Panel 4

The 1980s in Retrospect

Paul A. Volcker*

I am glad that Chairman Helfer invited me to this affair because it got my juices going about banking supervision and regulation—a subject close to my heart. I read those papers and I thought they were clearly written and very helpful. I used to think I knew something about this subject, but I have to say that I have lost confidence in myself in the face of rapidity of change. It is partly the change in the banking system and partly my growing age and declining analytic skill. But, in any event, I am glad to have this excuse to get back in the middle of thinking about it

Now, in the interest of full disclosure, I have to tell you I'm a bank director these days. It has not been my life-long ambition, but somehow I have ended up there. I do have to report that it gives one a somewhat different perspective on some of these questions—even though I am relatively new. I was struck in the first few meetings that I went to at Bankers Trust how much of the agenda was directed by the Federal Reserve. I am sure most people feel that is a bureaucratic intrusion. I sat there thinking how sensible most of these requirements were. I realized I wrote a number of them.

In any event, the job of the moderator is to pose some issues. I want to pose a few and get on to the people who are going to discuss them. A lot of what I might have said is really redundant after that splendid speech by Chairman Helfer. She focused on some key issues. But, I do have one complaint about our particular listing on the program. It says this panel—and I am conscious that we are at the end of the program—is concerned with the 1980s in retrospect. The whole conference title, "Lessons for the Future," may be more appropriate. I think we really

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ought to be focusing less on the 1980s in retrospect and more on the lessons for the future.

What strikes me in reading this material for the 1980s is how much has changed in the 1990s and is in the process of change. I have no doubt that if we had these papers somehow available at the beginning of the 1980s—that by some great process we could have absorbed the lessons of the 1980s before the 1980s took place—we would not have had many of the problems of the 1980s. But I'm not sure I could say the same thing about the 1990s because so much has changed. Would these same lessons be adequate for, say, 2007?

I do think we will continue to have these difficult questions of balancing official protection against market discipline. Let me just say quickly that I think the attitudes in that respect do change greatly depending upon where you sit. The 1980s exposed various excesses which I think, to some degree, were becoming apparent in the 1970s. I can remember very clearly sitting in my office then, as President of the Federal Reserve Bank of New York, thinking what this country needs is a first-class bank failure to teach us all a lesson—but please God, not in my District. When I went to Washington, I had the same feeling—we need a clear lesson from market discipline, but please dear God, not in my country. Then, if I read correctly the 1990s, and what happened when the Mexican crisis came along, Bob Rubin and Alan Greenspan thought what we need is a good country failure to teach everybody a lesson, but please not a large country in my hemisphere. I really want to emphasize a point that Bill Seidman made earlier—whatever the talk about the technicalities of deposit insurance, the particular level of it and whether or not you have it, and how much you theoretically want to rely upon market discipline, there isn't a developed country in the world in the 1980s and early 1990s that did not run into banking crisis. I don't know of any of those countries that didn't act to protect the banking system with assistance whatever the law said. The creditors and depositors didn't get hurt if it was a bank of any size. That included good, conservative, market-oriented Scandinavian banks, where the banking systems were almost wholly taken over for a time by the government.

Market discipline can be very important. We like to use it. But I remind those who want to rely upon it wholly of some simple facts. I can't remember any banks that failed who didn't have a clean auditing statement, sometimes as little as two weeks before they failed. Markets are prone to excessive exuberance in all dimensions—not just in the banking world. The question at issue is whether there is still something special about banks that deserves protection.

Today's banks—not all banks and not most banks, but some of the biggest banks—are different. If you want an extreme version of that, look at Bankers Trust. There is a bank with only a few deposits and with a few loans—maybe 15 percent of the balance sheet. Off-balance-sheet items are far larger than on-balance-sheet items, and I'm not sure they are completely understood by anybody in terms of what happens in really severe scenarios of pressure. The big banks are rapidly combining with investment banks, so we have all that kind of risk traditionally insulated from commercial banking. Tomorrow, I think we'll almost undoubtedly have insurance combined with banks. Traditional commercial banking, whether it is within an institution like Morgan or Bankers Trust where it has declined internally, has declined precipitously as a percentage of all financial assets in the country.

What does that mean? Individual "banking" institutions are bigger and bigger, more and more international, more and more inextricably combined with what we used to think of as different industries. Where does that lead us in this balance of market discipline, government support? What kind of supervision is appropriate? How far does the supervision go?

