CRS Report for Congress

Financial Crises of the 1970s and 1980s: Causes, Developments, And Government Responses

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FINANCIAL CRISES OF THE 1970S AND 1980S: CAUSES, DEVELOPMENTS, AND GOVERNMENT RESPONSES

SUMMARY

Financial panics have emerged over the last two decades as irregular, yet continuing, disturbances in the economy. Virtually all of them have involved the banking system, so that the Federal Reserve has often acted as lender of last resort to contain the damage. The Federal Government has often performed direct damage control through congressional initiatives: public laws. In yet other cases, the private sector has largely recovered by itself.

With increasing volatility of financial markets, Congress may have to focus more attention on "bailout" mechanisms that lessen the contagion of these infections of finance. A timely case is that of savings and loan associations. Their rescue may involve looking back to solutions to financial crises of recent years. This report accordingly provides analyses of sixteen selected domestic financial crises (in chronological order) to which the savings and loan crisis may be logically compared, especially with respect to the governmental role in their resolution.

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FINANCIAL CRISES OF THE 1970S AND 1980S: CAUSES, DEVELOPMENTS, AND GOVERNMENT RESPONSES

The financial panics of earlier periods of the Nation's development, believed to have been conquered after World War II, have resurfaced over the last two decades as irregular, yet continuing, disturbances in the economy. Virtually all of them have involved the banking system. Accordingly, the Federal Reserve has often acted as the timely lender of last resort to contain the spread of the damage. In other cases, the Federal Government has performed direct damage control through congressional initiatives: public laws requiring longer time periods for consideration. In yet other cases, the private sector has largely recovered by itself, leaving the major governmental role to one of investigation after the fact and prosecution of those responsible where this is applicable. Many crises have involved at least two of these therapies.

With increasing volatility of all financial markets arguably causing or being caused by these disturbances to a larger extent than in the past, Congress may have to focus more attention on "bailout" mechanisms that lessen the contagion of these infections of finance. A timely case is that of savings and loan associations. Current considerations of their rescue may involve looking back to reactions to financial crises of recent years. This report accordingly provides analyses of sixteen selected domestic financial crises of the last two decades (in chronological order) to which the savings and loan crisis may be logically compared, especially with respect to the governmental role in their resolution. Its case studies identify the institutions involved, the sources of difficulty, the linkages to the rest of the financial system, the forms of public sector intervention, the ultimate resolution of the cases, and provide references for more detailed analyses of them.

PENN CENTRAL

Event	1970 bankruptcy of the Nation's largest railroad.
Failing institution(s)	The January 1968 merger of the Pennsylvania Railroad and the New York Central Railroad System into the Penn Central Transportation Company became insolvent in June 1970.
Type of problem/ reason for failure	Insolvency due to falling revenues, badly rundown plant, high property taxes, incompatible systems and high labor costs.
Other private institutions directly involved	Six other railroads operating in the Northeast and Midwest also went bankrupt and could not be reorganized, at about the same time as Penn Central failed.
Linkages to financial system	Major banks and financial institutions were holding various notes, liens and investments in Penn Central and its predecessors. Wall Street had a lot at stake in the merger.
Public regulators and other officials involved	Interstate Commerce Commission, Federal Railroad Administration (Department of Transportation), United States Railway Association (USRA), several State regulatory commissions and transportation departments, State governors, especially Pennsylvania, and U.S. Congress.
Justification for intervention	Required in the case of regulatory agencies and transportation departments. Vested interest of State economies in the outcome of the merger and subsequent failure in the case of governors and other officials.
Major events punctuating crisis development	
– Discovery	Failure of the merged company to generate sufficient cost reductions and added revenues. Realization of basic system incompatibilities. Inability to lay off excess employees.
– Initial stage	Serious operating problems and lack of sufficient cash flow. Penn Central became unable to issue securities or to redeem its commercial paper.

– First regulatory actions	ICC and DOT unable to help. Problem was money and high costs. Executive branch would not guarantee $200 million in bank loans. Federal Reserve would not guarantee $225 million of these loans either.
– Private market response	Take losses, bankruptcy under Sec. 77 of Bankruptcy Act, and push for a Federal solution. The commercial paper market dried up in 1970, as Chrysler Financial and Commercial Credit Corporations could not roll over their paper.
– Subsequent supervisory actions	In mid-1970, the Federal Reserve markedly eased monetary conditions and provided discount window support to banks to prop up borrowers with comercial paper rollover problems. In 1971, Congress provided a $125 million loan guarantee after bankruptcy, P.L. 91-663, since inability of trustees to extract concessions from labor force made reorganization impossible.
– Stopgap resolution	Passage of Regional Rail Reorganization Act of 1973 as P.L. 93-236 created USRA; and Conrail as a Government-owned, for-profit railroad corporation, made up of the Penn Central plus six other Northeast-Midwest railroads.
– Ultimate resolution	Congress implicitly approved form of Conrail as proposed by USRA in 1975. Several years of authorization and appropriation laws funded its deficits. More than $7 billion in Federal subsidies were spent to create and sustain Conrail. It became profitable in 1983. The Government sold its 85 percent ownership (the railroad's employees had been given the remaining 15 percent ownership) in a public sale for $2 billion in March 1987.

