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Four Financial Crises in the 1980s

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Preface

The increasing interconnectedness of financial institutions and markets has highlighted the need to ensure that diverse federal, state, international, and private financial organizations work together to effectively contain and resolve financial disruptions. The federal government's ability to manage financial crises effectively is important to the stability of the U.S. financial system and economy as well as the worldwide financial system. In seeking to expand its current knowledge of financial crisis management, GAO studied federal actions that successfully contained four major financial crises of the turbulent 1980s—the Mexican debt crisis of 1982; the near failure of the Continental Illinois National Bank in 1984; the run on state-chartered, privately insured savings and loan institutions in Ohio in 1985; and the stock market crash of 1987.

On the basis of a review of emergency response literature, GAO focused on three phases of financial crisis management. The preparedness phase included activities undertaken prior to the occurrence of a crisis. The containment phase included activities undertaken in immediate response to a financial crisis to mitigate the financial disruption and lessen ill effects on the financial system. The resolution phase included activities undertaken to reduce the likelihood of the recurrence of the crisis or similar financial crises.

GAO observed that leadership was critical for effective management and containment of each of the four financial crises. Treasury and the Federal Reserve led crisis containment efforts because of their financial resources, access, and expertise, although each agency had its own distinct and complementary leadership role. As part of the executive branch, Treasury was better positioned than the Federal Reserve to provide the political leadership considered desirable in containing a financial crisis. At the same time, the Federal Reserve had critical mechanisms and resources for providing temporary liquidity in a crisis—currency swaps, discount window lending, and open market operations. Treasury also provided temporary liquidity during the Mexican crisis through the Exchange Stabilization Fund.

GAO observed that successful crisis response in each case depended greatly on swift and sometimes innovative action, which appeared to help reduce in scope and intensity the effect the crisis had on the financial system. In addition, the more effective the communication of the federal response the more it appeared to help prevent a crisis from worsening, because it provided clear and credible information that played a part in calming financial markets.

Several officials told GAO that contingency planning, including interagency planning, helped facilitate federal preparedness and response to a crisis. They said that contingency planning helped federal financial regulators identify resources to contain the crisis as well as potentially vulnerable firms or markets. GAO encountered mixed views on the part of financial crisis managers concerning whether or not contingency planning should be documented. Some officials were reluctant to document their planning efforts due to fears of triggering a panic or because circumstances of a crisis are never identical to those in the plan.

GAO observed that coordination of crisis containment efforts among key participants was important because rarely did one agency have the necessary authority, jurisdiction, and resources to contain the crisis. The decentralized structure of financial regulation often presented challenges to effective coordination in a crisis. In addition to coordinating with each other, federal regulatory officials said that they often needed to coordinate with state governments, international organizations, foreign governments, and Congress. Crisis containment also required coordination with the private sector to determine whether the private sector could contain the crisis without federal assistance, and to identify resources available for crisis containment.

Reliable and timely information was important to federal efforts to provide early warning of potential crises and to help regulators decide whether and how to intervene. Federal financial agencies, including the financial institution and market regulators, each collected crisis-relevant information in their routine monitoring of financial activity. However, several officials told GAO that the federal government's ability to identify incipient financial crises or to monitor a crisis once it had occurred was sometimes limited by the dispersed nature of the government's crisis surveillance capability, along with limitations and gaps in the available information.

Financial crises are complex events often involving multiple markets and institutions. To fully explore all of the actions and viewpoints involved would require a much lengthier discussion than this study provides.

However, because the information about each of the four crises GAO reviewed has not been previously published in consolidated form, GAO is publishing its results as a staff study to permit appropriate archiving and retrieval of the information for future reference by GAO staff and others who may have interest.

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Contents

Chapter	Section	Page
Preface		1
Chapter 1 Introduction		6
	Financial System Environment Changed	6
	Linkages of Financial Markets Affected Nature of Crises	9
	Public Sector Often Has a Crisis Management Role	11
	Objectives, Scope, and Methodology	15
Chapter 2 The Mexico Debt Crisis of 1982		19
	Summary of Chronology	19
	Preparedness: Interagency Contingency Planning Helped Contain Crisis	20
	Containment: Swift and Collaborative Action Taken to Avoid Immediate Default	26
	Resolution: Executive and Legislative Initiatives	32
Chapter 3 The Continental Illinois Bank Crisis		35
	Summary of Chronology	35
	Preparedness: Surveillance and Planning Prepared Regulators	35
	Containment: Joint Discussions Led to Containment Strategy	39
	Resolution: FDIC Strengthened Oversight of Nationally Chartered Banks	44
Chapter 4 The Ohio Savings and Loan Crisis		47
	Summary of Chronology	47
	Preparedness: Limited Information and Authority Made Planning Difficult	50
	Containment: Ohio Governor and Federal Reserve Led Crisis Containment Efforts	51
	Resolution: Legislation Enacted to Address Government Securities Fraud and Improve Disclosure	59
Chapter 5 The Stock Market Crisis of 1987		60
	Summary of Chronology	60
	Preparedness: Routine Market Monitoring and Existing Networks Helped Prepare Regulators	61
	Containment: Leadership, Swift Action, and Collaborative Efforts Helped Contain Crisis	63
	Resolution: Crisis Studies Accompanied by Regulatory and Legislative Initiatives	67

Appendix | Appendix I: Major Contributors to This Report | 70

Bibliography | | 71

Table | Table 1.1: U.S. Federal Financial Organizations Involved in Responding to Four Financial Crises in the 1980s | 11

Figures
Figure 2.1: Selected Events in the Mexico Debt Crisis of 1982 22
Figure 2.2: Selected Events in the Mexico Debt Crisis of 1982 26
Figure 2.3: Selected Events in the Mexico Debt Crisis of 1982 31
Figure 3.1: Selected Events in the Continental Bank Crisis 37
Figure 3.2: Selected Events in the Continental Bank Crisis 44
Figure 4.1: Selected Events in Ohio Savings and Loan Crisis of 1985 48

Abbreviations

BIS	Bank for International Settlements
CBOE	Chicago Board Options Exchange
CFTC	Commodity Futures Trading Commission
CME	Chicago Mercantile Exchange
DJIA	Dow Jones Industrial Average
ESF	Exchange Stabilization Fund
FDIC	Federal Deposit Insurance Corporation
FDICIA	Federal Deposit Insurance Corporation Improvement Act
FHLBB	Federal Home Loan Bank Board
FHLBC	Federal Home Loan Bank of Cincinnati
FIRREA	Financial Institutions Reform, Recovery, and Enforcement Act
FRS	Federal Reserve System
FSLIC	Federal Savings and Loan Insurance Corporation
IMF	International Monetary Fund
NASD	National Association of Securities Dealers
NYSE	New York Stock Exchange
OCC	Office of the Comptroller of the Currency
SEC	Securities and Exchange Commission
SPR	Strategic Petroleum Reserve
SRO	self-regulatory organization

Introduction

The federal government has faced many challenges in responding to financial disruptions that threaten the stability of the U.S. financial system.[1] In the 1930s, the United States experienced one of its most devastating financial crises. Loss of public confidence in banks caused disruptions in the financial system and, along with other factors, ultimately led to the Great Depression. In the 1980s, the federal government was challenged by a series of financial disruptions of considerable magnitude.[2] Some disruptions became full-scale financial crises that cost taxpayers, firms, and individuals collectively billions of dollars. Others became crises that had the potential to cause widespread damage but were successfully contained. The possibility of other such financial crises can not be dismissed.

This report presents our review of four financial crises of the 1980s: the Mexican debt crisis of 1982, the near failure and rescue of the Continental Illinois National Bank in 1984, the Ohio savings and loan crisis of 1985, and the 1987 stock market crash. These crises, which varied in magnitude, were ultimately successfully contained and resolved through joint efforts of federal agencies and others. By documenting these crises and the efforts to contain them, this report seeks to expand current knowledge of financial crisis management.

Financial System Environment Changed

The financial crises of the 1980s were preceded by the abandonment of the Bretton Woods system of fixed currency exchange rates, oil price shocks, higher than normal annual rates of inflation, and record-setting interest rates. For almost two and a half decades after World War II, western countries maintained a system linking the prices of foreign currencies to U.S. dollars and to gold. This arrangement, which the United States carried out with its allies, was known as the Bretton Woods international monetary system. External imbalances, inflation, and other economic problems forced the abandonment of the Bretton Woods system, which ended in August 1971 when the United States ceased to make dollars convertible into gold. In March 1973, a system of generalized floating exchange rates was adopted for the major international currencies. This

[1]Our nation's financial system is the collection of markets, individuals, institutions, laws, regulations, and techniques through which bonds, stocks, and other financial instruments are traded, financial services produced and delivered, and interest rates determined. The financial system enables funds to be channeled from savers to borrowers, payments to be made for goods and services, and risks to be transferred from those less able or willing to manage them to those who are more able or willing to do so.

[2]Financial history offers many examples of financial crises. See Charles P. Kindleberger, Manias, Panics and Crashes: A History of Financial Crises (New York: Basic Books, 1989).

followed an 18-month period during which an attempt was made to maintain a regime of fixed exchange rates.

The 1970s and early 1980s were characterized by protracted inflation, record-setting interest rates, and higher than normal rates of market volatility. By early 1979 the annual rate of inflation in the United States reached double digits. The rise of oil prices in 1973 to 1974 and 1979 to 1980 helped generate an increase in the overall inflation rate. Commodity and real estate prices also soared in the 1970s. To combat inflation, the Federal Reserve launched a strong anti-inflationary monetary policy in the period 1979 to 1982, eventually raising nominal and real interest rates to unprecedented levels for the postwar period. The anti-inflation policy ultimately succeeded in controlling inflation; however, it produced a massive interest rate shock and was a prime factor in precipitating the collapse of the savings and loan industry.[3] In the early 1980s, the United States experienced its severest recession since the 1930s.

Crises Affected Many Sectors of Financial Services Industry

Throughout the 1970s, banks attempted to increase income by aggressive lending. Rising oil prices enriched oil exporting countries. These oil exporting countries were depositing their foreign exchange holdings with large North American, European, and Japanese banks with international experience. With insufficient demand for loans in the United States and encouragement from U.S. government officials, large U.S. banks began to lend to newly industrializing countries as an outlet for these funds. Banks made substantial investments in these countries and other specific sectors, some of which had prospered from high commodity prices during the inflationary period of the 1970s. The sectors included commercial real estate, energy, and farming.

One of the first shocks to banks in the early 1980s came when the Comptroller of the Currency closed Penn Square Bank of Oklahoma in July 1982, a bank with easy lending policies and a large portfolio of loans to oil firms.[4] It had deposits of $470 million. Many oil and gas explorers and producers were unable to repay their loans due to failure to find oil and gas and declining oil prices. OCC officials told us that Penn Square's failure was mainly due to management problems and criminal activity. The failure of Penn Square had rippling effects on the economy. Banks

[3]See National Commission on Financial Institution Reform, Recovery, and Enforcement, Origins and Causes of the S&L Debacle: A Blueprint for Reform (Washington, D.C.: July 1993).

[4]FDIC provided deposit insurance to Penn Square and served as receiver for its assets by settling claims against the bank by creditors—including the claims of insured depositors.

experiencing losses included Chase Manhattan, Continental Illinois National Bank, Michigan National Bank, Northern Trust Company, and Seattle First National Bank. Continental had purchased loans worth $1 billion from Penn Square. After Penn Square's closure, Continental Illinois experienced a run on its deposits and received assistance from the Federal Reserve and FDIC.

Another shock to the banking industry was the debt crisis of Mexico, a major U.S. trading partner, which spread to other newly industrializing nations. In August 1982, Mexico experienced a financial collapse and was forced to suspend debt repayments to U.S. and foreign banks. By the end of the 1970s and early 1980s, when oil that Mexico exported commanded high prices, Mexico had about $100 million in foreign debt. However, when the price of oil slid, so did Mexico's foreign exchange earnings. Higher dollar interest rates meant larger borrowing costs on Mexico's sizable external debt. Following the Mexican debt crisis in August 1982, other developing countries—including Argentina, Brazil, Chile, Peru, Venezuela, the Philippines, and Yugoslavia—also had debt servicing problems.

The savings and loan industry was also hard-hit by high interest rates, the maturity mismatch[5] of savings and loan balance sheets, and deregulation. During the inflationary 1970s, many savings and loans became insolvent as home loan portfolio earnings were exceeded by high interest costs needed to keep and attract new deposits. By the latter 1970s and the early 1980s, the industry's net worth was virtually wiped out by record-setting interest rates and the maturity mismatch of savings and loan balance sheets. Deregulation in 1982 permitted savings and loans to enter new lines of business and led to increasingly risky asset choices. Many in the industry speculated aggressively with high-risk loans that eventually defaulted, and the tide of insolvencies continued. Institutions in the Southwest, California, and Florida were hardest hit.[6]

Commercial bank failures also increased in the 1980s. When oil prices fell sharply in 1986, many major banks in Texas failed, and others were sold or merged with other banks. Declining real estate prices also contributed to bank failures. Losses on loans to less-developed countries eroded bank capital. High-quality corporate borrowers began to raise funds in capital

[5]Matched maturities in bank asset-liability management is the funding of loans with deposits of about equal duration and is intended to minimize interest rate risk.

[6]See Thrift Failures: Costly Failures Resulted From Regulatory Violations and Unsafe Practices (GAO/AFMD-89-62, June 16, 1989); and Troubled Financial Institutions: Solutions to the Thrift Industry Problem (GAO/GGD-89-47 Feb. 21, 1989).

markets through bonds and commercial paper—driving banks to do more real estate lending. Banks lost low-cost sources of funds in savings and checking accounts as investors sought investments paying higher rates of return.[7]

The 1980s crises affected many U.S. financial markets, including equity, options, and futures markets. The most significant event in this sector was the market crash of 1987. Although the stock market declined during the recessionary period of 1981 through 1982, stock prices rose to a then post-World War II high between 1983 and 1987 as institutional and foreign investors poured money into the stock market. Some observers believed that concern about rising interest rates at home and abroad and large budget and trade deficits led to the crash of 1987. Other observers attributed the crash to proposed legislation that would have limited the merger and acquisition activity that had contributed to a large part of the increase in stock values during the 1980s. Nearly all stocks suffered a massive sell-off in the 1987 crash, which led to mechanical and liquidity problems in trading and financial systems at exchanges and clearing organizations.

Linkages of Financial Markets Affected Nature of Crises

Increasing financial linkages among domestic and global financial markets—a product of new financial products, foreign investment in capital markets, and advances in communications technology—affected the nature of financial crises during the 1980s. These linkages also introduced a new dimension to systemic risk[8] in the financial system.

During the 1980s, foreign investments in U.S. capital markets increased dramatically as did U.S. investment in foreign markets, especially equities. For example, foreign purchases and sales of U.S. securities grew from about $198 billion in 1980 to almost $4.2 trillion in 1990. During the same period, U.S. purchases and sales of foreign stocks and bonds grew from about $53 billion to about $904 billion. Financial linkages increased for many reasons, including the increased use of exchange-traded and

[7]See Martin Feldstein, The Risk of Economic Crisis, Chicago: University of Chicago Press, 1991.

[8]Systemic risk is the possibility that failure of one or more financial organizations or countries will trigger a chain reaction and cause the collapse of other financial organizations or countries. A chain reaction of failures could take place because of linkages between and among markets and due to participation by the same institutions in several markets. Systemic risk is the risk that a disturbance could severely impair the workings of the financial system and, at the extreme, cause a complete breakdown. A breakdown in capital markets could disrupt the process of savings and investment, undermine the long-term confidence of private investors, and cause turmoil in the normal course of economic transactions.

over-the-counter derivative products.[9] Derivative products, among other purposes, provide needed protection against risks associated with fluctuations in currency exchange rates, interest rates, and other prices and indexes. Beginning in the 1970s, private corporations—large commercial banks, securities firms, and institutional investors—began using derivative financial instruments on a wide scale, which helped foster linkages among equities, debt, and futures markets.

Advances in telecommunications and information technology had furthered linkages among financial industries and markets and also increased certain risks. Advances in communications and computer technology enhanced market participants' ability to quickly learn of foreign market conditions and do business worldwide. Cited as a contributing factor to the 1987 market crash were complex, technology-aided trading strategies. Moreover, the volume of trading during the crash challenged automated systems and created problems for systems that cleared and settled transactions.[10]

Many disruptions in the 1980s—beginning with the silver crisis of 1980[11]—heightened awareness that shocks could spread across markets, institutions, and borders, thus enlarging the scope of crises. All the major foreign securities exchanges experienced substantial increases in prices before the 1987 crash—and during the crash, sharp drops in value. The disruption to the U.S. financial system could have been great if the 1987 stock market crash had not ended when it did. In 4 trading days in October 1987, the Dow Jones Industrial Average lost about one-third of its total value—almost $1 trillion. Had the precipitous decline continued for another day, massive disruptions to the U.S. financial system and the financial systems of other countries might have occurred.[12]

[9]Derivative products are instruments that derive their value from a reference rate, index, or the value of an underlying asset. See Financial Derivatives: Actions Needed to Protect the Financial System (GAO/GGD-94-133, May 18, 1994).

