The FDIC Podcast – A Look Back at Bank Failures and Deposit Insurance in the U.S. (Part Two)

BRIAN SULLIVAN: Hey, welcome back to the FDIC podcast, a place where we talk about our banks and our money. And in our last episode, our history, I'm Brian Sullivan at the Federal Deposit Insurance Corporation and today we pick up where we left off in our last episode.

Art Murton joined us in part one of a two-part conversation about all those big moments in our banking history, since the Great Depression and since the creation of the federal deposit insurance corporation, these are great turning points that set the stage for how we bank today as the deputy to the FDI C chairman for financial stability. Art has been in the room where it happened for a number of big moments over the past 35 years since he first walked into the FDIC as an accountant. In part one, art took us through the history from the great depression up through the so-called S&L crisis in the 1980s, when savings and loans collapsed, and taxpayers had to pony up north of $100 billion to bail out the insurance fund that was set up to protect those depositors. In part two of our conversation, Art picks up the story from

ART MURTON: So the savings and loans, because of the high interest rates, were basically insolvent and the losses grew over the years and required taxpayer funding to protect depositors. And I should make it clear that no insured, depositor lost a penny during that period. But of course there was taxpayer outrage at having to pay for these losses. And as I said, FSLIC, and, regulator of the savings and loans was abolished.

BRIAN SULLIVAN: Right. But through it, all the FDIC and the insurance fund that was originally created to support deposits in commercial banks….how did that fare during this time?

ART MURTON: It had its own problems. It had its crisis too. And I can walk you through that and maybe start in the early ‘80s, 1984, when one of the largest, the seventh largest bank in the country…Continental Illinois…experienced severe difficulties. And that required essentially a bailout that protected, not just insured depositors, but *all* depositors and even other creditors of the bank and the bank holding company.

BRIAN SULLIVAN: And by bailout, what do you mean? I mean, beyond the Insurance Fund?

ART MURTON: Exactly. Exactly. We, the FDIC, provided protection and covered the uninsured depositors as well as other creditors of the bank. And that was controversial because up until that point in the prior few years, smaller banks had been failing, and when they failed, only uninsured depositors were protected—uninsured, depositors, lost money, other creditors lost money. Continental Illinois comes along, seventh largest bank, everyone is protected. So that disparate treatment is obvious to people and creates a double standard and that's where the term too big to fail, uh, entered the lexicon.

BRIAN SULLIVAN: Right? Well, but the insurance fund that FDIC manages survives to this day. So…

ART MURTON: It did, but let's walk through, what it experienced in the ‘80s. So after Continental, what the country experienced was a series of rolling regional recessions. So first in the mid-80s you had problems in

the agricultural belt, in the Midwest, and a number of banks failed there. And then the problems move to the Southwest, the energy belt, particularly in Texas and then up to the Northeast and the Mid-Atlantic.

And I might spend a minute on Texas. Texas at that time in the early '80s to mid-'80s was booming because of high oil prices. And in fact, the large banks in Texas were now rivals to what were known as the money center banks in New York. You've heard the names...Chase, Manufacturers Hanover, Chemical, and so forth, Citi and others. And the Texas banks began to rival them in terms of financial might. But that came, crashing to a halt in the, in the mid-80s and indeed seven-of-the-10 largest banks in Texas failed as a result of that. Two of the other largest had to be acquired by out-of-state acquirers...banks from out-of-state.

And so Texas experienced severe problems, which created large losses for the Deposit Insurance Fund. The FDIC started with just over $15 billion entering that crisis and within the span of two or three years, from '87 to '89, we had lost more than two thirds of that I'd say.

BRIAN SULLIVAN: Sounds like the '80s were pretty tumultuous. We came out of that period of time, did we enter a new period of calm?

ART MURTON: We did, but we had a little more trouble to go through first. After Texas, as I said, the problems moved up to New England. So we thought the problems were over when Texas ended and we still had a positive balance in the Insurance Fund. And I should say, I remember in 1988, we would have delegations from various states come to the FDIC to have lunch with the chairman and sit with staff. And I remember a table, there was a delegation from one of the New England states and they were complaining about what was going on in Texas and how much money it was costing the Deposit Insurance Fund that they had paid their premiums into. And they said, you know, Texas the way their banking down there, that's like gambling!

BRIAN SULLIVAN: This would never happened in New England!

ART MURTON: Never. That's right. And so fast forward a few years...

BRIAN SULLIVAN: Famous last words?

ART MURTON: Exactly. On one weekend we closed five of the largest banks in that state. The New England experience, again, created additional losses for the FDIC and in 1991 we reported the FDIC Fund as insolvent.

BRIAN SULLIVAN: Was that the first time?

ART MURTON: First time the FDIC fund ever had. So again, something needed to be done.