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LOCKHEED

Event	Large defense contractor's inability to renew borrowings in 1971.
Failing institution	Lockheed Aircraft Corporation.
Type of problem/ reason for failure	Cost overruns on Federal contracts, general decline in aerospace industry, bankruptcy of major engine supplier.
Linkages to financial system	Large loans owed to domestic banks by Lockheed.
Public regulators and other officials involved	U.S. Congress; U.S. Department of Defense.
Justification for intervention	Adverse effect on national defense and loss of employment.
Major events punctuating crisis development	
– Discovery	On February 4, 1971, Rolls-Royce declared bankruptcy. This British corporation was under contract to supply engines for Lockheed's Tristar, a passenger airplane under development. As a consequence of this bankruptcy, American commercial banks refused to loan Lockheed additional funds.
– Initial stage	On February 9, 1971, Lockheed laid off 6,500 employees working on Tristar.
– First regulatory actions	On August 9, President Nixon signed P.L. 92-70, the Emergency Loan Guarantee Act. It authorized a Federal guarantee of up to $250 million in bank loans for Lockheed, administered by the Emergency Loan Guarantee Board whose members were: the Secretary of the Treasury, the Chairman of the Federal Reserve Board, and the Chairman of the Securities and Exchange Commission.
– Private market response	Commercial banks resumed lending to Lockheed.

– Subsequent supervisory actions: Although legislation provided for loan guarantee support until December 31, 1975, unanticipated financial difficulties required Lockheed to request an extension of support. The Federal Government extended loan guarantees to Lockheed through December 31, 1977.

– Stopgap resolution: Commercial banks agreed to continue to provide loans to Lockheed.

– Ultimate resolution: An improved national economy, strong foreign sales, profitable Government contracts, and a rise in Tristar orders returned Lockheed to profitability. Private banks were willing to provide unguaranteed credit to Lockheed; and, consequently, Lockheed's loan guarantee privileges were ended October 14, 1977.

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FRANKLIN NATIONAL BANK

Event	1974 collapse of international bank: 20th largest in the United States.
Failing institutions	Large New York international banking firm and its parent bank holding company: Franklin National Bank and Franklin National Corporation.
Type of problem/ reason for failure	Speculation in foreign exchange, following poor domestic and international lending/borrowing experience. Franklin had sought to become a major multinational bank without managerial capabilities, squeezing earnings. New owner manipulated accounts.
Other private institutions directly involved	None.
Linkages to financial system	Some U.S. banks had foreign-based deposits placed in Franklin's foreign branches. Loss of confidence in U.S. banks, European money markets, and foreign exchange transactions as risk consciousness increased. Failure of Herstatt Bank in Germany added to unease in foreign exchange and interbank markets.
Public regulators and other officials involved	Federal Reserve, Comptroller of the Currency, Federal Deposit Insurance Corporation (FDIC).
Justification for intervention	Disruption of domestic and financial markets in time of recession and strained liquidity worldwide.
Major events punctuating crisis development	
– Discovery	In May 1974, Federal Reserve refused to allow Franklin's parent holding company to acquire another financial institution, citing internal problems. Franklin also stopped paying dividends and requested the Securities and Exchange Commission to halt trading of its stock, after disclosing foreign exchange losses May 12.
– Initial stage	By June, Franklin had lost $64 million so far in the year. Lenders of deposits and other funds staged "runs" and lack of confidence affected financial markets generally.

– First regulatory actions	Federal Reserve lent emergency assistance. Comptroller of Currency judged it viable if its funding problem could be solved.
– Private market response	"Flight to quality" in which bank certificates of deposit paid different rates depending on their issuers – the larger the bank, the lower the rate: "tiering."
– Subsequent supervisory actions	Federal Reserve lent Franklin $1.7 billion, acquired $725 million of its foreign exchange liabilities; and guaranteed other banks' lending to it in the Federal Funds market of around $300 million.
– Stopgap resolution	Bank regulators looked for a buyer for it, while keeping Franklin from closing. Only foreign banks would be large enough to rescue it while not being subject to antitrust or interstate banking prohibitions.
– Ultimate resolution	Comptroller declared it insolvent October 8, 1974; its assets and certain liabilities were sold to European American Banking Corporation (a foreign-owned consortium bank). FDIC retained certain liabilities for some years.