[10]See Clearance and Settlement Reform: The Stock, Options, and Futures Markets Are Still at Risk (GAO/GGD-90-33, Apr. 11, 1990).

[11]In March 1980, declining silver futures prices generated calls for hundreds of millions of dollars more margin from Hunt family members and related entities as well as calls for additional deposits to maintain required collateralization for loans. To fulfill these cash needs, the Hunts borrowed heavily from broker-dealers, banks, and others. A concern existed that the Hunt default might lead to the failure of one or more large broker-dealers and possibly jeopardize futures clearing houses, broker-dealers, and banks.

[12]See Financial Markets: Preliminary Observations on the October 1987 Crash (GAO/GGD-88-38, Jan. 26, 1988).

Public Sector Often Has a Crisis Management Role

In the 1980s, as today, federal financial agencies had congressionally determined roles in financial crisis management. Table 1.1 highlights the major responsibilities of the federal agencies. The Federal Reserve and the Department of the Treasury, the nation's finance ministry, had broad responsibilities for the health of the financial system. Three agencies—the Federal Reserve, Office of the Comptroller of the Currency (OCC), and Federal Deposit Insurance Corporation (FDIC)—were responsible for ensuring the safety and soundness of federally chartered banks and state-chartered banks that were federally insured. The same responsibility for federally insured savings associations was assigned to the Federal Home Loan Bank Board (FHLBB).[13] The National Credit Union Administration supervises insured credit unions. Since Congress permitted banks and savings and loans to operate under a state or national charter, responsibility for supervisory oversight of those institutions often involved federal and state regulators. With many self-regulatory organizations (SRO),[14] the Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) were responsible for market integrity and investor protection in the securities and futures markets, respectively. State regulators were responsible for oversight of insurance companies.

Table 1.1: U.S. Federal Financial Organizations Involved in Responding to Four Financial Crises in the 1980s

Federal agency	Responsibility
CFTC	Regulates the commodity futures and options markets and seeks to ensure fairness and integrity in the marketplace. Responsible for ensuring the economic utility of futures markets—price discovery and offsetting price risk—by encouraging their integrity and protecting market participants against manipulation, abusive trading practices, and fraud. Oversight includes exchanges, some off-exchange instruments, and market participants.
FDIC	Promotes and preserves public confidence in banks and protects the money supply by providing deposit insurance to commercial banks, savings banks, and savings and loan associations. FDIC's mission is to maintain stability in the national financial system by insuring bank depositors and reducing the economic disruptions caused by bank failures.

(continued)

[13]By authority of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), the Office of Thrift Supervision replaced the Federal Home Loan Bank Board as primary regulator of state and federally chartered savings institutions. The Federal Home Loan Bank Board was abolished.

[14]SROs include such organizations as the Chicago Board Options Exchange (CBOE), the Chicago Mercantile Exchange (CME), the National Association of Securities Dealers (NASD), the New York Stock Exchange (NYSE), and the Options Clearing Corporation (Options CC).

Federal agency	Responsibility
FHLBB	Supervised the Federal Home Loan Bank System and the Federal Savings and Loan Corporation (FSLIC) and regulated federally chartered savings and loan associations and federally chartered savings banks, supervised savings and loan holding companies, and shared with the states the supervision of FSLIC-insured state-chartered savings and loan associations.
Federal Reserve System	As U.S. central bank, makes and administers policy for the nation's credit and monetary systems. Through discount window operations and supervisory and regulatory banking functions, helps to maintain the banking industry in sound condition, capable of responding to the nation's domestic and international financial needs and objectives. Regulates and supervises bank holding companies and state-chartered banks that are Federal Reserve members.
OCC	Part of the Department of the Treasury that regulates about 2,700 national banks. Approves organizational charters, promulgates rules and regulations, and supervises the operations of national banks through examinations. Examinations assess the financial condition of banks, the soundness of their operations, the quality of their management, and their compliance with laws, rules, and regulations.
SEC	Administers federal securities laws that seek to provide protection for investors; ensures that securities markets are fair and honest; and, when necessary, provides the means to enforce securities laws through sanctions.
Treasury	A major policy advisor to the president that formulates and recommends domestic and international economic, financial, tax, and fiscal policies; serves as financial agent for the U.S. government; and manufactures coins and currency.

Source: GAO.

An international financial crisis may also involve foreign countries and international organizations. Three key international organizations are the International Monetary Fund (IMF), the International Bank for Reconstruction and Development (World Bank), and the Bank for International Settlements (BIS). Both IMF and the World Bank were established following World War II and funded by subscriptions or quota shares from the United States and other members. IMF, which was involved in one of the four crises we discuss, was established to promote international monetary cooperation and exchange rate stability and provide short-term lending to members experiencing balance-of-payments difficulties. Originally, IMF was to make medium-term loans of 3 to 5 years'

duration for balance-of-payments support. Its lending was to be based on a country's fiscal and monetary policies, exchange rates, and other macroeconomic factors. The World Bank, on the other hand, was to provide developing countries long-term loans for development when private financing was unavailable. Over the past several decades, however, both IMF and the World Bank have provided longer term financial assistance to countries involved in economic adjustments. BIS, a central bank for central banks, is both a wholesale money market bank accepting deposits from central banks and a forum promoting cooperation among central banks. Established in 1930, BIS performs a variety of trustee and other banking functions, mainly for central banks and international organizations. With encouragement and guarantees from leading central banks, BIS has helped provide bridge financing[15] to a number of central banks in Latin America and Eastern Europe pending disbursement of IMF and World Bank credits.

Policy Tools Available to Contain Crises

In a series of laws passed during this century, Congress gave federal financial organizations responsible for the health of the financial system a variety of policy tools to provide liquidity to help prevent or contain a financial crisis.[16] These include open market operations, access to the Federal Reserve's discount window, the Exchange Stabilization Fund, and deposit insurance.

Before the Federal Reserve was established in 1913, periodic financial panics led to many bank failures, associated business bankruptcies, and general economic contractions. In establishing the Federal Reserve, Congress gave it three important tools to carry out responsibilities as lender of last resort and regulator of the supply of money: open market operations, foreign currency operations, and discount window lending. Open market operations enable the central bank to buy and sell government securities, influencing the quantity and growth of legal reserves and thereby enhancing or diminishing liquidity to the overall banking system. The Federal Reserve can undertake foreign currency transactions to counter disorderly conditions in exchange markets. Discount window lending is a line of credit facility provided by the Federal Reserve primarily to depository institutions and occasionally to other institutions whose financial distress might harm the economy. The line of

[15]In the context of international finance, bridge financing is short-term credit extended to countries in anticipation of longer term financing.

[16]See the Federal Reserve Act of 1913, the Banking Act of 1933, and the Gold Reserve Act of 1934.

credit must be secured by adequate collateral, which is determined by the Federal Reserve.

Another policy tool available for containing financial crises is the Treasury Department's Exchange Stabilization Fund (ESF).[17] This fund provides the Treasury Secretary a means to (1) conduct international monetary transactions for the purpose of stabilizing the exchange value of the dollar, (2) counter disorderly market conditions, or (3) extend short-term credit to foreign governments when such credits are backed by assured sources of repayment. Congress has provided the Treasury Department wide latitude in its operation of ESF. The Secretary's decisions regarding the use of ESF resources are subject to approval by the President but remain final and unreviewable by any other government official.

In the Banking Act of 1933, Congress created the federal deposit insurance fund to better protect depositor savings and reduce the number of runs on bank deposits. At the time of the Continental bank and Ohio savings and loan crises, federal deposit insurance was administered by two separate entities, the Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loan Insurance Corporation (FSLIC). FDIC and FSLIC provided deposit insurance for the nation's banks and savings and loans, respectively. The insurance funds of these entities were funded primarily through assessments on members. Both funds enjoyed the full faith and credit of the U.S. government. In exchange, federally insured depository institutions would be subject to strict regulatory supervision and examination and limited in the types of activities they could pursue.[18]

U.S. Government: Ultimate Lender of Last Resort

Financial crises of the 1980s strained the basic regulatory framework for protecting the nation's financial system. Despite their deposit insurance mechanisms, the savings and loan industry turned to the federal government in the 1980s for assistance. The nation's experience with financial crises has increased public awareness that the federal government, and therefore the American taxpayer, is the ultimate lender of last resort. This means providing liquid funds to those financial institutions in need, especially when alternative sources of funding have dried up. That is, the federal government is the entity the international financial community and financial markets regard as a major source of funds to

[17]See 31 U.S.C. §5302.

[18]FSLIC was dissolved in 1989 by FIRREA. A new fund, the Savings Association Insurance Fund, was created and FDIC was designated as its administrator.

provide liquidity in a crisis. Ultimately, the U.S. government bore the costs of several crises.

The experience of banks and savings and loans in the 1980s provided ample evidence of the seriousness of the risks involved in concentrations of certain types of financial exposure—particularly when insufficient capital is held to protect against risk exposures. The failure of policymakers and regulators to effectively contain the savings and loan crisis proved costly to American taxpayers. Through FIRREA, Congress created a new agency—the Resolution Trust Corporation—to resolve failed savings and loans, liquidate their assets, and pay off insured depositors. The collapse of the savings and loan industry resulted in taxpayers incurring a large expense estimated, as of 1996, to be about $132 billion.[19]

Objectives, Scope, and Methodology

The objective of this study is to describe how federal financial agencies with responsibilities for financial institutions and markets recognized, contained, and eventually resolved four financial crises that occurred in the 1980s.

Scope

During the survey phase of our work, we sought to identify all financial disruptions in the 1970s and 1980s that had the potential, if not quickly contained, to cause wide-ranging damage to the financial system. We decided that information on some events that occurred during the 1970s—such as the Penn Central[20] commercial paper crisis and the failure

[19]See Financial Audit: Resolution Trust Corporation's 1995 and 1994 Financial Statements (GAO/GGD-96-123, July 2, 1996).

[20]In June 1970, Penn Central—the largest railroad in the United States and the sixth largest business enterprise in the country—declared bankruptcy and threatened the commercial paper market. Penn Central had about $200 million in outstanding commercial paper and after reporting losses, it was no longer able to sell commercial paper nor roll over maturing issues. Corporations that relied heavily on commercial paper had to seek alternative sources of funding. Actions by the Federal Reserve—encouragement of money center banks to lend to customers who were unable to roll over commercial paper and discount window lending—provided liquidity, enabling the commercial paper market to continue functioning. This prevented the crisis from developing into a full-scale panic.

of Franklin National Bank[21] and Bank I.D. Herstatt[22]—as well as official recollections of those events, were too dated to enable us to reconstruct an accurate chronology and understanding of the crises. These financial crises also were too dated for us to determine the interactions among the various agencies and officials involved in containing and resolving them.

We then considered the following financial disruptions that occurred in the 1980s:

- silver crisis of March 1980,
- Drysdale Government Securities failure of May 1982,
- Mexico debt crisis of August 1982,
- Continental Illinois Bank crisis of May 1984,
- Ohio savings and loan crisis of March 1985,
- market crash of October 1987, and
- Drexel Burnham Lambert failure of February 1990.[23]

We selected the Mexico debt crisis, the Continental Illinois Bank crisis, the Ohio savings and loan crisis, and the 1987 market crash for further review and in-depth analysis on the basis of the following criteria:

- Decisions and actions had to be quickly made and implemented.
- Diverse federal and nonfederal financial organizations were involved.
- The disruption was significant, occurred quickly, and involved an abrupt and widespread reversal of expectations of market participants about the stability of particular institutions or markets that, if left unchecked, could have caused significant damage not only to affected markets or institutions but to other parts of the financial system and the economy.

[21]In October 1974, the Franklin National Bank of New York—the 20th largest bank in the United States—was declared insolvent by OCC. At the time, it was the largest bank failure in U.S. history. Nine months before the collapse Franklin had $3.7 billion in deposits. Franklin had borrowed heavily in the Eurodollar interbank market and had speculated unsuccessfully in foreign exchange and municipal securities markets. When Franklin was closed, it had borrowed $1,723 million from the Federal Reserve discount window. This lending by the Federal Reserve avoided instability in domestic and foreign financial markets. Losses from Franklin's failure totaled $59 million.

[22]In June 1974, German banking authorities (Das Bundesaufsichtsamt fur das Kreditwesen) closed Bankhaus I.D. Herstatt in Cologne and ordered its liquidation. Herstatt was a large bank with international operations and a reliance on profits from foreign exchange and gold speculation. It had assets of more than 2 billion German marks. Hundreds of large and small companies and public authorities feared for their deposits. Several U.S. banks received no foreign exchange settlement payments. The total loss was $467 million.

[23]Drexel's holding company declared bankruptcy in February 1990. In 1989, it had settled felony insider trading charges, suffered decreased revenues as issuers in the high-yield bond market (upon which Drexel relied for a substantial portion of its revenues) began to default on payment obligations, and had severe short-term funding problems when its commercial paper rating was lowered. See pp. 44-46 of Securities Firms: Assessing the Need to Regulate Additional Financial Activities (GAO/GGD-92-70, Apr. 21, 1992).

- Federal agencies could rely on their existing statutory and regulatory authorities and resources to deal with the problem. Congressional action was not needed before federal agencies could respond to the crisis.
- Senior officials were available to be interviewed.

Taken as a whole, the crises we selected for our review sample reflected diversity in (1) the nature of the problem, (2) the financial institutions or markets affected, and (3) the types of players involved. We believe that the four cases selected cover a wide-ranging set of experiences involving different markets and participating decisionmakers from many sectors of government. Throughout, our primary interest was how federal organizations exercised their existing authority to cope with sudden financial distress.

Methodology

In conducting our study, we first undertook an extensive literature search of congressional testimony, books, journals, and newspaper articles pertaining to financial crises. This review enabled us to chronologically describe the four events and identify the participants involved in containing and resolving them and the actions the participants took.

We also reviewed the social science research literature in this area, which deals with responses to natural and technological disasters, for information relevant to our work on financial disruptions. Emergency situations have been the subject of social science research for decades.[24] Although a comprehensive review of all such research was not feasible, we reviewed the studies that disaster analysts suggested were the most significant and relevant to financial crises. Our review of disaster literature led us to conceptualize financial crisis management in terms of three primary phases, which we have defined as follows:

- Preparedness is the pre-crisis or pre-impact phase and includes the earliest sign of possible danger and any activities undertaken to prepare for managing a potential financial crisis before the crisis occurs.
- Containment is the period when the crisis actually occurs and includes immediate activities undertaken in response to a financial crisis to mitigate the financial disruption and to prevent or lessen ill effects that could result due to financial linkages.

[24]See Emergency Management: Principles and Practices for Local Government, Thomas Drabek and Gerald Hoetmer (Editors), International City Management Association (Washington, D.C., 1990); Emergency Management: Strategies for Maintaining Organizational Integrity, Thomas Drabek, Springer-Verlag (New York, 1990); Normal Accidents: Living With High Risk Technologies, Charles Perrow (New York, 1984).

- Resolution is the period of attempting to mitigate any long-term effects and includes activities undertaken to restore institutions and markets to normalcy and to reduce the likelihood that the crisis or similar crises will recur.

We interviewed more than 70 federal, private sector, and state and local officials involved in the four financial crises to determine the nature of their involvement, interactions they had with other participating officials, and the rationale for their actions. Generally, we asked the officials to draw on their experience in these events and discuss the important lessons from that experience—observations they would share with others who might go through a similar experience in the future. In addition to the interviews, we reviewed books, journal articles, congressional testimony, speeches, and newspaper articles. We also reviewed agency records, including letters, transcripts of meetings, memoranda, notes, special studies, and other documents relating to each organization's involvement in the four crises. Such records were not available for all crises.

We received technical comments on this report from the Commodities Futures Trading Commission, Federal Deposit Insurance Corporation, Federal Reserve, Office of the Comptroller of the Currency, Securities and Exchange Commission, and other officials involved in these crises. We incorporated the comments where appropriate.

The Mexico Debt Crisis of 1982

During the early 1980s, Mexico, a major U.S. trading partner, experienced a financial collapse precipitated in part by sharp declines in oil prices, which reduced Mexico's foreign exchange holdings from the sale of its oil. The crisis began formally on August 12, 1982, when Mexico's Secretary of Finance informed the Federal Reserve Chairman, the Secretary of the Treasury, and the IMF Managing Director that Mexico would be unable to meet its August 16 obligation to service $80 billion in mainly dollar-denominated debt obligations to U.S. and foreign banks. The Mexico debt crisis illustrated that growing ties between domestic and global capital markets could trigger a domestic financial crisis.