I regret John Heimann isn't here, who was also on the panel, because he is representative of one of these institutions that is not called a bank, but looks a lot like these other big institutions we still call banks. But, we do have three wise men, and I turn, first of all, to Carter Golembe.

Carter H. Golembe*

After almost 50 years of reasonable stability in banking, the distinguishing feature of the 1980s was, as George Hanc put it in his excellent paper, "the extraordinary upsurge in bank failures." It was a difficult time for everyone: the banks, the regulators, and the public. The intention now is to learn from and apply the lessons derived from studying the 1980s in order to avoid having to face banking problems of similar magnitude in the future and, more broadly, to enable the banking agencies and the banks to deal more knowledgeably and confidently with future problems. Clearly, this is a worthwhile exercise, and all of those responsible for initiating and conducting it deserve congratulations. I have a cautionary observation, plus several suggestions for future work.

My observation is really a reminder; certainly it is not new. It is to remember that from the same set of data or facts, analysts may draw dramatically different conclusions. Often the reason for this is that the future problems to which the lessons will be applied may be seen quite differently. The past can be intensely interesting, particularly for those who have lived through it, so much so that there is a danger of forgetting the most important point of all, which is that the problems of the past may have little or no resemblance to the problems of the future.

My hobby is reading military history, and I think I can say with some confidence that no profession spends more time than the military carefully going over past wars to identify mistakes and to prepare itself for the future, separating the strategies of enduring value from those soon to be irrelevant. This does not always work out well. No one spent more time than the French in their study of the bitter and immensely costly fighting during the four years of the first World War, from 1914 through 1918. The French applied the lessons of that war, as they perceived them, built the largest and best equipped army in the world, and then put it behind impregnable barriers. When war came again 20 years later and France was attacked, on May 10, 1940, it was completely defeated and capitulated in about six weeks. What happened?

First, in some important areas the French drew quite different conclusions from those drawn by the Germans, who had studied the same set of facts. The French became so obsessed with the past they forgot that the next war might be

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quite different. There is little question that if the war of 1914-18 had been resumed in 1939-40, the French would have been easy victors. Their fatal mistake was to forget that it might be a much different war—and it was.

I wish I could say with some confidence what future banking problems might be. I cannot. Of course there will be similarities with those that have been faced in the 1980s but there will also be differences. In fact, these differences might be so great as to render useless, or at best questionable, at least a few of the lessons likely to be drawn from a study of the 1980s, while at the same time pinpointing others of special value. The key question is: which?

I was delighted to find that the panel's assignment is to discuss "The 1980s in Retrospect." My dictionary defines "in retrospect" to mean "upon reflection," or "looking back on past events," which I hope gives me the liberty to go back a bit in history in the course of my reflections. I found the paper by George Hanc to be particularly useful in this regard: a readable summary of the findings of the study conducted by the FDIC. His paper covers the economic, legislative, and regulatory background of the bank failure experience of the 1980s, along with the regulatory and supervisory issues raised by that experience. Reflecting on it, I decided that those who had put this program together must have proceeded on a basic assumption: deposit insurance will continue more or less in its present form. But this is hardly likely to be the case; deposit insurance has changed continually over the past 60 years and will continue to do so. The fact that a primary, probably principal, reason for its creation was to help preserve a fragmented banking structure virtually guarantees this, since we are now in the midst of rapid consolidation of that structure. Moreover, deposit insurance, particularly the way it operates, is central to much of what is discussed in the FDIC's studies; key pieces of FDICIA, for example, reflect an explicit effort to protect the deposit insurance funds.

George's paper contains a statement that perhaps illustrates better why I think the study's underlying assumption is important. Discussing the collapse of the S&L insurance system, George points out that the hands of the authorities were tied by the shrinkage of their deposit insurance fund, noting that "one obvious conclusion" to be derived from this is that "an adequate insurance fund is a prerequisite for any attempt to control moral hazard." He is correct of course, but there are many other possible conclusions, such as that a different type of deposit insurance, not dependent on or tied to a deposit insurance fund, might be called for. Indeed, some of the most successful depositor protection systems we ever had in the United States—Indiana and Ohio before the Civil War for 30–40 years—were not based on an insurance fund.