BRIAN SULLIVAN: What was that 'something?'

ART MURTON: Congress passed a law, *The FDIC Improvement Act*, known as FDICIA. And what it did several things to address the problems. So what, what FDICIA did, what the new legislation did, was give the FDIC board, not only the ability, but the mandate to make sure the Deposit Insurance Fund reached a target as a percentage of the amount of deposits that it insures.

BRIAN SULLIVAN: Like a capital ratio?

ART MURTON: Exactly. And so what the FDIC board did, and was required to do by FDICIA, was to significantly raise premiums on banks in order to get the Fund back up to that target. And that's so that's what we did in the early '90s. Now, that reform legislation also did a number of other things in terms of addressing the problems. One was created something called the "Least Cost Test," which basically limited the FDIC board's ability to protect anyone *other* than insured depositors, it made it more difficult, took away some of the discretion that the FDIC board had to protect depositors beyond the *insured* depositors.

BRIAN SULLIVAN: It seems odd that anybody who's *uninsured* would be ultimately insured by an insurance fund that they didn't participate in.

ART MURTON: That's right. But what Chairman Seidman argued and that's why it was called the "Least Cost Test" was that there might be some cases where having another bank acquire it and protecting a small amount of uninsured depositors could actually preserve franchise value and actually be less costly to the Fund.

BRIAN SULLIVAN: The '80s, early '90s seemed pretty tumultuous with these rolling regional recessions and the effect that that had on the banks in those areas…and of course the depositors and ultimately the Deposit Insurance Fund. But then we entered this new period of relative calm and stability and, and it seems to take us, you know, through the '90s and into the 2000s…kind of a golden age, right?

ART MURTON: That's right. The Deposit Insurance Fund recovered, the industry returned to health and indeed had record earnings, a decade or more of very high earnings. And there were changes in the industry. There was consolidation of the industry. So the geographic restrictions on banking were relaxed and there was a great deal of consolidation throughout the industry. There was also relaxation of power. So bank companies could have powers just beyond the traditional banking ones. It was also what people have called 'financial engineering,' the creation of new products, such as derivatives and other instruments to help manage risk, help corporations and others manage risk…

BRIAN SULLIVAN: …or so they thought!

ART MURTON: Or so they thought. The regulators put in place, what are known as risk-based capital rules to try to tailor the amount of capital that banks have to hold to the risks that the banks are taking. The subprime lending, which had long been more the province of what are called finance companies, entered the banking system and of course there was a lot of residential mortgage lending.

BRIAN SULLIVAN: Oh my goodness….

ART MURTON: That eventually, as you know…

BRIAN SULLIVAN: Right. Well, I recall well the collapse of the housing market and the foreclosure crisis that ensued and just how scared folks were that things could have been so much worse, you know…because now we're hitting 2008, right? That's the year, everybody points to. You know, people lost homes and everything…businesses went out of business and we lost a lot of banks. What lessons did we learn through all that?

ART MURTON: Right. Well, before we get to the lessons there, it's probably, we're talking about some of the things we had to do that we had not done before. So when you think of that period, I think of sort of two parts. One is what people refer to as the global financial crisis, and as you said, that was 2008 was the epitome of that, particularly the second half of that. But, the year started early on with Bear Stearns in March having to be basically acquired by JP Morgan Chase with some support from, from the government. And then you get to the fall…

BRIAN SULLIVAN: …again, the too big to fail thing?

ART MURTON: Could be an example of that. And then you get to late summer, early fall, you have the government taking over Fannie (Mae) and Freddie (Mac), the government sponsored enterprises (GSEs). You have the bailout of AIG….you have the money market mutual funds that I referred to got into trouble and the Treasury had to put in place a guarantee of money market mutual funds, which was unprecedented. And created actually some issues for the FDIC, because now there was another product that had a full

government guarantee that could have competed with bank deposits. And so we had to work with Treasury to sort of tailor their programs so that it wouldn't have that impact.

So that was what was going on *outside* the banking system. But then *within* the banking system, you had problems. You had IndyMac failing in July of 2008—the most expensive bank failure, by far, in the FDIC's history. And then in September, you have the failure of Washington Mutual, the largest failure in terms of asset size that we ever had. And then we had problems with even larger banks…Wachovia…and we had to put together a rescue package over the weekend in late September. And that was the first time that the FDIC invoked what I referred to earlier, that "Systemic Risk Exception" that Congress had given us back in FDICIA.

BRIAN SULLIVAN: And that's the exception that says, if things get really bad, then you can forget everything?

ART MURTON: Exactly, exactly. And that was the first time we had used it in the 17 years that we had been given that authority. So that was the first time, but then later we also had to invoke that for Citibank and also for Bank of America in the fall of 2008.

