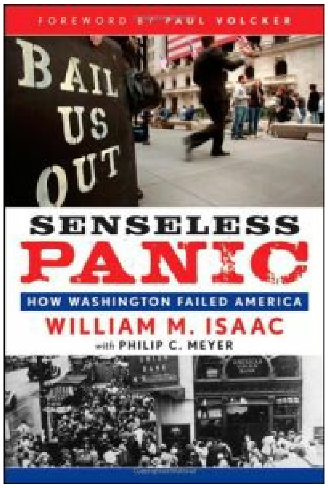

Book Senseless Panic

How Washington Failed America

William M. Isaac and Philip C. Meyer
Wiley, 2010

Recommendation

In his first-person account comparing the 1980s bank crisis to the 2008 financial panic, William M. Isaac excoriates government officials for needlessly stoking fear and costing taxpayers billions of dollars through the Troubled Asset Relief Program (TARP). Isaac, the former head of the Federal Deposit Insurance Corporation (FDIC), navigated that agency through the 1980s bank and thrift debacle, and he voices sharp opinions on the TARP's shortcomings, politicization and mismanagement. His presentation details how the government (read the FDIC) could have prevented this entire systemic mess had it responded as it had in the '80s under his lead. Unfortunately, most of Isaac's remedies are bank-centric and thus gloss over the roles nonbank financial institutions played in the 2008 crisis. He also doesn't acknowledge any of the experts who say TARP ultimately succeeded in many ways. Nonetheless, *BooksInShort* suggests this book for its well-informed treatment of the 2008 crisis in the context of recent bank history.

Take-Aways

- William M. Isaac led the US Federal Deposit Insurance Corporation (FDIC) during the 1980s bank and savings and loan crisis.
- From 1980 to 1991, about 3,000 US banks and thrifts failed; to contain the emergency, the US government considered nationalizing all banks.
- Despite an 11% unemployment rate and 21.5% interest rates, the '80s crisis did not end in panic.
- The FDIC used its authority to either recapitalize failing banks or arrange mergers.
- Continental Illinois Bank, the seventh-largest US bank in 1984, tested the "too big to fail" concept when the FDIC rescued it to prevent a systemic financial collapse.
- "Brokered funds" abuse the deposit insurance system but earn big Wall Street fees.
- Government created unnecessary alarm with 2008's Troubled Asset Relief Program.
- Agencies such as the FDIC could have rescued troubled banks without congressional approval.
- Mark-to-market accounting, short selling and uncontrolled leverage exacerbated the 2008 crisis.
- Government officials' erratic, disorganized crisis management worsened the situation.

Summary

Breaking the Banks

William M. Isaac chaired the US Federal Deposit Insurance Corporation (FDIC) during the economically turbulent 1980s. In the 1980-1982 recession, US unemployment reached 11% and interest rates hit 21.5%. Within a decade, about 3,000 banks and thrifts went out of business; nine of the 10 largest banks in Texas collapsed. The failure rate was so great that the US government considered nationalizing banks to save the financial system. Defunct financial institutions drained the FDIC's coffers by more than $100 billion.

> "The financial panic of 2008 and the ensuing deep recession did not have to happen."

Those who compare the 2008 financial emergency to the 1980s banking crisis often fail to note that the economy before the 2008 recession was stronger than it had been in the '80s. Yet the 2008 panic sent shock waves around the globe and threatened the stability of the world banking system, while the aftereffects of the '80s crisis were much more muted. Had government leaders better understood what really happened in the ’80s and instituted the proper remedies, they might have averted the 2008 panic.

> “Our leaders are already covering up their role in creating what I call the Senseless Panic of 2008, are trying to deflect blame to ‘greedy bankers’ and are offering slogans rather than solutions.”

Lehman Brothers’ collapse on Sept. 15, 2008, reverberated throughout the world. Starting on Sept. 18, Treasury Secretary Henry Paulson and Federal Reserve Board Chairman Ben Bernanke went to Congress to present their plan for a $700 billion Troubled Asset Relief Program (TARP), under which taxpayer funds would buy toxic assets from financial institutions. To drive home the severity of the situation, Paulson alerted lawmakers to an imminent “financial Armageddon.”

> “In fact, TARP accomplished nothing that could not have been done without legislation.”

Isaac disagreed with the plan. On Sept. 27, *The Washington Post* published his opinion piece listing his four recommendations for containing the crisis:

1. The Securities and Exchange Commission (SEC) should reverse its decision to allow short selling.
2. The FDIC should announce a “financial emergency” and cover all depositors and creditors in case of a bank’s failure.
3. The SEC should shelve mark-to-market accounting rules.
4. The FDIC should act to reinstate bank capital based on its experience with the 1980s thrift crisis.

> “I was appalled by the Paulson plan and urged Congress to take a cautious, considered approach before signing off on the largest bailout program in the history of the world.”

