Description of document: Two (2) Federal Deposit Insurance Corporation (FDIC) Documents: Report on Continental Illinois, 1985 and Current Issues in Systemic Risk (Too Big To Fail), 1995

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Federal Deposit Insurance Corporation
Legal Division
FOIA/PA Group
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Washington, DC 20429
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FDIC Electronic FOIA Request portal

FDIC
Federal Deposit Insurance Corporation
550 17th Street, NW, Washington, DC 20429-9990
Legal Division

September 1, 2020

In re: FDIC FOIA Log Number 20-0336

This is in response to your August 29, 2020 Freedom of Information Act (FOIA) request for:

> Two unpublished papers referenced in FDIC-authored Chapter 7 Continental Illinois and Continental Illinois and Too Big to Fail. One is referenced as FDIC, Report on Continental Illinois (unpublished paper) 1985. The other is called FDIC, Systemic Risk (Too Big to Fail) unpublished paper, 1995.

These documents have been released previously and are now being released to you. The enclosed documents, consisting of 257 pages, are being released in part.

The information withheld is exempt from disclosure under Exemptions 4 and 8, 5 U.S.C. § 552(b)(4) and (b)(8). Exemption 4 requires the withholding of trade secrets, and confidential or privileged commercial or financial information that was submitted by a person. Exemption 8 permits the withholding of information contained in, or related to, the examination, operating, or condition reports prepared by, on behalf of, or for the use of the FDIC in its regulation or supervision of financial institutions.

You may contact me (telephone: 703-562-2274; email: acolgrove@fdic.gov) or our FOIA Public Liaison, FDIC Ombudsman M. Anthony Lowe at MLowe@FDIC.gov or by telephone at 312-382-6777, for any further assistance and to discuss any aspect of your request. You also may contact the Office of Government Information Services (OGIS) at the National Archives and Records Administration to inquire about the FOIA mediation services they offer. The contact information for OGIS is as follows: Office of Government Information Services, National Archives and Records Administration, 8601 Adelphi Road-OGIS, College Park, Maryland 20740-6001, email at ogis@nara.gov; telephone at 202-741-5770; toll free at 1-877-684-6448; or facsimile at 202-741-5769.

If you are not satisfied with the response to this request, you may administratively appeal by writing to the FDIC's General Counsel. Your appeal must be postmarked or electronically transmitted within 90 days of the date of the response to your request. Your appeal should be addressed to the FOIA/PA Group, Legal Division, FDIC, 550 17th Street, N.W., Washington, D.C. 20429. Please refer to the log number and include any additional information that you would like the General Counsel to consider.

Sincerely,

Alisa Colgrove
Government Information Specialist
FOIA/Privacy Act Group

Report on Continental Illinois

This Report contains two separate parts. The first part, pre-pared by John Quinn, summarizes events leading to the May 1984 Continental Crisis. It goes back several years prior to Penn Square and focuses on Continental's performance, the market's and analysts' perceptions of Continental and what was being said about various aspects of Continental's operation in the financial press and in financial periodicals.

The second part covers my notes and recollections on the Continental transaction from May 10 to the July 26 Assistance Agreement. Some important aspects of the negotiation process and the Agreement are touched upon only briefly. These include the legal documents themselves and the loan collection process which are the subject of ongoing review, principally by others. Management selection is discussed only briefly because my information on that subject is limited.

Division of Research and Strategic Planning

July 26, 1985

Continental Illinois

The attached report describes and summarizes perceptions of Continental Illinois from the perspective of the marketplace. It reviews the observations and opinions of bank analysts and journalists, documenting what was being said about Continental before its 1984 crisis. Except for the attachment reviewing bank examination findings, all sources for this report were widely available to the public and provided the basis for general market opinion on Continental. It is important to bear in mind that this report is intended to provide background for the Continental Illinois crisis, not analysis of it: it discusses what was known and said about the bank, not what should have been known or said.

The report is in the format of a text and five attachments. The text discusses chronologically the factors leading to the crisis. It summarizes Continental's pre-Penn Square history and the effects of Penn Square's failure on its operations and on perceptions of it in the marketplace. Attachment 1 is a chronology of stock analysts' opinions and recommendations concerning Continental Illinois prior to the failure of Penn Square. Attachment 2 is a similar chronology of opinion after Penn Square. These two document the informed opinion of the banking industry'a closest private-sector observers. Attachment 3 provides basic financial data on the bank (not the holding company) for the years 1977-1983, all of which was puhlicly available. Attachment 4 provides extracts from magazine and newspaper articles pertaining to Continental Illinois during the period from 1978-1984. Highlights from these articles are grouped according to those aspects of Continental's operations which they discuss; there are six such headings:

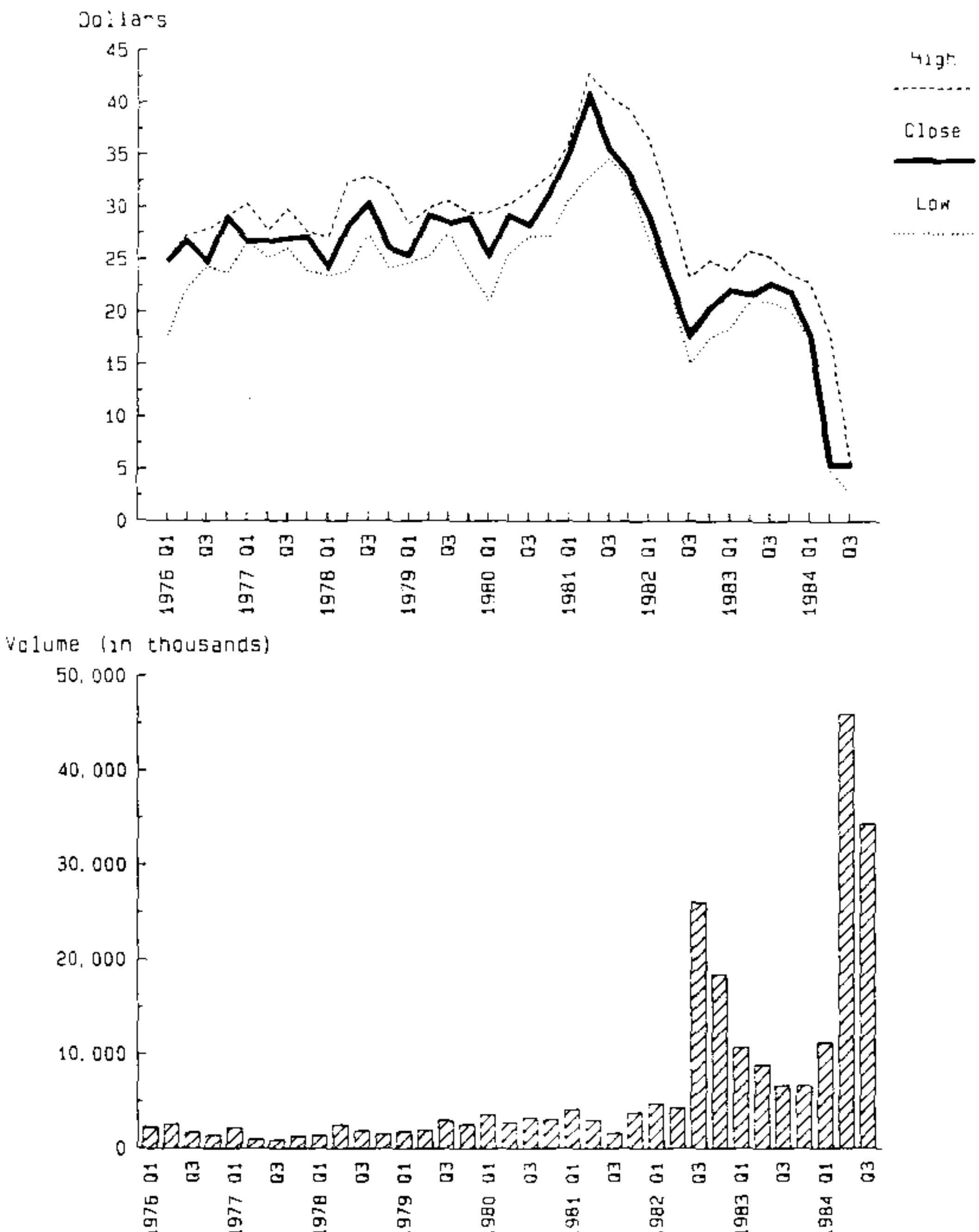
I. Aggressive management style
II. Cut-rate lending, loan growth
III. Loan review
IV. Aggressive energy lending
V. Real estate lending
VI. Interest rate risk

Attachment 5 provides a brief review of examination findings on Continental Illinois for the six exams conducted in the 1979-1984 period.

THE (RISE AND) FALL OF CONTINENTAL ILLINOIS

A Review of the Factors Leading to the Crisis at Continental Illinois

Continental Illinois Common Share Price and Trading Volume, First Quarter 1976 Through Third Quarter 1984



Even before Penn Square's demise, questions were being asked about Continental Illinois. While the bank had shown consistently superior earnings, asset quality and growth, many had begun to recognize the potential for problems arising from Continental's approach to banking. Yet, there was an abiding confidence in Continental's management that bolstered the bank's image.

Before taking over the reins at Continental Illinois in 1973, Roger Anderson had spent most of his previous 27 years at the bank in international operations, competing against east and west coast money-center banks. Upon becoming CEO, he reoriented the bank's strategy, and the once conservative, low-profile institution began competing aggressively with the nation's major banks on all fronts, as Anderson sought to make Continental Illinois the premier bank between the coasts.

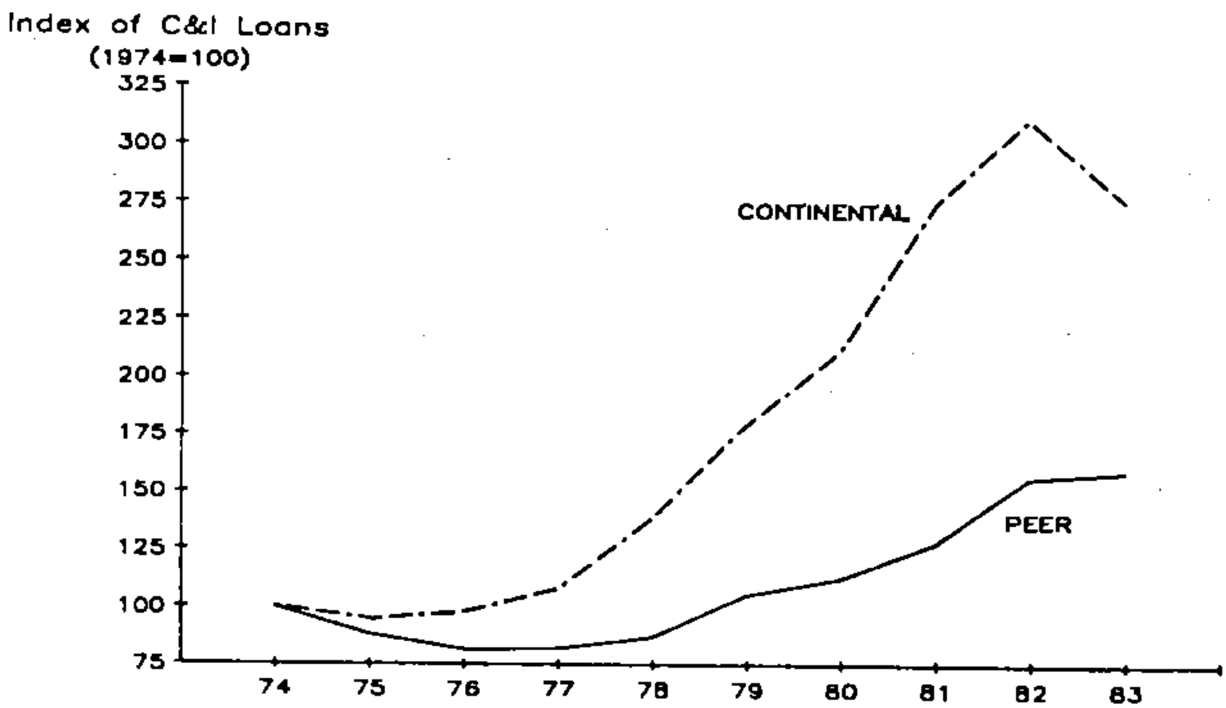
The focus of the operating strategy adopted in the mid-70s was on commercial lending. In 1976 bank management announced its goal of becoming one of the three biggest lenders to U.S. businesses by 1981. A combination of circumstances contributed to the exceptional growth Continental experienced between 1976 and early 1982:

1. Continental was primarily a domestic corporate lender and the U.S. economy experienced rapid real growth coming out of the 1974-1975 recession. For four consecutive years growth was strong, providing new lending opportunities.

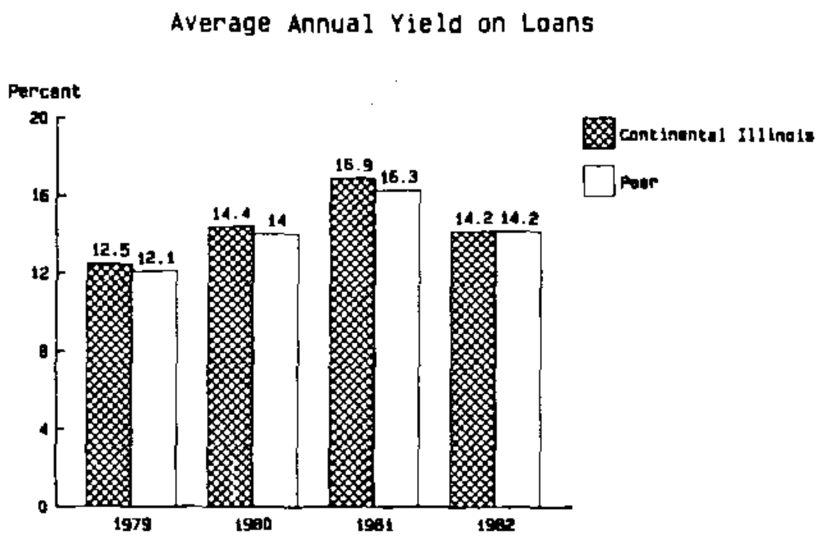
2. Some of the financial problems of Continental's prime competitors, notably First Chicago, Chase, Bankers Trust and some large regional banks, allowed a competitive opportunity to increase market share.

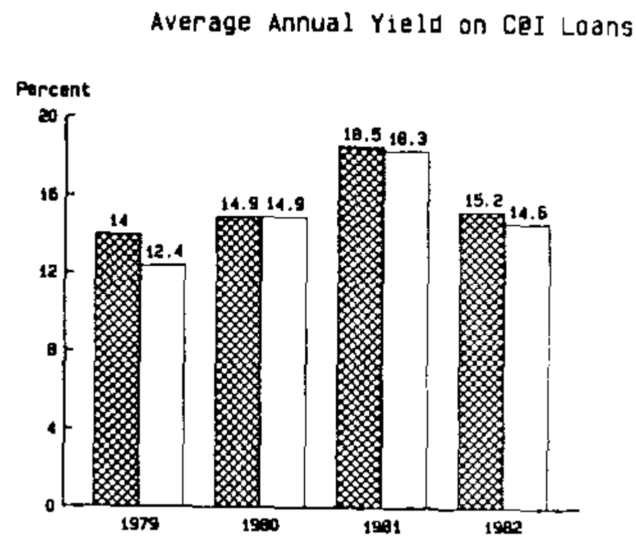
3. Continental had historically been an energy bank and the strong demand for energy financing (typically not available in public markets) permitted rapid growth in energy loans, some of it fueled by participations in credits originated in the Oklahoma market.

Management effected a major, marketing-oriented reorganization in early 1977 to provide an organizational structure that would enable it to attain its ambitious goals.

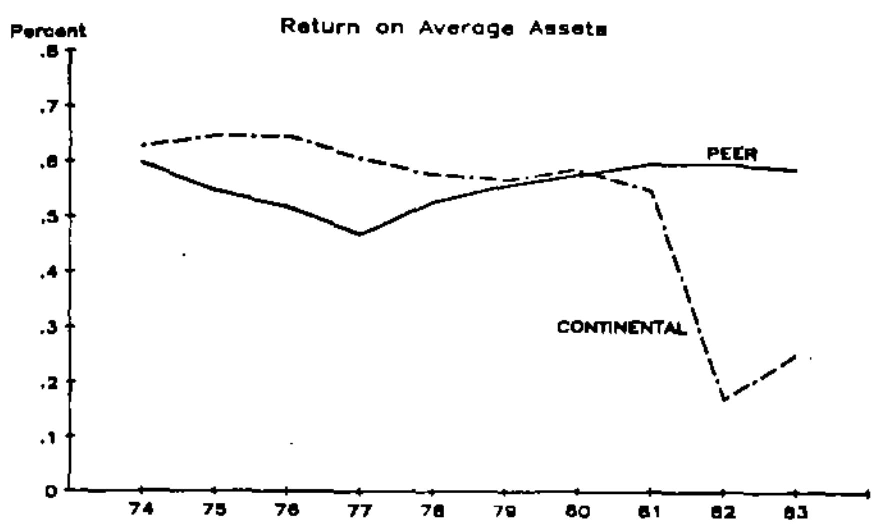


The bank also reaped financial benefits from its aggressive lending style. Continental's loans produced high returns, with average yields usually higher than those of its competitors.

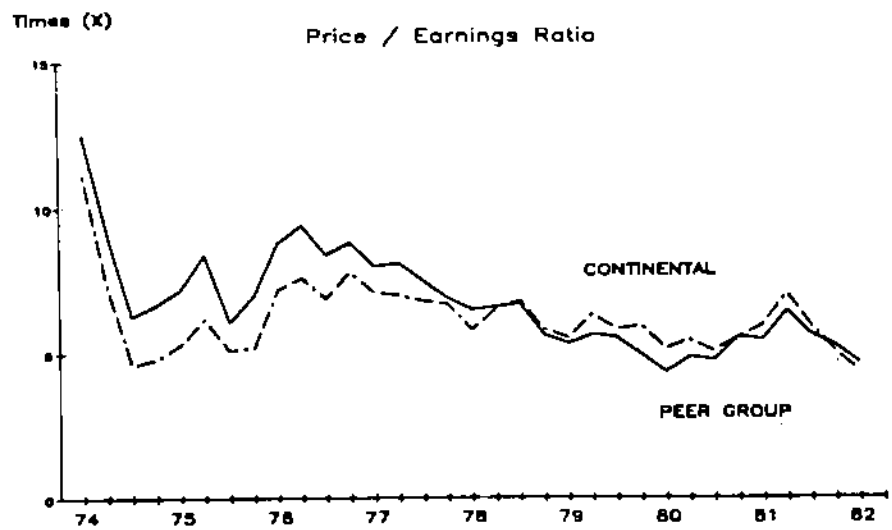




By 1981, Continental had become the largest commercial and industrial lender in the U.S., thus largely achieving its goals. During this period Continental also ranked near the top of its peer group in most measures of financial performance. Loans grew from $12.1 billion in 1976 to $29.5 billion in 1981 for a growth rate of 19 per cent per year. Peer group growth was approximately 15 per cent per year during the same time frame. Net income increased from $80.6 million to $260.3 million over the same period, or 15 per cent per year. Continental's returns on average assets consistently averaged .6% which, while not spectacular, was consistently above that of its peers.



The market reacted favorably to Continental's aggressive growth strategy. Until the fourth quarter of 1981, the bank appeared to be a favorite among Wall Street bank analysts. Many analysts regarded Continental as a pre-eminent money-center wholesale bank, citing its stable asset and earnings growth, its excellent record in loan quality and its expertise in energy lending. High marks were given to Continental's management for its innovative programs in steering the bank to meet its goal of becoming one of the nation's top corporate lenders. For three years, from 1978 to 1981, Continental Illinois common sold at a premium over other money-center banks.



Through most of 1981, most Wall Street analysts continued to believe that Continental would experience continued 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 good credit quality.

In two articles for the American Banker in August 1981, Sanford Rose outlined the situation at Continental Illinois and explained the potential for trouble there. At this point the virtually universal bullishness on

Continental began to be tempered by worries over the bank's involvement in major corporate bankruptcies. The Wall Street Journal ran articles in September and October that provided detailed description, replete with examples, of the riskiness of Continental's lending operations. Growing asset quality problems and losing gambles on interest rate movements began to erode the bank's support. The company's stock price dropped significantly and analysts went neutral on the stock. By March 1982 analysts generally felt that investor psychology had over-discounted the share price for Continental's loan quality problems, perceived favorable long-term prospects for the bank, and once again recommended buying the stock. A few analysts appeared concerned about Continental's name being associated with an increasing number of Chapter 11 filings; however, these concerns were not translated into investment recommendations.

The bank had been emphasizing loan growth and expanding market share for five years. The market saw that Continental had enjoyed good asset quality through the years, presumed that credit standards had been maintained during the "go-go" period, and therefore viewed emerging loan quality and balance sheet management problems as a short-term phenomenon precipitated by deteriorating economic conditions and the volatile interest rate environment. The focus of everyone's attention, management's, the market's and supervisors', had been on earnings and asset growth. Continental's reputation, wholesale nature and unit-banking constraints diminished concerns over its funding techniques. The bank was thought to have sufficient capability to meet any external pressures and to fund projected growth. Indeed, management was held in the highest esteem by the market and banking supervisors, and was considered strong enough to lead the bank through whatever difficulties might develop with the recession.

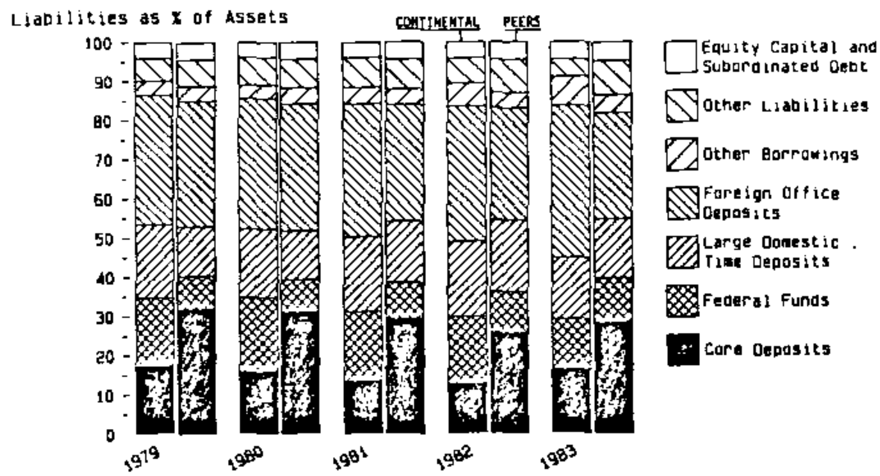
Then came Penn Square.

The growth in energy prices moderated in 1981 and prices began to fall in early 1982. Several sharp drops in oil prices occurred, causing a sudden and continuing decline in the energy industry. Banks that had lent money to a booming industry suddenly found many of their customers facing severe financial difficulties. Phillip Zweig's American Banker article in April 1982 questioned the quality of the credits that had been generated by Penn Square Bank. It noted the exceptional risk inherent in many of the over $2 billion of energy loans the bank had originated, and also reported that Continental Illinois had participated in half of them.

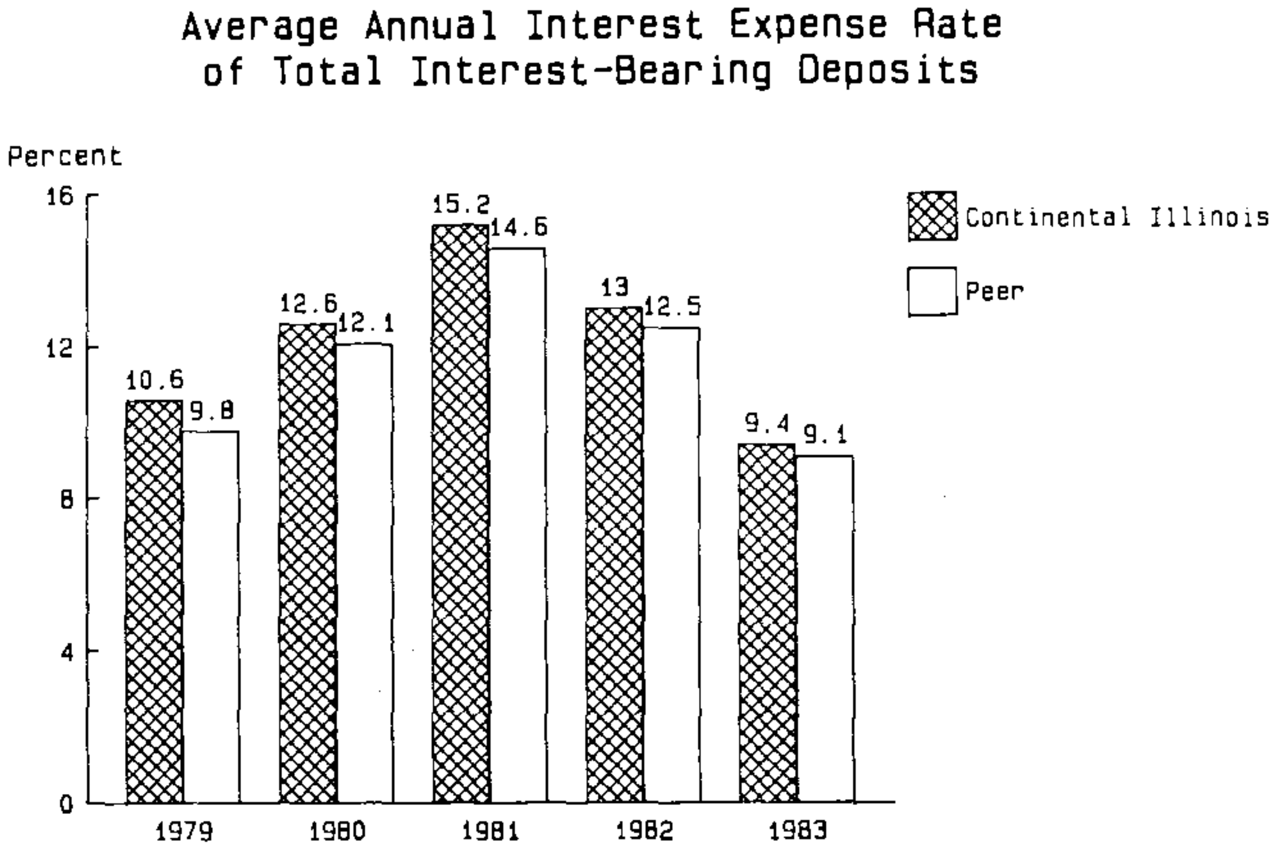
Nevertheless, Penn Square took Wall Street and Continental Illinois by surprise. When, on July 2, the American Banker ran another Zweig article on Penn Square in which it was reported that the FDIC was reviewing the bank, the mention of Penn Square's upstream banks drove down their common share prices in heavy trading. Within the first week of Penn Square's collapse, Continental had been generally identified as having the largest exposure. Sell recommendations immediately followed and, with few exceptions, the general sentiment of bank analysts remained negative for the remainder of 1982. Continental began to suffer funding problems and its stock price dropped from $25 in June to $16 a share by mid-August. Its credit rating was quickly downgraded by the major rating agencies; term debt ratings were also lowered. Fed Funds and CD markets began to dry up as Continental lost the confidence of domestic money markets. No longer would it be an asset-driven, growth-at-any-cost bank; suddenly funding became Continental's priority.