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NEW YORK CITY

Event	Nation's largest city was unable to borrow in 1970s.
Failing institution(s)	New York City (NYC).
Type of problem/ reason for failure	Rising budgetary deficits resulting from increased social spending, 1973-1975 recession, and mismanagement of city services.
Other private institutions directly involved	None.
Linkages to financial system	Large losses for over 200 banks holding NYC securities and adverse effects on municipal securities market; concern about the reputation of American securities in international markets.
Public regulators and other officials involved	Secretary of the Treasury, NYC Mayor Abraham Beame, New York Governor Hugh Carey.
Justification for intervention	Concern about adverse effects on the economy of the New York City metropolitan area. Concern about national prestige.
Major events punctuating crisis development	
– Discovery	In late 1974, NYC had difficulty borrowing funds.
– Initial stage	In February 1975, NYC had to cancel a note offering, and by April, NYC could not borrow any funds. The State of New York loaned funds to NYC.
– First regulatory actions	In June, New York State created the Municipal Assistance Corporation to assist the City's financing. The Emergency Financial Control Board took over the City's budget. On December 9, 1975, the New York City Supervisory Actions Seasonal Financing Act of 1975, P.L. 94-143, was passed. This legislation provided short-term Federal loans to the City.
– Private market response	Short-term Federal loans proved inadequate in restoring the creditworthiness of NYC to private lenders. The City of Cleveland also experienced somewhat similar distress in this general time period.

– Subsequent supervisory actions	On August 9, 1978, the New York City Loan Guarantee Act of 1978 was enacted as P.L. 95-339. This legislation provided over $1 billion in loan guarantees on bonds sold to city or State pension funds.
– Stopgap resolution	The entire $1.65 billion in guaranteed bonds was sold to City and State pension funds as part of a $4.5 billion fund package from both public and private sources.
– Ultimate resolution	New York City reduced expenses and raised taxes. The economy of the City recovered, and NYC was able to borrow on financial markets. The City retired all guaranteed bonds by mid-1986.

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CHRYSLER

Event	Large industrial corporation was unable to borrow in 1979.
Failing institution	Chrysler Corporation.
Type of problem/ reason for failure	The second energy shock, regulatory costs, and managerial mistakes.
Other private institutions directly involved	None.
Linkages to financial system	Large outstanding loans owed to domestic and foreign banks.
Public regulators and officials involved	U.S. Congress; executive branch.
Justification for intervention	Large potential loss of employment (expecially regionally), Federal regulatory costs, and national defense (Chrysler was sole source supplier of tanks).
Major events punctuating crisis development	
– Discovery	In early 1979, huge losses compelled Chrysler to sell off some of its subsidiaries, close plants, and reduce its employment.
– Initial stage	In June 1979, commercial banks refused to loan Chrysler additional funds unless the Federal Government guaranteed repayment. In July 1979, Chrysler requested Federal loan guarantees to avoid bankruptcy.
– First regulatory actions	In January 1980, the Chrysler Loan Guarantee Act was signed into law as P.L. 96-185. The resulting Chrysler Loan Guarantee Board could approve up to $1.5 billion in loan guarantees for Chrysler. Nearly all beneficiaries of the loan guarantee were required to make concessions before loan guarantees would be approved. Concessions had to be made by foreign and domestic banks, State and local governments, stockholders, automobile dealers, union and nonunion employees, suppliers, and management. Loan Guarantee Board members were: the Secretary of

the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, and the Comptroller General as voting members; the Secretaries of Labor and Transportation were nonvoting members.

– Private market response	Private and public beneficiaries agreed to make concessions.
– Subsequent supervisory actions	Chrysler Loan Guarantee Board approved loan guarantees.
– Stopgap resolution	Chrysler borrowed $1.3 billion in federally guaranteed loans from commercial banks. Chrysler restructured its operations and reduced its losses.
– Ultimate resolution	Chrysler earned profits and repaid its federally guaranteed loans. In September 1983, Chrysler, the highest bidder, purchased outstanding stock warrants from the Federal Government for $311 million to remove the last vestige of Government assistance.

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HUNT BROTHERS SILVER "CORNER"

Event	Hunt Brothers may have tried to "corner" the silver market in 1979 and 1980 following large purchases of contracts and futures in the mid-1970s.
Failing institution(s)	Bache Group and, perhaps, Merrill Lynch.
Type of problem/ reason for failure	The price of silver rose from less than $7 per ounce to over $50 per ounce, as the Hunts came to control, directly and indirectly, overwhelming amounts of the metal, supported by loans from brokers. Its price then plummeted to less than $11 by the spring of 1980.
Other private institutions directly involved	In addition to Bache (in which the Hunts had large stockholdings), with lending of $235 million to them, Merrill Lynch had lent over $160 million and E.F. Hutton another $100 million in this speculation. The Hunts had borrowed $125 million directly and indirectly from First National Bank of Chicago. Other Hunt borrowings were from First National Bank in Dallas, Swiss Bank Corporation, Citibank, Bank Leu, Schroeder Bank in New York, and Credit Lyonnais. Indirect lenders (to Bache) included Bankers Trust, Irving Trust, and Barclays Bank. The South African conglomerate, Anglo-American Corp., through its Engelhard Metals subsidiary, was severely exposed as well.
Linkages to financial system	Through multinational bank lending, Swiss and Saudi Arabian investments in silver, stockbrokers, and other parties. The Hunts own indebtedness exceeded $1.4 billion. Hunts' failure threatened a chain reaction leading to nonviability of even publicly held corporations.
Public regulators and other officials involved	Commodity Futures Trading Commission (CFTC), Securities and Exchange Commission, Board of Governors of the Federal Reserve System, and the Comptroller of the Currency.
Justification for intervention	Silver market intervention to prevent a market squeeze, or to protect the interest of holders of short contract positions. Treasury and the Federal Reserve were concerned lest the difficulties of speculators, brokers, and commodity dealers be transmitted to the banking system. First National Bank of Chicago by virtue of its exposure, and First Pennsylvania Bank, by an

extension of confidence effect, might have gone under. Broker-dealers such as Bache and Merrill Lynch were overextended and could have become insolvent.