Summary of Chronology

By the time that Mexico was unable to meet debt obligations to U.S. and foreign banks, the Federal Reserve and Treasury had jointly developed a strategy for U.S. assistance to prevent a financial crisis. The strategy was to condition the granting to Mexico of substantial extended credit on a commitment to an IMF economic reform or stabilization program; at the same time, the United States would provide short-term emergency credit and currency swaps[1] as necessary. When the crisis came in August 1982, the United States took the lead in a multinational response and played a key role in implementing the strategy. Mexican governmental entities, European and Japanese central banks and finance ministries, IMF, and commercial banks in the United States and abroad were also involved in crisis containment efforts. The Federal Reserve played a key role in organizing the responses of (1) U.S. and foreign commercial banks, which were asked to accept a moratorium on principal payments, provide $5 billion in new loans, and restructure existing debt; and (2) central banks in Europe and Japan, which were asked to provide $925 million in liquidity support. The Federal Reserve lent Mexico a total of $1.05 billion. The Department of the Treasury took the lead in putting together the more immediate executive branch responses, which involved a $1 billion ESF swap, a Department of Energy and Department of Defense Strategic Petroleum Reserve prepayment of $1 billion for oil that the U.S. purchased from Mexico, and a Department of Agriculture $1 billion Commodity Credit Corporation loan guarantee to Mexico to facilitate the import of grains and fundamental foods. Treasury also provided a $600 million longer term swap in conjunction with the Federal Reserve and BIS. IMF led economic reform negotiations with Mexico and led an effort to obtain $5 billion in new commercial bank loans for Mexico, and provided close to $4 billion in medium-term credits.

[1]Foreign exchange swaps are bilateral agreements to exchange two currencies at one date and to reverse the transaction at some future date. When a foreign central bank initiates the swap drawing, it uses the dollars to finance sales of dollars to support its own currency.

Preparedness: Interagency Contingency Planning Helped Contain Crisis

The Mexican debt crisis began on Thursday, August 12, 1982, when Mexico's Secretary of Finance informed the Federal Reserve Chairman, the Secretary of the Treasury, and the IMF Managing Director that Mexico would be unable to meet its August 16 obligation to service about $80 billion in mainly dollar-denominated debt obligations to U.S. and foreign banks.[2] Mexico owed $25 billion of this debt to U.S. banks.[3] The situation had the potential for upsetting the financial stability of the industrialized world. Because the private sector was initially unwilling to lend additional money to Mexico, the United States, IMF, and central banks of developed countries had to step in and fill the vacuum.

According to various U.S. government officials, the Mexico debt crisis, which developed visibly over several months, was not a surprise. The question, starting in March 1982, was not whether Mexico was approaching crisis but what to do about it. For months before the start of the crisis, Federal Reserve and Treasury officials had been watching changes in Mexico's foreign exchange reserves, borrowing patterns, balance of trade, and domestic economic and political situations. Crisis management leadership was an issue, but it was resolved before the crisis began. Generally, leadership in preparedness was shared by the Federal Reserve and Treasury, with Treasury focusing on political aspects and the Federal Reserve on the economic aspects of containment and resolution of the crisis. Three meetings between financial officials of the Mexican Ministry of Finance, the Bank of Mexico, the Federal Reserve, and Treasury concerning the deteriorating situation had already occurred before the August 12 start of the crisis. U.S. officials said they had a general understanding of a range of potential problems that Mexico's inability to repay its debts would precipitate. Federal Reserve and Treasury officials said they had discussed and generally decided on their respective agencies' responses to Mexico's expected requests for assistance, but a single written interagency contingency plan was not developed. U.S. officials said that, generally, the Federal Reserve, Treasury, and other organizations were sharing available information and communications were well coordinated.

[2]There were about 25 different kinds of Mexican debt. Debtors included the national oil company, the development bank, the telephone company, and other government corporations. A quarter of the debt was accumulated by the Mexican state oil company.

[3]At the time Mexico was the largest international borrower from U.S. commercial banks.

Agencies Shared Information, Planned Response, and Resolved Leadership Issues Before the Crisis Began

Fearful of a foreign currency crisis, Federal Reserve, Treasury, and the Department of State (State) officials said they were monitoring Mexico's borrowing, balance of trade, foreign exchange trends, and domestic economic and political situations for months before the start of the crisis. Senior officials at the Federal Reserve and Treasury said they met to discuss Mexico's likely request for assistance and develop a U.S. strategy. These were more "when/how" than "what if" discussions—that is, when Mexico asks for help, how shall we respond? The Federal Reserve and Treasury officials identified the first opportunities to meet with Mexico's newly appointed top financial officials at various multinational finance meetings as well as during visits by these officials to Washington, D.C.

Federal Reserve officials had information about the exposure to Mexican debt of most U.S. banks. They had determined, on the basis of country lending data that the bank supervisory agencies—in particular, OCC—maintained routinely,[4] that Mexican debt accounted for 44 percent of the capital of the 9 largest U.S. banks and 35 percent of the capital of the 15 biggest U.S. regional banks.[5] Officials also knew that if payments ceased, bank capital positions would rapidly deteriorate and threaten the banking system. They also understood that Mexico's debt servicing problems were likely to spread to other developing countries.

Preparedness planning took place before the crisis began. On January 7, 1982—7 months before the crisis broke—State officials asked for an interagency meeting on the Mexico debt situation. Reports from the Treasury attache in the U.S. Embassy in Mexico City expressed concern about Mexico's ability to finance its debt and access to U.S. financial markets. Federal Reserve and Treasury officials said they viewed State's requests as inappropriate because they saw the potential crisis as one best addressed as an economic rather than as a political problem. They said they were concerned that State might insist that terms of U.S. assistance be softened for foreign policy or diplomatic reasons. That is, Treasury officials were concerned that State would urge assistance even if the country was not taking economic adjustment and reform measures. The Federal Reserve and Treasury initially resisted State's call for a meeting. When the meeting did occur on March 23, more than 2 months after the State Department's request, Treasury officials said they asserted

[4]This information is maintained by the Interagency Country Exposure Review Committee. OCC develops and analyzes information on and assesses risk in international lending, including the evaluation of transfer risk associated with exposures to countries experiencing difficulties servicing their external debt.

[5]Banks are ranked according to size based on the amount of their assets.

themselves as leaders of the meeting. Once State Department officials understood that the Federal Reserve and Treasury officials were alert to Mexico's debt problem, they stepped back.

The initiative of top Mexican financial leaders played an important role in U.S. preparedness efforts. Soon after their appointments, Mexico's Secretary of Finance and Director General of the Bank of Mexico requested separate meetings with the Federal Reserve, the Department of the Treasury, and IMF—the three key organizations whose support Mexico would need if a financial crisis developed. (See fig. 2.1.)

Figure 2.1: Selected Events in the Mexico Debt Crisis of 1982 (May, June, July)

May

Date:

3 First visit of top Mexican finance officials and key staff to the Federal Reserve, Treasury, and IMF.

30 Bank of Mexico approaches the Federal Reserve about an overnight currency swap of pesos for dollars under existing reciprocal currency arrangements. The Federal Reserve agrees to the swap.

June

Date:

1 Bank of America has diffculty syndicating $2.5 billion loan for Mexican governmental entities.

11 Second visit of Mexican financial officials to the Federal Reserve, Treasury, and IMF.

29 The Federal Reserve agrees to an overnight currency swap of $700 million under existing reciprocal currency arrangement.

30 Federal Reserve Open Market Committee agrees to allow Bank of Mexico to draw down its full $700 million currency swap on an extended basis if certain conditions are met. Bank of Mexico draws $200 million overnight. Open Market Committee lets stand its conditional approval for the extended swap. The Open Market Committee wants the swap contingent on Mexico agreeing to an IMF program.

July

Date:

23 Third visit of Mexican finance officials to the Federal Reserve, Treasury, and IMF.

31 Bank of Mexico swaps pesos for $700 million overnight with the Federal Reserve under existing reciprocal currency arrangements.

Source: GAO analysis.

Agencies Shared Information and Views Before Crisis Broke

Mexican officials met with U.S. officials on three separate occasions before the crisis emerged in August. Treasury and State officials said they prepared for these meetings by developing and agreeing on the positions they would take. Treasury staff briefed the Treasury Secretary on Mexico's situation, requests Mexico might make, and proposed U.S. responses. The Treasury Secretary met with the Federal Reserve Chairman to discuss requests and responses before meetings with the Mexican officials. As of early August, Mexico had liquid reserves of less than $200 million, and the

country was losing dollars at the rate of $100 million a day.[6] Mexican capital was being moved out of the country for a safe haven in the United States and elsewhere. Mexico appeared unable to generate export surpluses and maintain confidence in its economy, which were essential for Mexico to find the hard currency needed to service its loans.

Treasury and the Federal Reserve had $1 billion in currency swap arrangements with Mexico: $300 million from Treasury's Exchange Stabilization Fund and $700 million from the Federal Reserve's swap line.[7] Overnight drawings on the Federal Reserve's swap arrangement were used to bolster month-end figures for dollar reserves.[8] Treasury and Federal Reserve officials both told their Mexican counterparts that before any substantial credit was granted to Mexico on other than an overnight or short-term basis, Mexico should have a convincing economic stabilization program to restore confidence in the peso and the Mexican economy. That is, Mexico should have an IMF-approved economic adjustment or reform program.[9] IMF requires that borrowing countries commit to reforms that improve the country's economy and balance of payments. Federal Reserve and Treasury officials said they knew, however, that Mexico's current president—who would soon be replaced by a successor—was unwilling to adopt the policy measures that would be required for an IMF program. According to these officials, the president was in the last year of a 6-year term and did not want to admit to having made any economic policy errors.

Before Crisis, Officials Coordinated to Agree on Strategy

Federal Reserve and Treasury officials said they agreed on a two-part strategy for dealing with Mexico: (1) refuse to grant Mexico any substantial credit unless Mexico committed to seeking an IMF adjustment program; but (2) continue to support Mexico with advice and overnight currency swaps until the December 1, 1982, installation of Mexico's next

[6]See Joseph Kraft. The Mexican Rescue. New York: Group of Thirty, 1984.

[7]A major feature of foreign currency operations of the Federal Reserve is the swap network, which consists of reciprocal short-term credit arrangements with 13 foreign monetary authorities and with the Bank for International Settlements. These arrangements enable the Federal Reserve to borrow the foreign currencies it needs for intervention operations to support the dollar. They also enable the partner foreign central banks to borrow the dollars needed to support their currencies. See The Federal Reserve System: Purposes and Functions, Board of Governors of the Federal Reserve, Washington, D.C.: 1984.

[8]See Paul A. Volcker and Toyoo Gyohten. Changing Fortunes: The World's Money And The Threat To American Leadership. New York: Times Books, 1992.

[9]IMF seeks to maintain stability in the world economic and financial system. See Paul R. Masson and Michael Mussa, The Role of IMF: Financing and Its Interactions with Adjustment and Surveillance, Washington, D.C.: 1995.

president, who was expected to seek IMF help. Any longer term credits would have to be repaid from IMF medium-term loans. According to Federal Reserve officials, at the end of May, Mexican officials asked the Federal Reserve to swap pesos for dollars overnight so Mexico could meet its requirements for a certain level of foreign reserves as backing for its currency. The Federal Reserve agreed to the overnight currency swap.

Agencies Jointly Developed Contingency Plans

Over the next several months, U.S. officials said this strategy was challenged as Mexico's need for assistance escalated. Mexican officials asked the United States for an extended swap as a bridge loan to a $2 to $3 billion jumbo loan they planned to arrange. The bridge loan was later obtained not through an extended swap, but through a loan from U.S. commercial banks. U.S. officials said they explored contingency plans to address the possibility that Mexico's President would not seek IMF help, but no such plans were put into writing. The outgoing President of Mexico had entered office in 1976 while a tough and unpopular IMF program was in progress. Treasury, Federal Reserve, and State officials said they discussed a variety of strategies and worked through their sometimes differing assessments of those plans. Among other ideas, they said they discussed alternatives to IMF credits to assure repayment of swaps if a crisis developed, including supplying dollars as prepayment for oil. The Federal Reserve could not approve an extended swap without an assured means of repayment. To have this means of repayment, Federal Reserve staff drafted a letter from the Secretary of the Treasury to the Chairman of the Federal Reserve in which Treasury agreed to provide backing for the swaps by assuring repayment of any drawings by Mexico.

At the end of April, Mexico requested a $600 million overnight currency swap with the Federal Reserve to satisfy international reserve reporting requirements. At the end of June, the Bank of Mexico requested a swap on an extended basis, which the Federal Reserve's Federal Open Market Committee approved. The Federal Reserve officials said they wanted such a swap contingent on Mexico agreeing to an IMF stabilization program to repay the swaps. When the request from the Bank of Mexico was changed at the last minute to an overnight swap for $200 million, the Federal Reserve Chairman asked the Federal Open Market Committee to let its approval stand, enabling him to make the swap available if needed to avert a liquidity crisis and provided conditions were satisfied. According to Federal Reserve officials, the Federal Reserve deposited $200 million in dollars in Mexico's account at the Federal Reserve Bank of New York, and the Bank of Mexico gave the Federal Reserve an equivalent quantity of

pesos at the going exchange rate, with a promise to reexchange them when the swap expired. U.S. officials agreed that swaps were temporary remedies and not the solution to the much larger debt repayment problem.

On July 23, Mexican finance officials again visited Treasury, the Federal Reserve, and IMF in Washington, D.C. Participants in the meetings said that Mexico's situation was discussed at length, particularly whether or not Mexico had the foreign currency reserves needed to get through August.[10] U.S. officials said they again stressed that dollars would not be provided on an extended basis to Mexico without that country's commitment to an IMF stabilization or reform program. Mexico's President reportedly would not seek IMF help even though borrowing was increasingly difficult. U.S. officials said they believed that the President of Mexico would not be interested in an IMF program until Mexico had run out of foreign reserves.

The situation then sharply deteriorated. Mexico officially asked for the full $700 million Federal Reserve swap at the end of July. Planning efforts ensured that everything was in place. According to Federal Reserve officials, the Federal Open Market Committee had given its approval the prior month, and officials were able to use the instrument that had been drafted to limit the length of time that Federal Reserve swap funds were in use. The swap drawing was provided August 4 and was supposed to last while Mexico began discussions with IMF. The funds were quickly depleted, setting the stage for the full-blown Mexican debt crisis. (See fig. 2.2.)

[10]Foreign currency reserves are the stock of official assets denominated in foreign currencies that can be used to meet external payment obligations. In most cases, reserves are managed by the central bank and are part of its balance sheet.

Figure 2.2: Selected Events in the Mexico Debt Crisis of 1982 (August)

August

Date:

4 Bank of Mexico swaps pesos for $700 million in an extended swap. Mexican officials agree to seek an IMF adjustment program if necessary for repayment. The funds are quickly depleted.

5 Mexico announces a two tier exchange rate for the peso. The higher exchange rate is for Mexican government payments and key imports.

12 Mexico's Secretary of Finance telephones the Federal Reserve Chairman, the Secretary of the Treasury, and the IMF Managing Director to inform them Mexico can not meet its August 16 debt obligations to banks and that he and the Director General of the Bank of Mexico will come to Washington, D.C., to discuss the situation.

Mexico announces foreign exchange markets will not open on August 13.

13 Mexican finance officials meet with officials of the Federal Reserve, Treasury, and IMF.

14 15 Officials from Mexico's Ministry of FInance, Bank of Mexico, the Federal Reserve, Treasury, Office of Management and Budget, Energy, and State work out provisions of a $1 billion currency swap, the purchase of Mexican oil, and agricultural credits. Federal Reserve Chairman contacts heads of European, Canadian, and Japanese central banks and gets indication of support in principle for lending to Mexico. Meeting to take place the coming week in Basle, Switzerland, under the auspices of the Bank for International Settlements.

Date:

15 Mexico's Secretary of Finance contacts heads of major creditor banks, alerts them to Mexico's problems, and invites them to a meeting of Mexico's bankers during the next week.

16 Treasury's Exchange Stabilization Fund lends $1 billion to the Bank of Mexico for about a week.

17 Mexico's Secretary of Finance announces assistance package.

18 Representatives of central banks meet in Basle, Switzerland, under the sponsorship of the Bank for International Settlements, and agree in principle to a loan of $750 million as a bridge to an IMF program if their central bank governors agree. Spain adds $175 million. The United States agrees to match the total provided and provides $925 million.

19 Mexico's foreign exchange markets reopen.

Mexico's Secretary of Finance meets with officials of U.S. banks.

The President of the Federal Reserve Bank of New York hosts a dinner at the Federal Reserve Bank of New York at which he, Mexico's Secretary of Finance, the Director General of Bank of Mexico, the Chairman of the Federal Reserve Board, and the Deputy Secretary of the Treasury, together with key staff, discuss strategy for the August 20 bankers meeting.