With limited access to retail banking markets and stable core deposit funding, Continental Illinois had funded its growth with purchased funds. This placed Continental at a decided disadvantage compared to its money-center competitors on the east and west coasts, as their core deposit bases averaged twice the size of Continental's. The chart below shows the extent to which Continental was forced to buy expensive fed funds and large time deposits to compensate for its relatively small core deposit base.

Liability Structure, Continental Illinois vs. Peers

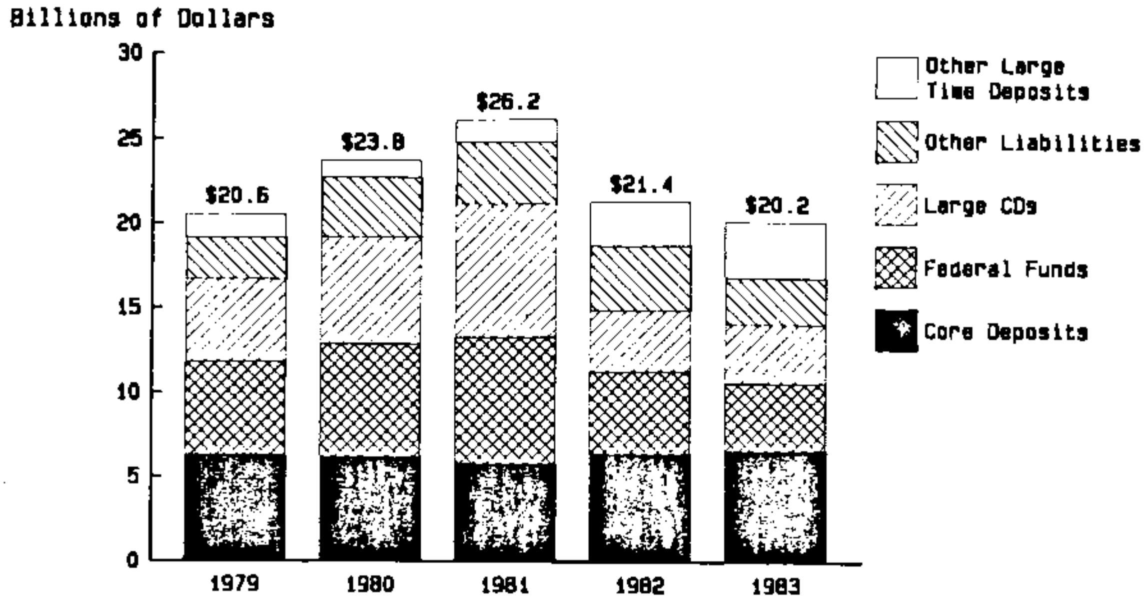


Owing to its stellar reputation and high profile, Continental had enjoyed access to money markets at the best rates, but due to the sheer volume of its funding requirements, the company incurred enormous interest expense. As the chart below indicates, the average cost of Continental's interest-bearing deposits stayed at least 50 basis points higher than peer because its liability mix was so heavily weighted with large liabilities to offset the relative lack of core deposits.



The fact that management opted to issue shorter term instruments, even as interest rates soared in 1981, increased costs. It also made the bank even more vulnerable to a flight of funds, as Continental was constantly in the marketplace rolling over large volumes of its extant deposits and trying to secure new ones. When Penn Square hit that vulnerability became readily apparent, as Continental's status in domestic money markets fell, and its ability to generate funds there was impaired.

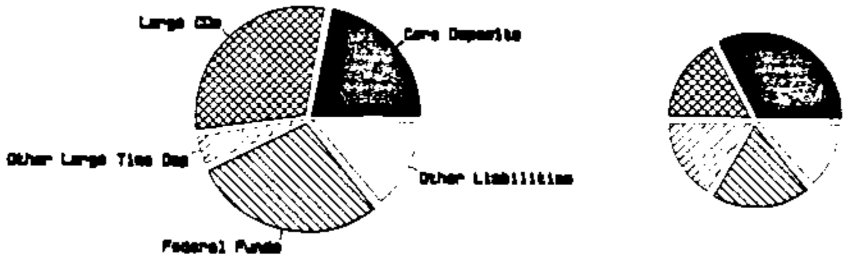
Domestic Liability Mix



Continental was forced to pay premium rates on its CDs almost immediately after Penn Square failed. Some CD brokers removed Continental from their lists of acceptable paper issuers altogether. By mid-July there was uncertainty as to whether Continental CDs would be deliverable against CD future contracts. On July 25th the bank, at its own request, was removed from the list of top-graded banks whose CDs are traded interchangeably in the secondary markets. This development was met with mixed reactions by analysts: some viewed it as a responsible, well-meaning gesture in light of market conditions, while others, feeling that it would further diminish Continental's reputation and make deposit gathering even more difficult, considered it a poor asset-liability management decision.

Because Continental had developed such a dependence on domestic money markets, its sudden reduced access meant an immediate reorientation of its funding strategy was required. From 1981 to 1983, the amount of funding Continental was able to generate through its domestic operations fell by 23 %.

Funding Through Domestic Operations



1981 Total Domestic Liabilities $26.2 billion

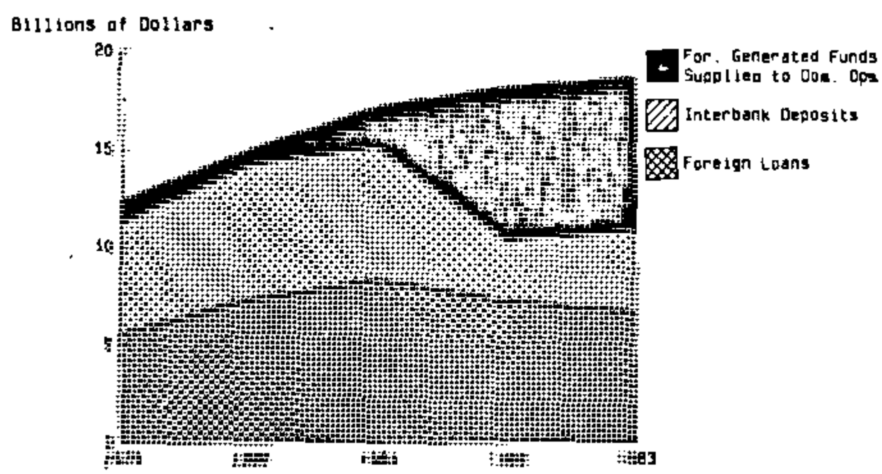
1983 Total Domestic Liabilities $20.2 billion

To compensate, Continental turned to the interbank European market as its primary source of funds, replacing domestic CDs, about a quarter of which had run off, with same maturity eurodollar time deposits. Although this enabled the bank to maintain its asset-liability structure, the total cost of these funds was some 75 basis points higher than domestic CDs.

For a month after Penn Square, Continental's management remained close-mouthed about its involvement with the failed bank. The uncertainty this fostered was counter to Continental's interests, because in the absence of hard news, negative rumors abounded. It also undermined the excellent reputation Roger Anderson and company had established with industry analysts. Still, once bank management had met with analysts and briefed them on Continental's exposure to Penn Square-originated credits and other troubled loans, faith waa restored to the extent that most commentary characterized Continental's problems as being limited and transient.

The manner in which Continental effected its funding change also won praise and helped restore some of the institution's lustre. Continental, in keeping with its image as a major U.S. wholesale bank, had been building its overseas business. By 1981 its foreign offices had $15 billion in assets and $17 billion in liabilities. These assets were distributed 50-50 between loans and interbank deposits. This distribution helped lend Continental credibility in foreign money markets, as U.S. multinational banks are typically major participants in the interbank market. When the need arose in the second half of 1982 to raise funds in foreign markets to fund its domestic operations, Continental reduced its sales of interbank deposits while continuing to buy increasing amounts of deposits itself. By the end of 1982 Continental was able to provide nearly $8 billion of foreign office deposits to its domestic operations, up from $2 billion at year-end 1981 and $750 million in 1980.

Foreign Office Liabilities Relative to Foreign Office Assets and Net Loans



The London market noted the bank's increased activity and aggressiveness, but viewed its approach as responsible and professional. Continental's offering high rates in the euromarket was described as a function not of credit quality, but of the ferocity with which it went after funds. One factor that helped the bank's reception in international money markets was its being perceived as unsinkable. As one international banker commented at the time, "If Continental goes, you can say goodbye to the banking system, and we'll all have more than a few CDs to worry about."

1982's third quarter had a series of events that rocked the financial sector. Starting with Penn Square, and all its fallout, news proceeded to worsen, with the Lombard-Wall bankruptcy, the Mexican debt crisis, the Argentine debt crisis, and several corporate bankruptcies. Continental had exposure in all these, yet it managed to maintain its credibility, and thus its viability, in the marketplace. When, in October, the company reported that third quarter earnings were only one-third of the year earlier quarter, however, the immediate market reaction was a sell-off of Continental common stock. The share price had rebounded from 16 back up to 24 in the two months from mid-August, on the belief that the company had identified its problems and was successfully containing them. When Continental had reported a second quarter operating loss of $61 million due to $262 million in credit losses, the worst had been presumed to be over. The $1.3 billion in non-performing loans reported at that time was considered to fully reflect the bank's asset quality problems, most of which were thought to have risen out of Penn Square participations. Payment of the regular quarterly dividend in mid-August also served to buoy perceptions of the company, and to make its stock very attractive on a yield basis. The bank still appeared to be conducting profitable operations: it had not attempted to inflate its bottom line with nonrecurring gains, while it continued to provide unprecedented amounts for loan losses. But the third quarter earnings report noted that nonperforming assets had jumped another $700 million, to $2 billion. The stock price lost

10% in one day as analysts began to realize that Penn Square may not have been an isolated case. The substance of reported earnings was not questioned, but future earnings prospects were uncertain.

In November the stock price recovered again, reaching $25 and matching its pre-Penn Square high for the year. Credit ratings from the major agencies, which had downgraded Continental's capital and money market ratings in a number of steps during the second half of 1982, stabilized in the single A category. Securities analysts were grouping around the outlook that Continental would regain its momentum in the intermediate term. Although the company's stock was recommended more as a speculation than an investment, support for the bank was apparent. When first quarter 1983 earnings were reported at less than half their year-earlier levels, the stock price didn't budge. Some analysts expressed encouragement with management's apparent aggressiveness, not in growing loans this time but in providing for loan losses. The annual shareholders meeting was held in April without incident or controversy, and management expressed optimism about the bank's prospects, although admitting that its previously announced goals of a 79% increase in operating earnings in 1983 and a 26% reduction in problem loans may have been too optimistic.

The second quarter of 1983 proved to be the high point of Continental's post-Penn Square comeback. Earnings, which were still considered high quality, were identical to those of the first quarter and, of course, far above the year-earlier quarter's loss. The common share price reached its post-Penn Square peak of $26. Non-performing assets, however, remained at the

$2 billion level and, as the bank was shrinking in size, they were creating a growing drag on earnings. By late 1983 analysts were well aware that Continental's basic operations were increasingly in the red. Third quarter profits were hurt by a squeeze on the net interest margin and a decline in earning assets. Operating earnings were only 20% of the two-years-earlier quarter. Analysts indicated that Continental's recovery was proceeding more slowly than had been hoped. Concerns developed regarding Continental's growing reliance on securities gains and extraordinary gains to produce earnings.

Continental's liability structure depended on satisfactory earnings levels to support access to the funds markets. A flurry of one-time gains taken in the second half of 1983 caused many to doubt the quality of Continental's 1983 earnings, even though they rose 39% over those of 1982. When the company was saved from a first quarter 1984 loss only by the last-minute sale of its profitable credit card operation, Continental's desperation was apparent. The first quarter report stated that non-performing loans had grown to $2.3 billion, due in large part to troubled Latin American loans. The common share price, which had started the year at $22, fell to $15. The departure of Roger Anderson during the first quarter marked not only the end of an era, but the dissipation of the markets' faith in Continental Illinois.

Given the bank's precarious funding position, the increase in interest rates in the first four months of 1984 worsened the outlook on Continental Illinois. Uncertainty about the true dimension of Continental's credit problems in light of increases in non-performing assets, the growing concern about the company's ability to turn a profit on its operations, and questions about the wisdom of selling earning assets to cover dividends combined to send Wall Street's opinion of Continental to new lows.

Then came the rumors of Continental's imminent bankruptcy.

Considering the setbacks it had already suffered in 1984, and because it had a regular requirement for $8 billion of overnight funds, Continental was uniquely vulnerable to a confidence-induced liquidity crisis. When a Japanese news agency published a report discussing Continental's takeover by a consortium of foreign institutions, a wave of rumors began rolling through overseas money markets. As trading activity began in each world money center on May 8th, the rumors spread. Having exhausted the confidence of world markets, Continental's paper, as well as that of other banks, was abandoned and its stock price began to plunge. The situation had become serious enough that on May 11th the Federal Reserve loaned the bank $3.6 billion at the discount window while Treasury Secretary Regan attempted to reassure bankers, stating that the government would protect the banking system at all times and under all circumstances. This briefly revived the stock price, but was not effective in returning deposits to the bank.

Over the weekend of May 12-13 arrangements were negotiated to have a consortium of 16 banks provide Continental with a $4.5 billion standby line of credit to enable the bank to withstand its liquidity crisis. The credit resource was announced on Monday, May 14th. On the same day Standard and Poor's downgraded Continental's debt and preferred stock ratings.

Despite the attempts to shore up Continental's liquidity and instill sufficient confidence in the bank to give it access to money markets, by mid-week it was apparent that Continental could not recover. Federal regulators arranged an emergency temporary capital infusion of $2 billion to stabilize the bank and buy time in order to work out a permanent solution. The consortium of assisting banks was expanded to number 24, and the line of credit increased to $5.3 billion. Under the terms of the assistance, Continental finally omitted its dividend, which it had maintained in an attempt bolster market confidence in its earnings potential and, thus, to permit continued access to money markets. Such image-building no longer warranted the expense.

From 1981 on there had been warning signs that Continental Illinois may have or encounter problems, or perhaps wasn't as good a bank as many thought, but often these signs were discounted, if not ignored, for basically one reason: faith in the competence of management. The bank's losses on interest rate plays in 1981 were considered "a fluke". Penn Square was "an isolated problem." Credit exposures to every major corporate bankrupt were "due to the deteriorating economy." With the benefit of hindsight, we now see that it was blind faith. Management took too many risks, failed to implement adequate internal controls, and was too single-minded in its pursuit of market share. But everyone, from bank stock analysts to bank examiners, so firmly believed in the quality of bank management that problems were viewed as aberrations. Of the lessons to be learned from the fall of Continental Illinois, one of the most basic is that there is no bank management, regardless of reputation or historical quality or its company's size, that should be spared the healthy skepticism of the banking industry's closest observers.

Still another important, and rather alarming, lesson the Continental Illinois crisis teaches is that a leading money-center bank can have its funding base destroyed in a matter of days, even on the basis of unsubstantiated rumors. The absence of a stable regional funding base was a major factor in Continental's downfall, because the bank found itself exposed to the sudden shifts of confidence which characterize wholesale money markets. When the domestic funding ran off in the wake of Penn Square, Continental was able to tap the euromarkets; but when its eurodeposits ran off, there was no private sector source to which it could turn. The funding risks apparent from this episode are disquieting, not only for money-center unit banks, but for any bank dependent on its reputation for raising multiple billions daily in world money markets. Continental had endured a two-year string of negative reports before it finally lost the markets' confidence. But no one spotted the crisis before it was upon us.

Chronology of Stock Analysts' Opinions and Recommendations
Concerning Continental Illinois Corporation
Prior to the Failure of Penn Square

January 14, 1981 Mark Bidderman, Oppenheimer & Co.

"We are recommending purchase of Continental Illinois Corp....Earnings have grown at a 13% annual rate for five years through 1980....In our opinion, this rate can be improved upon over the next 5 years. The key to earnings growth has been, and will continue to be, strong domestic loan growth....One factor critical to loan growth and the ability to maintain it in a sluggish economy is Continental's expertise in energy lending....Continental Illinois has an excellent record on credit quality....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 loan losses....We believe Continental Illinois is well positioned for superior earnings growth due to its position as a prime lender to the energy area, its potential for improved return on assets and its record of good credit quality."

"The weak [return on asset] performance [of Continental] in a high-rate environment can lead to the conclusion that much of the domestic loan market share gain was achieved at the cost of cut-rate pricing and, therefore, that the market share growth was not sufficiently profitable. However, we do not believe this to be true."

April 16, 1981 Lawrence W. Cohn, Dean Witter Reynolds Inc.

"As interest rates continue to decline, we expect the stocks of all multinational banks to do well. Continental Illinois should participate in this. Thus we continue to rate the stock Buy/Hold....We believe the company hid some earnings in the loss provision and expect to see [the loss provision] drop in future quarters."

May 15, 1981 - *Wall Street Transcript* Analysts Roundtable Discussion

Mark Bidderman, Oppenheimer & Co.:

> "We are recommending Continental Illinois....Continental has shown very strong loan growth over the past several years due to its energy lending franchise. Return on assets have been held down by float problems in 1979. These have been corrected."

James G. Ehlen, Goldman Sachs & Co.:

"Investors need to...find the banks that have been doing the most things right for the longest period of time. It would seem to us that Continental would come up very high on that list, and should enjoy a premium multiple over other money center banks. Continental would be one of our strong recommendations....Continental [has] the best prospects among money center banks."

C. Edward McConnell, Keefe, Bruyette, and Woods, Inc.:

"Continental, it's hard to fault the company. Basically they've done things right and now it's a valuation question. Do you want to pay the same for Morgan as you do for Continental or do you want to buy Chase at a cheaper multiple."

June 15, 1981 The Wall Street Transcript

"[The Wall Street Transcript's] runnerup silver rating [as the outstanding money center bank CEO in 1981] goes to Roger E. Anderson, Chairman of Continental Illinois....[He] has achieved consistently higher annual earnings...and has done this by avoiding problem areas."

Comments from unnamed analysts supporting this distinction:

"[There] is a growing perception that Continental is emerging as the pre-eminent money center wholesale bank. It comes through pretty clearly in terms of the numbers, in terms of profitability and in loan growth and asset quality."

"Continental's had volume growth, and they've managed the margin fairly well. They've chosen the markets they want to be in quite successfully. Their planning has been impressive."

"Continental has done a good job in defining their lending strategy, but I wouldn't go so far as to say that the bank has fully maximized their opportunities -- even from the standpoint of profits."

"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."

"Anderson has avoided a lot of problems which have affected other banks. He has managed to get increased market share while keeping the bank out of various problem areas."

July 17, 1981 Lawrence Cohn, Dean Witter Reynolds

"Over the short term Continental is well positioned to benefit from declining interest rates. Over the longer term, the recent changes in Illinois law to allow the formation of multibank holding companies should lead to the company's greater involvement in consumer banking. This, in turn, should give the company greater stability over the business cycle. For these reasons we continue to rate the stock Buy/Hold."

November 23, 1981 Wall Street Transcript

"W. Dolson Smith of the Bank of New York, because of heightened concern about the future of International Harvester, has lowered his rating on Continental Illinois from buy to hold, noting that while the long-term outlook for Continental Illinois remains very favorable he would temporarily defer accumulation of the stock at this time....Despite [the problem loans to International Harvester], Smith continues to view Continental Illinois as a premier money center bank holding, with above average loan growth prospects due to aggressive marketing efforts and participation in energy lending of about 15% of its domestic loan volume."

January 25, 1982 Wall Street Transcript

"Arthur Sorter of Morgan Stanley & Company still expects a rally in money center bank stocks....On a near term basis, several stocks among the money centers appear attractive to Sorter, including Bankers Trust New York, Chemical New York, Citicorp, and Continental Illinois..."

March 15, 1982 Kenneth Puglisi, Keefe Nationwide Bankscan

"In our view, the market's current disfavor with [Continental Illinois] represents a gross overreaction to the year-end increase in the bank's non-performing assets.

"One factor which may have also played a part in the price drop is the current disfavor with energy related banks....Since Continental has such strength in energy lending, many investors seem to hold the misconception that the bulk of the loan growth was in the energy sector. In reality, while energy lending was important, CIL's loan growth was much more broad based than that. It is this loan growth that we expect will give Continental the earnings momentum necessary to absorb a higher level of net charge-offs and still post a respectable earnings gain in 1982. At this point, we believe that CIL represents one of the better values among the bank group."

March 29, 1982 Wall Street Transcript

"W. Dolson Smith of The Bank of New York recently raised his rating on Continental Illinois Corporation from hold to buy in the belief that the decline in the stock price from the low 40's last June is unwarranted in view of the company's favorable fundamentals....Smith believes that [the] potential impact on earnings [of problem credits to major corportations, Poland, etc.] has been overly discounted in Continental's stock price and that most of these problems will diminish over the intermediate term."

April 5, 1982 Marc A. Hellman, Keefe Bank Review

"On March 19 Moody's Investors Service [reduced] its senior long-term debt ratings on nine of the most prestigious bank holding companies in the country. Citing a weakening in .qualitative and quantitative measurements of debt Protection'....Moody's reduced to Aa from Aaa their ratings on [Continental and eight other money center banks]....Among those holding companies whose ratings were cut by Moody's, we continue to retain our highest rating (A) on Continental Illinois, Northwest Bancorporation, First Bank System and Mellon."

April 23, 1982 Value Line Investment Survey

"Continental Illinois stock probably will outperform the year-ahead market....Continental's loan loss experience has been good for years....Continental Illinois is big in energy lending, an area of concern to investors now that oil prices have declined. But Continental is not a Johnny-come-lately to this business -- the bank has been making loans to the energy sector for about three decades -- and it has lots of experience in both good times and bad. Now for the bad news: Continental is a major lender to some financially beleaguered corportations...and nonperforming assets, though less burdensome to Continental than to many other banks, are likely to continue rising into 1983."

May 17, 1982 Wall Street Transcript Analysts Roundtable Discussion

Robert Albertson, Smith, Barney, Harris, Upham & Co.:

> "I have no fundamental problem with Continental Illinois, but I think it may be an underperformer for the immediate future, due to investor psychology....I do not look at [Continental's nonperforming assets] as a major fundamental concern, but I think investors partly chose Continental for a similar reason they choose J.P. Morgan: the presumption was that the bank had an exceptionally clean portfolio."

Richard Fredericks, Montgomery Securities:

"In my opinion, Continental Illinois has been bagged by the press....The stock appears cheap. I agree with others that there happens to be a psychological cloud that surrounds the company because of nonperforming assets and some of the visible loan loss names we have seen in trouble. To the credit of the company, they know exactly who they are and are good in the execution of their game plan....I would be inclined to buy the stock at these levels."

James Wooden, Merrill Lynch:

"My feeling is that on a longer term basis, I would prefer to be involved with Continental [rather than First Chicago]....The problem I have on Continental is that it seems like every time we pick up The Wall Street Journal for this week's nonperforming loan problem, Continental, for whatever reason, is associated with it."

Ron Mandle, Paine Webber:

"One of the things I find amazing is that they are overexposed to many of the domestic problem credits.... Nevertheless, I find that Continental can...still achieve my earnings target....It illustrates the point that Continental's problems are much more psychological than real...Because of the psychological problems, we're not recommending the stock, but the point is very well taken that the fundamentals seem pretty much intact for Continental."

Jim Hanbury, Mabon, Nugent & Co.:

"I draw a distinction between Continental Illinois and other energy lenders in that many of the energy lenders in Texas are asset-sensitive, whereas Continental Illinois is liability sensitive so if the oil price holds and we don't have problems in that area, lower interest rates could make for wider earnings gains there. I think its cheap from a trading point of view, but I think you have to be fairly careful."

Jim McDermott, Keefe, Bruyette, & Woods:

"You can't fight investor psychology. If investors feel that a banking company has literally booked just about every loan in the country, and most of those loans turn up in Chapter XI filings or experience cash flow problems or difficulties with respect to honoring their obligations, that's going to exert downward pressure on the stock. From a fundamental standpoint, we're encouraged by the management and the earnings capability of this company. Our own feeling is that the asset quality problem is overstated in terms of earnings impact."

Unidentified analysts quoted in a companion column:

"I think [Anderson] is doing a good job....Continental will have its fair share of loan losses. But I am not convinved at this point in time that Continental is going to have a disproportionate loss experience."

"One management where I think the jury is out [is that of Continental Illinois]....The question that they're facing now is whether they were too aggressive in their expansion and will pay a price in terms of loan losses. I think their losses will not be above average and they will have the growth in interest income to offset them."

"Continental has been eating up the world in the past few years in terms of loan growth. They've managed to have earnings strength go hand in hand with the growth. There is, of course, the big question out there as to whether this will continue, given the fact that they're associated with so many troubled credits in big ways."

"I think they've blown their own horn too much and have never dealt with what I think are some of the more realistic problems of growing so fast."

<u>May 24, 1982</u> <u>Wall Street Transcript</u>

"Ronald Mandle of Paine Webber ... says that the stock of Continental Illinois Corp has been depressed recently by an above average (89%) increase in non-performing loans in the last six months. In his view, the company's exposure to troubled borrowers [International Harvester, Braniff, Charter, etc.] can be offset by earnings improvement from lower interest rates....He has recently added Continental Illinois to his recommendation list."

ATTACHMENT 2

Chronology of Stock Analysts' Opinions and Recommendations
Concerning Continental Illinois Corporation
After the Failure of Penn Square

July 9, 1982 Keefe, Bruyette & Woods, Inc.

"Our 1982 earnings per share estimate [for Continental@ has been slashed approximately in half to $3.50 per share. This assumes that Penn Square-type problems do not permeate the rest of the energy loan portfolio."

"Either management held back information from analysts and shareholders or they had very little idea of the quality of the paper they were purchasing. In fairness to Continental, the likelihood that they were defrauded must also be considered. However, the possibility that they were duped does not strike us as being much better than the other two possibilities."

July 12, 1982 Smith Barney Harris Upham & Co.

In the wake of the Penn Square failure "we are tentatively reducing our 1982 estimate [of Continental per share earnings] by $2.00 per share to $4.85, and are shifting our investment opinion from hold to sell."

July 30, 1982 Goldman Sachs

"As a result of [a meeting with members of Continental's senior management]...we are now sufficiently convinced that Penn Square was a unique situation and not symptomatic of conditions elsewhere in the loan portfolio."

"There is unlikely to be a good answer to the control deficiencies that prompted the initial buildup [of problem loans] and then permitted outstandings to continue growing in light of documentation deficiencies. Management's credibility will likely continue to be questioned..."

"We are not prepared to overlook Penn Square and 'forgive and or forget'. However, we are prepared to believe that Penn Square represents an isolated situation based on our understanding of the special review procedures utilized recently by Continental management....Accordingly, we recommend purchase of the shares on a qualified basis for investors who are prepared to take an 18 to 24 month view and ignore the current prevalent emotionalism."