Major events punctuating crisis development

– **Discovery**: After being involved in a soybean market scandal in the 1970s, the Hunt Brothers entered the silver market most prominently in the fall of 1979. The CFTC became concerned about the Hunts' positions by that time.

– **Initial stage**: In October 1979, the Chicago Board of Trade imposed limits on the size of silver positions, fearing that its clearinghouse members might not be able to bear a default. The New York Commodity Exchange (COMEX) reduced the number of new positions a speculator could buy on January 9, 1980. The price of silver accelerated, nonetheless.

– **First regulatory actions**: COMEX made trading allowable for liquidation purposes only on January 21, 1980, changing the rules.

– **Private market response**: The demand for silver, including industry use, fell. Hunts paid off obligations to a metals company by exchanging silver bullion and oil properties for positions.

– **Subsequent supervisory actions**: Federal Reserve allowed four largest U.S. bank lenders to Hunts to borrow from its "discount window" in February and March 1980. In April, Federal Reserve Chairman acquiesced in allowing banks (Morgan, First in Dallas, Citibank) to ignore "credit control" guidelines designed to stop "speculative" lending and bail out Hunts with $1.1 billion loan collateralized by oil and gas.

– **Stopgap resolution**: Bank loan agreement required Hunts to liquidate silver position in orderly manner and prevent their further speculation in commodity markets entirely at Fed Chairman's insistence.

– **Ultimate resolution**: Bache became taken over by Prudential Insurance; the Hunts are no longer significant in any financial market because of their losses.

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DRYSDALE

Event	1982 U.S. Government securities dealer collapse.
Failing institution(s)	Drysdale Government Securities, Inc.
Type of problem/ reason for failure	Losses of perhaps $300 million in speculation on interest rates with capital of $20 million.
Other private institutions directly involved	Drysdale's clearing bank "agents": Chase Manhattan Bank, Manufacturers Hanover Trust Co., and United States Trust Co.
Linkages to financial system	Confidence in large banks clearing Drysdale's transactions.
Public regulators and other officials involved	Federal Reserve Bank of New York and Federal Reserve Board officials.
Justification for intervention	Disruption of largest financial market in the world, that of U.S. Government securities.
Major events punctuating crisis developed	
– Discovery	Rumors of Drysdale's losses confirmed when it could not pay Chase $160 million on May 17, 1982.
– Initial stage	Drysdale could not pay other creditors. Wall Street ceased doing business with it entirely. Decline in Federal securities prices.
– First regulatory actions	New York Federal Reserve Bank indicated it would assist banks with liquidity shortage associated with crisis.
– Private market response	Market worsened May 18.
– Subsequent supervisory actions	New York Federal Reserve pressured banks into covering Drysdale's payments due to others.
– Stopgap resolution	New York Federal Reserve liberalized its own lending of Government securities to prevent gridlock in the market on May 19th.

– Ultimate resolution	In 1984, Chase and other creditors recovered large part of losses from Drysdale's owners and auditors.

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PENN SQUARE BANK

Event	1982 demise of small Oklahoma bank.
Failing institution(s)	Penn Square Bank, National Association, and its bank holding company.
Type of problem/ reason for failure	Losses from energy industry loans in Oklahoma, funded by "brokered deposits" which allowed rapid growth.
Other private institutions directly involved	Purchasers of loan participations from it: Continental Illinois (see entry), Seattle First National Bank, Chase Manhattan Bank, Michigan National Bank, Northern Trust Company.
Linkages to financial system	Large banks suffered loss of confidence and had to pay higher deposit rates. Many credit unions and savings and loans, as well as banks, had deposits at Penn Square placed through money brokers.
Public regulators and other officials involved	Comptroller of the Currency, Federal Reserve, Federal Deposit Insurance Corporation.
Justification for intervention	Preserve confidence in banking system.
Major events punctuating crisis development	
– Discovery	Federal Reserve had lent to Penn Square extensively through its discount window. Comptroller's examination showed imminent failure; press discovery of regulatory concerns.
– Initial stage	Bank run depleted cash so that cashiers' checks issued for deposit withdrawals.
– First regulatory actions	Comptroller closed bank on July 6, 1982, naming FDIC as receiver. Depositors with insured balances in it were paid off and the rest got receivers' certificates.
– Private market response	In reaction to first FDIC deposit payoff and treatment of uninsured deposit balances, a loss of confidence in banks occurred. Abilene National Bank, subject to similar press reports, became subject to "runs" and closed August 9th.