Date:

20 Mexican officials meet with representatives of creditor banks at the Federal Reserve Bank of New York. Representatives of over 100 banks attend. Mexico's Secretary of Finance discusses Mexico's condition and liquidity problem, U.S. and other central bank support, and plans for an IMF program. Mexico's Secretary of Finance then asks for a 90-day moratorium on principal payments.

21 Representatives of 14 banks form a bank advisory group to start work on moratorium and other issues. The advisory group works to identify all creditor banks. The advisory group asks all identified banks for a 90 day payment moratorium starting August 23.

24 Mexico repays $1 billion to Exchange Stabilization Fund and receives $1 billion as advance payment for oil purchased for the strategic petroleum reserve.

26 The Bank for International Settlements announces $1.85 billion loan, $925 million of which comes from the United States. Funds are to be made available in three stages depending on progress toward agreement on an IMF economic adjustment program.

Source: GAO analysis.

Containment: Swift and Collaborative Action Taken to Avoid Immediate Default

The crisis formally began on Thursday, August 12, 1982, when Mexico's Finance Secretary informed the Treasury Secretary and the Federal Reserve Chairman that Mexico had almost run out of foreign exchange reserves and would not be able to meet its obligations to foreign banks on August 16. Money that was supposed to last a month or two drained out of Mexico's foreign exchange reserves in a flight of money abroad. Federal Reserve and Treasury officials said they knew immediately that the crisis

had come. They said that outright default would have ruined Mexico's credit rating and shut off the further lending that was essential to the operation of its economy. Creditor banks would suffer losses, and the solvency of some banks could be threatened. U.S. and foreign officials said that they were concerned because the world's largest commercial banks had heavy exposure to Mexico as well as other developing countries. The potential for worldwide financial system instability could not be discounted.

The next day, Mexican financial officials flew to the United States to meet with Treasury, Federal Reserve, and IMF officials to discuss a plan of action. U.S. officials said they encouraged accelerated negotiations with IMF for a reform program. According to U.S. officials, Mexican officials agreed, but they also said the country would need additional help until the IMF financing could become available.

Agencies Used Contingency Plans to Avoid Immediate Default

According to U.S. officials, the most urgent problem facing the government was to avoid Mexico's default on August 16, which could threaten the capital positions of the world's largest commercial banks. The Treasury Secretary assigned the Deputy Secretary of the Treasury the task of organizing the assistance effort. Treasury agreed that Monday morning it would provide Mexico with a $1 billion swap from its Exchange Stabilization Fund (ESF) for 1 week.[11] However, the swap would have to be secured, and Mexico had little undedicated cash flow. Various federal officials said they turned to one of the possibilities they had discussed during preparedness planning—namely, supplying dollars as prepayment for a U.S. purchase of oil from Mexico. Mexico's 1981 contract to supply oil to the Department of Defense's Strategic Petroleum Reserve provided a precedent for this possibility.

U.S. officials told us that arranging a U.S. government oil purchase from the Mexican government, with the proceeds of the sale to secure the loan, was difficult and required considerable effort by the Treasury Deputy Secretary and cooperation from the Departments of Defense and Energy, the Office of Management and Budget, and other U.S. government

[11]ESF was originally established to provide the Secretary of the Treasury with funds to conduct international monetary transactions to stabilize the dollar's exchange value. The Secretary of the Treasury may use ESF consistent with U.S. obligations in IMF regarding orderly exchange arrangements and a stable system of exchange rates. Financing is considered on a case-by-case basis on the basis of a demonstrated need for liquidity, evidence of an appropriate economic adjustment program in cooperation with IMF, and an assured source of repayment. For a more detailed discussion of ESF see pp. 114-117 and 148-152 of Mexico's Financial Crisis: Origins, Awareness, Assistance, and Initial Efforts to Recover (GAO-GGD-96-56, February 23, 1996).

agencies. Negotiations with the Mexican government were challenging, as both the United States and Mexico were concerned about the domestic political implications of the price for the oil. The difficulty was essentially avoided by obscuring the price. The United States would pay Mexico $1 billion from ESF for oil for the Strategic Petroleum Reserve valued at $1.2 billion. The oil would be delivered over the course of 15 months, and Mexico would pay a $50 million negotiating fee for the advance from the Treasury ESF.[12] The Commodity Credit Corporation would also provide Mexico with a $1 billion credit for the purchase of U.S. agricultural products by October 1. Some U.S. officials thought the price paid for the oil was too high, but they said that the Secretary of the Treasury overruled their objections. The agreement enabled Treasury to activate the $1 billion swap on August 16, 1982. According to U.S. officials, $1 billion dollars was credited to the Bank of Mexico account at the Federal Reserve Bank of New York. The Bank of Mexico subsequently used the funds from the Strategic Petroleum arrangement with the Energy Department to repay Treasury's $1 billion ESF swap.

Federal Reserve Chairman Sought Help From Central Bankers

As Treasury Department officials worked to avoid an immediate default, the Federal Reserve Chairman said he focused on providing somewhat longer term funding for Mexico. The Federal Reserve Chairman telephoned central bankers in other countries to discuss Mexico's financial difficulties. Mexico's Secretary of Finance made similar calls to other central bankers and finance ministries. At the Federal Reserve Chairman's request, the Bank for International Settlements (BIS) in Basle, Switzerland, called a meeting of central bankers for August 18 to discuss Mexico's situation.[13]

According to U.S. officials, the central bankers agreed that the central banks of industrialized countries would loan Mexico $1.5 billion as a credit bridge to IMF assistance, contingent on assurance of repayment if an IMF

[12]Treasury advanced payment to the Bank of Mexico for $1 billion. The Department of Defense, which actually received the oil, then paid Treasury $1 billion.

[13]BIS is the principal forum for consultation, cooperation, and information exchange among central bankers. In recent years it has mobilized supplementary resources for IMF and arranged bridge financing for heavily indebted developing countries. BIS was established in 1930—and is the oldest functioning international financial organization—to manage Germany's World War I reparations payments. After World War II, BIS evolved into a clearinghouse for the main European central banks. See "The Bank for International Settlements and the Federal Reserve," Charles Siegman, Federal Reserve Bulletin October 1994.

agreement was not reached.[14] The United States would advance half and the rest would be split among central banks in Europe and Canada and the Bank of Japan. Spain and the United States added an additional $350 million at the last moment, bringing the total to $1.85 billion. The funds were made contingent upon Mexico showing it could put up adequate collateral if IMF negotiations for a long-term economic stabilization program fell through. The U.S. share of the $1.85 billion was $925 million and consisted of a new Treasury ESF $600 million swap with the Bank of Mexico and a new Federal Reserve swap line of $325 million. According to U.S. officials, these funds were to provide Mexico with adequate financing until a larger package could be arranged.

Federal Reserve Facilitated Principal Payment Moratorium Agreement

U.S. officials said that to provide time for IMF to negotiate a program with Mexico, Mexico sought an agreement with U.S. commercial banks that would provide for a 90-day postponement of principal payments on Mexico's debt. The heads of about 100 leading commercial banks attended a meeting on August 20 in New York at the Federal Reserve Bank of New York to discuss the Mexican debt situation.[15] According to Federal Reserve officials, on August 21, Mexico's Finance Secretary met with an advisory group of U.S. commercial bank representatives.[16]

Emphasizing at the August 20 meeting that any agreements reached were between Mexico's Ministry of Finance and the banks, according to meeting participants, the president of the Federal Reserve Bank of New York described the funding provided by the U.S. government to Mexico as well as multilateral negotiations for the $1.5 billion, later raised to $1.85 billion. The Finance Secretary of Mexico told the bankers that Mexico would seek an IMF program, and he asked the banks to accept postponement of Mexico's principal payments for 90 days. With the support of this bank advisory group, headed by three Co-Chairmen, the Mexican government identified all the banks with loans outstanding and requested that they postpone payments due for the 90 days. No bank specifically objected to the request for a standstill on payments, and central bank and Mexican officials interpreted this to mean that commercial banks agreed to the

[14]The countries participating in this agreement were Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the United States. Spain and Switzerland cooperated with the agreement.

[15]Because the large banks had sought participation of other smaller banks in foreign loans, estimates of the number of banks that actively participated in loans to Mexico ranged from 500 to over 1,000.

[16]The advisory group banks were Citicorp, Chase, Chemical, Morgan Guaranty, Bank of America, Bankers Trust, Manufacturers Hanover, Bank of Tokyo, Lloyds, Societé Générale of Belgium, Bank of Montreal, Swiss Bank, Deutsche Bank, and Banamex.

terms proposed by Mexico's Finance Secretary. The advisory group also developed information on maturing debts.

Containment Was Slowed by Unexpected Actions of Mexican President

On September 1, unexpected actions by the President of Mexico slowed negotiations related to the IMF austerity program. In his last annual address, the President nationalized all Mexican banks because, he said, they had provoked and aided the capital flight. The President also imposed foreign exchange controls and denounced wage and spending restraints. These actions caused confusion about the Mexican government's willingness to reform its economy.

According to Federal Reserve officials, the announcement resulted in a surge of requests for repayments of dollar deposits in the foreign offices of Mexican banks, which brought the international foreign exchange clearing system to the edge of breakdown. Mexican banks could not honor demand for dollar deposits, and it was feared that all the foreign currency assistance provided might be used up in honoring these claims. A bank advisory group pressured banks with claims to roll over debts. On September 7, 1982, the Federal Reserve Bank of New York deposited $70 million from money advanced to Mexico by BIS in the Bank of Mexico's account. According to Federal Reserve officials, a standstill was arranged so that the foreign branches of Mexican banks received reduced requests to honor demands for repayment.

According to Federal Reserve officials, in September IMF provided Mexico's Finance Secretary with a carefully worded memo setting forth conditions for negotiations. The Finance Secretary informed IMF that the negotiations could continue. When Mexico requested access to the second part of the BIS and U.S. swap lines, however, the central banks were reluctant to provide access because Mexico's progress toward an IMF agreement seemed slow. (See fig. 2.3.)

Figure 2.3: Selected Events in the Mexico Debt Crisis of 1982 (September, November, December)

September

Date:

1 Mexico nationalizes banks and establishes foreign currency exchange controls. Director General of the Bank of Mexico resigns.

7 Federal Reserve Bank of New York deposits $70 million in Bank of Mexico's account at the Federal Reserve Bank of New York. These funds were provided by Mexican authorities to U. S. offices of Mexican banks to help ease demand on dollar deposits.

November

Date:

10 Mexico's Ministry of Finance sends IMF an official letter of intent to enter into an economic adjustment program.

16 IMF Managing Director advises representatives of major banks that Mexico's creditor banks must agree in writing to provide $5 billion in new loans before he will recommend that the IMF Executive Board approve the economic adjustment program for Mexico.

December

Date:

1 Mexico's new President takes office.

23 IMF Managing Director announces that $4.3 billion in new loans has been pledged and that he will recommend approval of the Mexican adjustment program.

IMF Executive Board approves the agreement with Mexico.

Source: GAO analysis.

Federal Reserve Chairman Encouraged Solution

The Mexican government agreed to the terms of an IMF program on October 23. The Federal Reserve Chairman acted quickly to encourage the containment of the crisis. Two days later, on the 25th, he informed BIS that the United States was prepared to permit limited drawdowns of its portion of the funds to Mexico, on the basis of the progress of the Mexico-IMF agreement.

The Finance Secretary of Mexico announced the agreement's terms on November 10. The announcement stated that Mexico would cut its budget deficit from 16.5 percent of gross national product to 8.5 percent to encourage private investment, reduce its foreign borrowings in 1983 to $5 billion from $20 billion in 1981, cut back the growth of the money supply to deal with inflation, hold inflation to 55 percent in 1983, reduce subsidies, limit wage increases, and increase exports. Taxes were to be raised. The details of the agreement were laid out in an attached memorandum on economic policies.

With this agreement in hand, the Managing Director of IMF informed the U.S. and foreign banks they would have to provide written commitments for an additional $5 billion in loans to Mexico by December 15 before the IMF assistance plan could be implemented; Mexico needed the additional loans to repay BIS and Federal Reserve loans and to build reserves. Unless the banks came up with the money, the Managing Director of IMF reportedly said that he would not recommend that the Executive Directors of IMF accept the Mexican program.

Once again, the Federal Reserve Chairman encouraged action on the resolution. He quickly announced his support for the new loans. He also indicated that new loans U.S. banks made to Mexico as part of a resolution package to service that country's international debt in an orderly manner should not be subject to supervisory criticism as imprudent. With this reassurance, the banks agreed to extend more loans to Mexico and began to negotiate terms and reschedule the $20 billion in loans coming due in 1983 and 1984. The banks also accepted a second 90-day moratorium. The banks launched lengthy negotiations among themselves about fairly sharing the new loans to Mexico.

Pace of Containment Quickened Under New President of Mexico

Once Mexico's new President took office on December 1, 1982, the pace of containment quickened. Steps in the restructuring program—eased exchange controls and increased fuel prices and interest rates—were announced within a week by Mexican government officials, and Mexican finance officials and the bankers agreed to terms on December 8. On December 22, with a commitment of $4.3 billion in new lending from the banks, the IMF Managing Director announced that a critical mass of new lending had enabled the IMF program to move forward. Throughout this period and in the weeks following, U.S. officials said that the United States and foreign central banks encouraged regional and smaller banks to give full consideration to making loans to Mexico sufficient to reach the previously announced goal of $5 billion. In the end, 526 banks participated in the lending to Mexico.

By the end of 1983, the containment effort could be called a success. According to U.S. officials, Mexico had repaid the interest arrears on its loans as well as emergency loans and currency swaps, established economic reforms, and restructured its debt through 1984. Mexico had not defaulted. Large U.S. and foreign banks had not failed, and financial system collapse had been avoided.

Resolution: Executive and Legislative Initiatives

To encourage more critical assessments of the risk of lending to foreign countries and more prudent U.S. bank international lending, Congress passed the International Lending Supervision Act of 1983.[17] Generally, the act sought to balance the interest of debtor countries in maintaining access to private credit markets against the need for maintaining a safe and sound banking system. The act required OCC, FDIC, FHLBB, and the

[17]Pub. L. No. 98-181, Title IX, as amended, 12 U.S.C. §§ 3901-3912.

Federal Reserve to establish uniform systems of supervision and ensure that, among other things,

- agency assessments of the adequacy of bank capital include country risk,
- banks achieve and maintain special reserves for foreign loans as required by the agencies,[18]
- banks provide quarterly data on international banking activities to the agencies,
- banks publicly disclose information about their exposure in foreign countries that is material to bank assets and capital, and
- banks amortize fees from loans over the life of loans.

The act significantly increased the oversight responsibilities of the Federal Reserve and other banking agencies with respect to foreign lending. The act directed federal banking agencies to consult with supervisory authorities of other countries to reach understandings aimed at achieving effective and consistent supervisory policies and practices with respect to international lending. The act also required federal banking agencies to establish regulations for accounting for fees on international loans.

The Baker and Brady Plans

As the decade of the 1980s proceeded, other less-developed countries—principally Latin American countries—went through debt crises. The approach used to contain the Mexican debt crisis in 1982 was used with these other countries. Two successive U.S. government initiatives were undertaken to readdress developing country debt. Since each initiative was launched by the Secretary of the Treasury, the plans bore the Secretary's last name. In 1985 the Baker plan tried to revive economic growth in developing countries by insisting that the heavily indebted middle income developing countries undertake economic reform programs designed to promote growth with the support of private banks and multilateral development banks. But the Baker plan did not succeed in restoring growth in these countries, and concerns grew about the monetary burden of the debt. In 1989, the Brady plan recognized that some

[18]The act provides for the maintenance of special reserves when the appropriate federal regulator determines that the quality of an institution's assets has been impaired by an inability of public or private borrowers in a foreign country to make payments on their external indebtedness for reasons that include a failure by the country to, for example, move toward implementing sound economic policies that can restore growth and enhance creditworthiness. Such reserves are not required for countries that are maintaining debt service and are working with international institutions to develop and implement sound economic policies. The act was amended in 1989 to provide for additional agency review of risk exposures, and appropriate additions to general reserves, of institutions with medium- and long-term loans outstanding to any highly indebted country. A highly indebted country is any country designated as such in the World Bank's annual world debt tables. See Foreign Debt Reserving Act of 1989, Pub. L. No. 101-240, § 402.

of the troubled debtors might not be able to fully service their debts and restore growth at the same time. The Brady plan sought permanent reductions in the debtors' existing debt-servicing obligations in countries with commitments to economic reform plans. Mexico reduced its debt-servicing burden under the Brady plan in 1990 by reducing its stock of debt, lengthening maturity, and lowering interest payments.

The Continental Illinois Bank Crisis

The Continental Bank crisis began on May 8, 1984, when Continental Illinois National Bank, then a major money center bank ranked the sixth-largest U.S. bank in terms of assets, experienced the beginning of a sudden run on its deposits. Beset by rumors about its difficulties, Continental faced a liquidity crisis of major proportions. Federal agencies agreed that Continental's failure would threaten the immediate health of many smaller banks whose deposits it held. This crisis illustrated that a financial crisis could develop as a result of a major financial institution having a high loan concentration in a few business sectors, such as oil or real estate.