August 2, 1982 Susan K. Skinner, Donaldson, Lufkin, Jenrette

"Investment in the common stock of Continental Illinois Corporation is unwarranted given continued uncertainty about the ultimate resolution of problem credits and future funding costs."

September 13, 1982 James Ehlen, Goldman Sachs

"...Over the intermediate time horizon, a strategy within the (bank) group is important, and ours favors both money centers and regions....Among the money centers, we believe the biggest potential lies with the downtrodden, such as Chase Manhattan Corp., Continental Illinois, and Manufacturers Hanover."

October 15, 1982 Robert Albertson, Smith Barney Harris Upham & Co.

"We have little confidence in our EPS estimates at this time and would avoid the stock."

October 18, 1982 Salomon Brothers Inc.

"Northwest Bancorp. replaced Continental Illinois as the most widely owned bank stock [by institutional investors]. Continental Illinois had reigned as the institutional favorite since 1979."

November 3, 1982 J. Frederick Meinke, Kidder Peabody & Co.

"We think that investors should defer purchase of the stock until tangible evidence of more stable operating results emerges."

January 21, 1983 Value Line Investment Survey

"Penn Square isn't Continental's only problem -- just the most obvious....The economy is likely to be sluggish through the first half of 1983 and loan write-offs and loan loss provisions seem sure to be large."

"Earnings are likely to improve in 1983. But the level of profitability will remain well below that of recent years. Continental stock probably will be a market laggard over the next year."

March 28, 1983 Wall Street Transcript Analysts Roundtable Discussion

William Gray, Kidder Peabody:

> "We are relatively optimistic that the banks would emerge from [a drop in oil prices] in reasonably good shape. However, there are some banks that have already gotten in trouble because of poor quality energy loans, banks that Larry mentioned, Continental Illinois and Seafirst. I think there would be great concern for the continued viability of those banks, whether the concern is really warranted or not."

Larry Cohn, Dean Witter Reynolds:

"We have Continental rated a hold/sell....Its funding problems are not as great now as they have been, but they are still there. We think that will pass by the end of this year....We like to play turnarounds in the banking industry as a rule and we've done so successfully in the past. But our view on Continental is that even if they turn around as expected, and making the most optimistic sorts of assumptions, you're not going to get paid at prices to compensate enough for the risk you're taking. And as a result our view is that we'd pass on Continental and go elsewhere."

Jim McDermott, Keefe, Bruyette, and Woods:

"The loan quality issue, particularly with respect to energy, leaves additional vulnerability in the stock....The turnaround aspect of the stock is best left to the speculators. At this point we would rate Continental as a hold/sell."

Robert Albertson, Smith Barney Harris Upham & Co.:

"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 princial area of expertise. Therefore, I have to remain uncertain as to where Continental will be going in the near term....I would not want to come up with a recommendation and would prefer that investors avoid this stock until more information is available. Having said that, I would also caution against being overly negative about Continental Illinois. There is still substantial respect left in the corporate community for them and once these problems are behind them it will certainly be worth a reevaluation."

William Gray, Kidder Peabody:

"[Continental] has damaged its credibiltiy with investors for a long time to come and it is going to be very difficult to reestablish again....I think the market is being kind to the stock at this point in time I think that it has downside risk. It is selling at 53 percent of book value and Chase Manhattan, for example, is only 64 percent of book value. I think there is an enormous difference between investing in Chase Manhattan, versus Continental Illinois, at this point in time."

April 22, 1983 Value Line Investment Survey

"Another massive loan loss provision is likely for 1983, though probably not as big as in 1982....It now appears that the special reserve won't be adequate to cover losses in the Penn Square portion of Continental's loan portfolio....Also the loan loss experience in the rest of the portfolio this year isn't likely to be any better than in 1982, and quarterly loan loss provisions are apt to be hefty. The stock isn't timely."

April 25, 1983 Dean Witter Reynolds Inc.

"While we think the worst is probably over for Continental, the road back to acceptable levels of profitability is likely to be difficult and long. At current prices we think the stock fully reflects the company's potential over the next 12-18 months. As a result, we would avoid investing in Continental in favor of other multinational banks that offer far greater appreciation potential. We rate the stock Hold/OK to Sell."

October 21, 1983 Value Line Investment Survey

"Asset quality is the big problem at Continental Illinois.... Energy is the big villain....The loan portfolio continues to shrink....We look for only a moderate earnings recovery in 1984....Continental stock isn't timely."

November 14, 1983 Dean Witter Reynolds Inc.

"[Continental], on true operations, was in the red in the third quarter....We believe that the third quarter represents the trough in earnings. There are some indications that asset quality is starting to improve, and spreads appear to be better in the fourth quarter. At current prices Continental sells at less than half of book value and yields nearly 10%....The combination of high current yield and good earnings leverage over the next several years means that Continental has the potential to be a better-than-average performer. We have therefore raised our rating on the company to Buy/Hold."

January 20, 1984 Value Line Investment Survey

"We would look elsewhere for near-term stock market performance. We think earnings have bottomed out, and we expect Continental to report consecutive-quarter progress throughout 1984. But year-to-year earnings comparisons will be poor until the second half of 1984, and Continental's asset quality is also a deterrent to investor's getting excited about this stock."

January 26, 1984 Dean Witter Reynolds Inc.

"The new interest rate forecast [of a more moderate decline than previously expected] implies a much more difficult operating environment for Continental Illinois than we had previously expected. Among multinational banks, Continental has a much heavier than usual reliance on fed funds. This makes the company's earnings much more sensitive than most multinationals to fluctuations in interest rates.. We are ... lowering our rating on the stock from Buy/Hold to Hold. We still believe Continental will make good fundamental progress in overcoming its credit quality problems over the next several years, but the tougher operating environment will make it difficult for this improved credit quality to result in improved earnings."

February 6, 1984 Dean Witter Reynolds Inc.

"The company earned no money on an operating basis in the fourth quarter....Although we continue to believe the company will make progress in solving its problems, this progress is coming more slowly than we had hoped. The higher rate forecast means that in 1984 and 1985 the improvement to earnings from declining nonperforming assets will be substantially offset by the rising cost of carrying the remaining nonperformers. Investors now face the real risk that Continental might not return to normal levels of profitabliity until the up phase of the next economic cycle. In our view the stock's only real attraction over the next year, at least, is the high current yield. We have thus lowered our rating on the stock to hold."

April 9, 1984 Wall Street Transcript

George Salem, A.G. Becker Paribas:

> "The company is out there looking to sell assets right now. It's obvious they want to cover their dividend; that's become a very important strategy for them, an objective. I think it's too early to move into this stock."

Richard Bove, Shearson, American Express:

> "[Continental Illinois] is properly structured from our point of view to take advantage of the strength that should develop in the domestic wholesale lending sector and the turn around overseas. However, since many other money center banks are selling at relatively low multiples there would appear to be less risk in those vehicles than Continental Illinois."

<u>April-June, 1984</u> Goldman Sachs

"Continental Illinois reported fourth-quarter earnings in line with our expectations. Our estimate of the company's fundamental earning power was zero....[We] remain cautious on the stock."

<u>April 20, 1984</u> <u>Value Line Investment Survey</u>

"The company is losing money on its basic banking business, and mangement wants to produce at least enough cash to cover quarterly dividends. So until operations improve significantly, Continental plans to continue selling off assets.....Earnings will probably be depressed in 1984. The stock isn't timely and we continue to allow for the possibility of a dividend cut."

<u>April 24, 1984</u> Dean Witter Reynolds Inc.

"It is clear that, excluding nonrecurring items, the company lost money in the first quarter, but it is not clear how much. The company experienced an increase of $400 million in nonperforming assets, slightly less than half of which was domestic. We find this rise in domestic nonperformers very distressing....There is still substantial uncertainty about the outlook at Continental, but current prices largely reflect this. We rate the stock Hold.

<u>May 29, 1984</u> Keefe, Bruyette and Woods, Inc.

"In our view, the best hope for the shareholders lies in the possibility that a large portion of the bank's non-performing assets can be sold to investors....As we have stated in our last three updates, any investment in Continental Illinois shares can only be viewed as speculation."

<u>July 20, 1984</u> <u>Value Line Investment Survey</u>

"Avoid Continental Illinois stock....These shares are <u>extremely risky</u> (Safety: 5), the stock provides no dividend income, and the company is in very poor financial health (Financial Strength: C). The company is in the midst of a liquidity crisis....The bank is losing an enormous amount of money from operations.

ATTACHMENT 3

CONTINENTAL ILLINOIS NATIONAL BANK AND TRUST

Consolidated Statement of Condition, 1977-1983 ($ millions)

	12/31/77	12/31/78	12/31/79	12/31/80	12/31/81	12/31/82	12/31/83
ASSETS:							
Interest-Bearing Deposits	3,906	3,738	3,883	4,016	4,992	1,819	3,483
Securities	2,759	2,635	2,896	2,817	2,482	3,009	2,175
Loans and Leases	14,462	17,489	21,871	25,725	31,071	32,185	30,103
SELECTED CATEGORIES OF LOANS:							
Commercial Loans	5,618	7,120	9,339	10,980	14,272	16,183	14,350
Real Estate Loans	555	869	1,645	1,926	2,584	3,092	3,284
Foreign Office Loans	3,672	4,376	5,502	7,310	8,337	7,287	6,640
LESS: Reserve for Loan Losses	154	173	191	225	265	364	368
Fed Funds and Reverse Repos	183	362	308	416	494	434	665
TOTAL EARNING ASSETS	21,157	24,050	28,769	32,749	38,774	37,083	36,059
Cash and Due From Banks	2,740	3,904	3,337	4,359	2,512	2,189	2,559
Other Assets	1,078	1,984	2,188	3,179	3,860	2,028	2,052
TOTAL ASSETS	24,975	29,938	34,294	40,287	45,146	41,300	40,670
LIABILITIES:							
Core Deposits	5,581	6,009	6,254	6,242	5,822	6,404	6,595
Large Time Deposits	4,525	6,117	6,260	7,371	9,174	6,234	6,836
Foreign Office Deposits	8,337	8,767	11,222	13,497	14,884	15,741	16,442
Fed Funds and Repos	4,403	5,152	5,914	7,257	7,886	5,893	4,811
Other Borrowings	256	1,151	1,247	1,475	1,917	3,340	2,041
Other Liabilities	772	1,516	1,997	3,901	3,685	1,652	1,905
TOTAL LIABILITIES	23,874	28,712	32,934	38,743	43,370	39,521	38,839
Total Equity Capital	1,102	1,226	1,360	1,544	1,776	1,779	1,831
TOTAL LIABILITIES AND CAPITAL	24,975	29,938	34,294	40,287	45,146	41,300	40,670
AVERAGE TOTAL ASSETS	22,892	26,359	32,035	37,846	42,320	44,084	39,020

CONTINENTAL ILLINOIS NATIONAL BANK AND TRUST

Consolidated Statement of Income, 1977-1983 ($ millions)

	1977	1978	1979	1980	1981	1982	1983
Interest on Deposits	217	293	430	615	722	487	209
Securities Income	162	165	199	253	253	223	183
Interest and Fees on Loans and Leases	1012	1469	2346	3315	4661	4585	3404
Interest on Fed Funds and Reverse Repos	12	39	62	66	81	46	28
TOTAL INTEREST INCOME	1402	1967	3036	4248	5716	5342	3825
Interest on Large Time Deposits	183	335	495	692	1138	880	324
Interest on Other Deposits (incl. For.)	495	703	1233	1668	2178	2323	1932
Interest on Fed Funds and Repos	255	398	676	1041	1390	1054	508
Interest on Other Borrowings	17	28	72	132	224	229	2[illegible]4
TOTAL INTEREST EXPENSE	951	1465	2475	3532	4929	4485	29[illegible]8
NET INTEREST INCOME	451	502	561	716	787	856	827
Non-Interest Income	115	149	188	234	284	306	359
Overhead Expense	310	374	451	539	605	648	691
Provision for Loan Losses	52	57	65	91	114	477	359
PRE-TAX NET OPERATING INCOME	205	221	233	320	352	38	137
Income Taxes (Credit)	64	62	51	101	116	(34)	34
NET OPERATING INCOME	141	159	182	218	236	72	103
Securities Gains (Losses)	(2)	(1)	2	1	(5)	(2)	1
NET INCOME	139	158	184	219	231	70	104
Dividends Upstreamed	50	34	50	30	0	62	50

	1981			1980			1979			1978		1977	
AVERAGE ASSETS ($000)	42319988			37845879			32035212			26358800		22892283	
NET INCOME ($000)	231284			219264			183867			158395		139375	
# BANKS IN PEER GROUP	21			18			17			17		15	
EARNINGS AND PROFITABILITY	BANK	PEER 01	PCT	BANK	PEER 01	PCT	BANK	PEER 01	PCT	BANK	PEER 01	BANK	PEER 01
PERCENT OF AVERAGE ASSETS:													
NET INTEREST INCOME (TE)	2.09	2.82	13	2.18	2.74	10	2.09	2.81	11	2.24	2.80	2.28	2.69
+ NON-INTEREST INCOME	.67	.80	22	.62	.76	26	.59	.66	44	.57	.65	.50	.59
- OVERHEAD EXPENSE	1.43	2.25	13	1.43	2.13	10	1.41	2.07	11	1.42	2.06	1.35	1.98
- PROVISION FOR LOAN LOSSES	.27	.25	59	.24	.25	47	.20	.25	38	.21	.27	.23	.31
= PRETAX NET OPER INC (TE)	1.06	1.13	40	1.13	1.12	63	1.07	1.15	38	1.18	1.13	1.20	.98
NET OPERATING INCOME	.56	.60	49	.58	.57	57	.57	.59	49	.60	.56	.62	.49
ADJ. NET OPER INCOME	.67	.68	54	.66	.63	47	.63	.70	38	.67	.65	.62	.52
ADJ. NET INCOME	.56	.54	59	.59	.53	68	.55	.57	38	.60	.55	.58	.47
NET INCOME	.55	.56	54	.58	.56	57	.57	.58	49	.60	.55	.61	.49
PERCENT OF AVG EARNING ASSETS:													
INTEREST INCOME (TE)	16.41	15.85	77	13.89	13.45	78	12.01	11.63	77	9.33	9.42	7.71	8.09
INTEREST EXPENSE	13.92	12.65	86	11.27	10.24	78	9.46	8.31	88	6.65	5.98	4.98	[illegible].76
NET INT INCOME (TE)	2.49	3.44	09	2.63	3.41	10	2.56	3.50	11	2.68	3.44	2.73	3.34
LOAN LOSS HISTORY													
NET LOAN LOSS TO AVG TOTAL LNS	.25	.30	47	.25	.33	36	.25	.27	52	.26	.35	.41	.50
EARN COVER OF NET LN LOSSES(X)	6.89	7.73	47	7.09	7.19	52	6.43	7.77	23	7.03	6.78	4.96	4.74
LOAN LOSS RESERVE													
LOSS RESV TO NET LN LOSSES (X)	3.92	4.21	57	3.88	4.02	68	4.11	3.87	47	4.37	3.44	2.97	2.33
LOSS RESERVE TO TOTAL LOANS	.86	1.00	36	.88	.97	42	.88	1.00	38	.99	.95	1.06	.91
LIQUIDITY AND RATE SENSITIVITY													
VOLATILE LIABILITY DEPENDENCE	85.04	65.27	90	88.68	66.72	94	82.80	64.27	88	84.91	63.10	76.94	57.05
NET LOANS TO TOTAL ASSETS	67.58	58.79	86	62.64	55.88	78	62.71	55.42	77	57.43	55.72	57.23	56.08
NET MKT RATE POSITN TO ASSETS	-5.33	-.32	27	-5.90	-1.42	15	-3.51	.84	22	-.30	5.24	7.63	9.11
CAPITALIZATION													
PRIM CAP TO TOT ASSETS & RESV	4.49	4.72	31	4.37	4.80	31	4.50	4.53	55	4.65	4.60	5.00	4.72
CASH DIVIDENDS TO NET INCOME	.00	43.27	04	13.68	43.15	05	27.19	39.92	11	21.46	40.86	35.73	44.09
RETAINED EARNS TO AVG EQUITY	13.99	7.84	95	13.07	8.14	89	10.48	8.40	72	10.81	7.42	8.42	6.29
GROWTH RATES													
ASSETS	12.06	9.29	68	17.48	11.78	84	14.55	15.86	33	19.87	13.91	16.49	15.12
PRIMARY CAPITAL	19.40	11.01	86	14.04	10.92	78	10.87	10.96	44	11.43	9.30	7.61	10.30
TOTAL LOANS	20.86	16.58	68	17.35	13.01	63	24.94	15.09	88	20.21	14.72	13.06	15.60
VOLATILE LIABILITIES	14.40	14.42	49	20.08	18.29	47	16.44	17.02	38	20.87	21.60	18.66	18.81

CONTINENTAL ILLINOIS NATIONAL BANK AND TRUST COMPANY OF CHIC CHICAGO, ILLINOIS
SUMMARY RATIOS

	1983			1982			1981			1980		1979	
AVERAGE ASSETS ($000)	39020253			44084128			42319988			37845879		32035212	
NET INCOME ($000)	103950			70008			231284			219264		183867	
# BANKS IN PEER GROUP	22			22			21			18		17	
EARNINGS AND PROFITABILITY	BANK	PEER 01	PCT	BANK	PEER 01	PCT	BANK	PEER 01	PCT	BANK	PEER 01	BANK	PEER 01
PERCENT OF AVERAGE ASSETS:													
NET INTEREST INCOME (TE)	2.29	2.80	21	2.14	2.86	08	2.09	2.82	13	2.18	2.74	2.09	2.81
+ NON-INTEREST INCOME	.92	.95	52	.70	.87	30	.67	.80	22	.62	.76	.59	.66
- OVERHEAD EXPENSE	1.77	2.35	21	1.47	2.36	13	1.43	2.25	13	1.43	2.13	1.41	2.07
- PROVISION FOR LOAN LOSSES	.92	.40	91	1.08	.33	91	.27	.25	59	.24	.25	.20	.25
= PRETAX NET OPER INC (TE)	.52	1.00	17	.28	1.02	08	1.06	1.13	40	1.13	1.12	1.07	1.15
NET OPERATING INCOME	.26	.54	13	.16	.56	08	.56	.60	49	.58	.57	.57	.59
ADJ. NET OPER INCOME	.29	.62	13	.40	.63	17	.67	.68	54	.66	.63	.63	.73
ADJ. NET INCOME	.27	.52	17	.26	.51	17	.56	.54	59	.59	.53	.55	.57
NET INCOME	.27	.54	13	.16	.53	08	.55	.56	54	.58	.56	.57	.53
PERCENT OF AVG EARNING ASSETS:													
INTEREST INCOME (TE)	11.20	11.29	56	14.01	14.04	60	16.41	15.85	77	13.89	13.45	12.01	11.63
INTEREST EXPENSE	8.63	7.88	86	11.57	10.78	86	13.92	12.65	86	11.27	10.24	9.46	8.31
NET INT INCOME (TE)	2.58	3.33	08	2.43	3.41	08	2.49	3.44	09	2.63	3.41	2.56	3.53
LOAN LOSSES, RESERVES AND NON-PERFORMING LOANS AND LEASES													
NET LOAN LOSS TO AVG TOTAL LNS	1.15	.52	91	1.15	.41	91	.25	.30	47	.25	.34	.25	.27
EARN COVER OF NET LN LOSSES(X)	1.42	4.44	08	1.39	4.86	08	6.89	7.73	47	7.09	7.19	6.43	7.79
LOSS RESV TO NET LN LOSSES (X)	1.05	2.77	08	.98	2.90	08	3.92	4.22	57	3.88	4.02	4.11	3.87
LOSS RESERVE TO TOTAL LOANS	1.23	1.16	60	1.14	1.07	60	.86	1.00	36	.88	.97	.88	1.03
%NON-PERFORMING LOANS & LEASES	8.01	4.17	91	7.47	4.03	91	NA	NA	NA	NA	NA	NA	NA
LIQUIDITY AND RATE SENSITIVITY													
VOLATILE LIABILITY DEPENDENCE	81.42	60.11	95	83.37	64.98	86	85.04	65.26	90	88.68	66.72	82.80	64.27
NET LOANS TO TOTAL ASSETS	72.62	59.30	95	76.49	59.89	95	67.58	58.79	86	62.64	55.88	62.71	55.42
NET ASSETS REPRICABLE IN 1 YR OR LESS TO ASSETS	-4.29	-.26	08	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
CAPITALIZATION													
PRIM CAPITAL TO TOTAL ASSETS	5.41	5.15	78	5.19	4.91	78	4.52	4.74	31	4.39	4.52	4.52	4.55
CASH DIVIDENDS TO NET INCOME	48.10	46.37	52	86.55	44.02	90	.00	43.27	04	13.68	43.15	27.19	39.92
RET EARNS TO AVG TOTAL EQUITY	3.00	6.48	17	.45	7.30	13	13.59	7.84	95	13.07	8.14	10.48	8.43
GROWTH RATES													
ASSETS	-1.53	2.26	34	-8.52	6.61	04	12.06	9.29	68	17.48	11.78	14.55	15.88
PRIMARY CAPITAL	2.58	9.05	13	5.01	9.95	21	15.40	11.01	86	14.04	10.92	10.87	10.96
TOTAL LOANS	-6.42	3.03	08	3.84	8.90	21	20.86	15.58	68	17.35	13.91	24.94	15.09
VOLATILE LIABILITIES	-3.58	-5.53	56	-7.08	5.65	17	14.40	14.40	49	20.08	18.29	16.44	17.02

HIGHLIGHTS OF ARTICLES PERTAINING TO CONTINENTAL ILLINOIS (1978-1984)

I. AGGRESSIVE MANAGEMENT STYLE

December, 1978 Duns Review

When Anderson became CEO, he realized that effective controls were needed if Continental was to successfully compete in markets dominated by the better known New York banks. He set up a system requiring the heads of the bank's 26 departments to report to top management both quarterly and annually on a variety of targets. These included such short-range goals as return on equity, expenses and profits; strategic goals like expanding market share, new services and long-range expense control; and personal goals, such as hiring and promoting more women and minorities and using staff more effectively.

"Continental has superior management at the top, and its management is very deep," says an analyst at First Boston Corp. "It has excellent people all through the bank."

Today, as the seventh-largest bank in the nation and the biggest between the two coasts, Continental Illinois is an international money-center bank offering services across the entire banking spectrum. More important, it is rated by security analysts and the banking industry as one of the top five banks in the nation serving the corporate community. Under the dynamic leadership of chairman Roger E. Anderson, Continental Illinois has garnered a reputation for quality service, innovation and a pragmatic, rather than conservative, approach to banking.

May 14, 1979 Business Week

"We believe 1979 will prove to be a tough year for Continental" sums up J. Richard Fredricks, a partner in San Francisco based Montgomery Securities. . . . The disenchantment is expected to be short-lived. Even Fredricks is bullish about the bank over the long haul. Other analysts agree that under Chairman Roger E. Anderson who took control in 1973, Continental has been transformed from a stodgy Midwestern bank into perhaps the most innovative and aggressive financial institution in the nation.

[The aggressive lending] worked best when interest rates were low and loan demand slack. . . Because Continental was so willing to lend in the past it is now saddled with a flock of fixed rate loans that are currently underwater. At the same time, it has a high level of purchased, short-term funds that have become very costly of late. . . Largely for these reasons, Continental "will probably show the lowest rate of earnings gain for any major money center bank," predicts one bank stock analyst. Adds Richard T. Hale, a bank stock analyst with Baltimore based Alex Brown and Sons' "The wind is going out of Continental's sails."

Anderson: "We want to be one of the three banks that do the most business with corporations in this country."

October, 1980 Institutional Investor

John Dancewicz upon visiting the Harvard Business School and talking with the students: "I told them they were too timid."

August 25, 1981 American Banker

Anderson: "Consider our loan production-office-strategy. When we open an office in, say, Minneapolis, we don't hire a bunch of Minneapolis bankers to staff it. Instead we choose people who have at least a few years training at Continental who know our credit standards, and who know how to get things done at our bank. As a result we have opened LPO's a bit more slowly than we would have liked. But once we get established in a particular market our volume takes off."

September 28, 1981 The New York Times

Anderson: "Five to 10 years from now, this bank will be a lot more profitable because of how we have begun to allocate our resources." He also commented that the bank has a hard time turning back: "We have a hard time closing things."

October, 1981 Euromoney

Anderson: "We have got to be conservative in our lending." But he adds another epithet, and it may seem, a surprising one: Aggressive. . . "We like to carefully and deliberately determine what we want to do, and then we like to do it aggressively."

A New York analyst: "Because Continental Illinois has clearly defined its marketplace as the corporate sector and has refined it continually, it is able to be aggressive and cut rates."

"It's one of the finest managed money-center banks going," commented Thomas Hanley, vice president and manager of bank research at Salomon Brothers. One reason, according to Hanley, is "it's not always running scared to show a profit each quarter. It has truly maximized its earning power in the long run."

Pity the person who does follow [Anderson]. Will he be able to emulate that peculiar mix of conservatism and aggression, of departmental autonomy and overall central direction, of imaginative strategic planning and short-term profitability? That is the combination that makes his peers respect him.

October 11, 1982 Business Week

Anderson: "We have no intention of pulling in our horns."

December 31, 1982 American Banker

Anderson: "Hopefully we are over the worst. And we don't expect a lot of surprises like we've had before." He added, that it was management that did not expect surprises because it is aware of the content of its portfolio. "That doesn't mean it won't surprise you."

August, 1983 Institutional Investor

Anderson: "We must be careful to create an atmosphere and culture where [large loan losses] will never happen again."

A Continental vice president: "There are no clearly enunciated goals here. At least they haven't filtered down to me. It's time our leaders led us."

Another Continental officer, bemoaning the lack of direction, enthusiasm and enterprise at the bank: "The best service Roger Anderson could render is to resign."

II. CUT-RATE LENDING, LOAN GROWTH

December, 1978 Duns Review

Analysts rank Continental's loan portfolio on a par with J.P. Morgan's, which is considered by many to be the premier corporate bank in the country.

May 14, 1979 Business Week

Nowhere is Continental's aggressiveness more apparent than in its zeal for occasional transactions that carry more than the average amount of risk. Such a deal cropped up last September, when a subsidiary of Gamble Skogmo Inc. was searching for funds. Continental offered a five-year, $5 million loan at 9.5%, with an additional $10 million line of credit, even though the subsidiary was carrying a significant amount of subordinated debt and the credit rating of its senior notes had just been downgraded. Says a senior officer at a large Minneapolis bank: "We hear that Continental is willing to do just about anything to make a deal."

[Continental] has been willing to offer whatever rate or terms are necessary to swing a deal. For example, last year when Pillsbury was lining up financing for its acquisition of Green Giant Co., Continental grabbed a $25 million chunk -- or more than half-- by offering a 9.5% rate. That was 105 basis points below the second-best bid among five competing banks. And when the treasurer of another major Midwestern corporation was shopping around for $50 million in trade financing last fall, he found that Continental was more than eager to do business. "Every other bank said 'Sure we'll take a share,' " he recalls. "Continental offered to take the whole thing and syndicate it."

In May 1977 Litton Industries Inc. asked the bank whether it could provide a loan of 40 million Swiss francs. Litton got a "Yes" from the bank's Los Angeles office within seven minutes.