The basic assumption that I think underlies the study can be broken into at least three parts. First, it is assumed that deposits in banks and in other institutions accepting deposits or near-deposits will continue to be protected by the federal government up to a specified amount, probably at least as large ($100,000 per depositor) as now. This I think is a reasonable assumption, even though there is no reason to believe that the same kind of protection could not be provided without the involvement of the government. In fact, there is a growing body of evidence to support this. Politically, however, this would be a difficult change to make and thus, as a betting man, I would say it is 10 to 1 or better that government will still be the guarantor 10 years from now.

The second part of the assumption is that the way in which the insurance or government guarantee is implemented will continue to be about the same as that followed today. This is much more questionable; I doubt that depositors care much, if at all, how they receive their protection, so long as it is received, and will not raise objections. The recent placing of more stringent limits on the ability of the FDIC to protect all depositors or all bank creditors is probably only the tip of the iceberg.

In 1935 the Corporation obtained legislation to inaugurate a quite reasonable program of encouraging those banks which had survived the debacle of 1932-33 but were still weak—banks had been permitted to join the new deposit insurance system with a minimum capital of $1—to merge with sounder banks. This program was reasonably successful for several years before being interrupted by World War II. After the war, it was discovered that the program was easily adaptable to handling, in addition to weak but solvent banks, those about to fail, enabling the FDIC to claim for a number of years that it had virtually eliminated bank failures (which were then defined as receiverships). In the mid-1950s, quite by accident, the FDIC discovered that it could also facilitate mergers after a bank was placed in receivership and, by the 1960s, the program began to be referred to as "purchase and assumption transactions." Such transactions were generally adopted by the FDIC for as many distressed banks as possible, in part because they provided 100 percent insurance protection.

In 1950 another important piece of legislation was obtained by the FDIC. Economists and others had predicted almost unanimously that the U.S. would face a great post-war depression after the end of World War II. The FDIC thought that this might lead to the failure of a number of large banks, which the deposit insurance fund would not be large enough to handle. Moreover, FDIC officials recalled that in the 1932-33 crisis the Federal Reserve had failed to assist a great many banks which, lacking such assistance, then failed. So the Corporation sought and obtained legislation enabling it to make loans to distressed banks without their having been merged out of existence or placed in receivership. The Federal Reserve was incensed at this request by the FDIC, regarding it as a transgression on its role as the nation's central bank and, in particular, as the "lender of last resort." Because of this opposition, as well as because the great post-war depression never happened, the FDIC did not make any use of this authority for about 20 years.

However, the Corporation crossed its own Rubicon in 1972 with a loan to the first billion-dollar bank to face failure (the Bank of the Commonwealth in Detroit), offering as justification, among other reasons, "the effect its closing might have had on public confidence in the nation's banking system." This was the beginning of the present "too-big-to-fail" program, although the FDIC had in fact long been following a policy of attempting to treat every bank in difficulty, regardless of size, as "too-big-to-fail." In any event, the program has assumed such dimensions that the President of the United States, no less, is now required by law to be consulted when disbursements for the purpose of saving a large bank are made.

It is useful to keep in mind that when it was created in 1933, the FDIC was asked to serve primarily as the paying agent for the government's deposit guarantee. All of the sophisticated paraphernalia that now exist—involving alternative methods of payment, open-bank assistance, closed-bank assistance, mergers, the treatment of very large banks etc.—came later. For the most part they came not because of a deliberate plan or adherence to specific banking policies, but incidentally or accidentally. Query: have they added very much value except to the size of the work force or the cost to the banking industry and to the government? If "yes," how relevant are they to the insurance function, as opposed, for example, to the lender-of-last-resort function? Or to the responsibilities of the chartering agencies?

The third element of the underlying assumption is that deposit insurance will continue to be provided in the future by an agency that also has authority to examine, supervise, and regulate banks. This is also questionable; I think the odds of it being the case ten years from now are probably about no better than even money. Once again, there are no political implications because depositor protection would not be altered; who does the actual regulating is not a matter that depositors know or care anything about.

Very shortly after the FDIC began operations, it asked for, and received, power to examine banks. Subsequently this authority was broadened and expanded, reaching its zenith, I hope, with FDICIA. But even from the outset, giving to an insuring agency the power to examine and regulate the banks whose deposits were insured was recognized as raising serious conflict-of-interest questions. In fact, the issue surfaced early in the Roosevelt administration.