– Subsequent regulatory actions	Federal deposit insurance agencies tried to limit use of brokered deposits.
– Stopgap resolution	Federal Reserve temporarily eased monetary policy in light of liquidity needs of financial institutions.
– Ultimate resolution	Seattle First and Continental banks were bought out by BankAmerica Corp. and bailed out by the FDIC in 1983 and 1984, respectively.

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THIRD WORLD ("MEXICAN") DEBT

Event	Continued non-payment of bank loans and other debt by Mexico and other Less Developed Countries (LDCs) beginning August 1982.
Failing institution(s)	Governments of Mexico, Argentina, Brazil, Peru, and numerous others.
Type of problem/ reason for failure	Lack of means of external debt payment due to U.S. recession, high interest rates, dwindling trade, oil and other commodity price declines, and political problems.
Other private institutions directly involved	Around 100 major and many smaller banks worldwide had loans due from Mexico at the time it precipitated the continuing crisis by defaulting in August 1982.
Linkages to financial system	At time of its default the Mexican government owed $80 billion to its foreign creditors: $25 billion to U.S. banks. The nine largest U.S. banks had Mexican loans of $13 billion, representing nearly half of their own total capital. Most indebtedness was denominated in U.S. dollars, and, through syndications of bank loans, involved all major and many smaller U.S. banks. The total exposure of U.S. banks to LDCs exceeded $130 billion.
Public regulators and other officials involved	Federal Reserve, the Mexican central bank and other central banks, the Bank for International Settlements (BIS), U.S. Departments of Treasury and Energy, U.S. Commodity Credit Corporation, and the International Monetary Fund (IMF).
Justification for intervention	Fears of defaults by U.S. banking system, relief of liquidity strains generally, U.S. policy of aiding "friendly" nations.
Major events punctuating crisis development	
– Discovery	In Mexico, asset holders staged a flight from the overvalued peso. A devaluation in February was followed by the August 5, 1982, devaluation. On August 12, 1982, the foreign exchange market was closed by the Mexican government.

– Initial stage	The foreign exchange market remained closed through August 19th, while Mexico negotiated a rescue package with the IMF, the U.S. Government (Department of Energy, Commodity Credit Corporation), the BIS, and over 100 of its commercial bank lenders.
– First regulatory actions	On August 20, 1982, Federal Reserve officials mediated a restructuring of Mexico's foreign debt, providing postponement of old debt payments of $10 billion; concurrent with federally guaranteed new bank loans of $1 billion.
– Private market response	Fears of banking collapse subsided.
– Subsequent supervisory actions	Federal Reserve eased U.S. monetary policy. U.S. agencies and BIS supported Mexican debt by short-term loans. IMF program agreed to by Mexico allowed more new bank lending early in 1983. Similar arrangements have been made for Mexico (again), Brazil, Argentina, and other LDC borrowers.
– Stopgap resolution	Congress passed the International Lending Supervision Act of 1983, as part of P.L. 98-181. This Act required bankers to disclose concentrations of credit by country, to meet stricter capital standards, and to recognize certain LDC loan losses as specified by their regulators.
– Ultimate resolution	LDCs still owe about $1.3 trillion in global debt. U.S. banks are at risk for perhaps $80 billion of it despite many "reschedulings" and buildup of internal reserves against losses on LDC loans – approximately one-quarter of their face value. The private market for such debts suggests that they are "worth" perhaps even less than one-half of face value, especially given the possibility of any downturn in world trade. U.S. Government policy is in a state of transition from "Baker Plan" of new LDC lending to "Brady Plan" of some forgiveness of outstanding debt.

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BALDWIN-UNITED

Event	1983 bankruptcy of leading life insurer.
Failing institution(s)	Baldwin-United Corporation (a holding company) and its insurance subsidiaries.
Type of problem/ reason for failure	Overexposure to interest rate fluctuations, too rapid expansion, draining of capital to other parts of the holding company.
Other private institutions directly involved	Sellers of Baldwin's annuities.
Linkages to financial system	Litigation against securities dealers for unlicensed sales of Baldwin's annuities. Banks owned its liabilities as well.
Public regulators and other officials involved	Arkansas, Indiana and Wisconsin insurance commissioners, National Association of Insurance Commissioners (NAIC).
Justification for intervention	Insolvency, protection of policyholders.
Major events punctuating crisis development	
– Discovery	State regulators' report on insurance subsidiaries' "impaired" condition; Prudential-Bache and other securities firms suspended sale of Baldwin annuities.
– Initial stage	Cash crisis; inability to pay on bank loans and debentures.
– First regulatory actions	NAIC established task force.
– Private market response	Brokers stopped marketing Baldwin products; creditors gave it extensions for about one-half year. Bankers then refused to lend to it and one of its prominent subsidiaries, Mortgage Guarantee Insurance Co., was forced out of the commercial paper market.
– Subsequent supervisory	Operations were closed down, and policyholder redemptions were frozen July 1983. Insurance

actions	subsidiaries were fined for overinvestment in securities of other parts of Baldwin.
– Stopgap resolution	Single-premium deferred annuities (Baldwin's product at issue) came under some suspicion. Chapter 11 bankruptcy, sale of assets.
– Ultimate resolution	$200+ million contributed by many brokerage firms and life insurers, supplementing $3.3 billion of Baldwin assets; Metropolitan Life Insurance Co. received assets, exchanged 165,000 annuities for new annuities with lower interest rates; policyholders were allowed to cash out as of November 1, 1987.