October, 1980 Institutional Investor

If Baker wants to do business with a corporation badly enough, he's prepared, quite unashamedly, to buy his way in. When a corporate treasurer doesn't succumb to other blandishments, Baker will offer a cheap deal -- usually a fixed-rate term loan -- that the financial officer can't refuse. There is, of course, a string attached to such deals. Says Baker of one firm that recently accepted a cut-rate loan: "It won't embarrass me for the next ten years to go in and remind them about it."

August 18, 1981 American Banker

Asset-Liability policy, suggests one Continental executive, is only the tail, and it should not be allowed to wag the dog. Continental is thus an old fashioned bank -- a volume driven, loan officers' institution. High and growing volume can paper over a lot of troubles. It can at times even compensate for fickle and untoward interest rate turns.

August 25, 1981 American Banker

President Perkins: "We are not a price cutter" on loans.

Sanford Rose, "It can be said that Continental's spectacular loan growth in recent years is less a matter of sharp pricing than it is of finding customers to whom the bank has been willing to lend more than the competition."

In response to questions about the nature of Continental's loan portfolio, Baker responded : "Frankly we are not competitive in providing short-term lending accomodations to blue-chip borrowers. We see no need to substitute for the commercial paper market."

October 15, 1981 The Wall Street Journal

In this article, there is considerable discussion of the extensive growth in loan volume as a result of taking risks other banks have been unwilling to take. Continental added 400 new customers primarily from the middle market (below Fortune 500) from 1978 to 1980.

Stuart Greenbaum (Northwestern University): "They've sold the hell out of the corporate market by taking more than the average risks in selected areas."

One of those selected areas is energy which will be discussed more fully below.

After borrowing from Continental, Norman Wright, treasurer for Central Louisiana Energy commented -- "They just had the best price in town...I was impressed by their aggressiveness."

"They quote low prices," says one Chicago competitor. "Even with a 20% prime they were doing 16% fixed rate loans. I don't know how they do it."

Baker calls this part of an "overall strategy ... we package it up and get other fee related business and I always remind customers what I did for them."

Perkins: "It may well be that we will make deals that others will say 'My God, why would they do that?' But the people who say that don't have the same background or confidence that we have."

Perkins: "You can say we are in a riskier world now with more volatile rates and so we should narrow our risk. And we've done that a bit. But remember there's an equal risk on the other side that's called forgone profits. That can be very very big too."

June 1, 1982 Wall Street Journal

Continental has drawn special attention because of its eager lending strategy of the last half-decade. The bank sought to spur loan growth by courting companies in profitable but high-risk markets.... In the process, however, the Continental Illinois Corp. unit appears to have taken some bad credit-gambles that aren't paying off. "They have been very aggressive and it is costing them now" says Lawrence Fuller, a bank analyst in New York with Drexel Burnham Lambert Inc.

"Continental commits a much greater portion of its legal lending limit than most banks," says one competitor. Mr. Baker says that this isn't a conscious strategy, but in any case it is good for profit in good times because it lowers overhead.

August 2, 1982 Business Week

Individual officers at Continental apparently took to heart management edicts to boost the bank's assets... The overzealous push for earnings -- especially in energy lending and real estate -- is now beginning to hurt. Many corporations that borrowed heavily from Continental are showing severe financial strains. The Penn Square mess compounds Continental's problems and raises questions about the quality of its loan portfolio. Furthermore, some charge, the bank "bought" its way into some credits by competitive pricing.

August 2, 1982 Newsweek

Sources close to Continental believe the Chicago bank also had a strong bonus program that would have encouraged officers to snap up Penn Square loans. "It was obviously one way to get a lot of volume without doing a lot of work," says one NY bank analyst.

October 11, 1982 Business Week

This article reinforces the impression gained from previously summarized accounts that Continental was intent on increasing loan volume regardless of the cost.

Anderson delegated major power to lending officers while imposing only minor controls -- and then allowed exceptions to those minimal rules. He clearly seemed to believe that the fewer the restrictions the faster his officers could exploit opportunities.... They moved fast, offered more innovative packages, took on more and riskier loans, and wrote business that other banks had eschewed. For instance, Continental became lead lender to Energy Cooperative Inc. after the refiner's original lead bankers, First National Bank of Chicago and Harris Trust and Savings Bank, refused to extend additional credit in 1977. "We set our limits because the company [ECI] was not earning much money and in our judgment was not well managed," recalls Richard Stebbins, the head of energy lending at First Chicago at the time. "We said no and Continental came in."

> ... ECI was in hock to Continental for $84 million when it went into Chapter 11 last year.
>
> Baker called the officer handling the [AM International Inc.] account to ask about the company's credit status. According to insiders, he was told that the bank's exposure at AM was being gradually reduced and that it would be almost eliminated by yearend. Baker's order: Lend AM more money. He had faith that Black would be able to turn the company around. But AM entered bankruptcy proceedings last April owing Continental $15 million.
>
> Lending officers were rewarded for volume. "In terms of salary increases and overall rating, my function clearly came to be much more a salesman than the credit analyst I had been in the mid 1970's," said one former lending officer
>
> The premise, explains a former officer, was that "if we were willing to commit $20 million, we should be willing to commit $30 million." This practice, critics charge, ignores the notion of spreading risk....
>
> Continental lured away the $3.5 million account of Wesco Products Co., a universal-joint manufacturer, from a smaller Chicago bank in early 1980 only to see the company in bankruptcy court eight months later. A competitor claims that, had the bank not been so eager for business, it would have noticed that Wesco had been overstating its receivables. "A first year accounting student should have figured that out," he says.
>
> Earlier this year [Continental] approached Transcon Inc., an ailing Los Angeles trucking company whose four banks wanted to tighten up the loan covenants on its $10 million credit line. Continental took over the account and jacked up the line of credit to $15 million, at the same interest rate.

A similar story is recounted concerning Belmoral Mines Ltd.:

> Canadian bankers were edgy about their loans. Continental approached the company with a plan for extending additional credit as more gold was discovered. Continental foreclosed on its $25 million loan in July after gold had tumbled to $300 from $425 per oz. and the mine couldn't meet its interest payments.
>
> When the bank made a push to beef up its European lending, a London executive told his staff to "stick your foot in the corporate treasurer's door and yell, 'Money: cheap, cheap!' ".

February, 1983 <u>Fortune</u>

> Anderson expresses befuddlement over why his bank has fared so much worse than its competitors: "I don't know what's happened elsewhere, but I'm surprised the level of nonperforming loans at other banks isn't higher."

August, 1983 Institutional Investor

This article contrasts Continental's post-Penn Square lending posture with its earlier policies. Noting the high turnover among key lending officers, as well as the changed attitude of top management, the article describes the more cautious approach Continental had taken towards lending.

> Mesa Petroleum chose Citibank and Texas Commerce to lead a $1 billion acquisition credit, after many years of using Continental to arrange its borrowings. One factor in the decision was that Mesa had the impression that Continental was no longer interested in taking large portions of takeover-related credits.
>
> When First Chicago won an agreement with Sears, Roebuck to form a joint-venture export trading firm, it was suggested that Continental hadn't fought for the business because, preoccupied with stabilizing the bank, it "wasn't interested in anything new."
>
> Anderson said his officers would not be allowed to use price cutting or overly large participations in loans as business-gathering tools to the same extent as in the past.

III. LOAN REVIEW

Continental gave its loan officers great autonomy.

October, 1980 Institutional Investor

> Chairman Anderson: Conservative and somewhat plodding himself, he has engineered Continental's impressive turnaround with a simple strategy: Giving free reign to a group of bright, aggressive officers.
>
> Like Chairman Anderson, Baker believes in giving his staff a remarkably free hand. He himself seldom looks at loan proposals, which leaves approval to the vice presidents and senior vice presidents in the bank. In practice, this means that junior lending officers in the field are almost totally free to lend the bank's money, so long as they call into headquarters now and again for a rubber-stamp approval. "In the years I was there, I never had a loan proposal turned down," says one calling officer who recently left for another bank.
>
> "Working territory for Continental is like running your own business," says one former officer. Treasurers, of course, like enthusiastic calling officers and they also like speed of movement, which Continental's system allows. "I wrapped up a $150 million deal in an hour-and-a-half not long ago, says one particularly chipper Continental youngster."

October, 1981 Euromoney

Anderson is proud that autonomy in the lending function is particularly strong at his bank. "The quality of the loans is better this way than it would be if we had somebody looking at every loan, or if I was to try to look at every loan or every large loan. I may think I am the best lending officer in the bank but from a time standpoint you just don't have time to do that sort of thing." Senior officers can lend up to $165 million to any one customer. As the amounts rise from that figure up to the banks legal lending limit, additional approvals are required. Freedom for the lending officers has not meant, said Anderson, any deterioration in the quality of credit. The record on loan losses has been good: "We have had some knocks, pretty much the standard ones, Chrysler and Penn Central, but overall our performance has been good."

August 2, 1982 Newsweek

According to one source familiar with Continental's dealings, just six loan officers staffed the bank's mid-Continental division which purchased the loans from Penn Square.

Penn Square's practice was to pool loans that had been made to debtors of varying credit worthiness; it then sold some on the condition that the lending banks not investigate them. Though other major banks turned down the loans for this reason, Continental and Chase went along.

October 11, 1982 Business Week

The mandate came from the top. How you went about dealing with the mandate was more or less your own business.

Many sources close to the bank say that its obsession with growth distorted management's perspective. "Assuming an aggressive lending posture in a touchy economy implies a willingness to take on marginal credits to meet loan and income goals," says bank consultant Edward E. Furash. "Add to that the kind of delegation of authority [practiced at Continental], and it is an explosive combination." Agrees another consultant: "When aggressive marketing is mixed with decentralized lending and rapid expansion, there is much less sense among the line officers of what kinds of credits are acceptable or not."

While decentralized lending operations are common, Continental is probably a leader in this approach. It uses the "two signature" system for loans: two senior officers can commit Continental to lending its legal limit to a single customer of 10% of capital, or $167 million. It took an officer about six years to get to the $1 million approval level, former employees say. But all a junior officer needed to sign up a $10 million credit was the countersignature of a senior executive. In contrast, Manufacturers Hanover Trust Co. sets a far more conservative lending limit. To reach that limit, a loan must be approved by a committee of senior credit officers.

Says a retired Continental officer, "being able to commit the bank on the spot gave us tremendous clout." Adds a former vice president: "Even if a lending officer [in energy] couldn't commit for a certain amount, he knew damn well what he could get away with back home. Continental lenders were renowned for being able to commit money faster than almost any bank around."

February, 1983 Fortune

As late as last March, non of [Continental] Penn Square loans was listed as nonperforming. However, that belated recognition may be more damning than exculpatory. Penn Square reported a substantial increase in its own nonperforming loans during 1981. At the very least the circumstance raises serious questions about the adequacy of Continental's procedures for identifying problem loans....[T]he Penn Square revelations may be evidence that Continental still hasn't come clean about all its problem loans.

August, 1983 Institutional Investor

There are tighter procedures for credit approval, with more officers signing off on large loans....A new credit risk evaluation division....has been formed to monitor the quality of loans after they have been made and to make sure Continental doesn't concentrate too many of its assets in one spot like Penn Square anymore.

IV. AGGRESSIVE ENERGY LENDING

August 14, 1978 Barrons

Much of Continental's success can be traced to its solid record as a lender to energy-related businesses -- petroleum, natural gas, coal mining and public utilities. Thus, Continental has stepped in to meet the burgeoning credit demands for development of energy sources.

Continental was particularly aggressive in extending energy loans to small, independent drillers and refiners. The experiences with Central Louisiana Energy and ECI were recounted above.

August 25, 1981 American Banker

Apparently banks will lend up to 50% of the present value of the expected net cash flow from a drilling operation. Gerald Bergman who headed the special industries lending department, justified the vast Continental volume in the energy field:

Bergman: "Keep in mind that the critical part of the oil lending formula is not that 50%, but the analysis of the future revenue flows. If we have a higher projection of future revenues than our competitors we will lend more and more and competitors may mistakenly believe that we are overextended."

Bergman adds: "We are so deep into the energy business and we have so much knowledge of specific oil fields that we feel we can often make a better judgment on reserve potential than others. If you've done one guy's field, you should have a pretty good idea of what is available on his neighbor's lease."

In justifying the practice [of a Houston-based subsidiary] of lending to start-up operators attempting to discover new fields by taking an equity share or sharing in the revenues Bergman says, "This seems a reasonable way to leverage our expertise in the oil industry."

September 18, 1981 The Wall Street Journal

GHK Vice President of finance, William Dutcher after taking a loan from Continental: "We have a big appetite... and we need a bank that's aggressive and willing to meet our requests."

Robert Swistock, Treasurer of Patrick Petroleum, claimed Continental offered 10% more credit than any other bank would permit.

Damson Oil received a $17.5 million unsecured loan. Continental would share in the revenues from successful oil fields.

Continental says energy financing is dangerous only for newcomers. Bank officials are confident that the current drop [which was in fact the start of a long-term decline in oil prices] will be brief. In dismissing the drop in oil prices, John Redding, senior VP in charge of oil and gas at Continental remarked, "This is just a little blip."

Continental is also willing to stretch further than other banks to win the business that it wants. Two years ago, it snared Patrick Petroleum Company...by agreeing to provide a $57.5 million revolving credit -- 10% more than any other bank would permit.

In May, Continental helped a partnership of Petro-Lewis Corp. enter the commercial paper market. Usually independents can't muster the top credit ratings required for successful issues. But Continental was willing to work out the technical difficulties of the unusual $52 million offering, backing it up with a bank letter of credit secured with reserves. In return, says Jerry Wendelin, manager of budgeting and financial analysis for Petro-Lewis, Continental is receiving a fee that amounts to $375,000 on an annual basis.

While it has many admirers, Continental's agressive lending style has also been criticized as unnecessarily risky. In response, Continental officials cite the bank's record. Cushioned in part by rising oil prices, charge-offs and net loan losses in the energy areas have averaged less than half of those in regular lending over the past five years, says Gerald Bergman, executive vice president in charge of lending to special industries.

June 1, 1982 Wall Street Journal

Continental is also suffering for its willingness to gamble on a former bad risk. In the mid-1970's, Continental was the lead bank to R.L. Burns Corp. of Evansville, Ind., which borrowed too much at the same time it was drilling a string of dry holes. Its fortunes improved only after its chairman, Richard L. Burns, resigned. Yet Continental followed Mr. Burns to a new job as chairman of Nucorp Energy Inc., of San Diego. Nucorp has lost more than $40 million in the last two quarters after it misjudged demand for its oil-pipe products. Continental now holds a big portion of Nucorp's debt of $325 million. "[Continental] should have known better," says Mr. Fuller the bank analyst.

August 2, 1982 Newsweek

Continental ended up with the "nickel business that other banks had long avoided" says one former banker familiar with its dealings. But with the loans earning rates well above the prime and usually backed by oil and gas reserves there seemed little cause to worry -- until energy prices slumped substantially in 1982.

August 21, 1982 Wall Street Journal

The creditors, seeking a way to get off the hook, introduced [GHR] to John Lytle of Continental Illinois.... Continental was then building a reputation that would for a time make it the envy of the banking world. Rising oil prices had spurred the domestic oil industry and Continental moved aggressively to finance that growth. Since the bank could often demand rates well above prime from these untried companies, the business was lucrative.

September 21, 1982 The Wall Street Journal

Continental Illinois memos show that the bank was well aware of GHR's cash problems and perhaps even welcomed them. One memo from Mr. Lytle noted the company anticipated that prospective cutbacks by GHR customers "will cause a cash problem in January which will force the creditors to allow some form of outside financing."

October 11, 1982 Business Week

Anderson admitted to a bit of overconfidence contributing to a "tendency to let one's guard down." Another executive added, "We went overboard. We thought we knew the business [energy lending] so well we didn't have to have all the documentation other banks might need."

"Energy was the elite," says a former Continental VP. "Nobody was going to tell that group what to do as long as it kept shooting out profits."

December 31, 1982 American Banker

Mr. Anderson on lending to the energy industry: "This has been a good business for us for many years, and we still want to play an important role. But we will be putting more emphasis on classical lending, such as against proven reserves" rather than against unknown risks like forecast reserves and oil rigs.

August, 1983 Institutional Investor

Tesoro Petroleum has replaced Continental as its agent bank. The energy concern wanted to increase its revolving credit from $100 million to $110 million last July, just at the time Continental was anxiously reexamining its oil and gas portfolio in the wake of Penn Square. Continental was reluctant to grant the increase, and Tesoro selected Manufacturers Hanover to lead a new revolver.

V. REAL ESTATE LENDING

August 14, 1978 Barrons

In the troubled real estate lending market, Continental has done better than many large banks.... The bank has whittled down its portfolio of REIT loans, mainly through asset swaps or exchanges of credits for specific assets.

October, 1980 Institutional Investor

Harper used to be the head of a REIT purchased by Continental in 1971 and therefore was, in part at least, the man who got the bank into so much trouble in the first place. "He's a real bright wheeler-dealer," says one bank officer. "Since he made the mess, it was assumed he would best know how to clean it up."

October, 1981 The Wall Street Journal

James Harper, head of "Harper's Army" [real estate services] lent to American Invsco and swapped bad debts for real estate. "Harper was lending in the mid-70's when other banks weren't even talking about a loan." said V. L. Pell, Sr. of Romanek-Golub Co. which switched to Continental from First Chicago. Real estate loans grew 2 1/2 times between 1977-1980.

Mr. Harper was known to run down the quiet corridors of the real estate department urging his officers to "rape, pillage, burn."

January 25, 1982 Fortune

Am Invsco converted The Plaza 400 in Manhattan into cooperative apartments quickly selling all but 89 units housing elderly tenants who remained under a NY state law protecting from eviction persons 62 years and older with incomes less than $50,000 per year. Am Invsco sued to force these individuals out.

Behind this inflammatory suit is a political miscalculation by Jim Harper and Continental Illinois. The original $24 million Invsco used to acquire and convert Plaza 400 was provided by Chemical Bank. As the individual apartments were sold, Chemical got paid back. Continental Illinois made additional loans -- amount unknown -- to Invsco on unsold units, including those occupied by aged and infirm tenants. "Harper didn't do his homework on this one," said a developer who knows him well. "He finally realized that [Am Invsco] wouldn't be aggressive about kicking out all those old people now that Engie [a partner in Am Invsco and wife of NY governor, Hugh Carey] is the first lady of New York."

A former Invsco officer claims that the Gouletases signaled 18 months ago that Invsco was headed for serious trouble when Nick and Engie put $50 million into Tamco, a holding company ... set up in 1977 to acquire companies outside the real estate business.... Fortune has ascertained that Continental Illinois loaned Nick and Engie the $50 million they invested in [Tamco].

June 1, 1982 <u>The Wall Street Journal</u>

> Bankers blame Continental's real-estate woes on the aggressive lending urged by James D. Harper Jr., the flamboyant, dynamic head of the bank's real-estate department. Known in the bank as "Jimmy the Magician" for his real-estate savvy, Mr. Harper pushed his officers to make deals. He was known to run through the bank's quiet corridors shouting "Condos for sale, Condos for sale." For a time the salesmanship paid off. But by the late-1970's, sellers of apartment houses were getting more money for their properties, thus narrowing profit margins for converters. Interest rates rose and stayed high. But as recently as 1980, sources say, Mr. Harper was inviting Invsco to borrow. Only too late, say insiders, did Mr. Harper realize his mistake and slow down lending. He put up a poster in his office illustrated with a lightening bolt and bearing the caption, "The Fastest No in Town." Mr. Harper admits to the condominium problems but says most of them are temporary.

February, 1983 <u>Fortune</u>

> The problem loans....are overwhelmingly concentrated in just two divisions...most of Continental's troubled loans are in energy or real estate. More than $500 million of problem loans are in real estate. Most notably, Continental was and is a major lender to American Invsco, the sickly granddaddy of condominium converters. Continental says loans to Invsco and its owners....now total $84 million...."
>
> The real estate and energy divisions were known within the bank as "lenders of last resort."

VI. <u>INTEREST RATE RISK</u>

August, 1981 <u>American Banker</u>

Rose criticizes the risks that Continental was taking in the summer of 1981. He pays particular attention to the rather blithe manner in which Continental was engaging in interest rate spreading:

> Continental has been a bigger dice thrower than most. It has routinely decreased the interest sensitivity of assets and increased that of liabilities when it expected rates to fall.

In the second quarter of 1980, the bank guessed right on rates and profits swelled. In the second quarter of this year [1981], the bank guessed wrong. So the margin suffered and reported earnings dropped by 12%. They would have fallen by a much much larger percentage if Continental had not taken some extraordinary gains.

In defense of interest rate positioning, Anderson said "I can remember just a short while ago when, although we were perceived as very interest sensitive, our stock sold at 103% of book, which was second only to Morgan among the top banks in the country."

A more detailed explication of Continental's interest-rate philosophy comes from chief planner Alex Pollock. Says Mr. Pollock: "There are three relevant interest-rate time horizons -- the very short run, the short run, and the long run. Taking an interest-rate position short against long is increasingly dangerous, and it is questionable whether, on a risk-adjusted basis, it is worthwhile doing. Arraying the very short against the long is even more dangerous. But there is abundant evidence that it is possible to make consistent profits taking rate positions within the very short and the short."

October 15, 1981 The Wall Street Journal

Miller: "Banks can't live by spreads alone."

October, 1981 Euromoney

Anderson agreed the decline [in earnings] was largely the result of backing interest rates the wrong way. The bank had been an active mismatcher of maturities and rates on assets and liabilities, though mainly in the shorter maturities. In 1980, as a result, net interest income rose nearly 24%, but the second quarter of 1981 saw a drop of 14.7% from $220.3 million to $187.9 million. That may have been just a blip on the chart according to a bank analyst: "They've done a brilliant job on the funding side. They indulge in a certain amount of betting on interst rates, but not to the same extent as some other major U.S. banks."

SOURCES

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"Can Continental Bounce Back?" Institutional Investor, (August, 1983).

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Appendix

1. May 17 Press Release

2. Rewrite of May 17 Press Release

3. July 26 Press Release

4. Continental's June 7 Proposal

5. Miscellaneous internal memos and proposals written between May 25 and July 25. These are ordered chronologically.

6. A Continental Postmortem memo written May 15, 1985.

Joint News Release

MAY 17, 1984

Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board

The Federal Deposit Insurance Corporation, the Federal Reserve Board and the Office of the Comptroller of the Currency, together with a group of leading banks, have assembled a comprehensive financial assistance program for the Continental Illinois National Bank and Trust Company. The program will provide assurance of the capital resources, the liquidity, and the time needed to resolve in an orderly and permanent way the bank's problems.

Under the program, the FDIC, together with a group of commercial banks, will provide a total of $2.0 billion in capital to the bank in the form of subordinated notes. This capital will be available for the period necessary to enhance the bank's permanent capital, by merger or otherwise. The subordinated notes bear interest at a rate equal to the one-year Treasury bill rate plus 100 basis points. The FDIC Board of Directors voted to grant assistance pursuant to Section 13(c)(2) of the FDI Act.

In view of all the circumstances surrounding Continental Illinois Bank, the FDIC provides assurance that, in any arrangements that may be necessary to achieve a permanent solution, all depositors and other general creditors of the bank will be fully protected and service to the bank's customers will not be interrupted.

To further augment the financial resources available to Continental Illinois Bank, a group of 24 major U.S. banks has agreed to provide over $5.3 billion in funding on an unsecured basis throughout the period during which a permanent solution is developed. This agreement was arranged between the Continental Illinois Bank and the group of commercial banks, for which the Morgan Guaranty Trust Company of New York is agent.

- more -

Suggested Revision of May 17, 1985

Press Release

The Federal Deposit Insurance Corporation, the Federal Reserve Board and the Office of the Comptroller of the Currency, together with a group of leading banks, have assembled a comprehensive financial assistance program for the Continental Illinois National Bank and Trust Company (CINB). The program will provide assurance of the capital resources, the liquidity, and the time needed to resolve in an orderly and permanent way the bank's problems.

Under the program, the FDIC will provide $1.0 billion in capital to the bank in the form of subordinated notes. This capital will be available for the period necessary to enhance the bank's permanent capital, by merger or otherwise. The subordinated notes bear interest at a rate equal to the one-year Treasury bill rate plus 100 basis points. The FDIC Board of Directors voted to grant assistance pursuant to Section 13(c)(2) of the FDI Act.

In evaluating CINB's situation, existing and potential customers of the bank should recognize several possible developments. CINB may be successful in strengthening its funding and other aspects of its position without further FDIC assistance, and repay the FDIC note over a reasonable period of time. This could involve a private capital infusion or a merger with another banking organization. The FDIC intends to give CINB an opportunity to find a solution to its problem without further FDIC assistance. Should this not be possible, the FDIC may provide further assistance to CINB (possibly converting its note into a longer-term instrument) to enable it to survive as a free-standing institution or to facilitate an open bank merger.

If CINB is closed the FDIC will arrange a purchase and assumption transaction so that all deposits and other CINB liabilities to general creditors are assumed by another bank.

In each of the options enumerated above, all deposits and nonsubordinated liabilities will be covered either by a surviving CINB or by another, healthy bank.

Sometimes when banks are closed by their primary supervisor, the FDIC elects to pay off insured depositors up to the insurance limit. Uninsured depositors and other creditors (including the FDIC standing in place of insured depositors) await the collection of assets placed in receivership to be paid a portion or, possibly, all of their claim. In deciding to place a subordinated note into CINB, the Board of Directors of the FDIC has decided to rule out a deposit payoff as an option, should the Comptroller of the Currency find it necessary to close CINB. The Board recognizes that its decision will affect the behavior of depositors and other creditors and for that reason further recognizes that this decision is not reversible.

Thus, whatever resolution of CINB's current problems occurs, the depositors and other general creditors of CINB will suffer no loss of principal or interest and no delay in access to their funds.

To further augment the financial resources available to CINB, a group of 24 major U.S. banks has agreed to provide over $5.3 billion in funding on an unsecured basis throughout the period during which a permanent solution is developed. This agreement was arranged between CINB and the group of commercial banks, for which the Morgan Guaranty Trust Company of New York is agent.

The financial assistance program is designed to enable CINB to resume normal patterns of funding in the market to meet its liquidity requirements and to operate normally in other respects. As a part of the overall program, and in accordance with customary arrangements, the Federal Reserve is prepared to meet any extraordinary liquidity requirements of the CINB during this period.

The Office of the Comptroller of the Currency -- the primary supervisor for CINB -- has worked closely with the FDIC and the Federal Reserve in connection with the structuring of this program. In the Comptroller's opinion the bank's difficulties will be resolved in an orderly way with the capital and liquidity support provided in this program.

July 26, 1984

Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board

Permanent Assistance Program

for

Continental Illinois National Bank and Trust Company

Chicago, Illinois

Mr. Ogden, 56, is a highly respected and experienced banker, having spent 31 years at The Chase Manhattan Bank. He retired last year from his position as Vice Chairman of the Board of Directors and Chief Financial Officer and has since been involved in entrepreneurial ventures.