Possibly there are some here who were in the audience in 1962 when the new FDIC building was dedicated and heard Wright Patman criticize the examination role of the FDIC, to the consternation of the officials on the dais. And in 1972-73, the separation of deposit insurance from bank supervision and regulation came within a hair of becoming fact; the Hunt Commission, solely because of its concern over the FDIC's conflict of interest, had recommended that the bulk of its supervision and regulatory responsibilities be transferred to another agency (to a new federal agency which, along with state agencies, would supervise and regulate state banks). With the overwhelming re-election of Mr. Nixon and the dedication of the Treasury Department to reform (in fact, it had created the Hunt Commission) it seemed quite likely that the recommendations would be adopted. But they were swept away by the tidal wave of Watergate.

Obviously this issue is still live. I was interested, but hardly surprised, to read in the paper on off-site surveillance systems that the "primary goal of bank supervision is to prevent losses to the deposit insurance fund." I believe that this is quite different from the way the objective would be described by many others engaged in the business of supervising banks.

The insurance agency, to be truly effective, probably must be something more than a mere paying agent. It would have to retain some minimum but essential regulatory functions, when Congress finally gets around to solving the conflict-of-interest problem. During the course of the debate over the administration's proposal several years ago to consolidate the FDIC, along with others, into a single new agency, thereby loosening the connection between insurance and examination, it is clear that the FDIC was giving its proposed new role some careful thought; I seem to recall a speech or possibly testimony by Director Hove on this subject. However, I did not sense in what I heard today, or read in the various study papers, that the consequences, for good or for ill, of separating the insurance function from the bank supervision function are being studied, and yet this separation could be part of the new world facing the FDIC.

William M. Isaac*

I think I'll go right into the subject Carter ended on. I think that Carter, you were using supervision and regulation sort of interchangeably, and I don't believe those are the same thing. A regulator approves corporate applications and powers and activities and the like. A supervisor conducts exams and/or looks over the shoulder of folks doing exams, takes enforcement actions, and the like. It was my view, while I was Chairman and since then, that the FDIC really ought to be a supervisor of banks and not a regulator of banks. I don't think it should be in the regulatory business. I was willing to give up the FDIC's regulatory powers when the Bush Task Force was deliberating these issues. I don't believe it matters to the FDIC whether a bank opens a new branch or not, and I don't think it matters to the FDIC whether a bank is in compliance with CRA and other such things. I don't believe that the FDIC ought to be dealing with anti-trust issues on mergers and the like. I believe firmly that this agency needs to be focused on the forest, not the trees. If we missed some things in the 1980s, I suspect it's because we were not stepping back and looking at the system and saying where is it going, what is happening, what is changing? The S&L industry is going like crazy—how is that going to impact banks?

I believe that is the kind of view and perspective the FDIC needs to be able to take and I think to do that it needs to be in all banks irrespective of their charter, whenever it chooses to be there. Hopefully not in an intrusive way, hopefully in coordination with the primary regulator. But I don't believe this agency ought to be restricted in any way from going wherever it needs to in the system to make sure it understands what is going on in that system and that the other agencies are doing their job. To me, it was unacceptable that the eighth largest bank in the country—Continental—was going down, and the FDIC had never been in the door before. I didn't think it was appropriate then and I don't think it is appropriate now, and don't think it will be appropriate in the future. This insurance agency, in my opinion, needs to be able to go where it needs to go, anytime it needs to go there, hopefully in coordination with the other agencies. It shouldn't matter what the charter is—it should only matter how big the bank is and what kinds of trends are evident in it.

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I wasn't going to spend my time, and I just wasted about two minutes of it, on that, but I really thought it was good to supplement what Carter said. I was hoping to focus a little bit on what I think is one of the FDIC's finest accomplishments during the 1980s, maybe in its history, and that is the way it handled the mutual savings bank problems. I first focused on the savings banks when I was still a director of the FDIC. I headed up a task force that was established to look at the savings bank problems. Some of the people in this room were involved in that task force. Because of the very, very high interest rates that were prevalent in the country, we saw a problem coming at us and we decided that we would prepare to deal with it. We did projections of the worst case, best case, most likely case scenario for interest rates; what that would mean for the FDIC's income; what that would mean in terms of savings bank failures in each of those cases; which banks would fail; how many months they had to live under the various scenarios. We had it all charted out, and I've got to tell you, if you look at that study today, it stands the test of time. It did forecast exactly what was going to happen under each of the scenarios.