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CONTINENTAL ILLINOIS

Event	1984 implosion of major U.S. money center bank.
Failing institution(s)	Continental Illinois National Bank and Trust Company and its bank holding company.
Type of problem/ reason for failure	Speculative lending — especially energy lending — and reliance on foreign deposits; losses on loans purchased from Penn Square Bank (see entry).
Other private institutions directly involved	Those with deposits at Continental.
Linkages to financial system	Many smaller U.S. banks had "correspondent" deposits with Continental; it relied on large foreign deposits as well. Confidence in other money-center banks.
Public regulators and other officials involved	Comptroller of the Currency, FDIC, Federal Reserve.
Justification for intervention	Continental's survival was deemed "essential" to banking system and U.S. financial linkages to the rest of the world.
Major events punctuating crisis development	
– Initial stage	Despite "recovering" from Penn Square crisis in 1983, it experienced a loss of $140 million in the first quarter of 1984 from bad loans. Rumors that Japanese would buy Continental; "runs" of uninsured foreign and domestic depositors on it.
– First regulatory actions	Denial of rumors by Comptroller of the Currency; secret Federal Reserve lending to Continental.
– Private market response	Deposit runs accelerated.
– Subsequent supervisory actions	Liquidity support in May 1984 arranged by FDIC, Federal Reserve and 16 other money-center banks. Depositors and other creditors told that uninsured liabilities would be fully protected.

– Stopgap solution	Other large banks considered but rejected buying Continental under regulatory urging.
– Ultimate resolution	In July 1984, the FDIC, Comptroller of the Currency, and Federal Reserve created another assistance package. It meant management changes, FDIC assumption of bad loans and borrowings, purchase of stock by FDIC, and funding by other large banks. The Government's aid was $4.5 billion. FDIC still holds a dominant position in Continental's stock and effectively controls it despite partial sale of shares to public.

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ESM

Event	1985 collapse of small Government securities dealer.
Failing institution(s)	ESM Government Securities, Inc., and closely related ESM Financial Group, ESM Group; Home State Savings Bank (see entry on Ohio Savings and Loan Associations).
Type of problem/ reason for failure	Losses of perhaps $400 million in complex transactions from 1977-1985 concealed by creative accounting.
Other private institutions directly involved	American Savings and Loan Association of Miami; cities of Beaumont, Texas and Toledo, Ohio; many other investors; Fidata Corp. (as clearing agent for ESM).
Linkages to financial system	To savings institutions directly, and indirectly to most markets as disturbance in U.S. Government securities market.
Public regulators and other officials involved	Securities and Exchange Commission.
Justification for intervention	Protection of ESM's investors and avoidance of Government securities-related problems elsewhere.
Major events punctuating crisis development	
– Discovery	ESM Government Securities pledged securities collateral on loans to more than one customer. Home State Savings announced large losses on these transactions early in March 1985.
– Initial stage	Fears of losses at ESM confirmed when collateral could not be verified.
– First regulatory actions	Securities and Exchange Commission closed ESM on March 4, 1985.
– Private market response	Runs on Home State; increased emphasis on safety in the Government securities market; which had seemingly forgotten Drysdale.
– Subsequent supervisory actions	Increased SEC surveillance of Government securities dealers.

– Stopgap resolution	Closure of other unsafe dealers in Federal securities in 1985, especially Bevill, Bresler and Schulman.
– Ultimate resolution	Passage of the Government Securities Act of 1986, P.L. 99-571, strongly increasing Federal (Treasury Dept. and SEC) regulation of Government securities markets and their derivative transactions.

References:

U.S. General Accounting Office. U.S. Treasury securities, the market's structure, risks, and regulation. Washington, 1986. p. 148-151. "GGD-86-80BR, August 20, 1986"

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Wolfson, Financial crises, p. 117-121.

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OHIO SAVINGS AND LOAN ASSOCIATIONS

Event	1985 Ohio savings institution runs.
Failing institution(s)	Home State Savings Bank, plus 70 other State-insured institutions.
Type of problem/ reason for failure	Liquidity/insolvency problems growing out of failure of ESM.
Other private institutions directly involved	None.
Linkages to financial system	Symbolic of problems with non-Federal deposit insurance.
Public regulators and other officials involved	Federal Reserve Bank of Cleveland, Ohio Governor Richard Celeste, Ohio legislature.
Justification for intervention	Disruption of local economy, plus some loss of general confidence in overall financial system.
Major events punctuating crisis development	
– Discovery	Failure of ESM Government Securities on March 4, 1985, led to realization that the Ohio Deposit Guarantee Fund (ODGF) would be totally depleted by covering Home State's losses in the ESM failure, and that other ODGF institutions would suffer. ODGF lacked formal Ohio State guarantee, as an essentially "private" mutual insurer.
– Initial stage	Runs on institutions began during week of March 4-8.
– First regulatory actions	ODGF closed Home State and six other insured organizations.
– Private market response	Runs began on other ODGF institutions.
– Subsequent supervisory actions	Governor Celeste closed all ODGF institutions on March 15.