After analyzing alternative solutions to Continental Illinois' problems, the agencies concluded that the best approach is to provide sufficient permanent capital and other direct assistance to enable the bank to restore its position as a viable, self-financing entity. This decision was based on considerations of cost to the FDIC, competitive consequences and the banking needs of the public.

Pending approval by shareholders and consummation of the permanent aid package, the interim $2.0 billion subordinated loan to the bank from the FDIC and a group of banks made on May 17, 1984, remains in place. Also, the assurance given by the FDIC on May 17 that "all depositors and other general creditors of the bank will be fully protected and service to the bank's customers will not be interrupted" remains in full force and effect.

As part of the interim financial aid program, the Federal Reserve stated that it was prepared, in accordance with customary arrangements, to meet any extraordinary liquidity requirements of the bank pending more permanent arrangements. In light of the FDIC's commitment of capital resources to the bank, the Federal Reserve will continue its lending assurance. The $5.5 billion funding facility provided by a group of major U.S. banks will remain in place.

Upon consummation of the permanent aid transaction, the bank will be strongly capitalized and virtually free of nonperforming loans. If, for any reason, the permanent assistance package proves to be insufficient, the FDIC will commit additional capital or other forms of assistance as may be required.

FDIC	OCC	FRB
389-4221	287-4279	452-3204
		452-3215

The loans in question have a face value of over $5.1 billion and a May 31, 1984, book value of approximately $4.5 billion, based on earlier chargeoffs by the bank of over $600 million in face value.

The FDIC will purchase these loans in two installments. Loans with a May 31, 1984, book value of $3.0 billion (face value of over $3.6 billion) will be purchased by the FDIC upon implementation of the program at a price of $2.0 billion with the bank absorbing a $1.0 billion chargeoff. The bank will have a three-year period to select other loans outstanding on May 31, 1984, with a book value of $1.5 billion and sell them to the FDIC for $1.5 billion.

The FDIC will pay the $3.5 billion purchase price for the loans by agreeing to repay an equal amount in bank borrowings from the Federal Reserve Bank of Chicago. The Federal Reserve borrowings assumed by the FDIC will bear interest at 25 basis points above the three-month Treasury-bill rate, established at the beginning of each quarter. The FDIC will repay the Federal Reserve borrowings by making quarterly remittances of its collections, less expenses, on the troubled loans. If there is a shortfall at the end of five years, the FDIC will make up the deficiency from its own funds.

The troubled loans will be managed for the FDIC by the bank under a servicing contract. The FDIC will have the right to terminate the servicing arrangement, in whole or in part, at any time. The bank may terminate the servicing arrangement upon six-months' notice to the FDIC.

B. Capital Infusion. Assuming an immediate transfer of $4.5 billion in book value loans and the $1.0 billion chargeoff in connection with the transfer, the bank would have total assets approximating $30.0 billion, equity exceeding $800 million and a reserve for loan losses approximating $325 million. To replenish the $1.0 billion chargeoff, the FDIC will acquire $1.0

Reserve debt under paragraph A above. The estimate of losses will be made by three referees, one appointed by the FDIC, one by the new corporation and a third appointed by the other two referees.

If the FDIC suffers any loss under the loan purchase arrangement, including carrying costs and expenses of collection, those losses will be compensated for by granting the FDIC the option to acquire common stock in Continental Illinois Corporation held by the new corporation. The transfer of common stock will be done on the basis of its approximate book value of $20 per share (i.e., the $800 million in shareholder equity at May 31, 1984, after taking into account the $1.0 billion loan chargeoff, divided by 40 million shares). For example, if the FDIC's losses are estimated at $800 million at the end of the five-year period, the FDIC will have a perpetual option to acquire, at $0.00001 per share, all of the 40 million shares of Continental Illinois Corporation common stock held by the new corporation. After this option is acquired by the FDIC, the new corporation could be dissolved and the remaining shares of common stock it holds in Continental Illinois Corporation, if there are any, distributed to its shareholders. If the FDIC does not suffer any losses under the loan purchase arrangement (disregarding any profit or loss from its interests in the preferred and common stock), all remaining loans and other assets acquired under the loan purchase arrangement will be returned to the bank. The new corporation will not be permitted to pay any dividends until after a final settlement is made with the FDIC. Any dividends received by the new corporation on its approximate 40 million share investment in Continental Illinois Corporation will be available to cover potential FDIC losses under the loan purchase arrangement.

successor bank would be immediately and adequately recapitalized by the FDIC with liquidity support from the Federal Reserve. Depositors and all other general creditors of the bank would be fully protected against any loss of principal or interest or any delay in funds availability. However, the current shareholders of Continental Illinois would no longer be involved in the ongoing bank.

G. Continuing Liquidity Support. As part of the interim financial aid program, the Federal Reserve stated that it was prepared, in accordance with customary arrangements, to meet any extraordinary liquidity requirements of the bank pending more permanent arrangements. In light of the FDIC's commitment of capital resources to the bank, the Federal Reserve will continue its lending assurance for the period during which FDIC capital is supplied to the bank. The $5.5 billion funding facility provided by a group of major U.S. banks will remain in place.

H. Cost to the FDIC. The FDIC's total cash outlay after consummation of the permanent financial assistance program will be $1.0 billion, $500 million less than under the interim aid program. The ultimate gain or loss to the FDIC of the permanent assistance package depends on the price it receives when it sells its stock interest in Continental Illinois Corporation and on any losses it incurs under the loan purchase arrangement. At this time, it is not possible to make an accurate forecast of any eventual gains or losses. It is hoped an estimate will be available during 1985, which estimate will be revised from time to time as conditions warrant.

Illinois loans reside, he is a director of The Chase Manhattan Bank (a position he will resign).

Mr. Ogden is a highly respected and experienced banker, having spent 31 years at The Chase Manhattan Bank. He retired last year from his position as Vice Chairman of the Board of Directors and Chief Financial Officer and has since been involved in entrepreneurial ventures.

In addition to Messrs. Swearingen and Ogden (see accompanying biographical material), a new President and Chief Operating Officer of the bank is expected to be named.

David G. Taylor and Edward S. Bottum, currently Chairman and President of Continental Illinois, have resigned these positions and their directorships, effective August 13, 1984, and each will serve as Vice Chairman of the bank until completion of the permanent management structure. Both individuals were instrumental in stabilizing the bank during the past two months and in arranging the permanent assistance program. Their change in status in no way reflects on their capabilities. Rather, it reflects the judgment that a change in leadership and direction is desirable under the circumstances.

In connection with the interim assistance package from the FDIC, all members of the Continental Illinois boards were requested to tender undated resignations. The boards will be substantially restructured as soon as practicable.

III. FUTURE BUSINESS PLANS

The agencies believe the permanent assistance package will create a viable, independent bank positioned to continue providing the full range of

JOHN E. SWEARINGEN

John E. Swearingen, 65, retired as chairman of the board of directors of Standard Oil Company (Indiana) on Sept. 7, 1983. He had been elected chairman in 1965, after having served as president since 1958, chief executive officer since 1960, and as a director since 1952.

Mr. Swearingen joined Standard in 1939 as a chemical engineer in research. In 1947 he transferred to Amoco Production Company, Standard's principal exploration and production subsidiary, and he advanced through a number of management positions to become a director of that company in 1951.

He returned to Standard in 1951 as general manager of production. He was elected vice president for production in 1954 and an executive vice president in 1956.

A native of Columbia, S.C., Mr. Swearingen is a 1938 graduate of the University of South Carolina with a B.S. degree in chemical engineering. He received his M.S. degree in 1939 from Carnegie-Mellon University. He has been awarded honorary degrees by a number of colleges and universities, received decorations from four foreign governments, and several medals and awards from engineering societies and petroleum industry associations.

Mr. Swearingen served as chairman of the National Petroleum Council in 1974 and 1975, and chairman of the board of the American Petroleum Institute in 1978 and 1979.

He is a director of The Chase Manhattan Corporation and The Chase Manhattan Bank, N.A., Lockheed Corporation, Combined International Corporation, Consolidated Foods Corporation, and Northwestern Memorial Hospital. He is a trustee of Carnegie-Mellon University, has been a trustee of the Orchestral Association of Chicago and is president of Chicago Boys Clubs.

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To the Chief Executive Officer

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-- DRAFT --

May 25, 1984

MEMORANDUM TO: Stanley C. Silverberg, Director
Division of Research & Strategic Planning

FROM: James A. Marino, Chief
Financial Markets Section

SUBJECT: 1984 Earnings Projection for
Continental Illinois Corporation

This memo presents 1984 earnings forecasts for Continental Illinois Corporation ("Continental") using both "optimistic" and "pessimistic" assumptions regarding non-performing assets. These forecasts are based on the holding company's past earnings performance as well as Continental's own 1984 income forecasts. The latter was generally felt to be too optimistic to be used without some revision.

I should note, however, that the information available to the FDIC on Continental's financial condition is limited. In many cases the estimates listed below are based upon reasonable guesses and, as a consequence, the results should be interpreted as only rough approximations.

In addition, this memo addresses the following questions:

-- What would it take to return Continental to profitability?

-- What have their funding costs been relative to their peers? and

-- What do their non-interest expenses look like relative to their peers?

Optimistic Forecast

Table 1 presents Continental's actual first quarter 1984 performance as well as quarterly projections for the remainder of the year.

TABLE 1

1984 EARNINGS FORECAST FOR CONTINENTAL ILLINOIS CORPORATION; OPTIMISTIC FORECAST ($ MILLIONS)

Item	First Qtr. (Act.)	1984 Projections Second Qtr.	Third Qtr.	Fourth Qtr.	Full Year	1983 (Act.)
Recurring						
Net Interest Income	149	119	159	168	595	911
Provisions for Loan Losses	140	130	125	105	500	395
Non-Interest Revenue	78	75	75	75	303	404
Non-Interest Expenses	218	200	200	200	818	721
Pretax Income	(131)	(136)	(91)	(62)	(420)	199
Income Tax Benefits	69	?	?	?	?	--
Non-Recurring						
Pretax Income	181	38	16	46	281	0
Taxes	90	19	8	23	140	0
Net of Taxes	91	19	8	23	141	0

Net Interest Income

The most critical aspect of Continental's future earnings relate to assumptions made about the course of non-performing assets. For the optimistic forecast, Continental's own projections (as of May 2, 1984) for non-performing assets are used, that is, they increase by $400 million in the second quarter (to $2.6 billion), decrease by $100 million in the third quarter (to $2.5 billion), and decrease by $400 million in the fourth quarter (to $2.1 billion).

The addition of an asset to the non-performing list has two impacts on earnings. First, interest accrued but not paid must be removed from the books. These interest reversals amounted to $132 million in 1983 and $53 million in the first quarter of 1984. Based on past experience, it is estimated that interest reversals will amount to $65 million in the second quarter and $20 million each in the third and fourth quarters.

Second, once an asset is on the non-performing list its contribution to income decreases. During the first quarter of 1984 Continental reported lost interest from non-performing assets of $83 million (net of income from these assets), or an annualized 15% loss. Based on these results, the increase in non-performing assets will have a negative drag on earnings (relative to the first quarter) of $8, $13, and $4 million for the second, third and fourth quarters, respectively (this impact is in addition to interest reversals).

In addition to the cost of non-performing loans, it is assumed that higher interest rates (both in general and the risk premium Continental will have to pay) will cost an extra $10 million per quarter. The estimated impacts on net interest income are summarized in table 2.

TABLE 2

ESTIMATED CHANGES IN NET INTEREST INCOME,
RELATIVE TO FIRST QUARTER 1984, DUE TO INTEREST
REVERSALS, DRAG AND HIGHER RATES; OPTIMISTIC FORECAST ($ MILLIONS)

Item	Second Qtr.	Third Qtr.	Fourth Qtr.
Interest Reversals	-12	+33	+33
Interest Drag	- 8	-13	- 4
Higher Interest Rates	-10	-10	-10
TOTAL	-30	+10	+19

Provision for Loan Losses

During the first quarter of 1984 Continental provided $140 million for loan losses to bring its loan loss reserves to $401 million as of March 31, 1984. Actual credit losses during the quarter were $122 million. Over the course of the past two years Continental charged off an average of $100 million per quarter representing about 20% of its non-performing loans. (This is consistent with peer averages.) It is assumed that this charge-off rate will continue and that Continental will seek to maintain its loan loss reserve at $400 million, thus provisions for loan losses will be $130, $125 and $105 million for the second, third and fourth quarters, respectively.

Non-Interest Revenue

The holding company estimates non-interest revenues of about $75 million per quarter for the remainder of the year. These estimates seem reasonable in light of the $78 million reported for the first quarter.

Non-Interest Expenses

Continental reported non-interest expenses of $218 million for the first quarter of 1984. Although this is up from the $180 million per quarter average of 1983, it does include non-recurring expenses related to such items as the charge card sale, an early retirement program, etc. These latter expenses amount to $12 million. I assume other cost-cutting measures amounting to $6 million per quarter to bring the estimate of non-interest expense to $200 million per quarter.

Non-Recurring Income Items

Continental did have a sizeable non-recurring income in the first quarter ($181 million) primarily due to the sale of its charge card operations. It does have other assets (such as real estate, rare coins, etc.) which it expects to sell during the remainder of the year. This expected income is listed at the bottom of table 1. Although this income can be used to protect Continentals capital position, it cannot be relied upon as a long-term source of income.

Summary

The optimistic scenario shows an improving situation over the course of the year; however, the holding company will still have losses of $62 million by the fourth quarter. Pretax operating losses for the year amount to $420 million; however, with income tax benefits (unknown) and a net income of $141 million from the sale of assets the company should survive the year in fairly good shape (assuming no major liquidity problems). Assuming income tax benefits of $150 million, Continental would experience a reduction of stockholder equity of $129 million ($420 - $141 - $150) to end the year with about $1.7 billion in stockholder equity. Including the $400 million in loan loss reserves, Continental would have a year-end capital ratio of about 5.25 percent.

Pessimistic Forecast

Net Interest Income

Table 3 lists the projections for the pessimistic forecast. Instead of assuming an improvement in non-performing loans, I assume they will increase by $400 million in the second quarter (to $2.6 billion), increase by $400 million in the thrid quarter (to $3.0 billion) and remain at this level for the remainder of the year. (This actually represents a continually deteriorating situation since substantial charge offs are assumed to take place during the year.) Estimated interest reversals would amount to $65 million during the second and third quarters and $30 million during the fourth quarter of 1984. Interest drag would increase relative to the first quarter by an estimated $8 million in the second quarter, $30 million in the third quarter and $38 million in the fourth quarter. Additional interest expenses are estimated at $15 million during the second quarter and $20 million per quarter for the remainder of the year. These expenses are summarized in table 4.

Other Expenses and Revenues

Provisions for loan losses, calculated as a percentage of non-performing assets, are assumed to be $130 million during the second quarter and $150 million per quarter thereafter. Once again, net charge offs are assumed to equal this provision. Non-interest revenues and expenses are assumed to be unchanged from the optimistic forecast.

Summary

Under the pessimistic scenario losses for the year increase by $247 million to $667 million. Assuming $250 million in tax benefits for the year, Continental would suffer a reduction in its capital position of $276 million to bring its year-end capital ratio (stockholder equity plus loan loss reserves) to around 4.8 percent. Clearly the holding company must show an improvement in 1985 to remain credible in the credit markets but it should be noted that Continental could sustain losses of $200 million a quarter for over 2 more years before loosing all of its capital.

Return to Profitability

In order for Continental to return to a profitable position in the third quarter, they must obtain approximately an additional $100 to $200 million of added income per quarter. Assistance could come in the form of cash to purchase non-performing loans.

TABLE 3

1984 EARNINGS FORECAST FOR CONTINENTAL
ILLINOIS CORPORATION; PESSIMISTIC FORECAST ($ MILLIONS)

Item	First Qtr. (Act.)	1984 Projections Second Qtr.	Third Qtr.	Fourth Qtr.	Full Year	1983 (Act.)
Recurring						
Net Interest Income	149	114	87	68	418	911
Provisions for Loan Losses	140	130	150	150	570	395
Non-Interest Revenue	78	75	75	75	303	404
Non-Interest Expenses	218	200	200	200	818	721
Pretax Income	(131)	(141)	(188)	(207)	(667)	199
Income Tax Benefits	69	?	?	?	?	--
Non-Recurring						
Pretax Income	181	38	16	46	281	0
Taxes	90	19	8	23	140	0
Net of Taxes	91	19	8	23	141	0

TABLE 4

ESTIMATED CHANGES IN NET INTEREST INCOME, RELATIVE
TO FIRST QUARTER 1984, DUE TO INTEREST REVERSALS,
DRAG AND HIGHER RATES; PESSIMISTIC FORECAST ($ MILLIONS)

Item	Second Qtr.	Third Qtr.	Fourth Qtr.
Interest Reversals	-12	-12	+23
Interest Drag	- 8	-30	-38
Higher Interest Rates	-15	-20	-20
TOTAL	-35	-62	-62

The purchase of non-performing assets would impact earnings in two ways. First, it would reduce the interest drag from these non-earning assets and, second, it would reduce charge offs. The impact of this latter item would depend on the condition of the assets acquired. I should note that, at present, the main income drain to Continental appears to be in the net-charge-off area. Under the optimistic scenario they will lose $500 million in 1984 due to this item; however, tbe effect of interest drag on, say, $2.3 billion of non-performing assets (at 15%) is only $345 million per year. Thus, we would derive a greater earnings impact per dollar spent if we were to purchase the worst of their portfolio.

If the optimistic scenario proves correct, the purchase of about $150 million of their worst assets would make them profitable on an operating basis for the second half by allowing them to avoid $150 million in charge offs and by providing an additional $7.5 million in income from the investment of these funds.

Since the pessimistic scenario assumes a determinating situation, it is not clear what it would take to bring them to a point of continual profitability. However, the purchase of $400 million of their worst assets would allow operating profitability for the second half of 1984 (charge offs would be reduced by $300 million and interest income would be increased by $20 million). Assuming that Continental's non-performing loan portfolio improves in 1985, it may take the purchase of an additional $200 to $300 million in bad assets to ensure profitability over the course of next year.

Funding Costs

Because Continental's problems have been well known since 1982, it has had difficulty in obtaining term money. A major portion of its funding is overnight money and the average maturity of its term money is a mere 2.5

months. Since Continental has been forced into the short end of the maturity spectrum and given that the yield curve has been significantly positively sloped since 1982, one may wonder whether their cost of funds has been higher, even with the payment of risk premiums, than would have been the case without premiums yet with a more normal liability maturity structure.

It is possible to answer this question by comparing Continental's cost of total interest bearing funds with that of its peers. For 1983, Continental's cost-of-interest-bearing-funds ratio was 9.22 percent compared to its peer's average of 9.08 percent (more recent information is not available). Thus, Continental's funding costs for interst bearing funds do not appear to be above normal. However, Continental's interest expense as a percent of average assets is well above its peer average (7.49 verses 6.70). This is primarily due to Continental's relatively low level of demand and savings deposits.

Non-Interest Expenses

Continental's non-interest expenses have typically been below peer group averages. Comparisons with peer averages can be misleading since Illinois has severe branching restrictions; however, a comparison with First Chicago Corporation shows that Continental has had lower non-interest expenses as a percentage of average assets (1.79% versus 1.97%). However, recent increases in non-interest expenses at Continental should put them on par until First Chicago.

Citicorp Proposal

Continental Bank's current balance sheet is approximately:

$ billions

Performing Assets	37	Liabilities	36
Non-Performing	3	Sub Debt	2
		Equity & Reserves	2
	40		40

Newcorp established by transferring

$3 billion nonperforming assets, $1 billion of FDIC subordinated note which becomes preferred stock. Continental HC shareholders receive stock with nominal value of, say, $1 billion in Newcorp.

Assets	$ 3 billion	Preferred Stock	1
		Common Stock	1
	3		2

It is assumed that actual value of $3 billion book is $2 billion.

Newcorp contracts with one or more banks for a fee (partly fixed and partly related to collections) to collect Newcorp assets. First net collections to FDIC. If FDIC is fully paid, subsequent collections are shared 50-50 between FDIC and Continental HC shareholders.

Continental Bank Balance Sheet

37 performing Assets	36 Liabilities
	1 Stock
	37

Bank and FDIC subordinated notes are converted to preferred or limited voting stock.

Bank then sells $17 billion in assets to reduce its size to $20 billion.

Assets	20	Liabilities	19
		Capital	1
			20

Bank presumably retains some tax benefits from having sold assets to Newcorp at a loss.

Angermueller maintains that $17 billion in assets could be sold by the end of the year.

He argues that $40 billion is simply too large for any institution to absorb.

At some point bank and FDIC stock could be sold publicly or to another institution.

Continental

For some time Continental has been faced with a precarious funding problem. It has "always" been among the largest purchasers of overnight money and, since Penn Square, it has not had access to some of the more dependable sources of domestic CDs. It became a substantial net purchaser of overseas funds after Penn Square and those sources virtually disappeared in May. Even before its most recent funding problems, Continental had been paying 10--20 basis points more than other money center banks for a significant share of its funding.

The Bank has a substantial volume of nonperforming and other classified loans (special mention and classified amount to 25 percent of loan volume). Chargeoffs have substantially impacted earnings during the last several years. During the last quarter the combination of chargeoffs and the reversal of previous accruals would have resulted in a sizable net loss were it not for the profit on the sale of Continental's credit card operation.

Some have argued that the Bank has not been as aggressive as it should have been in charging off or reserving problem loans -- for example, it has been slower to reserve private sector Latin American loans than other money center banks. It appears that Continental has been slow to accept or admit some of its problems. It has been reluctant to show losses and cut its dividend (until last month) and this may have reflected its precarious funding situation and a fear of the consequences of bad news.

It is difficult to gauge exactly how serious is Continental's problem loan situation. There are about $2.4 billion in nonaccruing loans. Preliminary FDIC review of the Comptroller's loan files suggest a maximum loss of $900 million. Continental maintains that, apart from energy problems (roughly $2 billion) and shipping loans with a loss potential of $300--$400 million, the rest of the loan portfolio is of good quality. They suggest high eventual collections on problems (I think they are overly optimistic). They maintain that most of their private sector Latin American loans are to good names and will eventually be collected.

Citibank has reviewed Continental's loans and theirs is a much less optimistic picture. They maintain that their own ratings of participations in the same credits are generally lower than Continental's. They point out the substantial resources necessary to collect problem loans and suggested Continental may be short in these areas (I am inclined to agree). Citibank has not put a number on losses. It is in their interest to paint a very bleak picture and they have done so. However, they can't afford to be too bearish in collection estimates of nonperforming loans since their volume is substantial and that would suggest their own capital position may be seriously impaired.

What needs to be done.

Regardless of whether there is a merger or direct assistance to Continental, certain steps seem necessary. Some nonperforming loans, probably having book value in the $3--$4 billion range, need to be pulled out of the Bank. While some chargeoff against the Bank's capital should be effected, cash or some kind of earning asset would be placed into the Bank in place of some of these loans. This would reduce the earnings drain from nonaccruals and would significantly reduce chargeoffs over the next few years.

The Bank's capital position needs to be bolstered by replenishing charged off loans with an equity injection or some kind of note or preferred stock. In addition there probably needs to be some paper exchange for a few years like ICCs to provide an additional cushion for depositors to replace the withdrawal of an FDIC guarantee.

Over time the Bank probably should be down-sized to reduce its disproportionate dependence on purchased funds. There is some difference of opinion on how fast and effectively this can be done. Some domestic loans can be sold. It is quite possible that European and Far East operations could be sold. It seems realistic to project a $10 billion reduction in size by the end of 1984.

It is important, particularly if Continental survives as a separate entity, to provide a package that makes the Bank profitable from the outset and provides an institution that will soon look strong enough to fund itself on competitive terms. However, perceptions are important and difficult to anticipate. That is why FDIC paper and a sizable Fed line will have to supplement any "permanent" assistance package.

Merger possibilities.

As of Friday, there were five possible merger candidates, and two of these are possibilities only on a closed bank basis or assuming a change in the Illinois law.

Citibank. They have sent in a lot of people and have a variety of interests in Continental. However, they are not likely to be an aggressive bidder for the Bank as a whole. Continental doesn't give them that much and would interfere with other acquisitions by Citibank. They have made it clear they would do most anything if the price were right. That might include managing nonperforming Continental loans, making some kind of convertible investment in a cleaned-up Continental or buying loans or parts of Continental.

Chemical. They have also put large numbers of people into Continental. We have not talked to them or received any feedback on their interest. They would complement Chemical's U.S. operation more so than Citibank. Apparently there had been some preliminary merger discussions between Continental and Chemical several months back but they never got very far. On the surface

Continental would be a lot for Chemical to swallow. Funding would be difficult. There would be a need for capital which might be hard to get. If Chemical is seriously interested in pursuing a merger, we will probably hear about it by the end of this week.

First Chicago. There have been discussions. They have access to confidential files. They have many of the funding problems of Continental. They have not been a great performer and it seems like Continental would be too much for them to absorb. They are in a position to reduce staff and noninterest expense. They would also like to keep any large, new competitor out of Chicago.

Sanwa Bank. They have picked up Continental's confidential package and had face-to-face discussions last Thursday. They are a $90 billion institution with a low capital ratio and a U.S. presence in several cities, including a $1.3 billion California subsidiary. I would think any ultimate interest on their part is likely to be in something less than the Bank as a whole. Of course, one should never underestimate the Japanese.

LaSalle NB. This is a $1.3 billion bank in Chicago with a large Dutch parent. Discussions have taken place between LaSalle and Continental and the CEO of the former has gone to Amsterdam to determine the extent of parent interest. While this is still probably a long shot, there is a possibility of a transaction where equity capital could immediately come into the Bank -- a far more remote possibility than if a merger were effected with a U.S. bank.

Assisted Merger.

It is extremely unlikely that anyone will acquire Continental without FDIC assistance. The shape of any assistance would vary depending on the acquirer, its preferences, etc. If done on an open bank basis it would probably take the form of a purchase of nonperforming assets by the FDIC with payments in cash or stock to Continental shareholders depending on the collections from that loan portfolio. Other assistance along the lines already suggested (FDIC note, Fed funding commitment) might also have to be part of any package.

Direct Assistance to Continental.

There is a good chance that there will not be a satisfactory merger proposal and that assistance will have to be provided to a free-standing Continental. How might that assistance look?

Suppose $3 billion of nonperforming loans are pulled out of Continental and placed in a separate subsidiary. One billion dollars is charged to Continental's capital and reserves, and a $2 billion loan from the subsidiary is placed on the Bank's books. There would also be a nominal capital investment by the Bank in the subsidiary. The note to the Bank would pay a market rate and be amortized over, say, three years. The FDIC would guarantee payment on the note. Continental would repay $1 billion of the FDIC's subordinated note. During the balance of the year Continental would shrink by about $10 billion so that the Bank's balance sheet would look as follows:

A		L	
Note from Subsidiary	2	Other Liabilities	27
Other Assets	27	Capital & Reserves	1
		Subordinated Notes	1
	29		29

The remaining subordinated notes are extended to, say, five years. They are registered and made convertible into stock at a price of about $8 per share. Banks might be given the option of staying in or taking a shortened maturity with no convertibility.