Summary of Chronology

On May 8, 1984, the Continental Illinois National Bank (Continental), which held a large amount of nonperforming loans,[1] experienced the beginning of a sudden run on its deposits. Initially, the Federal Reserve encouraged bank lending and provided massive amounts of liquidity support. Federal banking agencies crafted a multipart strategy to (1) stop the run and (2) sell or arrange to recapitalize the bank. They announced that FDIC would place a temporary $2 billion subordinated note in the bank, that the ultimate resolution of Continental's problems would not subject depositors or general creditors to loss, and that the Federal Reserve would continue to provide liquidity support through the discount window. Other money center banks participated by taking $500 million of the subordinated note. This successfully slowed the run. Unable to sell the bank, FDIC permanently resolved Continental's problems several months later with a capital infusion of $1 billion into Continental's holding company and the purchase of $5.1 billion of its poor-quality loans. Treasury resolved a disagreement among the bank agencies about the treatment of shareholders. In consultation with the Department of Justice, Treasury settled disagreements regarding the treatment of bondholders.

Preparedness: Surveillance and Planning Prepared Regulators

On May 8, 1984, when the crisis began, Continental was a major money center bank. In 1981 it was ranked as the sixth-largest U.S. bank in terms of assets. Continental was also the nation's leading commercial and industrial lender and was considered a preeminent money center wholesale bank.[2] Continental had hundreds of correspondent banks and

[1]Nonperforming loans are those not paying principal and interest according to the original terms of the loan agreement. When the principal and interest payments on a loan are past due by 90 days or more, the loan is considered in default.

[2]Continental had 57 offices in 14 states and 29 foreign countries with $34 billion in assets, about 12,000 employees, and about 21,000 shareholders.

over $30 billion in deposits, 90 percent of which were uninsured foreign deposits or large certificates substantially exceeding the $100,000 deposit insurance limit. Continental was the largest provider of correspondent banking services in the country. At the time of the crisis, according to U.S. government documents, Continental held a large amount of nonperforming energy and real estate loans that resulted from inadequate management controls. Due to these nonperforming loans, Continental's credit rating was downgraded in July of 1982. As a result of the downgraded credit rating, the federal funds and certificate of deposit markets began to dry up as the bank lost the confidence of domestic money markets. Continental turned to foreign money markets for funding. Throughout 1982, 1983, and the first part of 1984, Continental regularly required $8 billion in overnight funds. In the first months of 1984 the Vice-Chairman, President, and Chief Financial Officer resigned from Continental. As rumors spread about the bank's ill health, maturities on Continental notes began to shorten, and the bank had to offer higher rates of interest to attract lenders. Continental was relying heavily on volatile European funding sources. In response to rumors about the bank's financial difficulties, large uninsured depositors—particularly foreign banks—were removing funds to avoid losses in case the bank failed.[3] The bank lost about $9 billion in funding, and the prospect was for the total to reach the $15 to $20 billion range of lost funding. (See fig. 3.1.)

[3]Continental lost about $15 billion in funding in the 10-day period prior to May 17, 1984.

Figure 3.1: Selected Events in the Continental Bank Crisis (May)

May

8 Commodity News Service reports that Continental might be bought and has received special attention from regulators.

Depositors begin to withdraw funds from Continental.

9 Board of Trade Clearing Corporation leads trading community move out of Continental.

Depositor withdrawals continue. Continental borrows $850 million from the Federal Reserve.

10 OCC news release states that OCC is not aware of any significant changes in the bank's operations, as reflected in its published financial statements, that would serve as the basis for rumors that OCC solicited aid for Continental from Japanese banks.

Continental President contacts 200 banks to deny rumors.

Depositor withdrawals continue.

11 Heads of Federal Reserve, Comptroller of the Currency, and FDIC meet to discuss placing $2 billion subordinated debt in Continental.

Continental borrows $3.6 billion from Federal Reserve Bank of Chicago.

Continental approaches Morgan Guaranty officials for help in arranging a credit line from major commercial banks.

12
13 Continental President and the President of the Federal Reserve bank of Chicago talk with leaders of 15 of the nation's largest banks. Continental sends messages informing overseas banks of safety net.

14 Continental announces that 16 of the nation's largest banks have extended it $4.5 billion in credit for 30 days.

15 Chairmen of Federal Reserve, Comptroller of the Currency, and FDIC decide to put $2 billion into Continental and meet with Treasury Secretary. Treasury Secretary agrees to assistance package and suggests commercial banks participate.

First National proposes merger with Continental.

16 Chairmen of Federal Reserve, Comptroller of the Currency and FDIC meet with heads of major banks to discuss their participation in the assistance package.

FDIC chairman announces that "FDIC would ensure...all deposits at Continental, no matter how large."

17 Regulators announce a temporary assistance program of a $2 billion subordinated debt note, that Continental resolution will protect depositors and general creditors, and that the Federal Reserve will support Continental at the discount window. Continental President announces Continental availability for merger or takeover. Continental's line of credit is raised to $5.5 billion with 28 participating banks.

Source: GAO analysis.

As uncertainty about the bank's health continued in May 1984, the bank was unable to meet its funding requirements. Beset by rumors about its difficulties, Continental faced a liquidity crisis of major proportions. According to FDIC documents, federal agencies agreed that Continental's failure would threaten the immediate health of many smaller banks whose deposits it held and would have severe consequences for the entire economy. It would also, they agreed, generate flights to quality throughout the financial markets—that is, investors and depositors in money center banks would seek more profitable investments and safer places for their funds, respectively—and create severe funding problems for other large, highly leveraged money center banks suspected of weakness because of poor-quality loans in their portfolios. The FDIC Chairman said that something had to be done quickly to stabilize the situation. By May 11, 1984, when other funding sources were unavailable, the Federal Reserve loaned Continental $2.8 billion at the discount window.

According to an FDIC official, the timing of the run on Continental was the only aspect of the crisis that surprised regulatory officials. According to the Comptroller of the Currency, through its routine monitoring and surveillance of Continental's financial condition, OCC was aware of Continental's problems, which had developed over several years. In the 2 years before the run, OCC had provided nearly constant supervision with bank examiners located on-site in the bank. After a 1982 bank examination, OCC sought corrective measures and took enforcement action.

Regulatory officials said they had not met to jointly develop contingency plans to address a possible run on the bank. However, OCC, Federal Reserve, and FDIC officials said they had informal relationships and had taken steps individually that prepared them to manage the crisis. In addition, federal officials involved in managing this crisis had previously worked together. For example, staff of the Federal Reserve, FDIC, OCC, and Treasury had communicated and coordinated on the resolution of the Penn Square Bank in 1982.

Agencies Were Aware of Continental's Condition Through Routinely Collected Information

Continental's funding difficulties began in July 1982, when the failure of Penn Square—one of its correspondent banks—revealed that Continental had more than $1 billion in problem energy loans.[4] Problems in Continental's loan portfolio grew in the years following the Penn Square failure. Continental owned nearly $1 billion in shipping loans of questionable quality and also had loan exposure to the Mexican and Argentine debt crises. Continental's lenders were increasingly concerned about the bank's creditworthiness.

Although regulatory agency officials said they were aware of Continental's problems, they said that no interagency meetings were held to discuss Continental's financial condition or federal responses to a possible run on the bank. Before the run in May 1984, OCC was monitoring the development of the bank's funding problems and reporting to the Federal Reserve Bank of Chicago and FDIC. In fact, for months before the run, OCC and Federal Reserve Bank of Chicago officials told us that they had tried to contain Continental's problems by urging the bank to improve the quality of its loan portfolio, retain earnings to rebuild capital, and investigate ways of writing off bad loans.

[4]Penn Square was a small bank in Oklahoma City that made energy exploration loans to many companies who failed to find oil and gas and faced sharp drops in energy prices. Penn Square sold these loans to other banks for a fee. Continental purchased $1.1 billion of these loans. Penn Square had more than 24,000 accounts with $250 million in insured deposits.

OCC routinely collected considerable documentary information about Continental's condition, including the quality of Continental's loan portfolio and the stability of its funding.[5] This information, and the agencies' attention to it, increased federal agency preparedness for the crisis that later occurred. Once the run was under way, regulators said they made a special effort to collect information on correspondent bank exposures to Continental for a detailed determination of the systemic risk associated with a Continental failure. However, the Federal Reserve, FDIC, OCC, and Treasury officials said they understood the general magnitude of the crisis without having details on correspondent bank exposures.

Federal Reserve and FDIC Were Strategically Prepared in Some Ways

The Federal Reserve and FDIC had already taken steps that prepared them for the crisis. The Federal Reserve Bank of Chicago had developed documents describing its response to a run on a "major" money center bank—with the unwritten understanding that the unnamed bank was Continental. The Federal Reserve Bank of Chicago had planned to arrange extraordinary levels of collateral to secure discount window lending and, if needed, quick possession of more collateral.[6] Although FDIC had not developed a specific response to a run on Continental, the agency had prepared legal documentation for the placement of subordinated debt in a large bank. FDIC had originally developed this documentation to respond to another possible crisis, but it was adaptable for use in responding to the Continental crisis.

Containment: Joint Discussions Led to Containment Strategy

Generally, federal agencies shared the leadership in containing the Continental crisis as each agency exercised its statutory authority. Agency officials said they agreed readily on some containment and resolution strategies and less readily on others. If the federal agencies had met to make contingency plans before the crisis occurred, as was done in the case of the Mexican debt crisis, they might have avoided having to resolve their differing views in a crisis setting.

[5]On April 2, 1984, OCC determined that Continental had no significant additional domestic liquidity available, excluding the Federal Reserve discount window, and that major sources of international funding were drying up. Even so, OCC did not declare Continental insolvent.

[6]The discount window is a line of credit facility maintained by the Federal Reserve for direct loans to a financial institution. All institutions that hold required reserves with the Federal Reserve are eligible to borrow at the discount window.

Officials Agreed on Intervention and Containment Strategy

Top officials of OCC, FDIC, and the Federal Reserve had the first of many joint discussions about the Continental crisis on the morning of May 11, 1984, at Federal Reserve headquarters in Washington, D.C.[7] They immediately agreed that the government should intervene to prevent the bank's failure. They believed Continental's failure would seriously threaten the banking system. They also agreed that FDIC would not pay off depositors by liquidating the bank and meeting its obligations from the proceeds. Regulators thought that a pay-off would be disruptive to the financial system and FDIC, could cause a run on other money center banks, and could disrupt relations between U.S. banks and foreign creditors. At this time federal banking regulatory agencies generally wanted the management and shareholders of Continental to be accountable for mistakes they made, and OCC communicated this to Continental officials. An interim financial assistance program was to ensure that Continental would have the capital resources, liquidity, and the time it needed to end the crisis of confidence and resolve problems in an orderly and permanent manner. Agency officials also agreed that FDIC should purchase $2 billion in subordinated debt from Continental, and the Federal Reserve should provide loans to Continental through its discount window as long as FDIC was involved in providing capital to Continental.[8] The subordinated debt note was viewed as a short-term funding solution—that is, a mechanism to stabilize Continental's funding sources.[9]

Other elements of the strategy emerged in discussions among Treasury and the other money center banks. On Monday, May 14, the Secretary of the Treasury said he suggested, and bank regulators agreed, that other banks should participate in the FDIC-subordinated note to demonstrate the banking system's confidence in Continental. After discussions revealed that the other banks had concerns about the riskiness of this participation, the FDIC Chairman suggested that FDIC assure the banks and all depositors and lenders that the resolution of the bank would not result in any losses in dealings with Continental. After some discussion, the other regulators agreed to this, and the banks participated by taking $500 million of the note.

[7]See Irvine H. Sprague. Bailout: An Insider's Account of Bank Failures and Rescues. New York: Basic Books, 1986.

[8]Federal Reserve discount window borrowing reached a daily high of $7.6 billion in August 1984.

[9]The note was conditioned on Continental's accepting certain restrictions related to hiring, promotions, and other factors. FDIC could replace senior management; remove members of the Board of Directors; and, in principle, control the bank.

The discount window loans to Continental—which quickly exceeded any previous bank loan from any Federal Reserve Bank—gave Continental the funding it needed to pay off maturing notes. However, this Federal Reserve assistance did not mitigate the market's distrust of Continental's financial strength, and normal funding was impossible.

Joint Agency Announcement of Rescue Package Slows Run

With the hope of ending the run and restoring confidence in Continental, FDIC, OCC, and the Federal Reserve jointly announced on May 17th the placement by FDIC of the $2 billion subordinated debt note. As subordinated debt, the note would be the last debt repaid in the event of a failure. Therefore, all current creditors would be repaid before FDIC. This was by far the largest commercial bank bailout in FDIC history. FDIC provided $1.5 billion of the subordinated debt, and a group of seven major U.S. banks provided the balance. In addition, a consortium of 28 banks provided Continental with a $5.3 billion funded line of credit, which was later replaced by a $4.5 billion standby line of credit. The agencies also announced that the resolution of the bank would not impose losses on anyone. This meant that FDIC would not pay off depositors by liquidating the bank and meeting its obligations from the proceeds—which could fall short and would take a considerable period of time. Instead, FDIC would support a takeover, find a merger partner, or recapitalize the bank; in any event, all Continental obligations would be honored. The Federal Reserve would continue to meet the bank's liquidity requirements.

This announcement did not completely end the run. Withdrawals from Continental slowed considerably after the announcement, but they continued. However, the announced intervention bought regulators some limited time to explore alternatives.

Secretary of the Treasury Mediates Agencies' Disagreement Over Rescue Methods

In keeping with its statutory authority, FDIC officials said it developed the solution to Continental's problem in consultation with the other regulatory agencies. FDIC first allowed the bank to look for a merger partner or a buyer. When Chemical, Citicorp, and First Chicago banks reviewed Continental's loan files, they decided that Continental was in worse shape than they expected and declined to participate in a merger or purchase. Regulators said they were concerned that Continental could worsen the financial condition of an acquiring institution. The regulators said they believed that any merger or purchase would likely require massive FDIC assistance. FDIC developed a plan to place capital in the bank and resolve the difficulties through open bank assistance. The continuing withdrawals

from the bank limited the amount of time available for the resolution effort.

Regulatory officials said they resolved several disputes in the development of the resolution. Concerned that the bank's shareholders would not support a package that left them entirely at risk, FDIC proposed that the resolution leave the shareholders with 15 percent of the bank's stock free and clear so that the shareholders would not be at risk to absorb further losses. FDIC would hold 85 percent of the stock. OCC and the Federal Reserve said they objected strongly, arguing that the government should not bail out stockholders of the bank or its holding company, who should risk a complete loss on their investment. The agencies brought the dispute to the Secretary of the Treasury, who agreed with OCC and Federal Reserve officials that stockholders should be at risk. FDIC agreed that the final package would leave the stockholders at risk of losing their entire investments.

A similar dispute arose over the treatment of the bank holding company's bondholders.[10] All agencies agreed that the holding company bondholders should be at risk—but their bonds had indenture covenants[11] preventing infusions of capital into the bank from outside the holding company by sales to others of bank securities without the approval of debt holders. Placing capital directly into the bank without waivers from bondholders, which would not help the holding company, could provoke a lawsuit. Placing the capital in the holding company to be downstreamed into the bank avoided legal complications but left the holding company solvent and the bondholders whole.

Treasury officials said they believed that the holding company bondholders should not be bailed out and the assistance should be placed directly in the bank. As the primary regulator of bank holding companies, Federal Reserve officials said they argued that the holding company should be bailed out to avoid major financial and confidence problems in other bank holding companies. FDIC officials said they argued that Continental could not afford the legal battles involved with a direct placement of capital in the bank; they also said that placing subordinated debt that does not count as capital—and that does not have legal

[10]Continental's parent holding company was Continental Illinois Corporation.

[11]Indenture covenants are formal agreements between bond issuers and bondholders specifying the terms and conditions of bonds. The indenture covenants may include such considerations as, for example, amount of issue, interest to be paid, maturity date, repayment schedule, call provisions, collateral pledged, appointment of a trustee, and other items.

complications—would not adequately reassure the public that the bank was properly capitalized. Treasury officials said they continued to insist on the placement of subordinated debt. The head of FDIC eventually took the issue to the Secretary of the Treasury, who indicated that FDIC should use its legal authority to press ahead with its plan to downstream assistance from the holding company to the bank. FDIC's version of the assistance package was supported by a legal opinion from the Department of Justice.

The final rescue package was announced at a joint OCC, FDIC, and Federal Reserve news conference by the FDIC Chairman on July 26, 1984. The permanent assistance program was designed to prevent the failure of Continental and enable the bank to restore its position as a viable self-financing entity. FDIC placed $1 billion in the holding company in exchange for holding company stock. This $1 billion was immediately downstreamed to the bank as equity capital. FDIC also purchased troubled loans with a face value of $5.1 billion for $3.5 billion. FDIC paid for the troubled loans by assuming Continental's debt to the Federal Reserve Bank of Chicago. Final accounting of cost to FDIC was $1.6 billion.