– Stopgap resolution	Federal Reserve Bank of Cleveland offered liquidity support. Legislation passed by Ohio legislature to allow out-of-state banks to purchase institutions. Federal Savings and Loan Insurance Corporation accelerated processing of applications for Federal deposit insurance.
– Ultimate resolution	Two-thirds of institutions received approval for Federal insurance and reopened. One-third of institutions acquired by other federally insured ones. A somewhat similar set of circumstances occurred in Maryland as well, influenced by these Ohio developments.

References:

Garcia, Gillian G. The 1985 S and L crises in Ohio and Maryland. Unpublished paper, 1987.

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* Most of the text of this entry was originally provided by a congressional office to CRS. The format has been used for the other entries; references to this entry were added by CRS.

FARM CREDIT SYSTEM

Event	Threatened insolvency of the largest commercial lender to U.S. farmers. Its crisis years were 1985-1987.
Failing institution(s)	Farm Credit System (FCS), a network of farmer-owned, but federally chartered, lending institutions.
Type of problem/ reason for failure	Severe agricultural recession beginning in the early 1980s contributed to a rapid decline in farmland values (as much as 50 percent in some regions between 1982 and 1986). This severely diminished the collateral value of farm real estate loans and caused many agricultural producers to default on their FCS loans.
Other private institutions directly involved	None.
Linkages to financial system	Private investors viewed FCS bonds as a riskier investment as the crisis worsened. Historically, FCS bonds sold at a small spread over comparable maturities of Treasury debt issues. The spread widened by more than 1 full percentage point, as investor confidence diminished, causing FCS funding costs to rise dramatically.
Public regulators and other officials involved	U.S. Congress, Farm Credit Administration (FCA).
Justification for intervention	Potential disruption of both the agricultural economy and the banking system. At the time, FCS was the largest institutional lender to the agricultural sector with nearly $80 billon in total loans outstanding. FCS debt represented a large share of the Federal agency bond market, in which FCS bonds were issued and traded. Loss of confidence could have spilled over into other Federal securities' prices.
Major events punctuating crisis development	
— Discovery	FCA Governor and FCS officials separately announced in Sept.-Oct. 1985 that the FCS might need as much as $6 billion in Federal financial assistance within 2 years in order to remain solvent.

– Initial stage	FCS recorded its first net operating losses since the Depression: $2.7 billion in 1985 and $1.9 billon in 1986. FCS nonperforming loans rose from $6.7 billion to $14.3 billion between 1984 and 1986, while gross loans outstanding declined from $80 billion to $58 billion. Earned surplus capital dropped from $11.8 billion to $1.5 billion, as FCS charged off bad loans in record proportions.
– First regulatory actions	The Farm Credit Amendments Act of 1985 (P.L. 99-205): 1) Gave FCA enhanced enforcement authority, making it an arms-length regulator of FCS; 2) Created the FCS Capital Corporation to reassess stronger FCS institutions to support weaker ones and to serve as a "workout" bank for nonperforming loans; and, 3) Established a mechanism by which FCS can request Federal financial assistance.
– Private market response	FCS loan losses and borrower flight to other lenders continued. Several FCS institutions drew down earned surplus to the point that capital stock impairment was inevitable, fueling investor fears.
– Subsequent supervisory actions	Use of profits of healthy FCS institutions to cover losses of weak ones.
– Stopgap resolution	The Farm Credit Act Amendments of 1986 (P.L. 99-509): 1) Allowed FCS banks to set their own interest rates without FCA approval, in order to enhance FCS competition vis-a-vis commercial banks; and, 2) Allowed FCS banks to use regulatory accounting practices to amortize high cost debt and loan losses over a maximum 20-year period, to help forestall capital stock impairment.
– Ultimate resolution	The Agricultural Credit Act of 1987 (P.L. 100-233) was enacted January 6, 1988. It authorized as much as $4 billion in financial assistance for vulnerable FCS institutions. Funds are raised through a newly created authority, the FCS Financial Assistance Corp., with interest on the 15-year bonds paid by the Treasury in the first 5 years, shared between Treasury and FCS the second 5 years, and by FCS in the final 5 years. All Treasury-paid principal and interest must eventually be repaid by FCS. The Act mandated FCS structural changes including mergers of institutions within districts, in order to reduce FCS operating expenses. It required FCS to establish minimum

capital adequacy standards for FCS institutions, and granted specific rights to FCS borrowers threatened by potential foreclosure.