If loan collections are insufficient to pay the note from the subsidiary to the Bank, the FDIC's guarantee comes into use. To the extent the FDIC incurs such a cost, stock of the holding company in the Bank is transferred into newly created convertible stock in the Bank owned by the FDIC. If losses are sufficiently large (the Bank was insolvent) then the equity position of the holding company is essentially wiped out and transferred to the FDIC. It may be appropriate if the Bank's profits are sufficient to use a portion of them to compensate the FDIC before the holding company's position is wiped out altogether.

For some time depositors will probably want more reassurance about the viability of Continental. That could probably be effected by an exchange of paper -- much like the certificates provided to savings banks. The amount of paper might be large, say, $1.5--$2 billion.

If $3 billion reasonably cleans the portfolio, Continental should immediately become profitable. Reducing nonaccruals (after capital adjustment) would add about $150 million to earnings. The reduction in the need for chargeoffs could add another $150--$200 million to annual earnings during the next two years. If confidence is restored in the Bank, its funding costs could be reduced and eventually this could add $20--$40 million annually to earnings. Having written off $1 billion in loans, earnings would be tax free for several years. Thus, Continental could be in a position to add substantially to its capital, particularly with restrictions on dividend payments.

There are a lot of potential variations on this structure and other issues that have to be addressed. Who will collect on the nonperforming loans? As outlined above, it would probably be Continental, but it doesn't have to be. It could be the FDIC, both, or a third party.

S. C. Silverberg
June 4, 1984

PROFORMA BALANCE SHEET
(DOLLARS IN MILLIONS)

ASSET RANK-28

BALANCE SHEET	CONTINENTAL	CHEMICAL	CONSOLIDATED
CDFB & IBBB	5456	5481	10937
INV SEC&TRADING ACCT	2576	6025	8601
OTHER QUICK ASSETS	647	1142	1789
LOANS & LEASES-TOTAL	30108	33328	63436
OTHER ASSETS	3065	5189	8254
TOTAL ASSETS	41852	51165	93017
DEMAND DEPOSITS	3699	8378	12077
TIME DEPOSITS	24580	24074	48654
TOTAL DEPOSITS	28279	32452	60731
BORROWINGS	10113	11826	21939
OTHER LIAB	1231	4582	5813
TOTAL LIAB	39623	48860	88483
TOTAL CAPITAL	2229	2305	4534
TOTAL LIAB & CAPITAL	41852	51165	93017
TOTAL PRIMARY CAPITAL	2429	2826	5255
TOTAL ASSETS & RPLL	41852	51536	93388

CONSOLIDATED CAPITAL AT EACH LEVEL OF CHARGE OFF

CHARGE OFF AT CIL($)	0	500	1000	1500	2000
CONSOLIDATED CAPITAL	4534	4034	3534	3034	2534
PRIMARY CAP(%)	4.87%	4.34%	3.80%	3.26%	2.72%

PROFORMA BALANCE SHEET
(DOLLARS IN MILLIONS)

ASSET RANK-36

BALANCE SHEET	CONTINENTAL	ALGEMENE, AMSTERDAM	CONSOLIDATED
CDFB & IBBB	5456	13516	18972
INV SEC&TRADING ACCT	2576	1596	4172
OTHER QUICK ASSETS	647	520	1167
LOANS & LEASES-TOTAL	30108	22721	52829
OTHER ASSETS	3065	1566	4631
TOTAL ASSETS	41852	39919	81771
DEMAND DEPOSITS	3699	8304	12003
TIME DEPOSITS	24580	17507	42087
TOTAL DEPOSITS	28279	25811	54090
BORROWINGS	10113	6203	16316
OTHER LIAB	1231	6250	7481
TOTAL LIAB	39623	38204	77827
TOTAL CAPITAL	2229	1655	3884
TOTAL LIAB & CAPITAL	41852	39859	81711

CONSOLIDATED CAPITAL AT EACH LEVEL OF CHARGE OFF

CHARGE OFF AT CIL($)	0	500	1000	1500	2000
CONSOLIDATED CAPITAL	3884	3384	2884	2384	1884
PRIMARY CAP(%)	4.75%	4.14%	3.53%	2.92%	2.31%

COMMENTS: Strong Candidate

U.S. Presence (3-30-84)		Total Assets (000000)
Branches -	New York	1408
	Pittsburg	28
	Chicago	102
	Seattle	6
Agencies -	Miami	48
	Atlanta	151
	Los Angeles	56
	San Francisco	43
Edge Corps -	Chicago	6
	Houston	14
SuSubsidiary Bank -		
	LaSalle National Bank	1270
		3132

PROFORMA BALANCE SHEET
(DOLLARS IN MILLIONS)

ASSET BANK 16

BALANCE SHEET	CONTINENTAL	SANWA BANK LTD.	CONSOLIDATED
CDFB & IBBB	5456	22000	27456
INV SEC&TRADING ACCT	2576	3033	5609
OTHER QUICK ASSETS	647	9094	9741
LOANS & LEASES-TOTAL	30108	46672	76780
OTHER ASSETS	3065	8938	12003
TOTAL ASSETS	41852	89737	131589
DEMAND DEPOSITS	3699	10143	13842
TIME DEPOSITS	24580	59125	83705
TOTAL DEPOSITS	28279	69268	97547
BORROWINGS	10113	14658	24771
OTHER LIAB	1231	4089	5320
TOTAL LIAB	39623	88015	127638
EQUITY	1828	1722	3550
CAPITAL RESERVES	401	0	401
TOTAL CAPITAL	2229	1722	3951
TOTAL LIAB & CAPITAL	41852	89737	131589

CONSOLIDATED CAPITAL AT EACH LEVEL OF CHARGE OFF

CHARGE OFF AT CIL($)	0	500	1000	1500	2000
CONSOLIDATED CAPITAL	3951	3451	2951	2451	1951
PRIMARY CAP(%)	3.00%	2.62%	2.24%	1.86%	1.48%

Comments: Home state difficulties.

U.S. Presence (3/31/84)		Total Assets (In Millions)
Branch		
	New York	6855
	Chicago	937
Agency		
	San Francisco	2615
Subsidiary Bank		
	Golden State Sanwa Bank	1265
	Total	11672

PROFORMA BALANCE SHEET
(DOLLARS IN MILLIONS)

ASSET BANK-1

BALANCE SHEET	CONTINENTAL	CITICORP	CONSOLIDATED
CDFB & IBDB	5455	15434	20889
INV SEC&TRADING ACCT	2576	9624	12200
OTHER QUICK ASSETS	647	3596	4243
LOANS & LEASES-TOTAL	29707	90283	119990
OTHER ASSETS	3066	15718	18784
TOTAL ASSETS	41451	134655	176106
DEMAND DEPOSITS	3699	10341	14040
TIME DEPOSITS	24580	69453	94033
TOTAL DEPOSITS	28279	79794	108073
BORROWINGS	10113	34520	44633
OTHER LIAB	1231	14570	15801
TOTAL LIAB	39623	128884	168507
EQUITY	1828	5771	7599
TOTAL LIAB & CAPITAL	41451	134655	176106
TOTAL PRIMARY CAPITAL	2429	6588	9017
TOTAL ASSETS & RPLL	41852	135421	177273

CONSOLIDATED PRIMARY CAPITAL AT EACH LEVEL OF CHARGE OFF

CHARGE OFF AT CIL($)	0	500	1000	1500	2000
CONS. PCAP($)	9017	8517	8017	7517	7017
PRIMARY CAP(%)	5.09%	4.82%	4.55%	4.28%	4.00%

(DOLLARS IN MILLIONS) Page 177 ASSET BANK-50

BALANCE SHEET	CONTINENTAL	1ST CHICAGO	CONSOLIDATED
COFS & IBBB	5455	7292	12747
INV SEC&TRADING ACCT	2576	2727	5303
OTHER QUICK ASSETS	647	1717	2364
LOANS & LEASES-TOTAL	29707	22035	51742
OTHER ASSETS	3066	2552	5618
TOTAL ASSETS	41451	36323	77774
DEMAND DEPOSITS	3699	3194	6893
TIME DEPOSITS	24580	24486	49066
TOTAL DEPOSITS	28279	27680	55959
BORROWINGS	10113	6129	16242
OTHER LIAB	1231	772	2003
TOTAL LIAB	39623	34581	74204
EQUITY	1828	1742	3570
TOTAL LIAB & CAPITAL	41451	36323	77774
TOTAL PRIMARY CAPITAL	2429	2060	4489
TOTAL ASSETS & RPLL	41852	36541	78393

CONSOLIDATED PRIMARY CAPITAL AT EACH LEVEL OF CHARGE OFF

CHARGE OFF AT CIL($)	0	500	1000	1500	2000
CONS. PCAP($)	4489	3989	3489	2989	2489
PRIMARY CAP(%)	5.73%	5.12%	4.51%	3.89%	3.26%

Transaction Outline

1. CIC will transfer $4B of loans to a new national bank (New Bank) for $2.6B in cash.

Cash will be advanced in the form of a loan by FRB-Chicago to New Bank, guaranteed by FDIC. Rate on the loan will be 7-year Treasuries.

2. FDIC will retain $500M of subordinated loans to CI Bank in the form of a three-year note.

3. Make-whole agreement. FDIC will be made whole on any losses on its guaranty to the extent of the consideration paid to CIC shareholders. Calculation will be made at the end of 7 years: The FDIC will be paid the difference between (i) cash flow from collections less interest and (ii) $2.6B.

4. Incentives for collection. A management fee of 5% of collections to be paid to acquiring bank. Acquiring bank will assume 5% of losses. All operating expenses paid by acquiring bank.

5. Differential between proceeds paid to CIC shareholders and book equity of CI Bank will not be excessive.

6. Litigation: To extent FDIC guarantees acquiring bank against litigation losses/expenses, and suffers any loss in respect thereof, losses will be included in make whole.

7. FDIC will continue guaranty of deposits at CI Bank for up to one year.

8. No operating restrictions on acquiring bank or on loan vehicle (which is being operated by acquiring bank).

9. CIC will write off and charge loan loss reserve to extent of differential between $4B of transferred loans and $2.6B of loans.

10. Any recoveries in New Bank for the account of acquiring bank or CIC shareholders.

11. Acquiring bank will make a capital injection of $400M-$600M into CI Bank.

G.S. & CO. SUGGESTION OF A TRANSACTION OUTLINE

1. CIC will transfer (for example) $4B of loans to a new national bank for (for example) $2.6B in cash.

CIC will charge loan loss reserve and reduce capital to extent of difference between (in this example) $4B of transferred loans and $2.6B of cash.

Cash will be advanced in the form of a loan by FRB-Chicago to new national bank, which will be guaranteed by FDIC. Rate on the loan will be seven-year Treasuries.

2. FDIC will retain (for example) $500M of subordinated loans to CI Bank in the form of a three-year note.

3. FDIC will continue support of deposits (for example) by an exchange of $1.5B of its notes for a similar amount of subordinated notes issued by CI Bank. Notes will bear identical interest rate, and there will be no right of set-off. Federal Reserve will continue to provide funding availability.

4. Make-Whole Agreement. FDIC will be made whole on any losses on its guarantee to the extent of the consideration paid to CIC shareholders. In order to provide sufficient incentives to acquiring bank to maximize loan collections in new national bank, FDIC desires that it also be made whole

by acquiring bank to extent of common equity in CI Bank (without giving effect to capital injection by acquiring bank) or through some form of loss-sharing arrangement. Calculation will be made once at the end of (for example) seven years: in this illustration, no make-whole would be required unless cash flow on $4B of transferred loans failed to pay principal and interest on $2.6B FRB-Chicago loan. FDIC can be made whole in cash or securities (at acquiring bank's option).

5. Additional incentives for collection. To accommodate FDIC concerns about sufficient collection incentives, any recoveries on the $4B of transferred loans above $2.6B (plus interest on FRB-Chicago loan) would be shared on a pre-determined basis by acquiring bank and CIC shareholders. No incentive would, of course, be required if FDIC itself were to collect the loans.

6. Litigation. To meet concerns of acquiring bank, CI Bank will establish a litigation reserve of (for example) $100M. If litigation losses exceed this reserve, FDIC and acquiring bank will share additional losses on a pre-determined basis. To the extent FDIC sustains losses, the amount thereof will be attributed to the make-whole arrangement.

7. No operating restrictions on acquiring bank or on new bank, although a general plan of operations may be required for CI Bank.

8. Acquiring bank will make a capital injection of $400M--$600M into CI Bank.

1. Bank sets up $100 million reserve for litigation.

2. Bank transfers $4 billion in loans (BV) to FR Bank Chicago and cancels $2.7 billion FR debt. $200 million is charged against Loan Loss Reserve and $1.1 billion against Capital Account, leaving "equity" of $800 million.

3. FDIC agrees to collect loans and guarantees FR payment of principal and interest (coupon equivalent Treasury bill rate + 50, rate adjusted quarterly). Principal paid down quarterly based on collections with full amount paid off in five years.

4. Two classes of common stock are created. Existing shareholders given class A stock. New class B stock (= 2 shares of class A) sold through rights offering with underwriting by Bass group. $800 million sold. New stockholders (class B) own 2/3 of common.

5. To the extent FDIC guarantee is exercised, ownership of class A stock is transferred to FDIC. FDIC provides guarantee against certain additional excess charges during next several years and, to the extent that these involve additional FDIC outlays, they also require transfer of class A stock to FDIC.

<u>Additional Points</u>

Guarantees might include 60 percent of litigation expenses in excess of $25 million per year for five years. Also, sixty percent of chargeoffs in excess of $150 million per year assuming loans were on the books 6/84 (FDIC to select and recover on excess chargeoffs with FDIC having the right to choose from any loans charged off that year). Numbers used are for example purposes.

The FDIC is essentially freezing book capital at $800 million.

FDIC stock interest would have to be convertible preferred.

Bank acquires sizable tax benefit, a portion of which might be booked following a period of positive earnings.

Bank would have the right to retire FDIC-owned stock on certain specified terms (reasonably favorable to FDIC) as long as Bank's capital remains above specified level.

GS - Continental Proposal

1. $4.5 billion book loans removed from bank and placed into separate vehicle. FR Chicago pays $3.5 billion in cash or loan cancelation. FDIC agrees to guarantee repayment to FR with interest over five-year period.

2. Loans to be collected by Continental. To the extent that collections are insufficient and FDIC guarantee comes into place, FDIC acquires old Continental shareholder equity through stock transfer or use of warrants.

3. Provision is made for new stock class (B) that is insulated from guarantee provision in order to facilitate sale of new stock.

4. FDIC purchases $500 million in subordinated notes or preferred stock. Also receives warrants for some percent of class B stock (probably to be exercised at initial stock offering price).

5. FDIC provides an exchange of paper of about $1.5 billion to give additional depositor protection for several years in connection with removal of deposit guarantee.

6. Bank continues to be shrunk -- probably about $28 billion when this transaction is completed and about $24 billion by year-end 1984.

7. Initial capitalization is $1.1 billion in equity and loan loss reserve plus $500 million of FDIC preferred. Some early public sale of common stock is contemplated.

8. Initially, FDIC is repaid $1 billion of its $1.5 note. $500 million is retained in bank or converted into preferred stock.

Points of Difference With FDIC Staff:

We would prefer larger initial writeoff against $4.5 billion. This means smaller capital account in Continental to be made up through larger FDIC contribution or other capital source.

GS--Continental argues for new vehicle to be a national bank. We think this is unnecessary. They initially argued for expense collections to come from bank. We think they should be charged against collections. It is not clear who should collect. In the case of energy loans, a joint effort might be appropriate.

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Years of Confidence 1933 – 1983

June 25, 1984

Confidential

MEMORANDUM TO: Mr. William M. Isaac
Chairman

FROM: Stanley C. Silverberg SCS
Director, DRSP

SUBJECT: Comments on Continental

These comments relate to two issues discussed in Thursday's meeting on Continental.

You have suggested that, rather than removing most classified assets from Continental all at once, the FDIC agree to make up some percentage of operating losses for several years. I believe there are several advantages to a considerable loan removal at the outset.

First of all, our examination and the observations of others argue for a considerable chargeoff. Going beyond this and removing virtually all nonperforming loans (and those likely to attain that status) will boost operating earnings, even if a sizable chargeoff is taken. Removal of these loans will significantly reduce chargeoffs over the next several years and remove from the bank's operating expenses the costs of collecting nonperforming loans and collecting on foreclosed assets.

It is very important that Continental gets well into the black quickly. I think the circumstances are a lot different than those that existed with Bank of the Commonwealth and First Pennsylvania. In those cases the banks were allowed to limp along and, apparently, survived at modest cost to the FDIC. They had lost or didn't have any customer base that was affected by their condition. I think that Continental is too big to be allowed to limp along and that it will be risky and, very likely, more expensive to try to do so.

If the bank can become profitable and show reasonable prospects to stand alone or be merged into another (probably foreign) bank, it will be able to attract new equity investment and retain competent staff. As a floundering institution it will do neither, continue to fund at above-market rates and not be able to retain or attract good customers.

Covering losses over time is not likely to prove cheaper or even to conserve initial cash outlay. With a sizable initial loan removal, the Federal Reserve can be used as a financing vehicle. With an appropriate writeoff, our guarantee may result in little or no FDIC cash outlay. That cost, if it occurs, could be offset by the value of an equity interest in a profitable bank. Funding losses over time is likely to involve FDIC money and recouping that outlay through stock in a floundering bank may be difficult. Of course, it may be possible to combine a large initial loan removal with future commitments to purchase loans (after a deductible). This is apt to be necessary for a merger or a large initial capital injection.

Open versus Closed Bank

We are exploring the possibility of separating an open Continental Bank from the holding company. At this point there appear to be several ways in which such a transaction can be blocked by litigation. We are also looking into ways to impose some kind of hit on preferred shareholders. However, even if this can't be done without closing the bank, it is important to consider the pros and cons of an open bank transaction.

Preferred Stock

If the bank is closed, the preferred stockholders (and, of course, common stockholders) receive nothing initially. Depending on any ultimate value realized by the FDIC or an acquiring bank, they might be entitled to some compensation. In an open bank transaction, assuming the bank can't be separated from the holding company, the preferred shareholders might get "full value". That's $87.5 million. As a cost to Continental, that's something less. Dividend is one percent less than long-term Treasury rate with a 13 percent maximum. Because an open Continental will be in a non-tax status for some time, the preferred would be equivalent to a debt instrument from Continental's standpoint and probably command a yield at least two points above Treasuries for a surviving bank. Also, dividend payments can and would be held up (dividends are cumulative but not compounded). Eventually, if new common is to be sold and the bank is profitable, dividends would have to be restored. Of course, if the bank doesn't become and remain reasonably profitable, dividends won't be restored.

Taking account of delayed dividend payments and below-market cost, the value of the preferred (viewed as a liability of Continental) is probably $50--60 million.

Litigation

Closing the bank would not afford significant protection from litigation against the bank arising out of Penn Square and other bank activities. Such litigation would come against the FDIC acting as receiver instead of an open bank. In the case of stockholder suits mostly against the holding company, a closed bank would probably afford considerable protection to the FDIC. I have been told by the bank's outside counsel that stockholder suits can probably be settled for less than $25 million (I have no basis for evaluating this).

Closing the bank would invite another set of lawsuits directed against the FDIC and the Comptroller for closing a "solvent" institution. We would probably win such suits though they might be expensive and, possibly, embarrassing in view of our own loss estimates. I realize that, in principle, the bank can be closed by pulling the Fed line or demanding the FDIC note. However, I think we would be hard pressed to defend such action publicly at this time unless the bank did something to provoke it or was considered to be insolvent.

Tax Benefits

The bank is likely to lose $100 million in the second quarter. $1 billion or more would probably be charged off in removing classified loans from the bank. At some point about $100 million in book losses on tax exempts should be charged off to improve income. That's at least $1.2 billion in losses that can be carried forward for 15 years. A profitable bank will be able to use these benefits even without a merger. While most banks don't pay a lot of taxes, they give up income by taking lower pre-tax returns on tax exempt securities and lease financing (and other activities) so as not to pay taxes. The value of tax benefits depends largely on future income. Conservative estimates suggest a discounted value of future tax benefits of $350--400 million.

Accounting Problem

A closed bank probably will not be able to retain any capital account. Thus, we will start out with zero capital which would have to be made up by a contribution from the FDIC and/or an acquiring bank. Retained earnings would have to come from taxable income.

Principle

What are the principles involved? We don't want preferred stockholders (or holding company creditors) to come out okay in a situation where the FDIC loses. That is certainly a possibility in an open bank transaction. Sometimes it's not possible to get all the right results.

In the bank--holding company capital issue I have argued that it is possible for the bank to survive while the holding company doesn't. In this case it seems difficult to fail the holding company if the bank survives. I'm not sure that's such a serious problem.

Information

I. No new bidders (last foreign possibilities will be gone this weekend).

a. Citibank conversation since last meeting suggests no movement. Manage, make investment, not want to take risk beyond investment (what might be acceptable?).

b. First Chicago discussion with Salomon Bros. indicates proposal next week.
What can they bring?
Is there some level of acceptable capitalization?

c. Continental

d. Continental + Bass Group (they will send people into bank).

e. Closed bank. W/other bank. FDIC

+ wipe out stockholders	minimal delay
preferred stkholders	some lawsuit protection
H.C. creditors	some contractual protection
	-- taxes, may not be used easily
	capital

Continental

- Information has been slow in coming.

- Some shifting positions

- There is not great confidence in bank's presentation (hard to distinguish between candor and knowledge.

- Since Continental's free-standing proposal of 3 weeks ago - Reassessment of their problem

- Loan problem - a little bigger

- Expectations about asset sales - prices have been scaled back. e.g., shipping loans would be sold w/ Greek branch(es) - no cost. (shipping loans added to package)

FDIC's exposure increased. Need to collect 3.5 on 4.5. Costs changed to collections. Earnings projections not changed.

Continental's projections are fragile.

1. Downsizing - will parts be sold w/o discount?

2. Cost reductions - while end result does not produce a low-cost bank, cost reductions may not be attainable.

- assume passing of personnel w/ parts (leasing, foreign offices)

- then, substantial overhead and other personnel reductions, other cost reductions.

Income assumptions - margins, non-interest income, etc., are probably conservative.

Loan loss - possible, but <u>very</u> optimistic.

Is downsizing overdone? Seems to be driven by magic $20 billion number.

- Concern about funding

  but will funding problem be solved w/marginal earnings?

FDIC's dilemma

- it would be desirable to get more protection on 3.5/4.5 but less

  cash to Continental hurts earnings.

Smaller loan purchase 2.5/3.5 would not adversely affect earnings. Would clean up bank less. Could be accompanied by some put -- .

Is the bank painting an overly bleak picture to assure sizable FDIC contribution? Perhaps. But if this were such a good deal and could easily be profitable, wouldn't other banks be interested?

How can we improve prospects? Additional subsidy? Below market rate on convertible preferred? Higher price for loans? Additional guarantee on loans?

More equity improves prospects. How much can G-S sell?

<u>Bass Group</u> maintains they are prepared to underwrite $800 million equity. Others have expressed skepticism. I think we must pursue with them.

Next Week

Examine financial projects more closely.

Look at loan package - compare to Chemical. -

What else?

If we go with Continental, must bring in top management.

We should be looking actively now. If we announce a plan - by before end of month. Should have someone in place

even if stockholder approval is required.

Prior to Penn Square, Continental's earnings measured as a percent of assets were average to slightly-below-average compared with other money center banks. Interest margins were low because of the extraordinarily high dependence on purchased funds (this was partially offset by a higher-than-average loan-asset ratio). Non-interest income was slightly low, but this was more than made up by a lower-than-average non-interest expense ratio.

When loan losses were low in 1979-81, Continental earned between .55 and .58 percent on assets which was about average for money center banks. Following Penn Square loan losses escalated and directly impacted net income. In addition, the increase in nonperforming loans adversely affected interest margins. Thus, prior to the recent deposit outflows Continental was experiencing serious earnings problems.

In the proposed assistance package there would be a sizable initial loan write-off accompanied with a purchase of most of Continental's present nonperforming loan portfolio. Presumably this will reduce the need for loan write-offs during the next several years. (If some of the loan purchase is deferred there would be greater assurance of low charge-offs over the next few years.) It will not dramatically improve interest margins because loans removed would exceed the cash injection by about $1 billion.

The bank would be dramatically shrunk over the next 6 - 12 months. Foreign offices would be sold and some domestic business would be allowed to run off. This, presumably would alleviate some of the bank's funding problem. Interest margins might be raised slightly. However, overhead expenses, measured as a percentage of assets could increase dramatically.

It is contemplated that staff and other non-interest expenses would be pared directly through the sale of foreign branches and other activities. Nevertheless, dramatic further reductions would be necessary to prevent non-interest expense ratios from rising sharply and impairing earnings.

Last week Continental submitted a proposal in which \$4.5 billion in loans (including most nonperforming) would be removed from the bank for \$3.5 billion in cash, the FDIC would invest \$500 million in convertible preferred and the bank would be sized down to \$20 billion by 1985. Pro forma balance sheet and income statement (A) suggest modest profitability, given extreme assumptions on expense reductions.

We can beef up the proposal by assuming \$750 million in convertible preferred with dividends in early years paid in additional stock or warrants. Assume further that \$200 million in new common stock is sold, that size reduction is to \$25 billion (bank retains more domestic loan volume), some better retention of non-interest income, less spectacular expense reduction. This gives rise to pro forma statements (B).

Even if loan losses are raised to (a still modest) \$60 million per year, earnings would be a respectable \$200 million. The bank, which would pay no Federal taxes for quite a few years, still has about \$600 million of municipals with limited marketability. As these run off or can be sold earnings could be boosted considerably. These projections presuppose that the bank can fund itself satisfactorily. Funding is apt to be tied to the bank's ability to reestablish itself through reasonable earnings, capital and nonperforming loan ratios.

Rep[illegible]ned Continental
Pro-Forma Income Statement
(dollars in millions)

(A.)

	1984					1985
	First Quarter Actual	Projection				First Repositioned Quarter
		Second Quarter	Third Quarter	Fourth Quarter	Full Year	
	$	$	$	$	$	$
Net Interest Income	149	165	151	143	608	108
Provision for Credit Losses	140	485	10	10	645	10
Net Interest Income After Provision for Credit Losses	9	(320)	141	133	(37)	98
Security Trading Revenue	5	(6)	5	5	9	3
FX Trading Revenue	7	5	5	5	22	2
All Other Revenue	247	61	45	40	393	30
Gross Profit	268	(260)	196	183	387	133
People Expense	102	111	96	85	394	55
Other Expense	116	90	72	69	347	50
Provision for Loss on Sale of Selected Criticized Credits	-	465	-	-	465	-
Total Non-Interest Expense	218	666	168	154	1,206	105
Income Before Income Taxes	50	(926)	28	29	(819)	28
Income Taxes	21	19	-	-	40	-
Net Income	29	(945)	28	29	(859)	28
Net Interest Margin %	1.83	1.94	2.30	2.50	2.14	2.48
ROA %	.27	-	.35	.42	-	.48
ROE %	6.3	-	12.6	12.8	-	12.2

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PRELIMINARY

A.

