largely dependent upon its management, and Continental's rapid growth throughout the late 1970s was to a great extent due to its very ambitious goals and limited controls on lending activity. As a mark of its success over the short run, Continental's return on equity increased from 12.7% to 15.1% during the period 1973–1979 at the same time that its net income increased from $85 million to $196 million. The bank was able to grow at such a rate because it

was aggressive and was willing to loan to riskier, but potentially more profitable, firms. Roger Anderson was convinced that the troubled loans the bank would incur would be few and far outweighed by the sheer volume of good loans (*Business Week*, October 11, 1982, p. 82). Although Continental indeed flourished for nearly a decade under such aggressive and decentralized management, it was these same management policies which were eventually to result in its decline.

V. Conclusion

As we have seen, Continental's management goals and methods led the bank to loan to far too many risky borrowers, a course of action which eventually led to a nonperforming loan total that threatened the bank itself. Continental offered large ambitious loans to energy companies, to real estate concerns, and to foreign developing countries—all very volatile sectors. The unbridled zeal for lending at the bank led to a substantial lack of credit quality control and to far too many risky loans. As one bank consultant aptly described Continental's predicament, "Aggressive marketing mixed with decentralized lending and rapid expansion creates a situation in which there is much less sense among officers of what kinds of credit are acceptable" (*Business Week*, October 11, 1982, p. 84). As a result, by 1984 Continental was plagued with $2.3 billion worth of nonperforming loans which were draining net income and distressing creditors.

The Continental downfall came as a surprise to many, but upon reflection it really shouldn't have. Simply stated, the bank's management was far too ambitious and decentralized to survive in the very competitive U.S. banking industry.

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