Key management changes were also announced. FDIC had the right to convert up to 80 percent of the preferred stock. Stockholders were left with a 20-percent stake in the bank, but losses on the bad loan portfolio were charged against that stake and eventually wiped it out. FDIC sold its remaining interest in Continental in June 1991. Continental continued to operate, but as a much different institution. (See fig. 3.2.)

Figure 3.2: Selected Events in the Continental Bank Crisis (July, September)

July

16 Interagency regulator group begins work on agreement with Continental.

FDIC plans to take two-thirds of the holding company and loan losses are to be charged against the shareholders' remaining third.

18 Treasury disagrees with decision to provide aid through the holding company and believes the plan needs Treasury approval.

Borrowings from the Federal Reserve, FDIC, and safety net banks are $8.2 billion.

19 FDIC Chairman proposes taking 85% of stock and giving stockholders the remaining 15% without liability. Comptroller of the Currency objects strongly. FDIC board meets with Treasury Secretary and Federal Reserve Chairman. Treasury Secretary decides shareholders must be liable for loan losses. Deal returns to old format with an 80/20 split. Stock options included in package. Meeting also includes discussion of legality of assistance to holding company.

21 Negotiators draw up plan.

22 Treasury and Federal Reserve discuss format of rescue.

23 FDIC assumes Treasury will drop objection to plan and prepares congressional briefing. Treasury still objects and the briefing is cancelled.

25 Question of FDIC's legal authority referred to Justice Department. Justice says that if FDIC has a basis to conclude this approach was necessary then transaction is legal. Treasury Secretary criticizes plan as bad public policy in memo to Chairmen of FDIC, Federal Reserve, and Comptroller of the Currency. FDIC Chairman supports the plan, and the Federal Reserve approves protection of holding company bondholders.

26 At joint news conference with Federal Reserve, FDIC, and OCC, Continental announces permanent assistance package. $1 billion is placed in holding company and downstreamed to Continental. FDIC purchases troubled loans with a face value of $5.1 billion for $3.5 billion and assumes Continental debt to the Federal Reserve Bank of Chicago.

Borrowings from Federal Reserve, FDIC, and safety net banks reach $12.6 billion.

September

25 Federal Reserve Bank of Chicago tells FDIC it will file public lien on all Continental assets. Federal Reserve Bank of Chicago thinks Continental does not have enough collateral.

Federal Reserve Chairman persuades Federal Reserve Bank of Chicago President to wait on lien.

Final assistance package approved by Continental stockholders.

Source: GAO analysis.

Resolution: FDIC Strengthened Oversight of Nationally Chartered Banks

FDIC officials told us that the Continental failure led to some changes in procedures at FDIC. For example, before the Continental failure, FDIC examined only state-chartered banks that were not members of the Federal Reserve System. After Continental, FDIC conducted examinations of state-chartered banks that were members of the Federal Reserve System as well as nationally chartered banks like Continental. Also, FDIC officials said they began to meet weekly with senior officials of other federal bank supervisory agencies to exchange information about emerging bank problems.

Hearings on the failure of Continental were held in September and October 1984 by the House Committee on Banking, Finance, and Urban

Affairs. Senate hearings were not held. The failure of Continental raised questions for the Committee about

- whether regulators had created a two-tier system for large and small banks, with large banks being considered “too big to fail”;
- whether Congress should have a voice in rescue plans created by bank regulators;
- whether the decades-old system of deposit insurance needed to be reformed; and
- whether Congress should further deregulate banks.

Legislative Initiatives to Limit “Too Big to Fail” Policy

Although Congress considered several banking bills in 1984 through 1986 that contemplated a wide variety of banking topics, bank reform legislation did not pass during this period. In 1987, Congress passed the Competitive Equality Banking Act of 1987 (P.L. 100-86). Among other things, the act gave FDIC bridge bank authority to facilitate FDIC’s disposition of failed banks. The bridge bank is to assume the assets and liabilities and carry on the business of the failed bank for a limited time until the bank is acquired or merged. Bridge bank authority essentially buys FDIC time to arrange an orderly merger or acquisition and enables the agency to delay resolution of holding company issues until other issues are resolved.

The Federal Deposit Insurance Improvement Act of 1991 (FDICIA)[12] established cost constraints for regulators resolving financial difficulties of banks. Before the passage of FDICIA, FDIC could fully protect all bank depositors and creditors, regardless of cost, if the bank was deemed essential to its community. The new act narrowed the circumstances under which FDIC could act in this way. The least-cost provision of the act sought to limit the circumstances under which uninsured deposits are fully protected by preventing FDIC from incurring a loss when it protects them.[13] Only when a large bank failure is determined to pose a systemic risk to the nation’s financial system may FDIC protect all deposits and nondeposit liabilities in a failing depository institution and sustain a loss. FDICIA also required that such action be approved in advance by FDIC’s Board of Directors, the Board of Governors of the Federal Reserve, and the Secretary of the Treasury in consultation with the president. Absent such approval, FDIC must resolve the problems of a failing institution using the

[12]P.L. 102-242.

[13]1992 Thrift Resolutions: RTC Policies and Practices Did Not Fully Comply With Least-Cost Provisions (GAO/GGD-94-110, June 17, 1994).

resolution method that is least costly to the insurance fund—which can be a liquidation in which only insured deposits are protected. Other legal changes would also influence how FDIC would handle a failure like Continental's today. Also, the Resolution Trust Corporation Completion Act of 1988[14] prohibited the use of federal deposit insurance funds to benefit shareholders in connection with a resolution.

[14]P.L. 103-204.

The Ohio Savings and Loan Crisis

The Ohio savings and loan crisis began on March 5, 1985, when the most widespread run on depository institutions since the Great Depression began. The run was set off by the collapse in March of Home State Savings Bank, the largest of Ohio's 71 privately insured savings and loan institutions. About $4 billion in deposits of a half-million depositors were threatened at 71 institutions. This crisis showed that a financial crisis occurring in a financial institution that is not federally insured could involve the federal government in a financial rescue. This case also illustrated the linkage that had developed between securities markets and financial institutions. Factors that helped contain the Ohio savings and loan crisis included the joint leadership of the Ohio Governor's Office and the Federal Reserve, provision of liquidity by the Federal Reserve Cleveland Bank, innovative action by the state of Ohio and federal regulators, and collaboration between federal and state regulators.

Summary of Chronology

The 1985 Ohio savings and loan crisis was the most widespread run on depository institutions since the Great Depression. The run was set off by the collapse in March of Home State Savings Bank, the largest of Ohio's 71 privately insured savings and loan institutions. A concern of the Federal Reserve was that the run could spread to other states with private insurance funds and ultimately to federally insured savings and loans. Because the 71 thrifts were not federally regulated, federal agency officials said they lacked immediate access to important crisis-related information. At the Ohio Governor's request, the Federal Reserve provided liquidity support to qualified thrifts experiencing heavy withdrawals. Federal Reserve officials and staff also worked closely with the Ohio Governor, sometimes engaging in nonroutine activities. Federal Reserve officials helped the state monitor the run, collect information, respond to questions from the public, and find a permanent solution to the instability. Ultimately, the run was contained through a state-declared bank holiday, temporary limits on withdrawals, and state-mandated conversion of most of Ohio's privately insured thrifts to federally insured status. The Federal Home Loan Bank of Cincinnati provided the thrifts with federal deposit insurance. By the middle of June 1985, most thrifts had reopened with federal insurance, and confidence had been restored in nearly all of the institutions.

Figure 4.1 lists a chronology of events in the Ohio savings and loan crisis.

Figure 4.1: Selected Events in Ohio Savings and Loan Crisis of 1985
(March)

Sunday	Monday	Tuesday
3	**4** • ESM Government Securities is closed by regulators. • Home State asks Federal Reserve Bank of Cleveland about borrowing documents.	**5** • Depositors stage run on Home State. • Federal Reserve Bank of Cleveland asks Federal Home Loan Bank of Cincinnati for information about Home State and Guarantee Fund.
10 • Governor of Ohio announces closure of Home State and appoints conservator to wind up its affairs. • Federal Reserve Bank of Cleveland announces Guarantee Fund thrifts eligible to borrow at discount window.	**11** • Federal Reserve Bank of Cleveland staff monitor activities from positions at Guarantee Fund thrifts. • Deposit outflow is $6 million.	**12** • Governor of Ohio appoints conservator to wind up Home State affairs. • Guarantee Fund institutions have $13.4 million outflow.
17 • After meeting with thrift executives, Governor of Ohio decides to extend the bank holiday 2 more days. • Federal Home Loan Bank Chairman meets with Federal Reserve Chairman in Washington, D.C., to discuss Ohio thrift situation.	**18** • Governor of Ohio orders 48-hour extension of bank holiday. • Federal Home Loan Bank officials call Ohio thrifts and ask whether they intend to seek federal insurance.	**19** • Governor of Ohio meets separately with Federal Reserve Chairman and Federal Home Loan Bank Board Chairman in Washington, D.C. • Federal deposit insurance exams are to begin at Guarantee Fund institutions.
24 • Federal deposit insurance examinations continue.	**25** • Deposit outflows are $7.7 million.	**26** • Eighteen institutions are now open on a full-service basis. • Deposit outflows are $3.9 million.

Wednesday	Thursday	Friday	Saturday
		1 ESM Government Securities audit report withdrawn.	**2** Guarantee Fund officials discuss ESM and Home State situation with Ohio Superintendent of the Division of Savings and Loan.
6 • Federal Reserve Bank of Cleveland ships cash to Home State. • Federal Reserve Bank of Cleveland and Federal Home Loan Bank do not have data on Home State. • Federal Reserve Bank of Cleveland sends examiners to Home State to review collateral.	**7** • Governor of Ohio calls Federal Reserve Bank of Cleveland President to discuss Home State and ask for assistance. • Ohio Superintendent of Savings and Loans, Guarantee Fund, and Home State meet to discuss discount window borrowing.	**8** • Home State announces Saturday closure. • State of Ohio gives Federal Reserve Bank of Cleveland data on Guarantee Fund thrifts. • Home State signs note to borrow at the discount window.	**9** • Federal Reserve Bank of Cleveland starts monitoring and analyzing data on Guarantee Fund thrifts. • Home State conservator is named. • Ohio Superintendent of Savings and Loan has meeting to discuss Home State options.
13 • Ohio legislature lends $50 million to new state deposit insurance fund. • Guarantee Fund runs total $23 million. • Federal Home Loan Bank takes preliminary look at Guarantee Fund thrifts.	**14** • Federal Home Loan Bank Chairman tells Ohio delegation that insurance applications will be handled expeditiously. • Guarantee Fund runs total $64 million. • Thrift executives tell Governor of Ohio they may not make it through next day.	**15** • Governor of Ohio declares 3-day bank holiday. Federal Reserve Bank of Cleveland President indicates liquidity help will be available when thrifts reopen. • Governor of Ohio and Federal Reserve Bank of Cleveland meet with Ohio financial institutions to ask their help.	**16** • State of Ohio asks Federal Reserve Bank of Cleveland to discuss sale of Home State and other thrifts with out-of-state financial institutions. • Ohio Superintendent of Banks asks federal bank regulatory agencies to help examine Guarantee Fund thrifts.
20 • State of Ohio requires all Guarantee Fund thrifts to get federal deposit insurance. • Guarantee Fund thrifts are opened with partial withdrawals allowed. • Federal Reserve Chairman reiterates Ohio thrift eligibility for liquidity assistance.	**21** • One Guarantee Fund thrift gets federal deposit insurance.	**22** • A task force is set up by State of Ohio to coordinate Superintendent of Savings and Loans, Federal Reserve Bank of Cleveland, and Federal Home Loan Bank actions.	**23** • Federal deposit insurance examinations continue. • Guarantee Fund thrifts reopen for limited service. • Guarantee Fund thrifts have $5.4 million in runs.
27 • Deposit outflows of $2.9 million.	**28** • Deposit outflows of $4.4 million.	**29** Twenty-six thrifts are now open for full service.	**30** • Deposit outflows of $1.3 million.

Source: GAO analysis.

Preparedness: Limited Information and Authority Made Planning Difficult

In 1985, savings and loan institutions in Ohio experienced the most widespread run on depository institutions since the Great Depression. About $4.3 billion in deposits of a half-million depositors were threatened at 71 institutions. The run, which began on March 5, resulted from publicized losses of $150 million from Home State Savings Bank (Home State), Ohio's largest privately insured savings and loan institution.[1] The run continued despite efforts by Ohio and Ohio Deposit Guarantee Fund officials to reassure the public. State officials said that depositor funds were safe, and officials of the private Guarantee Fund said that depositors would not lose their money. The Ohio Deposit Guarantee Fund was a private, state-chartered insurance system that guaranteed 100 percent of all deposits. After questions were raised on a radio talk show about the ability of the Guarantee Fund to meet the needs of Home State depositors, withdrawals began at other thrift institutions.

Home State's losses were due to the failure on March 4, 1985, of a largely unregulated government securities dealer, ESM Government Securities, following a massive fraud involving false audit reports. ESM was missing about $300 million in customer funds. Home State was heavily exposed to this failed securities dealer through repurchase agreement transactions.[2] Lax supervision had allowed Home State to borrow almost 50 percent of its funds through ESM. As the result of ESM's failure, Home State and American Savings and Loan Association in Florida, which were part-owned by the same person, sustained substantial losses. Home State estimated losses at $150 million or more.

Home State's deposits, like those of the other state-chartered and privately insured Ohio thrifts, were insured by the Ohio Deposit Guarantee Fund. Immediately before the run on Home State, the Guarantee Fund had total assets of $130 million to guarantee about $4.3 billion in deposits for about 500,000 depositors. According to Federal Reserve officials, the thrifts had chosen private deposit insurance because such insurance was less expensive and burdensome compared to federal deposit insurance. The Guarantee Fund had no legal power to ensure compliance by its members and had no cease and desist power. According to a Guarantee Fund official, the privately insured Ohio thrifts were regulated by the Ohio Department of Commerce's Division of Savings and Loan Associations.

[1] On March 6, 1985, the Cincinnati Enquirer reported that Home State might suffer large losses in connection with the failure of ESM.

[2] Repurchase agreements are contracts to sell and subsequently repurchase securities at a specified date and price.

Federal Agencies Had Limited Information About Home State

When the run on privately insured thrifts began, federal agencies had little information about the Guarantee Fund or thrifts it insured. The Federal Reserve Bank of Cleveland had been concerned for some time about the condition of the fund and its insured thrifts. However, the fund had not honored the Reserve Bank's 1982 requests for information.[3] FHLBB, which had failed in its attempts to bring the privately insured institutions under Federal Savings and Loan Insurance Corporation (FSLIC) coverage, also lacked information about the condition of the thrifts.[4] The Guarantee Fund had collected information on the financial condition of the thrifts it insured, but it did not share this information with the Federal Reserve.

Although Ohio state banking regulators and officials of the guarantee fund were aware of the exposure of Home State to ESM Government Securities, they said they had not initiated any interagency meetings with federal officials to prepare for a possible crisis resulting from the failure of Home State. Ohio state regulators had initiated interagency meetings, but those meetings had not involved federal officials. About 5 months before the run—in October 1984—the Ohio Superintendent of Savings and Loans met with officials of ESM Government Securities, Home State, and the Guarantee Fund to caution them on Home State's exposure to ESM. However, according to a state official, state banking officials were reluctant to issue cease and desist orders because state judges would not support them. In addition, the Guarantee Fund had no authority to issue or enforce a cease and desist order.

Containment: Ohio Governor and Federal Reserve Led Crisis Containment Efforts

A lack of information about the scope of the crisis and the financial condition of the 71 Ohio thrifts complicated and slowed federal and state responses to the crisis, which took about 3 months to resolve. State and federal officials said the State of Ohio and the Federal Reserve intervened after it was clear that Home State and many of the other Ohio thrifts were in poor financial shape and unable to stop the runs on their deposits, and the private Guarantee Fund was insufficient to cover depositor withdrawals.

[3]The Federal Reserve Bank of Cleveland was aware of financial problems at at least one privately insured thrift as a result of its discount window transactions.

[4]FSLIC was established by Congress in 1934 to insure deposits in savings and loan institutions and savings banks. The Financial Institutions Reform, Recovery, and Enforcement (FIRREA) Act of 1989 transferred the assets and liabilities of the Corporation to a new deposit insurance fund called the Savings Association Insurance Fund. This fund is operated by the Federal Deposit Insurance Corporation.

Among other things, the containment and resolution efforts involved discount window borrowing to satisfy deposit withdrawals, intensive information gathering to monitor the run, carefully managed communications with the public, the declaration of a bank holiday for the thrifts, emergency state legislation, and an intensive effort to bring Guarantee Fund-insured thrifts under federal deposit insurance.