References:

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U.S. Library of Congress. Congressional Research Service. Farm Credit System: legislative issues, by Remy Jurenas. [Washington] 1988. 14 p. (Archived Issue Brief no. IB87033)

----- Implementation of the Agricultural Credit Act of 1987, by Ralph Chite. [Washington] 1988. (Issue Brief no. IB88089, continually updated)

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STOCK MARKET "CRASH"

Event	Severe equity market decline, October 1987.
Failing institution(s)	First Options of Chicago (a subsidiary of Continental Illinois; see entry above), other options and futures traders, brokers and securities dealers.
Type of problem/ reason for failure	Interrelated cash equity and speculative futures and options trading. "Overvalued" market assaulted by rising interest rates, potential threats to takeover activity in proposed legislation, sales of securities by Japanese investors, and especially computer-driven "programs" that accentuated price movements automatically.
Other private institutions directly involved	Brokers, dealers, investors, traders, and publicly held corporations.
Linkages to financial system	The securities industry depends on banks for its working capital. Capital-raising requirements of corporations were clearly affected as well. Psychological linkages between all international securities markets were apparent as prices fell worldwide despite differing economies and trading structures.
Public regulators and other officials involved	Commodity Futures Trading Commission (CFTC), Securities and Exchange Commission (SEC), Federal Reserve System, and the executive branch (Treasury).
Justification for intervention	Potential parallels with 1929 market crash, in which the Federal Reserve had tightened credit further, leading to collapse of Bank of the United States in New York and further market and economic implosions.
Major events punctuating crisis development	
– Discovery	Fears of retreat from over-valued prices of stocks after five years of general surges became publicized. The Dow Jones Industrial Average (DJIA) declined by its fifth-largest drop September 1, 1987, and by early October the fragility of the stock market had become apparent.

– Initial stage	In October, prices had softened from the historic highs of August. On Monday, October 19, 1987, sell orders and computerized "program trading" caused prices to fall 23 percent. The DJIA fell by more than 500 points in the day's meltdown.
– First regulatory actions	Federal Reserve made rare public statement of intent to support economy and financial system by providing liquidity. It lent over $2 billon to New York banks by October 21. Bank regulators allowed Continental to fund large losses of its First Options subsidiary.
– Private market response	Banking system extended loans to purchase and carry securities extensively after October 19. Volatility in equities market continued. Fears of recession or worse in 1988. Federally insured deposits gained popularity with risk avoidance rising. Exchanges considered closing, but did not.
– Subsequent supervisory actions	New York Stock Exchange and other "self-regulatory" bodies limited computer trading mechanisms which had allegedly amplified price swings.
– Stopgap resolution	58 securities firms closed between October 19 and November 19. Federal Reserve eased monetary policy generally.
– Ultimate resolution	Numerous studies of the event were undertaken by public and private bodies, without resulting in legislation. Market recovered in 1988, but not to pre-October 1987 highs. Many corporations purchased their own stock at the lower prices. Computer-guided program trading remains popular to date.

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Wall Street Journal, various issues.

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FIRST REPUBLIC

Event	1988 failure of largest Texas bank holding company (11th largest in the United States).
Failing institution(s)	First RepublicBank Corporation and its subsidiaries.
Type of problem/ reason for failure	Bad domestic and foreign loans, regional financial distress. Purchase of large rival bank holding company with similar loan problems in 1987 did not work out.
Other private institutions directly involved	None.
Linkages to financial system	Symbol of distress of real estate and commodity lenders. Confidence in large banks would fall if not bailed out, especially in remaining leading Texas banks.
Public regulators and other officials involved	FDIC, Federal Reserve.
Justification for intervention	Disruption of Texas economy; "domino effect" if another such large bank holding company were allowed to fail outright. BancTexas Group had set a precedent by the FDIC rescuing it in 1987. A similar large Texas financial institution, First City Bancorporation, had been rescued by FDIC late in 1987 and financial restructuring of it continued in 1988.
Major events punctuating crisis development	
– Discovery	Consolidation of InterFirst into RepublicBank Corporations in June 1987 did not stem losses of $657 million for year ($347 million in the last quarter).
– Initial stage	Billion-dollar deposit runs starting at beginning of 1988.
– First regulatory actions	Increasing Federal regulatory monitoring and preparation for rescue.

- Private market response	Fears of losses of uninsured deposits at other Texas institutions following press reports of First Republic's situation.
— Subsequent supervisory actions	Federal Reserve Bank of Dallas discontinued financial reporting on large Texas banks, while providing secret discount window liquidity support to First Republic.
— Stopgap resolution	FDIC lent it $1 billion and stated that all depositors would be protected. First Republic lost $2 billion in the first half of 1988 and defaulted on debt. FDCI encouraged bidders to buy it.
— Ultimate resolution	Bankruptcy of Corporation. The North Carolina-based bank holding company NCNB Corporation acquired First Republic's bank subsidiaries with aid of an estimated $4 billion in FDIC assistance. Resulting NCNB Texas National Bank is now capitalized by FDIC, and can place bad loans with FDIC. NCNB effectively controls it, and intends to increase its financial stake in it; unlike FDIC's Continental Illinois "nationalization." (See entry above.) Texas banks continue to suffer insolvency, as shown by the 1989 seizure of most of the MBanks (subsidiaries of the MCorp bank holding company) by the FDIC.

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