We looked at the FDIC's investment policy and we decided it was too long on the maturities. The FDIC's maximum exposure to savings bank losses was going to be highest in a high-rate environment, so we needed to shorten maturities to maximize our income and liquidity in a high-rate environment. It was going to cost us money if rates declined, but that was all right because then our savings bank losses would be lower.

We had a big debate in the task force about how aggressive we should be in dealing with savings bank problems. The prevailing view, inside and outside of government at the time, was that this was a liquidity problem—I mean an interest-rate spread problem and not a solvency issue. All we needed to do was give these institutions a chance to get through this period of very high interest rates. We had to make sure they had the liquidity to get through this period, and if they did, they would be able to make it.

The FDIC task force had a different view. Our view was that the main thing we needed to do was to keep terminally ill savings banks from infecting healthier institutions. We didn't want to close down institutions needlessly. Bob Litan spoke earlier about the social cost of not taking prompt corrective action, and is there a social cost. But if we had marked-to-market accounting back in that period, and if we had wanted to, we could have closed every savings bank in the country at a cost to the FDIC of tens of billions of dollars. That is what the numbers were. We had it documented in the savings bank task force. So, we could have shut them all down, marked-to-market, and spent tens of billions of dollars. I say the social cost of that would have been inordinately high.

Instead, we decided to pursue what I considered a more reasonable course. We made a decision that we would adopt certain policies with respect to these savings banks to try to help them get through this period without infecting other institutions. So, what we said is our minimum capital standard is 5 percent tangible capital—that is our minimal standard. Any savings bank that drops below that floor will be monitored very, very closely and it will be put under operating restrictions. It will not be allowed to grow. It will not be allowed to pay up for deposits. It will not be able to enter into new activities. It will not be able to expand or in any way increase the risk exposure, the risk profile, of the institution. We instructed the savings banks to that effect. We told them that if they violated our rules, we would remove the management and if that didn't work, we would close the institution.

We also agreed that when an institution hit a book capital ratio of zero, we would close it. We would do a deal with a stronger institution with real FDIC financial assistance going in—no phony deals, no goodwill, just real money being spent to solve real problems. We would allow other institutions to bid, but those institutions had to be viable. The resulting entity after the deal was done had to be viable. We wouldn't put two or three weaklings together, hoping and praying that the merged firm would survive. That was our policy. It was pursued and what was a $150 billion industry with a potential insolvency of tens of billions of dollars was handled at a cost of roughly $1.8 billion.

The S&L policy was exactly the opposite. It was a policy of lower capital standards. It allowed massive amounts of goodwill, allowed weak institutions to merge, and allowed them to grow. If S&Ls could get bigger and add new assets bearing higher rates, the problems would go away—they'll bury the old assets with the new higher-yielding assets. It failed spectacularly. The S&L problem in 1980 or so was roughly the same type of problem and the same size problem relative to assets as we had in the savings bank industry. The savings bank problem was resolved for $1.8 billion; the S&L problem was resolved for $150 billion. They allowed the cancer to spread.

I believe that a series of governmental policies led to the failure of the S&L industry and cost the taxpayers $150 billion. Number one, the S&Ls were clearly in trouble in the 1970s. Banks should have been allowed to acquire them. They were not allowed to do so. Second, we ignored the Hunt Commission's recommendations for variable rates on the S&L loans, to phase out Regulation Q, and to allow thrifts to have broader asset powers. These recommendations were made in the early 1970s. If they had been implemented, we probably wouldn't have had a serious S&L problem in the 1980s.

Number two, we allowed inflation to get out of control during the 1970s due to rather aggressive or sloppy government monetary and fiscal policies, which led to the very high interest-rate period that necessarily had to follow. We had an abrupt withdrawal of Regulation Q once the rates went up, without having dealt with the asset deregulation first. There was no choice—it was either get rid of Reg. Q in a hurry or these institutions were going to fail anyway because they wouldn't have any liquidity.

Congress raised the deposit insurance limit to $100,000. The FDIC strongly objected to allowing the deposit insurance ceiling to go to $100,000 because weak institutions would be able to bid up for funds. There was no Reg. Q on those deposits. Weak institutions would be able to bid for the funds without any sort of discipline whatsoever from the market.