According to Federal Reserve and Federal Home Loan Bank officials, leadership during the Ohio savings and loan crisis came primarily from the Governor of Ohio and officials of the Federal Reserve. The legal authority necessary to contain and resolve the crisis rested with the Governor of Ohio. Federal Reserve officials—including the president and staff of the Federal Reserve Bank of Cleveland and the Federal Reserve Board Chairman—facilitated decisions and actions of the Ohio Governor. According to the Governor of Ohio, the Federal Reserve also provided liquidity support to the privately insured thrifts, supplied bank examiners to monitor the run and conduct federal deposit insurance examinations, and assisted in other ways.

Federal Agencies Did Not Agree on Necessity of Involvement

Federal financial officials said they disagreed about the necessity to become involved in the Ohio savings and loan situation. The top FHLBB official told us that he was responsible for regulation and oversight of federally chartered thrifts and the operation of FSLIC and was not inclined to involve FHLBB in crisis management efforts, since the thrifts had elected private rather than federal deposit insurance. A Federal Reserve official told us that the Federal Reserve Board Chairman was instrumental in encouraging Federal Home Loan Bank officials to provide federal deposit insurance for qualified Ohio thrifts. According to Federal Reserve and Ohio officials, FDIC officials were also reluctant to be involved; they considered the crisis a state problem.

Federal Reserve Opened Discount Window as Run Continued

On March 4—the same day that ESM failed—the Federal Reserve Bank of Cleveland received a request from Home State for information about discount window borrowing. After reviewing Home State's application, the Federal Reserve Bank of Cleveland judged Home State's collateral acceptable and began discount window lending.[5] During the week of March 5 through 9, the Federal Reserve Bank of Cleveland followed routine procedures to make cash shipments to various Home State offices.

[5]The Depository Institutions Deregulation and Monetary Control Act of 1980 (P.L. No. 96-221) gave nonmember depository institutions, including the state-chartered thrifts in Ohio, eligibility for discount window borrowing.

Federal Reserve officials told us they were increasingly concerned that Home State's problems could spread to other privately insured Ohio savings and loans.

By the end of the first week of the run, Home State depositors had withdrawn an estimated $155 million, and the Guarantee Fund had advanced $45 million to satisfy deposit demands, according to a Guarantee Fund official. On March 10, 1985, the Federal Reserve emphasized in a public statement that privately insured, state-chartered depository institutions could be eligible for discount window assistance.

Federal Reserve Believed Risk of Contagion Made Containment Efforts Necessary

During the week of March 4 through 9, the Federal Reserve Bank of Cleveland officials said they worked to determine Home State's financial condition and the likelihood that the run would threaten other institutions in Ohio and other parts of the country.[6] They were also concerned about the payment system, since Guarantee Fund thrifts had correspondent clearing relationships with commercial banks. In addition, the Federal Reserve Bank of Cleveland helped educate some members of the Ohio Governor's staff about banking issues, including possible approaches to solving the Home State problem. On March 6, a senior Federal Reserve examiner who had reviewed Home State's books told the president of the Federal Reserve Bank of Cleveland that the financial condition of Home State was as bad as any he had seen.

Federal Reserve Bank of Cleveland officials said they conferred with other Federal Reserve officials in Washington, D.C., and New York about possible effects of the run on other thrifts and banks. Federal Reserve officials decided that the Federal Reserve was compelled to act to contain the crisis because of the possibility of contagion and possible effects on the dollar in international foreign exchange markets. The decision was difficult because of the lack of reliable information on the financial condition of the privately insured institutions.

Federal Reserve Led Efforts to Obtain Reliable Information

Federal Reserve officials said the lack of information on the financial condition of Guarantee Fund thrifts delayed decisive action by the state of Ohio and the Federal Reserve and prompted debates about the existence of risk to the financial system. When Home State's problems were first disclosed, little information was available to state and federal agencies.

[6]Georgia, Maryland, North Carolina, Pennsylvania, Rhode Island, and Utah also had privately insured savings and loans.

The Federal Home Loan Bank of Cincinnati had quarterly and annual reports of the Guarantee Fund insured thrifts, but these were considered of little value because they had not been verified by on-site federal examinations and did not provide information about financial linkages, such as creditor relationships.

With assistance from Ohio thrift regulators, the Federal Home Loan Bank of Cincinnati, the Office of the Comptroller of the Currency, and FDIC, the Federal Reserve said it initiated a large effort to quickly determine the financial condition of the privately insured Ohio thrifts and how many would qualify for liquidity assistance through the discount window.[7] On March 6, 1985, several senior members of the Federal Reserve Bank of Cleveland's Division of Bank Supervision and Regulation reviewed records at Home State. On March 8, 1985, the Federal Reserve received the available examination reports from the state on thrifts with deposits insured by the Guarantee Fund. Next, about 200 examiners—most of them Federal Reserve examiners—were deployed throughout the state on March 11 to collect operational and financial information on those thrifts. The Federal Reserve Bank of Cleveland and the Federal Home Loan Bank of Cincinnati began assessing the condition of Guarantee Fund thrifts. On this basis, the Federal Reserve Bank of Cleveland decided which thrifts could survive with liquidity assistance from the discount window until a permanent solution could be devised.

Ohio Governor Developed Basic Strategy

The then-Governor of Ohio told us that on March 6, 1985, he received a telephone call from the owner of Home State, who told him that the failure of ESM Government Securities had caused his thrift problems. The Governor asked his chief of staff to define the problems, ascertain the causes of the problems, and determine whether other thrifts were threatened. The Governor received assurances from his staff that there were no problems. Federal Reserve officials initially had difficulty convincing the Governor of Ohio that the situation could prove serious. The Governor also discussed the Home State situation with state legislative leaders. He and they agreed that Ohio had to act to protect depositors and thrifts; they also agreed, however, that the state would not put money into Home State, although it should do something to protect other institutions. One of the Governor's objectives was to quickly find a buyer for Home State.

[7]The discount window loans would be made by the Federal Reserve Bank of Cleveland and secured by government and agency securities, commercial loans, and residential mortgages.

State and Federal Officials Discuss Objectives and Strategies

The weekend of March 9 and 10, the Governor met with advisors to discuss options; he also formally requested help from the president of the Federal Reserve Bank of Cleveland. Federal Reserve officials and the Governor's staff discussed the possibility of bringing the privately insured thrifts under federal deposit insurance. The president of the Federal Reserve Bank of Cleveland told us that on March 10, 1985, the Federal Reserve invited several large Ohio bank holding companies to discuss purchasing Home State. Similar meetings with out-of-state institutions concerning Home State and other privately insured thrifts that would not qualify for federal insurance took place on March 16 and 17. The potential buyers, which were unable to determine the financial condition of Home State, wanted the state to provide indemnification or compensation for losses. The Governor said he believed this would be unacceptable to the legislature and voters.

Federal Reserve and Ohio state officials said they worked closely together, despite the differences in their primary goals. Federal Reserve officials were most concerned about stopping the run and preventing it from spreading to other states. State officials were most concerned about limiting the financial exposure of the state of Ohio and minimizing losses to individual depositors. Officials of the Federal Reserve Bank of Cleveland and the Ohio Governor's Office had not worked together before, and neither group fully understood at first the other's responsibilities, concerns, and resources, according to officials we interviewed. Officials said that educational efforts required considerable time.

During the weekend of March 9 and 10, Federal Reserve officials said they discussed the objectives of the Federal Reserve's involvement; possible future events; and operational and logistical actions, including ways to improve operations for monitoring the run. Federal Reserve officials focused on promoting cooperative efforts among the various parties involved in managing the crisis.

To Enhance Coordination and Communication, Federal Reserve Engaged in Nonroutine Activities

Federal Reserve officials anticipated problems communicating and coordinating with their examiners in the field who were monitoring the run. The Federal Reserve Bank of Cleveland said it set up a situation room to facilitate communication and coordination during crisis containment efforts. The room, which was near the offices of senior officials, was equipped with 20 telephones, maps, televisions, and radios to monitor the crisis, including media reports. Examiners were briefed about events, provided with the latest financial information on thrifts insured by the

Guarantee Fund and packages of documents necessary for discount window borrowing for the thrifts, and equipped with cellular telephones or pagers.

Federal Reserve officials said, and Federal Reserve documents demonstrate, that they engaged in other nonroutine activities to facilitate crisis containment efforts. On March 11, 1985, Federal Reserve examiners were positioned throughout Ohio near Guarantee Fund thrifts to unobtrusively survey levels of depositor traffic in thrift lobbies and parking lots. Examiners were to report activity back to the situation room. The examiners were instructed to avoid doing anything that would alarm thrift employees or their customers. Examiners were also to deliver documents for borrowing at the discount window and establish secure warehouses for collateral. Situation room personnel began to contact the thrifts to advise them of the availability of the discount window, inquire about withdrawals, and offer to send an examiner to deliver borrowing documents and secure collateral.

Federal Reserve Communicated Carefully With the Public and Media

Communications with the public were carefully managed by the Federal Reserve Bank of Cleveland. Officials of the Ohio Superintendent of Savings and Loans, the conservator of Home State, and the Guarantee Fund were not answering questions from the public. According to Federal Reserve documentation, the Public Information Department at the Federal Reserve Bank of Cleveland took calls from depositors, bank officers and directors, municipal officials, congressional offices, and the print and broadcast media. Questions concerned when deposits would be available, deposit insurance, why thrifts had been closed, and how depositors were supposed to pay their bills. The most difficult task was explaining that the thrift crisis was the responsibility of the state of Ohio and not the federal government and that the Federal Reserve was acting as a facilitator.

To ensure consistency and minimize confusion in communications with the media, two officials were assigned the task of communicating with media representatives. The Federal Reserve publicly restated its policy that state-chartered institutions were eligible for liquidity assistance through the discount window under normal terms and conditions.

As Runs Spread, Ohio Governor Closed Home State and Legislature Acted

The runs on deposits intensified, spreading to other institutions insured by the Guarantee Fund, despite continued assurances from officials of the State of Ohio and the Guarantee Fund that depositor money was safe.

About $23.4 million in withdrawals occurred on March 13 and $63.9 million on March 14. According to Federal Reserve documentation, six Guarantee Fund-insured thrifts were particularly hard-hit. At the drive-in windows of some Cincinnati institutions, examiners observed some lines as long as 100 cars.

The Governor of Ohio and the state legislature took several actions to reduce the widening depositor withdrawals. The Governor told us that he announced that Home State would not reopen for business; he also appointed a conservator to wind up the thrift's affairs. At the time of its failure, Home State had $1.4 billion in assets and 92,000 accounts at 33 offices. Home State's problems would clearly exhaust the $130 million Guarantee Fund.

On March 13, 1985, the Ohio legislature passed a bill that appropriated $50 million for a new fund to back the remaining Guarantee Fund thrifts—excluding Home State—and provided for thrift contributions of $40 million. On March 14, the Chairman of the Federal Home Loan Bank Board met with members of Ohio's congressional delegation in Washington, D.C. The Chairman of the Federal Home Loan Bank told us that the subject of the meeting was expedited approval of federal deposit insurance for the thrifts insured by the Guarantee Fund. Also on March 13, 1985, Federal Home Loan Bank officials began examining state reports on thrifts to estimate the number eligible for federal deposit insurance.

Governor Declared Bank Holiday and Established Public Communications Center

The then-Governor of Ohio told us that on March 14, 1985, officials of some of the privately insured thrifts told him that they were unable to stay open through the end of the next day and lacked adequate collateral for discount window borrowing to meet depositor demands. The Governor considered several options: doing nothing, imposing limits on withdrawals, or closing the thrifts. He decided to close the privately insured thrifts for 72 hours to stop the runs and buy time to devise a permanent solution to the problem.

The then-Governor of Ohio said that on March 15, 1985, he and the president of the Federal Reserve Bank of Cleveland held a news conference announcing a Guarantee Fund thrift holiday for the remaining 70 thrifts.[8] The president of the Federal Reserve Bank of Cleveland also announced that liquidity help would be available when thrifts reopened. That same day, the state of Ohio opened a telephone bank staffed by 300

[8]Executive Order 85-7.

people to handle inquiries from the public concerning the state's actions and the safety of deposits. The day before the closed thrifts were due to reopen, on March 17, the Governor met with over 100 thrift executives, who told him they were concerned about additional runs on deposits. After the discussion, the Governor decided to extend the bank holiday by 2 days.[9]

Governor and Federal Officials Pushed for Federal Insurance

The Governor's strategy was to restore depositor confidence by (1) completing emergency legislation requiring federal deposit insurance for the Guarantee Fund-insured thrifts, (2) pursuing expedited approval of federal deposit insurance from the federal government for those thrifts by March 19, and (3) reopening those thrifts by March 19. According to Federal Reserve documents, on March 19 and 20 Federal Reserve examiners examined closed thrifts to determine which would be eligible for federal deposit insurance. Some thrifts were well managed, in sound financial condition, and would qualify for federal insurance; others were not likely to qualify. On March 18 and 19, the Federal Home Loan Bank of Cincinnati telephoned the privately insured thrifts to determine their plans to seek federal deposit insurance. Over 200 examiners were sent to expedite the application process for thrifts that indicated they would apply for federal deposit insurance.

State Legislature Limited Withdrawals, Required Federal Deposit Insurance

The then-Governor of Ohio told us that on March 20, the Ohio state legislature enacted a law that provided for the reopening of the closed thrifts—on a limited basis in some cases and on a full-service basis in others. The law limited thrifts to no more than $750 in withdrawals per month per customer and required thrifts to have federal deposit insurance before opening on a full-service basis. On March 29, 1985, 26 of the former 71 Guarantee Fund institutions had reopened with a full range of banking activities—most with federal insurance. By the 24th of April, 51 of the 71 thrifts had opened, 31 with federal deposit insurance and 19 without, as approved by the Ohio Superintendent of Savings and Loans. As of June 14, 1985, all but 8 of the original 71 privately insured thrifts had opened on a full-service basis.

Home State, acquired by Hunter Savings and Loan of Cincinnati, reopened on June 14, 1985. The state of Ohio had contributed a total of $129 million, in addition to the resources provided by the Guarantee Fund, to reopen Home State. The state of Ohio received $134 million from lawsuits.

[9]Executive order 85-8.

Resolution: Legislation Enacted to Address Government Securities Fraud and Improve Disclosure

Following the containment of the Ohio savings and loan crisis, two federal laws were enacted to address problems that surfaced during the crisis—fraudulent sales activities of government securities and disclosure to depositors about their depository institution's insurance coverage. The Government Securities Act of 1986 (P.L. 99-571) created tighter regulation of government securities brokers and dealers like ESM Government Securities. The act focused on secondary brokers and dealers that sell government securities by requiring the dealers to register with SEC. It also required new regulations designed to prevent fraudulent and manipulative practices and protect the integrity, liquidity, and efficiency of the market for government securities. Previously, such government securities brokers and dealers were not regulated. The act required government securities brokers and dealers to file independently audited balance sheets and income statements at least once a year. Dealers were to meet regulatory standards showing they had adequate cash reserves and properly managed customer accounts and securities. Newly regulated members were required to join a stock exchange, which made them subject to exchange regulation.

The Federal Deposit Insurance Corporation Improvement Act of 1991 (P.L. 102-242) required all state-chartered banks, thrifts, and credit unions without federal deposit insurance to conspicuously disclose that fact to existing and prospective customers. These institutions were also required to disclose that depositors are not guaranteed return of their money if the institution fails. The provision also applied to any other institution, as determined by the Federal Trade Commission, that might be mistaken for a bank.

The Stock Market Crisis of 1987

The stock market crisis began on October 19, 1987, when a large and rapid sell-off of equity securities led to mechanical and liquidity problems in trading and financial systems at stock, options, and futures exchanges and associated clearing organizations. Credit relationships between financial firms and banks were also strained. The market break was extraordinary in terms of the speed and extent of falling prices and skyrocketing trading volume. This crisis showed that the size and potential impact of increased linkages between the equities markets and futures markets could change the character of a financial crisis. Factors that contributed to containing the crisis included the complementary leadership of the financial exchanges, the Treasury Department, and the Federal Reserve; the early offer of liquidity by the Federal Reserve to keep the markets functioning; swift and innovative action by federal financial regulators; and the collaboration of the private and public sectors.