Adopting these proposals would have led to a better outcome, reduced the cost to taxpayers and raised less concern than Paulson’s “ill-conceived plan.”

Isaac’s editorial prompted five House members of both parties to ask him to come to Washington. On Sunday, Sept. 28, he presented his ideas on the bailout and the developing financial crisis to 200 members of Congress, but not to the Democratic or Republican leaders, who had already decided to fast track the TARP vote for the next day. But lawmakers rejected the TARP, 228 to 205. Congressional leaders went right to work to reverse the bill’s defeat. On Tuesday, Sept. 30, President George W. Bush’s administration added provisions to appease and attract opponents, including higher FDIC insurance limits and $150 billion in unnecessary “pork” spending. After much debate and controversy, Congress finally passed the $850 billion bill, including the pet projects.

> “As I watched the crisis unfold in 2008, I was dumbstruck by the apparent lack of planning and a coherent strategy – it seemed like utter chaos.”

After the contentious vote, Paulson discarded his original plan of using TARP money to buy toxic assets. Instead, he chose to inject capital directly into financial institutions. Regulators eventually implemented each of Isaac’s four proposals, though some as late as the following April. So, in hindsight, Paulson and Bernanke had no need to go to Congress at all: They could have used the SEC and FDIC’s existing authority to fund the banks and enact the modified rules. They could have avoided forcing a public battle over billions in emergency appropriations.

Early FDIC Experience

Isaac joined the FDIC board in 1978 and faced terrible inflation. During his term, the FDIC concentrated on bank safety and fundamental financial strength, both under stress due to high interest rates. These rates, which peaked at 21.5%, strained bank portfolios of long-term fixed-rate loans and bonds. A bank that fell below the FDIC’s mandated 5% minimum capital ratio faced supervision and restricted activities. In cases where a bank’s capital was wiped out, the FDIC sought to arrange acquisitions by stronger banks.

> “I am still trying to figure out where financial Armageddon fits in this picture!”

In 1981, President Ronald Reagan named Isaac chairman of the FDIC. At the time, the FDIC lacked experience with large banks, whose potential troubles posed the greatest systemic threats, and it did not regulate savings and loans (S&Ls). That job fell to the Federal Savings and Loan Insurance Corporation (FSLIC). The FDIC was under great political pressure to overlook the looming capital inadequacy in the S&L industry. Isaac, though, believed that arranging the quiet transfer of assets from a failed thrift to a stronger one was preferable to allowing insolvent S&Ls to continue operating under special rules. When Isaac proposed merging the FSLIC into the FDIC, critics accused him of a political power grab. No one, including Reagan, supported his efforts. In the interim, the FSLIC and the Federal Home Loan Bank Board, with the president and Congress’s tacit approval, encouraged troubled S&Ls to expand and assume more risk. As a result, a problem that the government could have solved for $15 billion in 1984 eventually cost taxpayers $150 billion.

Penn Square Fails

In 1982, Oklahoma City’s small, $500-million-asset Penn Square Bank was in distress and, therefore, so was the banking system. Penn Square had sold $3 billion in loans to big banks nationwide, so its failure could directly undermine some of the US’s largest financial institutions. Under then-existing law, the FDIC would reimburse its depositors and repay its creditors. But Penn Square had also engaged in fraud, so, if the FDIC arranged its merger with another bank, the agency would take on unquantifiable future liability. The FDIC wanted to let Penn fail to limit the agency’s exposure to no more than $3 billion and to let the system absorb its mistakes without federal assistance.

> “Someone once said that blaming greed for bank failures is akin to blaming gravity for airplane crashes. Greed, like gravity, is a force of nature.”

However, the Comptroller of the Currency and the Federal Reserve opposed the failure. After a hastily convened meeting on July 4, 1982, Secretary of the Treasury Donald Regan agreed that the FDIC had the authority to make its own decision. Isaac allowed Penn to fail, marking the first time the FDIC had taken the lead in a crisis. The subsequent failure of other banks continued to point up the conflicts among overlapping supervisory bodies. For instance, the Federal Reserve monitors bank holding companies, but other agencies supervise subsidiary banks. This problem has not been solved.

Deposit Insurance

New York started the first bank deposit insurance plan in the US in the 1820s. Some other states set up their own schemes, but the programs did not survive financial stress. During the Depression, one-third of all US banks collapsed, wiping out depositors. Proponents called for a national deposit insurance program, which Congress passed into law in 1933 to restore faith in the banking system and to protect individual investors.

> "Good bank regulation always leans against the prevailing wind."

The FDIC served its purpose well, but by the 1980s, companies with "brokered funds" began abusing the program. Brokers – from Wall Street banks to single-person firms – deposited money from people seeking high interest rates into FDIC-insured banks, usually weaker banks offering better returns. The law said coverage for these funds had to "pass through" to the depositors, increasing the FDIC's potential liability in a bank failure. Isaac wanted to limit coverage to the brokers, not their clients. He needed the FSLIC's cooperation to prevent brokers from switching their accounts to S&Ls. The FSLIC agreed, and soon a new rule barred brokered funds from deposit insurance.