We had the abrupt change in tax policy with respect to real estate in 1986 to throw more fuel on the fire. These changes had a very negative effect on the viability of real estate projects already on the books of financial institutions.

I've already talked about how the government decided that the S&L problem was a liquidity problem—all we had to do was let them grow real fast and they would grow their way out of the problem. They would bury the old yielding assets with much higher yielding new assets. We had little or no regulation or supervision of marginal institutions. Institutions without capital were encouraged to grow. Finally, we had this terrible failure to deal with the issue of brokered deposits. Money brokers were going around the country sweeping up hundreds of billions of dollars of funds, dumping them into the institutions that paid the highest rates. Most of those were S&Ls. My guess is this raised the cost of the S&L crisis by some $50 billion. The FDIC and the FSLIC tried to stop that abuse of the system by eliminating pass-through deposit insurance coverage. We were sued by the money brokers and they won in court. They said we didn't have authority to adopt the regulation. We asked Congress for relief, and all Congress did was criticize us for picking on the poor Wall Street firms. The Wall Street firms were charging fees to gather up that money. They were charging the institutions that bought the money a fee. Then they were taking the money that those institutions collected and investing it in junk bonds to fund the LBO deals that the investment banking firms were putting together. There were some investment bankers that earned as much as $500 million a year—and I'm talking about individuals—and it was clearly made possible through a massive abuse of the deposit insurance system. I think the problems in the S&L industry were foreseeable. They were foreseen. I think the problems in the S&L industry affected much of the banking system. I suspect we wouldn't have had nearly the problems in the banking system had we not had an S&L crisis.

I'm at my ten minutes and I will need to stop at this point.

John G. Medlin, Jr.*

I'm delighted to be here with this distinguished panel of friends and observers of banking—the younger one of the group, I think, of these old timers from the 80s. There is not a lot I add at this point to all that has been said today and all that is in the papers except a blinding flash or two of the obvious. The bottom line is that the fortunes of banks and their performance are determined largely by three basic factors. One is public policy. The second is the condition and performance of the economy. The third is management practices, internal management of those institutions.

We've talked a lot about public policies and to boil the problem down in a one-liner—what we had, and to some extent what we still have, is the democratization of credit—the democratization and liberalization of credit to everyone, cheaper credit, more liberal credit, but in the final analysis, the socialization of the risks underlying that credit falls ultimately back on the people. We have some other things like that—we have Medicare and we have Social Security which are actuarially unsound and ultimately will cause problems and deposit insurance is not a problem as long as times are good. It is only when we have unusual times like the 80s that it becomes a problem.

Also, public policies were relaxed and changed in all ill-timed way, as several have described. Raising deposit insurance to $100,000 just before removing interest-rate limitations was a huge mistake. A lot of bankers look back on their figures for the 1980s and say, gosh, we did a terrific job. Well, the reason they did a terrific job is because it was a no-brainer time for growing deposits. You put a sign up on a busy corner that said "Insured by FDIC" and people would stop by and leave money. They even mailed it in, or if you didn't want to go to that much trouble, you could broker it in, as Bill said—$100,000 pieces from the Indian tribes and whoever else had a computer program to send money from all over the country.

Economic history will record the 1980s deposit growth in banks and thrifts as an anomaly. We have never in history had those kinds of savings flow into banking. Historically, bank deposits have come largely from three sources: transaction money; parked money that somebody is going to need—and they park it in

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the bank for a while; and from small savers who don't have enough for more sophisticated investments.

Traditionally, those with larger amounts of longer-term savings have invested more in other media like stocks and bonds or mutual funds. That was not true in the 80s. We had this huge flow of money into banks and thrifts first because Congress said it was guaranteed by the federal government. One way or the other people believed the full faith and credit declaration for the thrift fund also applied to the FDIC fund. Secondly, during most of that decade, we had a negative or relatively flat yield curve, which meant that money market accounts or CDs of banks and thrifts often had a yield as good or better than long governments.

So, large investors as well as small savers were smart—they said, my gosh, I don't need to go into those other market instruments, like stocks and bonds and risk market value loss. I'll just put it in the bank and do better than elsewhere. That was true until we got to the late 80s and early 90s when the yield curve became positive and money started trickling out of banks and thrifts in search of higher returns. The money that was bailed out by the FSLIC and the FDIC, where is it now? Much of it is in mutual funds—those permanent savings that trickled out. Since the late 80s bank consumer deposit growth has been anemic. If you take off the interest credit, they have actually shrunk. Mutual fund balances now exceed total consumer deposits in banks, thrifts, and credit unions.