Repositioned Continental
Pro-Forma Balance Sheet
(dollars in millions)

	1984				1985
		Estimate			First
	March 31 1984	Second Quarter	Third Quarter	Fourth Quarter	Repositioned Quarter
	$	$	$	$	$
Cash and Due From	2.04	1.50	1.50	1.50	1.50
Interest Earning Deposits	3.42	1.00	1.00	1.00	3.10
~~Placement with FDIC~~	-	~~1.50~~	~~1.50~~	~~1.50~~	~~1.50~~
Investment Securities	1.81	1.65	1.60	1.50	1.40
Trading Account Securities	.76	.30	.30	.30	.20
Short-Term Investments	.65	.30	.20	.20	.30
Current Loans and Leases	27.76	25.25	21.90	17.00	11.80
Non-Performing Loans and Leases	2.35	.50	.50	.50	.50
Total Loans and Leases	30.11	25.75	22.40	17.50	12.30
Less: Reserve for Credit Losses	.40	.30	.30	.30	.30
Net Loans and Leases	29.71	25.45	22.10	17.20	12.00
Acceptances	.87	.50	.50	.50	.50
Other Assets	2.19	1.30	1.30	1.30	1.00
Total Assets	41.45	32 ~~33.50~~	28.5 ~~30.00~~	23.5 ~~25.00~~	20 ~~21.50~~
Purchased Funds	33.82	26.50	23.04	18.00	14.58
Demand Deposits	3.70	2.70	2.70	2.70	2.70
Borrowing from FDIC	-	~~1.50~~	~~1.50~~	~~1.50~~	~~1.50~~
Acceptances	.87	.50	.50	.50	.50
Other Liabilities	1.23	.92	.87	.89	.80
Total Liabilities	39.62	32.12	28.61	23.59	20.08
Adjustable Rate Preferred Stock-FDIC	-	.50	.50	.50	.50
Stockholders' Equity	1.83	.88	.89	.91	.92
Total Liabilities and Equity	41.45	32 ~~33.50~~	28.5 ~~30.00~~	23.5 ~~25.00~~	20 ~~21.50~~
Net Demand Deposits	1.7	1.2	1.2	1.2	1.2
Net Interest Free Funds	2.9	2.0	2.0	2.0	2.3
Leverage - Total Equity %	4.4	2.6	3.0	3.6	4.3
Leverage - Primary %	5.8	5.3	6.0	7.2	8.4
Leverage - Loans and Leases X	16.5x	29.6x	25.1x	19.2x	13.4x
Reserve to Total Loans and Leases %	1.3	1.2	1.3	1.2	2.4
Reserve to Non-Performing %	17	60	60	60	60
Non-Performing to Primary Capital %	92	28	28	28	28
Loans and Leases to Total Assets %	73	77	75	70	62

June 28, 1984

B.

Repositioned Continental
Pro-Forma Income Statement
(dollars in millions)

	1984 First Quarter Actual $	1984 Projection Second Quarter $	1984 Projection Third Quarter $	1984 Projection Fourth Quarter $	1984 Projection Full Year $	1985 First Repositioned Quarter $	
Net Interest Income	149	165	151	143	608	~~100~~	150
Provision for Credit Losses	140	485	10	10	645	10	
Net Interest Income After Provision for Credit Losses	9	(320)	141	133	(37)	~~90~~	140
Security Trading Revenue	5	(6)	5	5	9	3	
FX Trading Revenue	7	5	5	5	22	2	40
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People Expense	102	111	96	85	394	55	
Other Expense	116	90	72	69	347	50	
Provision for Loss on Sale of Selected Criticized Credits	-	465	-	-	465	-	125
Total Non-Interest Expense	218	666	168	154	1,206	105	
Income Before Income Taxes	50	(926)	28	29	(819)	28	
Income Taxes	21	19	-	-	40	-	55
Net Income	29	(945)	28	29	(859)	28	
Net Interest Margin %	1.83	1.94	2.30	2.50	2.14	2.48	
ROA %	.27	-	.35	.42	-	.48	
ROE %	6.3	-	12.6	12.8	-	12.2	

PRELIMINARY (B)

Repositioned Continental
Pro-Forma Balance Sheet
(dollars in millions)

	1984				1985	
		Estimate			First	
	March 31 1984	Second Quarter	Third Quarter	Fourth Quarter	Repositioned Quarter	
	$	$	$	$	$	
Cash and Due From	2.04	1.50	1.50	1.50	1.50	
Interest Earning Deposits	3.42	1.00	1.00	1.00	3.10	
~~Placements with FDIC~~	-	~~1.50~~	~~1.50~~	~~1.50~~	~~1.50~~	
Investment Securities	1.81	1.65	1.60	1.50	1.40	
Trading Account Securities	.76	.30	.30	.30	.20	
Short-Term Investments	.65	.30	.20	.20	.30	.80
Current Loans and Leases	27.76	25.25	21.90	17.00	11.80	16.3
Non-Performing Loans and Leases	2.35	.50	.50	.50	.50	
Total Loans and Leases	30.11	25.75	22.40	17.50	12.30	16.8
Less: Reserve for Credit Losses	.40	.30	.30	.30	.30	
Net Loans and Leases	29.71	25.45	22.10	17.20	12.00	16.5
Acceptances	.87	.50	.50	.50	.50	
Other Assets	2.19	1.30	1.30	1.30	1.00	
Total Assets	41.45	~~33.50~~ 32	~~30.00~~ 28.5	~~25.00~~ 23.5	~~21.50~~ 20	25
Purchased Funds	33.82	26.50	23.04	18.00	14.58	
Demand Deposits	3.70	2.70	2.70	2.70	2.70	
Borrowing from FDIC	-	~~1.50~~	~~1.50~~	~~1.50~~	~~1.50~~	72
Acceptances	.87	.50	.50	.50	.50	
Other Liabilities	1.23	.92	.87	.89	.80	
Total Liabilities	39.62	32.12	28.61	23.59	20.08	
Adjustable Rate Preferred Stock-FDIC	-	.50	.50	.50	.50	.75
Stockholders' Equity	1.83	.88	.89	.91	.92	1.16
Total Liabilities and Equity	41.45	~~33.50~~ 32	~~30.00~~ 28.5	~~25.00~~ 23.5	~~21.50~~ 20	25
Net Demand Deposits	1.7	1.2	1.2	1.2	1.2	
Net Interest Free Funds	2.9	2.0	2.0	2.0	2.3	
Leverage - Total Equity %	4.4	2.6	3.0	3.6	4.3	
Leverage - Primary %	5.8	5.3	6.0	7.2	8.4	
Leverage - Loans and Leases X	16.5x	29.6x	25.1x	19.2x	13.4x	
Reserve to Total Loans and Leases %	1.3	1.2	1.3	1.2	2.4	
Reserve to Non-Performing %	17	60	60	60	60	
Non-Performing to Primary Capital %	92	28	28	28	28	
Loans and Leases to Total Assets %	73	77	75	70	62	

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Assume: no ~~dividend~~ cash dividend payments, Pfd dividend paid in additional stock, 5 per cent growth in noncapital funding.

Total Assets	27.7 billion
Equity	1.42 (5.15%)
Equity + reserves	1.72 (6.20%)
Pfd Stock	.95
Total Capital + reserves	2.67 (9.6%)

Dividends presumably would be resumed. Part of Pfd might be retired. Remainder converted to dividend paying status & sold to public.

Options for Assisting Continental

The basic assistance options available to the FDIC are to purchase assets, to lend money or to purchase prefered stock. These same options exist whether the FDIC assists an open bank or closes Continental and assists a newly chartered institution that acquires Continental. There are variations in the available options and these are discussed later on along with specific alternatives and recommendations. Before getting into that it seems appropriate to set forth what we want to achieve and how easy or difficult that is likely to be.

An assisted Continental should be able to establish market place confidence. Depositors and other bank customers must not only expect Continental to survive, they should be able to expect it to have the backing and financial flexibility to offer the range of services that a good bank can offer. Continental should have positive earnings and, after it becomes appropriately repositioned, it should achieve earning's results that are at least comparable to its peers. That's not only necessary for market confidence, but it will be necessary if the FDIC is to recoup a significant share of the assistance it provides. There are important interrelationships among goals. Confidence will be necessary to obtain adequate funding at market rates. The cost of funding will substantially impact earnings and market confidence. Good performance will allow the bank to achieve and maintain the good financial ratios that are necessary to get favorable analyst ratings, etc.

At the earliest possible time Continental should produce favorable financial ratios: good capital ratios, good protection for depositors and other general creditors, and low ratios of nonperforming loans to assets and capital. Otherwise depositors and other creditors may be skeptical about whether the bank has been turned around. In previous assistance transactions the FDIC has rightly been concerned about cost. The short-run niggardly solutions probably turned out to be the cheapest ones over the longer run. That may not be the case with Continental. The heavy reliance on purchased funds gives rise to a situation where cheap may be very risky. And even if the institution survives cheap may keep funding costs high and prevent the generation of the positive momentum necessary to repay the FDIC.

Size of the Problem

The amount of assistance "necessary" is larger than many originally contemplated (it is certainly larger than what I thought was necessary). Adverse classifications have risen. Some of the bank's earlier estimates on what price its staff thought branches and operations could be sold appear to have been exaggerated. The bank has lost some good business that is not apt to return quickly. Despite sizable staff reductions over the past two years a shrunken Continental will result in very high overhead ratios that will adversely affect earnings.

Banks that have looked at Continental have backed away from discussing an assisted merger. Funding problems and uncertainties were suggested. However, they recognized the posibility of an orderly shrinking and the likely availability of funding assistance from the Fed. I believe they were aware of possible FDIC assistance that might have included a purchase of assets, some capital assistance and some guarantees on future losses. I believe they recognized the difficulty and uncertainty associated with turning Continental around without an enormous amount of assistance. My conclusion is that if it is reasonable to expect to turn Continental around cheaply we would have had several merger proposals. If things go well we might get out with no cost. However, I don't think that should be our expectation going into the transaction.

Types of Assistance

Capital infusion. Because a substantial second quarter charge-off will occur, Continental will need some kind of capital infusion to bring its capital ratio up to a respectable level. The minimum figure to produce a 5 percent capital ratio would be $500 million (assuming charge-offs bring remaining equity and reserves to $1.1 billion and that post-charge-off bank has assets of about $32 billion). In order to have a positive impact on earnings a capital infustion (say, preferred stock) would have to have a below market cash rate, at least initially. This can be accomplished in several ways: (1) an instrument whose rate rises over time; (2) an instrument with a favorable common stock conversion feature such that it is essentially a way for the FDIC to make an equity investment; or (3) an instrument that pays dividends in early years in the form of additional shares of preferred stock or warrants to acquire common. I would favor (2) or (3) to provide the maximum boost to earnings. However, it may be appropriate to use more than one type of capital instrument. One might be retired from proceeds of public stock sales. Another might he more suitable for longer term purposes or sale to investors. In today's market "free" capital would add somewhere between 11 and 13.5 percent of its amount to earnings, depending in whether it was viewed as a reduction in funding (that's probably most appropriate initially) or as a means of financing new loans.

In setting terms on preferred stock, several additional considerations are important. The FDIC probably does not want to dominate stock ownership so much that we preclude a future public stock issue. The FDIC should have ways of getting out by a public sale or by selling its stock to another bank. This may require provision for future dividend payment or other features that will increase the stock's marketability.

Loan Purchase. Loss loans could be purchased at book as a way of keeping capital in the bank, but generally this can be effected by replacing losses with a stock purchase (that also enables the bank to realize a loss for tax purposes. The principal reason for purchasing loans is to remove nonperforming loans and those most likely to become nonperforming from the bank. Such loans afford a drag on interest margins and earnings. They also afford an important basis for the assessment of a bank's condition by analysts and bank creditors. Continental has indicated that interest earnings on nonperforming loans average about 4 percent, suggesting that the purchase of $1 billion in nonperforming loans would add at least $70 million to current earnings and, very likely forestall the need for significant charge-offs during the next few years. If an initial loan purchase is combined with a subsequent put, greater assistance will be provided against subsequent loan losses. The downside is that collections on nonperforming loans will be significantly less than 100 cents on the dollar. Still, removal of such loans may significantly boost early year earnings at an ultimate cost that will not be substantial. Removal will significantly improve balance sheet appearance; it will provide the market with a sense that a lot of the problem has been removed; and (to the extent it is desired) it will help downsize the bank.

Pulling loans out of the bank requires a decision on whether loans are to be collected by the bank, the FDIC or both. This can be viewed positively or negatively. A defined, concerted loan collection effort can improve results.

In various forms of assistance proposals the removal of loans can accomplish two other things. It provides a rational basis for transferring stock ownership from existing stockholders to the FDIC. To the extent that collections on removed assets fall short of the price paid, shares of existing shareholders would be transferred to the FDIC. Should collections exceed the price paid, stockholders would retain their shares and receive additional cash. This type of arrangement would be easy for the FDIC to support. The purchase of loans from Continental can be largely financed by the Federal Reserve. If ultimate collections are sufficient the FDIC has no casb outlay in this form of assistance; and, assuming there is a collection shortfall, the FDIC's cash outlay from this assistance will be considerably delayed. If the FDIC's assistance is restricted to a capital infusion, that infusion will have to be greater as will the FDIC's initial cash outlay.

Specific Options

As already indicated, the FDIC will have to purchase stock or a facsimile. I believe it would be preferable for the FDIC to facilitate (guarantee) a loan purchase as well as to acquire capital. One option is just to rely on a capital infusion. I believe that will require about $1.5 billion from the FDIC unless stock can be sold to the public for a portion of this. Another option is to combine a loan purchase with a capital infusion of, say, $1 billion. Following is a proposed assistance package built around this approach.

-- Bank writes off approximately $ 1 billion in loans and these along with, say, $2 billion of other, largely nonperforming, loans are transferred (sold) to a new bank or corporation. Bank also gives a note for $1 billion maturing in about two years to new bank. Federal Reserve lends $3 billion to new bank which buys loans and note from bank.

-- Bank may transfer additional loans in next two years up to about $1.1 billion and receive 90 cents on the dollar paid through a reduction in note principal. (Bank prereserves $100 million against this additional put.) The use of the note to the Federal Reserve could be eliminated by the Fed's providing a smaller amount of cash initially ($2 billion in this example) and agrees to lend up to $1 billion of additional funds over the next two years.

-- Bank's capital account is reduced to $700 million, unallocated reserves remain at $400 million. (It may be appropriate to precharge expenses related to severance pay in a special reserve account and pre-charge capital account.

-- FDIC guarantees repayment of Fed note plus interest (variable Treasury bill rate). Principal paid down as received with full principal paid to Fed after five years. To the extent FDIC guarantee is used existing stock is transferred to the FDIC (mechanism described elsewhere). If FDIC guarantees exceed current bank equity, then all (or practically all) old shares transferred to FDIC.

-- FDIC acquires preferred stock or permanent capital notes in bank of about $1 billion. This amount could be reduced by amount of any new stock sold to public. FDIC "capital" has warrants, provision for dividends in warrants or additional shares, or some other means to substitute for early year cash payments.

-- Bank sells most European and Asian branches over next nine months, reducing assets and liabilities by about $5 - $6 billion and reducing staff in the process. Holding company sells leasing operation and selected other activities and property.

Bank Balance Sheet Following Transaction

Total Assets	Remaining capital	.7
$30 billion	FDIC capital	1.0
	Unallocated reserves	.4
	Allocated reserves	.1
Capital and unallocated reserves/Assets		7 percent

Repositioned Bank

Total Assets		
$ 25 billion	Capital and reserve ratio	Approx. 8.4%
	Nonperforming loans/ capital and reserves	Approx. 25%
Repositioned Income Statement	Net interest income	$600 mill.
	Noninterest income	150
		750 mill.
	Noninterest expense	-480
	Loan loss prov	-50
	Taxes	--
	Net income	220
	As % of Assets	0.88%

This presupposes very substantial reduction in noninterest expenses from present levels as a percent of assets they would be slightly above present level. Nevertheless, this figure is $60 million higher than bank's etimate originally based on a slightly smaller bank.

Downside risks:

-- interest rates. bank has some exposure to rising rates with its heavy reliance on short funding. Lower rate environment would help bank's repositioning. It would probably facilitate getting rid of remaining $600 million in municipals with limited marketability. Greatest rate exposure probably comes from nonperforming loan portfolio -- which is largely removed in this scenario.

-- loan deterioration. bank has considerable protection because of the loan put (it might be possible to raise the put by allowing, say, another $500 million to be put at 80 cents on the dollar).

-- Latin America. bank bas about $2 billion in sovereign risk loans.

-- Noninterest income and expenses. It is important that bank prevent very substantial erosion of noninterest income (trust income, trading income, fees, etc.) and that bank act aggressively on expenses. Otherwise tbe bank would have to find some way to increase interest margin.

-- Funding. some people at the bank are skeptical of the bank's ability to fund deposits and borrowing of about $23 billion. Good ratios and earnings will help.

<u>No Asset Purchase Option</u>

Bank writes off approximately $1 billion in loans leaving capital of $800 million and loan loss reserve of $400 million. FDIC invests $1.5 billion in bank's capital with conditions similar to previous example. A significant amount of capital should be convertible into common at a price approximating pre-transaction market for Continental or price new stock is sold to the public.

<u>Post Transaction Balance Sheet</u>

Total Assets	Capital	
Approx. $32.5 billion	Original	$ .7
	FDIC	1.5
	Reserves	.4
	Capital and Reserves	2.6
	Ratio = 8 percent	

<u>After Asset Reduction</u>

Assets: approx 27.5	Capital ratio:	approx 9.6%
	Nonperforming/Capital:	approx .80

Exact comparisons are difficult since they depend on loans going nonperforming, servicing expenses, etc. Our best estimate is that of the $3 billion more in loans, about $2 billions are nonperforming. It has $500 million more in "free" funds. Assuming funding costs are not otherwise affected (not realistic) interest margin declines by $60 million. Noninterest expenses, considering collection effort, etc. may be up considerably. Also, loan losses are apt to be considerably higher. Thus earnings of the bank, at least in the short run, will be considerably less than in the previous example. On the other side, the bank has its charged-off and nonperforming loans and would benefit from recoveries. Also, the FDIC is not exposed to loss in the loan collection process and, overall, this is a much simplier transaction.

Compared With Previous Example

Net interest income	- 60
Non interest expense	+ 20
Net income	- 80 = 140

This is before taking account of higher funding costs, higher charge-offs and higher recoveries.

The bank is much more vulnerable to loan deteriation and that could affect funding, regaining good business, etc. Market perception might be that this is still a very troubled bank. Some of this uncertainty could be eliminated by giving the bank a limited put for a few years. Perhaps this could be at less than book value and some special reserve allocation may be possible. Depending on how the terms of the put are designed (they could include provisions for the FDIC's taking warrants as preferred stock) this assistance transaction could be made to look a lot like our first example.

Closed Bank Option

The bank could be closed and merged into a newly chartered bank. Writing down the bank's capital account would remove the majority of loans presently nonperforming and other loans could be removed to provide a "reasonably clean" loan portfolio. The FDIC would then have to recapitalize the bank initially with about $1.5 billion, but this could be reduced if and when the bank's size is reduced to, say $25 billion or less. The new bank would lose any tax benefit from loan write-offs and this would make it more difficult to recapture our investment. Existing stockholders of the holding company would be wiped out unless the holding company assets are wortb more than we think they are. This is probably positive. Without closing the bank those holding preferred stock in the holding company would probably receive a windfall.

In several respects this is a simplier transaction than an open bank one. The main problem is, how is the new bank run? The FDIC selects new top management and they and the FDIC select a new Board. How would this institution be perceived in the market? Would business firms deal with it like any private institution? Somewhere down the road the FDIC will want to sell out its position to another bank or through a public sale of stock. Will that discourage businesses from entering into a relationshp with the bank?

Cost to the FDIC

Costs to the FDIC would come from the use of the guarantee on the Fed note -- that is a shortfall on collections. While it is true the FDIC gets stock in that situation, the collection shortfall could exceed the remaining book value of Continental stock. In addition, the value of this and other stock may not be high enough to allow us to recoup -- either because the bank doesn't perform that well or because the market continues to put a low valuation on stock.

<u>How can we limit our costs?</u>

To the extent we are the principal owner and capitalizer of the bank, the worse the condition of the bank the greater our loss. That presumably would have also been the case in a P and A or payout. It is important that we don't create a situation where new stockholders buy in too cheap -- that is, where we give up too much of the upside benefit. There is also the possibility that we incur big losses on the loan guarantee, the rest of the bank does well, but our stock position and the markets valuation of it doesn't allow us to fully recoup. For that reason we may want more protection in connection with tbe use of the guarantee - say, a Fed loan of $2.8 billion on $4 billion book value of loans or $3.25 billion on $4.5 in loans. That, of course would reduce the bank's capital and its earnings.

Another means of reducing the FDIC's cost would be for the Fed's funding to be at a preferred rate, say the discount rate.

Suppose the bank charges off all loss and doubtful loans (about $1.2 billion) and purchases about $900 million in new stock. The bank's capital and reserves are about $1.9 billion or about 6 percent of assets before foreign branches are sold. The FDIC agrees to purchase or cover loan losses from loans presently on the books at 75 cents on the dollar from the next several years. This assures that the impact of future loan losses won't be excessive and encourage the bank to remove nonperforming loans from the books.

Nevertheless, compared with our first example, the bank continues to carry a large volume of nonperforming loans with their drag on interest margins. If these loans are aggressively charged-off, he FDIC ends up with a significant amount of nonperforming loans, but less than in the first example. The bank's earnings and capital are significantly less.

Suppose the FDIC covers a higher percentage of losses (say 90 percent), and takes shares of convertible preferred in connection with providing assistance, the bank is now encouraged to sell most nonperforming loans to the FDIC. Purchased loans now approach the amount in our first example. Earnings are slightly lower because of lags in the use of the put. The bank's stock is diluted though there is no mechanism for substantially wiping out original stockholders. Moreover, there is considerable delay before the bank's balance sheet looks good. Finally, it may be difficult to get Federal Reserve funding into the picture.

Approx July 12

BASS PROPOSAL TO FDIC FOR CONTINENTAL

The Bass interests ("BASS") are prepared in principal to underwrite an equity infusion of $800 million for Continental Illinois Corporation ("the bank").

Our commitment is conditional on satisfactory undertakings and arrangements with various parties including the FDIC, the Federal Reserve, the bank's directors, key senior managers and the existing shareholders. These conditions are outlined in this memorandum, and are designed to create a "level playing field" for the new management and equity capital.

Our commitment is also subject to final documentation and appropriate "due diligence" to validate key assumptions as to the bank's condition, and future prospects.

STRATEGIC CONSIDERATIONS

The proposal consists of a "private sector alternative" for the continued existence of Continental Illinois as a major money center bank. It envisions an "open bank scenario" under the assumption that the standing of the Bank in its markets may be irreparably damaged if it is forced to close, however briefly.

Our proposal assumes the Bank will undergo a period of retrenchment and reorganization, emerging to sound overall profitability within a two to three year period. We intend to emphasize the domestic US corporate market sector. At the same time, we intend to maintain an ongoing and positive commitment to international markets, as a continuing source of business and of funding.

We expect to recommend changes in the top management structure including the board. These will be subject to FDIC and Federal Reserve concurrence. Should we reach agreement to proceed, an immediate priority will be to correct the policy, system, and control failures which were responsible for the domestic loan losses leading to the Bank's present difficulties.

Our plan seeks a "level playing field" upon which $800 million of new private capital can be attracted. For this reason, federal support will be required to help underwrite future risks already existing by virtue of prior operating decisions. The existing shareholders will need to recognize permanent diminution in the value of their holdings. As new shareholders we shall assume responsibility for future actions of the bank.

Assets

1. The bank will sell to the FDIC $6.0B of loans on a staged basis for $5.0B of cash. The resulting loan losses will be charged to the bank's capital.

2. The Bank will segregate an additional $6.0B of loans which management deems to have credit risk. The FDIC will reimburse the bank for losses of principal and interest on these loans in excess of .3% per annum. The FDIC will have the option to purchase any and all of these loans at par at any time.

Capitalization

1. The FDIC will lend $1.0B of subordinated debt at the federal reserve discount rate for a period of five years.

2. The FDIC will invest $1.0B of perpetual convertible preferred stock convertible into 30% of the bank's common stock. Annual non cumulative dividends will be paid as follows:

6% for years 1-3
8% for years 3-5
10% for years 6-8
12% for years 9-10
15% thereafter

3. Book equity of the bank will be reduced to approximately $600 million through a combination of losses from the above mentioned sales of loans and special reserves for litigation and overhead reductions (discussed later). Existing shareholders will be diluted to approximately 15% of the Class A voting shares. Existing shareholders may receive additional ownership of the recapitalized bank depending upon the ultimate success of a public offering of shares discussed below.

4. The Bass interests will underwrite the sale of $800 million of common equity for the bank. Bass intends to hold approximately $200 million of this equity for its own account. Such holdings will be held 50% in Class A voting stock comprising approximately 10% of the voting securities of the bank and approximately 50% in special non voting Class B shares which are subject to transfer restrictions for five years. This Class B stock comprises approximately 20% of the aggregate common stock of the bank. In addition, key management and employees will be offered approximately $20 million of new voting and non voting shares.

<u>Funding</u>

1. The Federal Reserve will assure funding availability for the balance of the bank's requirements. Such assured

availability will extend for a period of 5 years, at competitive rates and maturities, and in a form and substance to be mutually agreed. This funding will replace the present interim arrangements.

2. It is anticipated that the bank will be virtually self funding within a year and agreed penalties for failure to attain and maintain such self sufficiency would be appropriate.

Contingency Reserves

1. The bank will establish a $100 million reserve for litigation costs and settlements (net of insurance proceeds) for actions arising from prior events and from the implementation of this revised structure. The bank will fund the first $20 million per year of such costs and 10% of any additional costs for a period of five years, subject to a maximum total annual amount of $30 million. Costs in excess of these amounts may be credited against the subordinated notes payable to the FDIC.

2. The bank will also establish a special $150 million "meltdown" reserve to account for the anticipated costs associated with shrinking the bank's overhead to accomodate a reduced earning asset base.

Board and Top Management

A reconstituted board of directors will be named to head the bank, and two outside experienced senior executives will be recruited subject to FDIC and Federal Reserve approval.

Timing

Our proposal is contingent upon proceeding toward definitive documentation and closing of this transaction in a timely fashion.

I.

Open versus Closed Bank

Financial

Taxes PV = $250-325 million   Pfd stock = $87 million

PV of financial obligation = 60 - 65

Net liability in H.C.

Balance Sheet: Open bank permits retention of equity & reserves.

Less new capital needed.

Law Suits: FDIC (bank) exposure on stockholder suits may be reduced.

Other

- Closed bank is simpler; no stockholder approval.
- Mkt perception: Closing draws attention to wholly govt.-owned and organized bank.
- Impact on other money center banks.

Open Bank

- Continental charges off approximately $1 billion in loans and sells these along with $1.5 billion other loans (principally nonperforming) to New Bank for $1.5 billion cash. Funds lent by FR Bank of Chicago. New Bank agrees to purchase $2 billion additional loans for cash during next two years, funds to be advanced by FR - Chicago.