Summary of Chronology

On October 19th, 1987, an accelerated and massive sell-off of equity securities and futures and options contracts led to automation and liquidity problems in U.S. financial markets and institutions. Difficulties also occurred in the clearance and settlement system and in bank extensions of credit to securities firms. European and Pacific rim financial centers experienced similar declines. Federal officials were most concerned that the U.S. system for allocating credit would be halted. To keep markets open and functioning as they should, federal officials and agencies took various actions in accordance with their individual authorities and responsibilities. For example, the White House and Treasury collaborated in making public announcements to foster confidence in the markets. Treasury discussed with finance ministries in London and Tokyo and other financial centers the importance of providing liquidity support to their markets. The Federal Reserve also discussed with other central banks the importance of providing liquidity support. The Federal Reserve provided prompt and sizable liquidity through open market operations. Around noon on October 20th, the market was plummeting and uncertainty existed about whether NYSE could remain open. However, buying activity in one stock index futures contract around noon signalled the turnaround of the markets. By the end of the week, markets were calmer, but some officials involved in trying to manage the crisis believed that luck played a major role in the recovery.

Preparedness: Routine Market Monitoring and Existing Networks Helped Prepare Regulators

On October 19 and 20, 1987, a large and rapid sell-off of equity securities led to automation and liquidity problems in trading and financial systems at stock, options, and futures exchanges and associated clearing organizations. Credit relationships between financial firms and banks were also strained. The crash was extraordinary in terms of the speed and extent of falling prices and skyrocketing trading volume. From the close of trading Tuesday, October 13, to the close of trading Monday, October 19, the Dow Jones Industrial Average (DJIA) declined by almost one-third, representing about a $1 trillion loss in value of all outstanding U.S. stocks.[1] On October 19, the DJIA plunged 508 points (23 percent).[2] NYSE volume was 604 million shares, more than twice the average daily volume for the year.

The individual markets experienced a variety of difficulties on the 19th and 20th of October. NYSE specialists faced large order imbalances throughout both days. NYSE's automated order entry system was overloaded because of insufficient capacity. Due to reduced over-the-counter market-maker[3] participation, investors had difficulty getting timely price information, and NASD transaction reports were delayed. A proliferation of option transactions within the same underlying securities at CBOE in response to rapid price changes slowed trading. CBOE stopped offering some options on individual stocks that were not trading and did not trade one stock index option contract for over 1 hour. CME's clearing department received late payments[4] and delayed some of its payments, and CME suspended trading in the S&P 500 index futures contract for about an hour on October 20, 1987. Derivatives option and futures markets became disconnected from equity markets. Some securities firms said that their banks were refusing to lend them additional funds. Many firms were overwhelmed with customer orders, and some firms were pressuring NYSE and NASD to stop trading so that they could catch up with customer order flows.

At mid-day on October 20, the securities markets and the financial system approached breakdown. The ability of stock, options, and futures markets

[1]The DJIA, a price-weighted index of 30 stocks listed on NYSE, is the most widely followed indicator of U.S. stock market movements.

[2]Since the 1920s, only the drop of 12.8 in the DJIA on October 28, 1929, and the fall of 11.7 percent the following day, which together constituted the Crash of 1929, have approached the October 19 decline in magnitude.

[3]Market makers are professional securities dealers who have an obligation to buy when there is an excess of sell orders and to sell when there is an excess of buy orders.

[4]These late payments were not rule violations, and CME took no action to declare the firm making the late payments in default.

to price equities was in question, and those markets were described as disconnected. Many individual stocks ceased to trade because few buyers were in the market, and trading in many individual options was halted. Stock index futures were selling at a large discount, and investors were questioning the value of equity assets. Rumors circulated that several major market participants, including a clearinghouse, were about to fail. The financial system was close to gridlock, and a widespread credit breakdown seemed possible. The primary concern of federal officials was that the U.S. system for allocating credit would be halted, and the financial system would stop functioning.

Agencies Depended Largely Upon Information and Existing Communication Networks

Although the Federal Reserve had developed a written plan that outlined potential responses to a range of financial crises, no interagency meetings had been held before October 1987 to prepare for a market crash like the one that occurred. However, an SEC official told us that a joint SEC-CFTC effort in 1986 to monitor expiration day effects—so-called triple-witching days—helped prepare them to handle the market crash.[5] The readiness of federal officials and agencies to manage the market crash largely depended upon the availability of information that federal agencies had routinely collected, the existing communication networks among the agencies, and the ability of the agencies to influence the behavior of market participants and their creditors.

At the time of the crash, federal regulators, exchanges, and clearing organizations routinely collected information on the financial health of firms, the trading of financial instruments, and payments. Federal regulators received quarterly detailed reports of firm capital levels. These reports provided information on the likely resilience of firms to market volatility. Exchanges and some federal regulators collected information on the trading of financial instruments, such as customer identity, the number of shares or contracts, price, and other trading information. CFTC collected trading data through its large trader reporting system. Exchanges and the over-the-counter securities market also collected information about the performance of their specialists or market makers. CME's clearing department had a system that provided information about payments in the futures clearance and settlement system.

Many of the federal agencies involved in responding to the market crash had established interagency communication networks before the market

[5]The term "triple-witching days" refers to the third Friday of March, June, September, and December, when options and futures on stock indices expire concurrently and trading on index futures, index options, and underlying stocks has been characterized by increased volume and price volatility.

crash occurred. SEC, CFTC, and the exchanges had jointly developed a telephone list of public and private sector market officials that included both office and home phone numbers. Also, CFTC had routinely invited SEC officials to market surveillance meetings focusing on volatility in stock or options futures contracts, including a special surveillance meeting called for the afternoon of Monday, October 19, on the basis of the previous Friday's 120-point drop. Many officials at SEC and CFTC had worked with exchange and firm officials and understood their responsibilities, concerns, and organizational resources. However, Federal Reserve and Treasury officials had limited working experience with SEC and CFTC officials.[6] Also, the SEC Chairman, who was new to his position, had little working experience with other senior federal financial officials.

Containment: Leadership, Swift Action, and Collaborative Efforts Helped Contain Crisis

Generally, federal officials and agencies acted within their respective authorities in responding to the market crash. Officials and agencies shared information willingly, although some information was simply unavailable. Interagency and public communications were occasionally problematic. The most significant policy decisions, especially the decision on whether or not to close NYSE, were made collaboratively. The NYSE Chairman consulted on this matter with officials at other exchanges, federal regulatory agencies, Treasury, the Federal Reserve, and the White House.

Federal Officials Acted Within Their Agencies' Authority

Federal officials and agencies responded to the market crash in accordance with their respective authorities and responsibilities. Treasury's objective was to keep markets open and encourage investor confidence in the markets. To this end, according to the Secretary of the Treasury, Treasury officials (1) consulted with and encouraged the Federal Reserve to provide liquidity with open market operations; (2) prepared a message for the president to encourage investor confidence in the financial markets, including a call for a budget summit agreement to reassure credit markets about the direction of long-term interest rates; and (3) discussed with finance ministries in London, Germany, and Tokyo the importance of providing liquidity support to their markets.

SEC and CFTC objectives were to preserve the integrity and economic utility of securities and futures markets. To do this, SEC expedited various rule reviews, and both SEC and CFTC consulted with exchanges and clearing

[6]After the silver market crisis of 1979-1980, CFTC established quarterly interagency financial futures surveillance meetings involving staff from CFTC, the Federal Reserve, and Treasury. SEC was invited to participate after initiation of stock futures trading in 1982.

organizations to ensure that these organizations were fulfilling their responsibilities. One expedited rule review allowed additional issuer stock buy-back programs so that companies could purchase their own securities as long as they did not engage in manipulative activities.[7] SEC and CFTC also collected and disseminated information to federal officials on the financial condition of member firms. The exchanges and NASD were directly responsible for keeping their markets liquid and their trading systems open and for monitoring firm capital. The NYSE Chairman consulted with other officials—especially those at SEC and the White House—concerning conditions at NYSE and the implications of closing it. Clearing organizations were to keep payments flowing by ensuring timely payments.

The Federal Reserve's primary objective was to provide financial system liquidity, mainly through system repurchase agreements in open market operations. To that end, and to reassure the markets, the Federal Reserve issued a public statement of its readiness to serve as a source of liquidity to support the economic and financial system. The Federal Reserve also maintained a highly visible presence through open market operations in arranging system repurchase agreements. One Federal Reserve official was concerned that the liquidity put into the financial system would not be working liquidity, i.e., would not be used for its intended purpose. Finally, Federal Reserve officials discussed with officials of major banks the importance of meeting unusually large customer financing needs.

Many Activities of Federal Agencies Were Routine

In responding to the market crash, federal agencies performed many well-defined, routine tasks. Exchanges and clearinghouses generally used existing operational procedures to ensure that individual financial instruments were trading and that payments were timely. NYSE operations procedures followed existing rules that allowed specialists additional time to open securities and to halt trading. SEC and CFTC monitored volatility through procedures already developed to oversee expiration day effects. SEC followed a drill to monitor the capital of the 25 largest firms. CFTC used the large trader reporting system to analyze trading for the effects of portfolio insurance and index arbitrage. The Federal Reserve's arrangements of system repurchase agreements were also a matter of routine.

[7]SEC regulations include a rule designed to prevent an issuer from dominating the market for its securities; the rule pertains to volume, timing, price, and the manner of purchases. See 17 C.F.R. Sec. 240.10b-18.

Agencies Shared Information but Some Information Was Not Available

In the market crash case, agencies effectively shared crisis-relevant information—data related to the financial health of firms, the functioning of trading systems, and payments in clearance and settlement systems. Generally, such information went quickly and directly to senior decisionmakers both inside and outside the federal government. However, federal regulators and some exchanges did not have all the information they wanted.

Some of the desired information was available with some difficulty or after some delay. For example, derivatives markets had difficulty pricing options and futures because of an inability to get price data from NYSE. CBOE had to request information from NYSE on which stocks were trading. SEC and CFTC had to request additional information from firms on trading strategies. The Federal Reserve and SEC had to collect information about credit relationships between firms and banks.

Other information was simply unavailable. According to a Federal Reserve official we interviewed, no one knew whether capital calculations were correct because equity prices were changing so rapidly. This complicated the task of reassuring banks of the solidity of a firm's capital. The largest unknown during the crisis, of course, was the market sentiment of participants and when and how much they would buy and sell.

Communications Were Sometimes Problematic

The federal response to the market crash included some significant communications problems. A message regarding the possible closure of NYSE that the NYSE Chairman intended to give differed from the message some heard. The NYSE Chairman said he told others that NYSE was having problems, and if the decline continued there would be further problems. Federal regulators and exchanges said that they were told that NYSE was about to close. The NYSE Chairman called SEC and, according to SEC officials, told them that NYSE was about to close. SEC called CFTC, NASD, CBOE, and other exchanges and told them that NYSE was about to close. According to an SEC official, the NYSE Chairman called SEC back about 10 minutes later and said that buyers were coming into the market and that NYSE would stay open.

Miscommunication on this point also occurred between the SEC Chairman and the print media. On the morning of October 19, 1987, at about 11:15 a.m., the SEC Chairman told reporters that he had discussed market conditions with the NYSE Chairman and that a trading halt had been among the items covered. He stressed that if the market fell too rapidly a trading

halt was an option. The wire services reported that SEC was considering a trading halt, and SEC officials said that the SEC Chairman was misquoted. About 1 p.m., SEC announced that no such trading halt was under consideration. The NYSE Chairman announced that NYSE did not intend to close unless required to do so by the President. CFTC told reporters that no halt in trading of index futures was under consideration. According to a NYSE official, although the comments attributed to the SEC Chairman appeared to some to have spooked the markets and led to further price declines, the sell-off of equity securities actually had nothing to do with what the SEC chairman said.

Agencies Decided Some Multijurisdictional Issues Collaboratively

In the market crash case, the heads of federal financial organizations and exchanges and their senior staff collaboratively decided multijurisdictional issues. One example of this was the decision to keep NYSE open even though specialists were overwhelmed and automated systems were malfunctioning. Because this decision had implications beyond equities markets, the NYSE Chairman consulted on this matter with officials at other exchanges, federal regulatory agencies, Treasury, the Federal Reserve, and the White House.

Another example of collective leadership was in the case of the near failure of First Options of Chicago Inc. (First Options). Federal Reserve, the Comptroller of the Currency, CBOE, and Options CC officials decided how to keep First Options solvent, although this action was not well coordinated according to OCC officials. First Options, the options clearing firm with the largest number of option market makers, had severe liquidity problems and required an infusion of $312 million from its holding company, Continental Illinois Corporation. Continental bank, the parent company, initially infused cash into First Options but took back the advance at the instructions of OCC officials. These actions violated OCC restrictions on the amount of money a bank can advance to an operational subsidiary. Instead, First Options was made a subsidiary of the holding company and received a cash infusion from the holding company.

Treasury and Federal Reserve Led Efforts to Calm Markets

In the market crash case, the Federal Reserve and Treasury played significant leadership roles in helping to restore confidence in the markets. Actions of the Federal Reserve that helped restore confidence in the market included the agency's statement of readiness to provide liquidity, its support of keeping NYSE open and First Options solvent, and its encouragement of extensions of credit during the market crash.

Treasury's successful effort to reassure institutional and individual investors through statements from the President was especially important. One exchange official we interviewed pointed out that in times of financial panic, the most effective reassurance is likely to come from the White House, especially because elected officials can be held accountable for their words and actions.

Resolution: Crisis Studies Accompanied by Regulatory and Legislative Initiatives

Immediately after the market crash, various studies sought to describe and explain the market crash and recommend actions to prevent such a crash from occurring again.

One study commissioned by the President said that the precipitous market decline of mid-October was triggered by (1) an unexpectedly high merchandise trade deficit that pushed interest rates to new high levels and (2) proposed tax legislation that led to the collapse of the stocks of a number of takeover candidates. According to this study, the initial decline ignited mechanical selling by a number of institutions employing portfolio insurance strategies and mutual fund groups reacting to requests from investors to exit the fund and receive cash.[8] This study concluded the following:

- One agency should coordinate regulatory issues that have an impact across related market segments and throughout the financial system.
- Clearing systems should be unified across marketplaces to reduce financial risk.
- Margins should be made consistent across marketplaces to control speculation and financial leverage.
- Circuit breaker mechanisms should be formulated and implemented to protect the market system.
- Information systems should be established to monitor transactions and conditions in related markets.

SEC, CFTC, GAO, and exchanges also conducted studies that identified various issues and set forth recommendations.[9] Our study found two areas needing immediate attention to help restore confidence in the markets and alleviate concerns that the markets could crash again. Specifically, we

[8] Presidential Task Force on Market Mechanisms, Report, Washington, D.C.: January 8, 1988.

[9] See Commodity Futures Trading Commission, Division of Economic Analysis. Division of Trading and Markets, Final Report On Stock Index Futures And Cash Market Activity During October 1987, Washington, D.C.: Jan. 1988; and Securities and Exchange Commission, Division of Market Regulation, The October 1987 Market Break, Washington, D.C.: Feb. 1988.

found that (1) problems with the New York Stock Exchange's systems adversely affected trade executions and pricing information both in New York and in other markets, and (2) decisions of federal and self-regulators were made without benefit of any formal intermarket contingency planning.[10]

In March 1988, a Working Group on Financial Markets was appointed by the President to consider the major issues raised by numerous studies and their recommendations.[11] The members of the Working Group were the senior officials of Treasury, the Federal Reserve, SEC, and CFTC, with the Under Secretary for Finance of the Treasury serving as Chairman. The Working Group made conclusions and recommendations in the areas of circuit breakers,[12] clearance and settlement, margin payments, contingency planning, capital adequacy, and trade processing systems.[13] The Working Group has continued to provide a forum for high-level discussion of interagency financial regulatory issues.

The Market Reform Act of 1990 included provisions responsive to the market crash experience.[14] These provisions granted SEC additional authority to suspend trading on a temporary basis in any nonexempt security and at securities exchanges, subject to a presidential disapproval. The act also gives SEC emergency authority to take steps to restore order to securities markets, which can be accomplished through altering rules on hours of trading, position limits, and clearance and settlement.

SEC, CFTC, and securities and futures exchanges implemented coordinated circuit breaker mechanisms that provide for a 30-minute trading halt of all securities and all derivative instruments after a 350-point DJIA decline in a day and a 1-hour halt after a 550-point DJIA decline. Stock, options, and futures markets also implemented a teleconferencing system linking financial markets and regulators. Computer capacity has been increased at exchanges and at broker-dealers. A 3-business-day settlement period has also become standard for securities markets, which eliminates 2 days of potential participant default.

[10]See Financial Markets: Preliminary Observations on the October 1987 Crash (GAO/GGD-88-38, Jan. 26, 1988).

[11]Executive Order 12631.

[12]Circuit breakers are intended to deal with large and rapid market declines. When a particular price has fallen by a specified amount over a specific time period, exchanges temporarily halt trading.

[13]Working Group on Financial Markets, Interim Report, Washington, D.C.: May 16, 1988.

[14]Public Law 101-432.

The Federal Deposit Insurance Corporation Improvement Act of 1991 clarified that in extraordinary circumstances, the Federal Reserve could lend from its discount window to anyone without legal constraints on the use to which the credit was being put. As before, however, all borrowers were required to show that they needed the Federal Reserve's cash to remain in business, could not borrow elsewhere, and had secure collateral to back up the loans.

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