> "I fume when I think about how much money Wall Street firms made helping to create the problems and then helping to clean them up."

But the ban incurred the wrath of Wall Street and Regan, a former Merrill Lynch executive. Wall Street firms were collecting about $100 million annually in fees from investors, banks and S&Ls as part of their brokered loan programs. Then the firms would borrow the money back to finance lucrative leveraged buyouts. If a broker-funded bank or S&L suffered a crippling loss, the FDIC would be on the hook in "the biggest scam against taxpayers in history – at least up to that point." But the practice of pass-through deposit insurance coverage still continues: A court reversed the rule and soon brokered funds poured into weak banks and S&Ls willing to pay high interest rates to attract new money.

Continental Illinois and More

In May 1984, Continental Illinois, the US's seventh-largest bank, tested the "too big to fail" concept when it teetered on collapse. In addition to Continental, the FDIC identified other big, troubled banks: Bank of America, First Chicago, Manufacturers Hanover, Chemical Bank and Chase Manhattan. Worse, Continental held billions in deposits from 2,500 small correspondent banks. If Continental failed, it would pull many banks down with it. To stabilize the situation, the Fed, the FDIC and the Comptroller of the Currency worked with seven major banks to set up a public-private rescue package.

> "The banking industry's principal watchdog, the FDIC, was neutered for over a decade during the high growth period in banking leading up to the crisis of 2008."

Continental survived with new leadership, but its shareholders lost everything. The FDIC took control and ordered the bank to reduce its balance sheet by 50%. Regulators averted the panic that would have certainly ensued if Continental had been allowed to fail. They also prevented a contagion effect that might have brought down the banking system and resulted in the nationalization of US banks. Contrast that result with the aftermath of Lehman Brothers' 2008 bankruptcy – a fearful, destabilized financial system.

> "Managing a crisis is more art than science – it requires a good deal of judgment about how much disruption and uncertainty the public psyche can tolerate."

Isaac's team prepared reports on US banks' exposure to defaulting emerging markets and on the nation's S&L problems; the latter study showed that correcting the thrifts' insolvencies would cost $15 billion more than the FSLIC had. Treasury Secretary James Baker never acted on the study's recommendations. The General Accounting Office (GAO) conducted an audit of the FDIC and ordered it to tax banks to cover nonexistent losses; this levy continues to drain money from the banking system and reduce lending capacity. In 1987, 200 US banks failed. In 1989, a year that saw the shuttering of 534 financial institutions, Congress finally approved a merger between the FSLIC and the FDIC.

Past Failures, Current Mistakes

Deregulated, free markets work best when accompanied by effective bank supervision, including minimum bank capital ratios, deposit insurance reforms and better disclosure. Regulators should closely monitor banks for incipient troubles during good times and encourage confidence in the system during bad times. This "countercyclical" strategy makes bank examiners unpopular, but it reduces risk to taxpayers and shareholders, while promoting economic growth. The severe, widespread problems in the 1980s did not cause the same kind of worldwide panic and deep recession that occurred in 2008. Some mistakes that exacerbated the 2008 crisis include:

- Mark-to-market accounting forced banks to price their long-term assets inappropriately according to changeable market values, erasing $500 billion in bank capital.
- The FDIC imposes "procyclical" insurance premiums in bad times when banks can least afford them.
- "Prompt Corrective Action," which requires increasingly severe restrictions on undercapitalized banks, shortens the time distressed banks have to correct their problems.
- Securitized loans mushroomed into uncontrolled lending, overleveraging balance sheets.
- Political pressure forced Freddie Mac and Fannie Mae to extend mortgages to less qualified borrowers.

> "Financial markets and the public can handle almost anything except uncertainty."

The US government politicized its monetary policy by offering erratic crisis management in late 2008. Many Americans felt as if Wall Street was managing its own bailout and leaving taxpayers with the bill. Phone logs from autumn 2008 show that Timothy Geithner, then president of the Federal Reserve Bank of New York, telephoned ex-Goldman Sachs executives, like Treasury Secretary Paulson, more than he did his own boss, the New York Fed chairman. One of Treasury's mistakes was to announce government backing for money market funds, without first specifying that its guarantee would apply only to existing investments; clearly, no one anticipated that bank depositors might flock to higher return, fully guaranteed funds, leaving banks in even worse straits. All this, topped by Lehman Brothers' pointless failure, created widespread fear in the financial markets. Before forcing TARP on the country, officials should have recognized that existing agencies like the FDIC could have taken cheaper, more effective action. Instead, disorganized thinking undermined investor confidence and resulted in "senseless panic."

About the Authors

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