- FR loan to be paid off in five years. Interest at extended discount rate, principal repayment from collections after expenses and interest, with final payment after five years (could be extended). FDIC to guarantee payment of interest and principal.

- To the extent that FDIC has to use guarantee, it obtains warrants to acquire current CIC stock. For each $20 payment, one share (warrant is transferred). Preliminary calculations of FDIC exposure to be made after three years with final settlement after five years.

- To the extent loan collections and remaining value exceed payments to Federal Reserve, residual value transferred to interest of stockholders.

- FDIC purchases $500 million preferred stock in CIC convertible into 80 million shares of common ($6.25 per share). FDIC (and possibly large commercial banks) acquire additional preferred stock and/or subordinated notes for $500-$700 million).

- CIC stockholders given rights to acquire 20 million shares of CIC stock at $6.25 per share, proceeds to pay down FDIC ARP or notes.

- Rights or warrants for additional shares of CIC common reserved for senior management compensation.

Issues

1. How much dilution of existing shareholders -- assuming they get to keep their shares? Should any portion of their shares be retained by them regardless of collections by New Bank?

2. Extent of loan purchase ($4.5 or $5 billion?). Should write-down exceed $1 billion? If it does FDIC gets more protection on loss on loan collections. However, bank's remaining capital is reduced. If bank equity is reduced to $600 million, number is consistent with 1/3 stock ownership.

3. How much capital should FDIC put in? It should be noted that bank will have loan loss reserve of $400 million and assets are expected to be about $27 billion at year-end and $25 billion or less after it is repositioned.

Loan Loss Reserves	.4
Original Equity	.6 - .8
New Capital	1.0 - 1.2
total	2.0 - 2.4

As percent of Assets	Sep 30	6.6 - 7.9
	Dec 31	7.4 - 8.8
	Repositioned	8.0 - 9.6

Retained earnings and gain on asset sales would increase equity.

Closed Bank

Bank is closed. Placed in receivership.

FDIC assumes Federal Reserve loan to bank (say, $4 billion). FR releases collateral. FDIC agrees to repay FR loan over five years.

FDIC purchases nonperforming loans and other classified equal to FR loan, book capital and reserves.

New H.C. created. New national bank (HC subsidiary created) acquires remaining assets and liabilities. FDIC's $1.5 billion note converted to H.C. preferred (or other securities) and placed in bank as common. Bank subordinated loan to Continental may remain in bank, possibly converted to term.

Balance Sheet

A	L	
28	FDIC stock	1.5
	Bank sub. notes	.5
	Other	26
		28

Pro Forma Earnings - Closed Bank Option

- Assets transferred to new bank can be similar to those in restructured bank.
- Initial capital will probably be less, resulting in lower interest income.
- Some H.C. expenses (net interest expenses) will not be incurred. And it may be easier to terminate employees.
- Tax benefits will be lost. Bank presently has about $33 million per year in tax-exempt income, assuming municipals are transferred.

Repositioned Income (Assets $25 billion)

Net interest income	145
Other Income	30
	175
Non-interest expense	120
Prov for loan loss	15
Net Income before taxes	40
Taxes	15
Income after tax	25

Assistance Transaction

- Bank transfers $3 billion pre-May 84 BV loans to FDIC for $2 billion.
- FDIC assumes $3.5 billion of bank's loan to FR. Payment is $2 billion from loan transfer and $1.5 billion note from bank to FDIC.
- Bank may place $1.5 billion in additional loans to FDIC during next 3 years. Payment is through reduction in FDIC note.
- FDIC purchases $1 billion in convertible and AR preferred from bank.
- Bank repays $2 billion subordinated note to FDIC.

Balance Sheet Changes

A		L	
Loans	-3,000	Due to FDIC (net)	-500
		Due to FR (Net) (balancing acct.)	-2,500
		Capital (net)	0

Subsequent Changes

Loans	-1,500	Due to FDIC	-1,500

CONTINENTAL ILLINOIS CORPORATION
PRO-FORMA BALANCE SHEET
($ Shown in Billions)

	6/22/84	9/30/84	12/31/84	1st Repos. Qtr.
Cash & Short Term Investments	$ 4.8	$ 4.6	$ 4.5	$ 5.5
Current Loans	27.2	25.3	22.3	17.6
Non-Performing Loans	3.1	0.5	0.5	0.5
* TOTAL LOANS	30.3	25.8	22.8	18.1
Less: Loan Loss Reserve	0.4	0.4	0.4	0.4
* NET LOANS	29.9	25.4	22.4	17.7
Other Assets	1.8	1.8	1.8	1.8
** TOTAL ASSETS	36.5	31.8	28.7	25.0
Deposits and Borrowings	30.1	26.0	22.9	20.1
FDIC and Bank Notes	2.0	1.5	1.5	1.0
Other Liabilities	1.5	1.4	1.4	1.0
Long-Term Debt	1.1	1.1	1.1	1.0
* TOTAL LIABILITIES	34.7	28.3	25.2	22.9
Stockholders Equity	1.8	0.8	0.8	0.9
FDIC Equity	0.0	1.0	1.0	1.0
* TOTAL EQUITY	1.8	1.8	1.8	1.9
** TOTAL LIABILITIES AND EQUITY	36.5	31.8	28.7	25.0
Equity & Reserves/Total Assets	6.0%	6.9%	7.7%	9.2%

CONTINENTAL ILLINOIS CORPORATION

PRO-FORMA INCOME STATEMENT

($ Shown in Millions)

	1st Qtr. Actual	2nd Qtr. 1984	3rd Qtr. 1984	4th Qtr. 1984	1st Repos. Qtr.
Net Interest Income (NII)	$149	$165	$130	$162	$140
Provision for Loan Losses	140	--	10	8	8
NII After Provision	9	165	120	157	132
Noninterest Revenue	78	40	35	35	35
Noninterest Expense:					
People Expense	102	111	96	90	69
Sale of Bad Assets	--	1,000	--	--	--
Other Expense	116	90	80	75	56
Pretax Operating Income	(131)	(996)	(21)	27	42
Nonrecurring Income	181	15	*	*	*
Income Tax	21	(30)	--	--	--
Net Income	29	(951)	(21)	27	42
ROA	0.27%	--	--	0.36	0.67

*Potential Sales of Real Estate and Other Assets Could Generate Around $100 Million of Additional Income During These Periods.

Transitional Earnings

The bank's earnings are very sensitive to changes in interest margins and expense ratios. With a low percentage of nonperforming loans and a high capital ratio we might expect an interest margin of 2.5--2.6 percent. However, funding pressures and, possibly, the need to pay premium rates, could reduce margins considerably during a transitional period.

The bank's noninterest expense ratio was about 1.75 percent in the past. Asset shrinkage will drive that ratio up considerably, especially in the next few quarters before expense reduction programs are implemented.

The table below assumes an average asset size of $27.5 billion during the first half of 1985, noninterest income of $35 million per quarter and a loan loss provision of $8 million per quarter. Figures in the table are quarterly earnings ($ millions) using different sets of assumptions on interest margins and expense ratios.

	Net Interest Margin				
Noninterest Expense ÷ Assets	2.6	2.4	2.2	2.0	1.8
1.9	58	46	33	21	8
2.0	52	40	26	14	1
2.1	44	32	19	7	-6
2.3	30	18	5	-7	-20
2.5	16	4	-9	-23	-34

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Balance Sheet Changes

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Equity & Reserves/Total Assets	6.0%	6.9%	7.7%	9.2%

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- Continental charges off approximately $1 billion in loans and sells these along with $1.5 billion other loans (principally nonperforming) to New Bank for $1.5 billion cash. Funds lent by FR Bank of Chicago. New Bank agrees to purchase $2 billion additional loans for cash during next two years, funds to be advanced by FR - Chicago.

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- FDIC purchases $500 million preferred stock in CIC convertible into 80 million shares of common ($6.25 per share). FDIC (and possibly large commercial banks) acquire additional preferred stock and/or subordinated notes for $500-$700 million).

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Issues

1. How much dilution of existing shareholders -- assuming they get to keep their shares? Should any portion of their shares be retained by them regardless of collections by New Bank?

2. Extent of loan purchase ($4.5 or $5 billion?). Should write-down exceed $1 billion? If it does FDIC gets more protection on loss on loan collections. However, bank's remaining capital is reduced. If bank equity is reduced to $600 million, number is consistent with 1/3 stock ownership.

3. How much capital should FDIC put in? It should be noted that bank will have loan loss reserve cf $400 million and assets are expected to be about $27 billion at year-end and $25 billion or less after it is repositioned.

Loan Loss Reserves	.4
Original Equity	.6 - .8
New Capital	1.0 - 1.2
total	2.0 - 2.4

As percent of Assets	Sep 30	6.6 - 7.9
	Dec 31	7.4 - 8.8
	Repositioned	8.0 - 9.6

Retained earnings and gain on asset sales would increase equity.

The most straightforward approach to deal with repayment of principal and interest on the Fed loan would be 1).

1) Collections are applied each quarter to collection expenses, interest and principal reduction in that sequence (interest might come before collection expenses). Any shortfall in collections that do not permit payment of interest would be added to principal for the next interest period.

2) A variation on this would be for the FDIC to pay for collection expenses and interest should collections be insufficient in any quarter. If the FDIC were paid back principal and interest (at the same rate as the Fed) before there were principal reductions on the Fed loan, the result would closely approximate 1). However, the Fed would be assured of regular interest payments and the principal balance on the Fed loan would never rise in any quarter.

3) The FDIC has proposed a variation on 2) where a reserve fund of $75 million would be accumulated before principal reduction. This would help absorb variations in cash collections so that the amount of FDIC funding would be minimal. It is contemplated that where the reserve fund has been used up and an FDIC advance is necessary, principal and interest payments back to the FDIC and reserve replenishment would precede principal reduction on the Fed loan. The reserve would not be a source of profit. Interest earned on the reserve would be credited to collections and would be at a rate comparable to the Fed loan.

4) The Fed has suggested that 3) be used, but that the FDIC not get interest back for its advance of funds prior to principal reduction. That would require a running account (assuming the $75 million reserve were not always sufficient) where unpaid interest owed the FDIC would be accumulated (and additional interest calculated on it) and this accumulation would be added to any collection shortfall at the end of five years.

It is difficult to estimate the likely amount involved. Even if there ultimately is a substantial shortfall in collections, average quarterly collections should be well above interest and collection expenses. However, there may be considerable variability in collections so that FDIC advances will occasionally be necessary. The $75 million figure would probably cover one quarterly payment for the first year: Assuming $1.5 billion loan interest offsets, even if rate goes up to 13%, 1/4 x .13 ($2 billion) = $65 million + expenses of $10 million = $75 million.

When additional loans are put, net Fed loan balance probably would go over $3 billion. This could bring quarterly interest and expense payments to $100 million. Quarterly interest on a $100 million advance would run about $3 million. If collections are extremely poor, the amount of interest on FDIC advances could accumulate to $100 million by the end of five years. Our guess is that the amount is likely to be less than half of that.

Of the options cited above, the FDIC preference is for any of the first three. 2) and 3) have the advantage from the Fed's standpoint that the principal balance on the line will never increase.

July 25, 1984

50 Years of Confidence 1933 – 1983

MEMORANDUM TO: The Board of Directors

FROM: Wm. Roger Watson
Associate Director
Div. of Research and Strategic Planning

SUBJECT: Proposed assistance transaction involving Continental Illinois Corporation (CIC) and Continental Illinois National Bank and Trust Company (CINB)

The purpose of this memorandum is to outline the reasons why FDIC staff has recommended that capital assistance to CINB be channeled through the parent holding company (CIC) rather than made directly to the bank. In formulating this recommendation, FDIC staff consulted, on a continuing basis, with representatives of Morgan, Stanley and Company. They believe that this recommendation most likely represents the least cost means of preserving stability within the U.S. banking system and discharging the FDIC's current responsibilities to the general creditors (including depositors) of CINB.

One of the major considerations in structuring this transaction is to create a bank that is capable of funding itself from private sources at rates comparable to those paid by similar institutions. CINB has relied almost exclusively on purchased funds from both domestic and foreign sources. The providers of these funds are sensitive to reported financial results and to perceptions as to the longer-term viability of the institutions in which they place funds. The FDIC's "guarantee" of May 17 removed almost all risk, yet CINB has been forced to steadily increase borrowings from the Federal Reserve Bank of Chicago to replace term CDs as they mature, even though the bank has offered above-market rates for purchased funds. It thus is felt that, for the bank to remain viable, a strong balance sheet is of the utmost importance.

Additionally, it is felt that a bank that is perceived to be controlled by the U.S. Government would not be well received by the market and would have trouble retaining competent employees. Thus, a second major concern is that some degree of private ownership be retained.

It always has been the policy of the FDIC that assistance to an open bank should result in minimal or no benefit to owners of the institution. As in the First Pennsylvania transaction, an effective way to accomplish this is for the FDIC to significantly dilute the present ownership interests by taking warrants or convertible preferred stock in exchange for any assistance that is provided. The value of the original ownership interests is immediately reduced because of the potential dilution effects, and sale of the quasi-equity securities may result in a gain that could offset losses incurred by the FDIC.

The CINB assistance package is structured along these same lines. The major variation arises because of the indentures of the holding company debt; any dilution of CIC's ownership of CINB (whether through sale of common or preferred stock or warrants) triggers an acceleration clause in a significant portion of CIC debt. If this should happen, the holding company is likely to be forced into bankruptcy. This could further complicate the funding problems already existing for CINB.

One alternative would be to close the bank and merge it into a newly chartered bank (a purchase and assumption transaction) capitalized by the FDIC. Although this would remove any necessity to deal with the holding company, there are at least three distinct disadvantages relative to an open bank transaction. First, the bank would be 100 percent FDIC owned, and this would remove any perception of private participation. Second, the FDIC probably would have to make a large initial capital infusion which would commit more of FDIC's resources to a single institution; this could result in diminished public confidence in the ability of the deposit insurance fund to handle additional bank failures. Finally, cutting a major bank holding company loose from its major asset could precipitate problems for other large bank holding companies in terms of retaining funding sources; this is a major concern of both the Federal Reserve Board and Morgan, Stanley staff.

Another alternative is to buy subordinated debt in the bank that is convertible into equity at the holding company level. While this would have the same economic effect as the proposed transaction, the practical consequence would be to reduce the equity capital ratio and, for a given return to the FDIC, the net income (before dividends) reported at both the bank and holding company levels. These are key figures to the bank analysts and have an effect on the reports and debt ratings of banks and bank holding companies. Moreover, it is difficult to convince potential purchasers of CDs, especially foreign purchasers, that subordinated debt is a perfect substitute for equity capital.

Another variation on this theme would be for the FDIC to make a capital contribution to the bank in return for preferred stock in the holding company. The major problem with this alternative is that the markets may be uncertain with respect to the tax treatment of the FDIC capital contribution (FDIC assistance is not exempt from Federal income tax unless value is received) and the appropriate accounting treatment of the contribution (it could be construed as a debt of the bank to the holding company). The end result, however, is identical to the proposed transaction.

Each one of these variations has the same economic effect as a direct purchase of convertible securities in the holding company and downstreaming these funds to the bank in the form of equity. However, from an accounting standpoint, each has the effect of making the financial results (either of the bank or the holding company on a fully consolidated basis) less attractive or of introducing uncertainty into the transaction. Both of these effects will make the future viability of the bank less certain and, ultimately, may require further outlays and losses by the FDIC. Moreover, any transaction that preserves the bank on an open basis will insure the future viability of the holding company, regardless of whether the assistance initially goes to the bank or the holding company.

It is the opinion of both Morgan, Stanley and FDIC staff that the proposed transaction has the highest probability of minimizing FDIC's costs than the alternative transactions outlined above.

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SYSTEMIC RISK ("TOO BIG TO FAIL")

Summary

Large-bank insolvencies carry the potential for systemic banking crises and have therefore traditionally been resolved with methods that protect deposits in full. This special treatment has raised questions periodically regarding the fairness of resolution policy as well as the adequacy of depositor discipline for controlling bank risks. For most of the period prior to the passage of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), the flexibility available to regulators to select resolution methods served to moderate any inequities in the treatment of small versus large institutions, but this same flexibility was criticized as undermining depositor discipline. FDICIA removes much of this flexibility by requiring "least-cost" procedures that will often entail losses for uninsured depositors. It also specifies a new institutional arrangement of shared responsibility for determining whether large-bank insolvencies warrant special treatment.

This briefing document discusses failure-resolution methods used by the FDIC. The handling of large-bank failures, both pre- and post-FDICIA, is highlighted. Policy issues raised by these methods also are discussed.

Background

The insolvency of a large bank has the potential to provoke a system-wide banking crisis. Many small banks may be exposed to losses when a large bank fails, due to interbank deposits or other outstanding loans to the failed bank. Small banks often maintain such balances as a result of correspondent relationships or other business arrangements with large banks. In addition, a large-bank failure may inflict losses on other banks by disrupting payments systems, including electronic funds transfers as well as check- clearing systems. And because large banks typically carry substantial amounts of uninsured deposits or other uninsured debt, losses incurred at one bank may trigger fears among the uninsured creditors of other large banks, thereby precipitating a widespread liquidity crisis.

More generally, large banks often are highly complex organizations with multinational operations and holding company relationships involving numerous financial businesses. While the consequences of a large-bank default on its obligations are almost certain to be far-reaching, the precise locations and the probable magnitudes of the effects are often uncertain. At the moment of decision for banking authorities, these realities weigh heavily against any course of action that includes the possibility of a disorderly liquidation.

Because of systemic risks, large-bank insolvencies often receive special treatment. In most developed countries, the government steps in during times of crisis to honor the obligations of its nation's major banks, even in the absence of an explicit deposit insurance program. In the United States, prior to passage of FDICIA, the federal deposit insurance system was the vehicle through which large-bank defaults were averted: insolvencies of major banking institutions typically were resolved using methods that protected all deposits against loss.

Failure Resolution Pre-FDICIA

Before FDICIA, the statutory "cost test" governing failed-bank dispositions did not require the FDIC to choose the least-cost method of resolution. Rather, it required the FDIC to use the estimated cost of a "payoff and liquidation" as the standard of comparison for alternative resolution methods. A payoff of insured deposits, followed by a liquidation of the failed bank's assets, generally results in losses to uninsured depositors and to other uninsured creditors of the failed bank.

Under the cost test, an alternative resolution method (such as a whole-bank acquisition or an open-bank assistance transaction) could be selected if either: The alternative method was expected to be less costly than a payoff and liquidation; or the bank's services were determined to be "essential" to the community. Cost considerations could be disregarded in the latter case, and the FDIC's Board of Directors could establish criteria for essentiality at their discretion. The reference to the bank's "community" was sufficiently broad to cover cases involving systemic risk as well as cases involving only localized disruptions.

The cost test gave the FDIC considerable flexibility to deal with bank failures. For most of the period prior to FDICIA, the FDIC used this flexibility to moderate any unfairness in the treatment of small versus large institutions. Given resolution procedures that serve to protect uninsured depositors of major banks from loss, small banks may be placed at a competitive disadvantage if their uninsured deposits are less likely to receive full protection. Partly in recognition of this fact and partly because full protection for deposits minimizes any local economic disruptions, the FDIC generally selected methods that protected all small-bank deposits whenever permitted by the cost test.

While the protection of all deposits ensures financial stability in the short run and equalizes the treatment of differently sized institutions, it also weakens a potential source of disipline on bank risk-taking. Uninsured depositors need not care about the safety and soundness of their bank if they can be reasonably sure of receiving full protection in the event of a bank failure. In the early 1980s, the FDIC became concerned about a lack of depositor discipline in the banking system and therefore decided to place uninsured depositors at risk in bank failures.

The vehicle chosen to accomplish this was the "modified payoff," whereby the FDIC paid off insured deposits immediately following a bank failure and, at the same time, made a cash advance on uninsured balances based on the estimated present value of future recoveries. Thus, creditors with uninsured balances shared in the losses generated by the bank failure, but disruption was minimized due to the immediate cash advance. The largest institution to be resolved with a modified payoff was Penn Square Bank of Oklahoma City, in 1982, with assets of nearly $500 million.

The modified payoff experiment was a success in the sense that losses were imposed on uninsured deposits without causing any depositor panics or other major disruptions. However, the details of this new approach were still being worked out when, in 1984, it became apparent that Continental Illinois National Bank and Trust Company of Chicago would not survive. Continental was a $44 billion institution with only $3 billion in insured deposits. The stock prices of other money-center banks had previously tumbled in the wake of bad news about Continental, foreign deposits were leaving the bank at an accelerating pace via wire transfers, and U.S. banking authorities were understandably concerned about systemic risk. Continental was resolved with an open-bank transaction, all deposits were protected in full, and the FDIC abandoned its commitment to the modified-payoff approach.

The Continental case highlighted the fairness issue in failure-resolution policy, and many small banks subsequently called for explicit, 100 percent protection of all deposits in the banking system. Throughout the remainder of the 1980s, the FDIC protected small-bank deposits whenever this was permitted by the cost test, but there was nonetheless a perceptible disparity in the frequency of payoffs for small- versus large-bank failures. Because of this disparity, the common perception was that the FDIC considered large banks as "too big to fail."

"Too big to fail" was in fact a misnomer as an explanation for the FDIC's choice of resolution methods: The FDIC did not consider "failure" per se as a relevant issue, did not favor open-bank over closed-bank transactions for any reason other than cost, and did not seek to protect bank owners or managers from the consequences of their firm's insolvency, regardless of the firm's size. The direct and indirect effects of imposing losses on uninsured deposits were the major concerns; thus, the FDIC did consider whether local circumstances or systemic risk warranted failure-resolution methods that could not be justified by the usual cost calculations. These concerns contributed to the observed disparity in the frequency of payoffs.

Another, often-overlooked factor contributing to this disparity was the difference in marketability of small versus large institutions. Experience has shown that large banks are more likely to be attractive to acquirers than small banks, thus making it more likely that a franchise sale (as opposed to a payoff) will be cost-effective for the FDIC. There are at least three reasons for this. First, large institutions tend to have larger relative franchise values, probably reflecting their greater flexibility to seek and secure new market niches as opportunities arise. Second, many small banks are located in states that restrict geographic expansion, thus limiting the number of qualified bidders for a failed-bank franchise. Finally, extensive disclosure requirements applicable to publicly traded companies often alert regulators to large-bank problems at a fairly early stage. This tends to reduce costs overall and to make large-bank acquisitions more attractive.

Thus, had the FDIC protected uninsured deposits only when cost-effective, the fraction of small-bank failures resolved with payoffs would have nonetheless exceeded the comparable fraction for large-bank failures. However, the role of these cost differences does not diminish the real concern created by a de facto guarantee for large-bank deposits. As noted, such a guarantee may weaken depositor discipline as a check against excessive risk-taking by large banks. While the protection of uninsured deposits may ensure stability in the short run, it may produce more risk-taking, more large-bank failures, and more financial instability in the long run.

The FDIC was consistently mindful of this unpleasant trade-off throughout the latter half of the 1980s. But the terms of the trade-off are not quantifiable, and striking the proper balance is largely a matter of judgment. Little is certain except that depositor discipline is obtained at a cost of greater systemic risk in the short run. The FDIC's choices -- particularly those involving the large Texas banks -- probably reflected the primacy of stability as a policy objective of the deposit insurer. In this regard, it is relevant to consider that large banks are subject to discipline from a variety of sources other than depositors (shareholders, subordinated debt holders, holding-company creditors, bank supervisors, etc.). It is not obvious that depositor discipline must be maximized in order to maintain effective control over bank risk-taking, and thus it can be argued that the safest course is to place primary emphasis on systemic stability when a sizable failure is at hand.

These considerations notwithstanding, the experience of the late 1980s convinced many observers that stronger market discipline was needed. Given the unprecedented rates of bank failure, record losses for the deposit insurance funds, and ample evidence of increased risk-taking by banks, lawmakers sought to reverse these adverse trends with the reforms contained in FDICIA. Several reforms in this legislation pertain specifically to failure-resolution policy.

Failure Resolution Under FDICIA

FDICIA makes it more difficult to resolve bank failures in ways that protect uninsured deposits. The FDIC must choose the least-cost resolution method, and this often requires that uninsured depositors share losses with the FDIC. Even if a bank is sold intact as a going concern rather than liquidated piecemeal after closure, it is often possible to lower costs by excluding uninsured deposits from the transaction. There are cases in which an acquirer is willing to pay a premium for uninsured deposits that is sufficient to meet the least-cost test, but such cases are few. The intent of FDICIA's least-cost requirement is clarified by a provision that explicitly prohibits the FDIC, after December 31, 1994, from protecting any uninsured deposits or nondeposit bank debts in cases where such action would increase losses to the insurance fund.

One implication of FDICIA's least-cost requirement is that open-bank assistance may not be granted by the FDIC Board unless this option would be more cost-effective than a closed-bank resolution. Previously, the Board could approve requests for financial assistance at its discretion, provided the assistance was cheaper than a payoff and liquidation of the bank, or the bank was "essential" to the community. In accordance with FDICIA, the FDIC has adopted a revised policy statement outlining the new criteria to be used in considering requests for financial assistance. This policy statement stresses the importance of timing in requesting open-bank assistance, encouraging management to submit any proposals "well before grounds first exist for the institution's closure."

FDICIA allows an exception to the least-cost requirement in cases of systemic risk. For such an exception to be considered, the FDIC and the Federal Reserve Board must submit written recommendations to the Secretary of the Treasury. The Secretary will then determine, in consultation with the President, whether the exception should be granted. If a systemic-risk exception is granted, the FDIC must recover any losses to the insurance fund through special assessments collected from the members of the fund.

FDICIA thus creates a shared responsibility for managing systemic risk in cases of large-bank insolvencies. Presumably, these new institutional arrangements will provide stronger safeguards against any undue extensions of the federal safety net. A potential danger is that such arrangements may prove cumbersome when timely decisions are necessary for effective control of systemic risk. Moreover, in removing the flexibility to protect uninsured deposits at small banks, FDICIA will likely raise the fairness question anew if any large-bank deposits are fully protected in the future.

The experience to date under the least-cost test has been favorable. Losses imposed on uninsured depositors have not prompted any large-scale withdrawals elsewhere in the system, even in large-bank cases. This may indicate that depositors are not sensitive to the risk of small losses (these rarely exceed 15 percent for large-bank failures), or it may reflect unusual circumstances that are imperfectly understood. There is no guarantee that uninsured depositors will react similarly in the event of difficulties at a money-center bank or in times of greater economic stress. Moreover, there is yet to be a case under FDICIA in which many small, independent banks are imperiled by the demise of a larger bank.

In many respects, the industry's current circumstances may be compared to those of the early 1980s, prior to the difficulties encountered by Continental. As described earlier, the FDIC's "modified payoff" experiment produced no significant deposit flights and thus gave no indication that large-bank problems might provoke adverse reactions by uninsured depositors. Despite such reassuring evidence, Continental experienced huge outflows of uninsured foreign deposits when its plight became apparent (a "silent run," by electronic wire transfer) and, ultimately, the bank was unable to renew its large domestic certificates of deposit in May 1984. If today's uninsured depositors were to react similarly to unfavorable developments at a major U.S. bank, the Federal Reserve, the FDIC, and the Administration would be called upon to make difficult decisions with urgency.