BRIAN SULLIVAN: Right, this exception, everybody had to say yes to that.

ART MURTON: That's right. Okay. But you know, perhaps the most notable use of that exception was what was called the "Temporary Liquidity Guarantee Program" or TLGP. And this was one of the programs that came out of Columbus Day weekend of 2008, when Treasury called a number of the agencies together to try to find a solution to the seizing up of credit markets. And so one of the things that came out of this that weekend was the FDIC, for the first time ever, guaranteeing bank debt, debt that banks issued into the marketplace. So if they issued, for example, bonds…

BRIAN SULLIVAN: Not just people's deposits.

ART MURTON: No, no. This was, investor bonds that investors purchased would have a guarantee by the FDIC and again, that was unprecedented.

BRIAN SULLIVAN: That was a temporary guarantee though, right?

ART MURTON: It was, it was. And along with that, we also put in place what was known as the "Transaction Account Guarantee Program" where we provided *unlimited* deposit insurance for non-interest bearing transaction accounts. So think of very large corporate accounts that could be used for payroll, to pay the payrolls and so forth. So those became fully guaranteed. The idea was that you didn't want them being at risk and possibly having to cut off payrolls if the bank were to fail.

BRIAN SULLIVAN: So Art as we're coming through this crisis in 2008 and 2009, it seems like the financial system was stabilizing somewhat, but the next shoe to drop was the effect it had on our banks at the time. What happened to the banking industry after the financial sector went into crisis?

ART MURTON: Right, as I mentioned, first IndyMac failed in the middle of 2008 and that was, you know, the most expensive. But in late 2008, and for the next several years, community banks and smaller regional banks failed. We had to resolve over 500 banks during that period. And once again, it put pressures on the Deposit Insurance Fund. So we had started the crisis, with over just over $50 billion in the Deposit Insurance Fund and by the end of 2010, we had a negative balance of $20 billion. So once again, The Deposit Insurance Fund went negative and we had to take measures to shore up our resources.

BRIAN SULLIVAN: We began this two-part podcast. I said, you know, you, you had seen it all in your time here at the FDIC of course that's, that's nonsense. I mean, here we are experiencing something we've never experienced today in this pandemic and all the economic consequences that come with it. But as we sort of wind up our conversation…after all you've seen over the years and all these stories that you've told us, what observations can you share with those of us who are looking for some perspective at a time like this?

ART MURTON: Well, maybe I'll go back to some of the lessons we hope we've learned. When I look back to the experience of the 1980s, I think it's fair to say that people at that time did not see the problems that could develop in insured depository institutions, the banks and the savings and loans. I don't think they contemplated the problems that they may face. I think they were slow to respond to it and eventually they responded to it in some ways better than others but, but they got through it and again, no insured depositors lost a penny. But they learned that. I think one of the lessons coming from there was that a deposit insurance system needed to have adequate resources to avoid having to go to the taxpayer. So there were measures put in place to do that.

You go to 2008 and we entered that, and I think what we didn't see was the way risk had built up outside the banking sector in other parts of the financial system and the impact that that might have on the banking system. And again, we didn't fully see that coming and we had to react to that. We had to respond to that again in some ways better than others, but at the end of the day, I think fairly effectively. But what we learned is that we have to look for risk not just within that sector, but in other places…

BRIAN SULLIVAN: …right, it's an ecosystem.

ART MURTON: Absolutely. And I think that's relevant today because the financial industry is changing, technology is changing, there are cyber threats…we've changed the way the financial system works in terms of, for example, going back to derivatives, it used to be a lot of bilateral arrangements between banks where they would have these instruments as transactions between one another…sort of like a bowl of spaghetti. One of the things that the reform did was to call for central clearing, which means it's more like a hub and spoke where banks deal with a central party to have those transactions, which is a way of a good way of mitigating the risks in there. But it also creates centers where the risk might build up and, many of us have been working to, to try to keep an eye on how that is working.

BRIAN SULLIVAN: It never stops does it? I mean, we're always learning and we're always learning from what maybe we should have learned before, you know? Is that the nature of the beast?

ART MURTON: I think it is, I think it is. And, you know, hopefully, I think we have a lot of tools that we didn't have before. We may not completely see what's coming but I expect that we'll be able to respond in the future. And I'm very confident that whatever comes next, we'll again, be able to say no insured depositor lost a penny.

BRIAN SULLIVAN: Cause that's been true all along. Maybe that's the one constant we can end on here. Nobody's ever lost their money when they put it into a bank, in an insured institution. Right?

ART MURTON: That’s Correct

BRIAN SULLIVAN: Art Murton, thank you so much for taking us down memory lane.

ART MURTON: Thank you, Brian it's a pleasure.