As Carter said, I think in some respects we may be preparing for the wrong war. The problem that regulated and insured financial institutions face looking ahead is a funding problem. Part of the problem back in the 80s was that they had the tremendous inflow of money burning a hole in their pocket and they went out and lent it—unfortunately, not very wisely.

Management practices—banking can't blame public policy, can't blame the economy really for its problems. It can blame itself for failing to exercise proper private sector disciplines. We should have learned to expect public policies not to be very smart—in most times—very politically driven, very expediently driven. In the management side of this equation, we had competition in laxity. Unfortunately the dumbest and weakest competitors in the marketplace set the basic standards of pricing and credit terms. We developed what I call a stretch sock pricing approach that said one rate fits all—no risk discrimination. This is where the real problem comes.

An old timer in the credit program at Wachovia that I went through in 1959 said there are no loans we won't make that aren't illegal, immoral or unethical, but there are lots of people who won't pay the price that the risk demands. It is true—there aren't any bad loans when they are made but interest rates sometimes are too low to cover the risk. They just go bad and if you are able to put enough away in reserves, you could charge off loans where you have a 40 percent interest rate and 30 percent charge-offs and come out very well. Today, you can look back at the 80s and say the problem was pricing, not the loans that were made. Proper pricing means that some real estate projects won't be economic if the loans to finance them are priced at the rate that properly reflects the risk. That is where banking went wrong in the 80s.

Also, and it is probably more popular now than back in the 80s, problems can arise from syndication or selling out pieces of loans, where the syndicator takes a nice fee for putting it together, but sells it off and keeps very little risk. A syndication is sometimes characterized as a transfer of risk from someone who lacks courage to someone who lacks knowledge. There is an enormous amount of that going on today—most smaller banks do not have the capability to assess the syndicated risks they are putting on their books.

I think our greatest lesson from the 80s would be complacency, and probably our greatest risk today is complacency. Everything is wonderful; the economy is wonderful; public policies have gotten better in many respects, but have managements learned their lessons? You look at the balance sheet of banking, as reported by the FDIC for September 30, and you see on the surface adequate capital of $370 billion, loss reserves of about $50 billion, so $420 billion of capital and reserves to cushion about $2.5 trillion of loans. But, you look further and you see approximately $2.5 trillion of unused loan commitments. Remember I said there may be a funding problem. You can also see $20 trillion of derivatives exposure, off balance sheet. If other off-balance-sheet exposures were reported, you would see foreign currencies and a bunch of other things that aren't reflected. There is not $20 trillion of risk in those derivatives, but, say, there is only 5 percent or 6 percent or 7 percent, which is probably more accurate. It is still $1 trillion or more of risk and you begin to not be so impressed with that capital ratio.

The economy gets leveraged today more in off-balance-sheet-type risks than in actual loans-outstanding risk, and this is the war I think regulators should be preparing for—being able to analyze and understand and help management see all the other risks that are being taken that aren't explicit on the balance sheet.

Another thing that old timer in my credit school said, you can't extinguish risk—you can only transfer it to another party. Actually, all derivatives and other such things do is diffuse risk and spread it out across the system, but does that risk accumulate on the backs of the weaker or the stronger participants in the marketplace? Who knows—we will find out. But the ability for all this risk to be permanently transferred depends on the ability of the transferee to absorb it in adverse times. Otherwise, in most cases, it comes trotting back like a hungry little puppy dog at the time when the crisis hits, as Paul Volcker well knows from some of his big ones that he wrestled over. So, I would say my time is up—a little over. But, let's not be complacent and let's not let ourselves be blinded by some of the better aspects of the financial landscape at this point.

Volcker: We have 25 minutes, by our imposed deadline, for discussion, and I want to invite people out there to discuss. To expedite things, let me ask a few questions of these experts which may be on your minds and that have come up earlier. Is there any role for private insurance? I don't think it was getting very good notices earlier in the day. But, in a marginal sense, if you had FDIC insurance for 90 percent of the deposits, is there any room for somebody else taking the other 10 percent or something like that?

Subordinated debt did arise and was a favorite proposal of yours, Bill. I thought it made a lot of sense ten years ago. Do you still think it makes a lot of sense in the context that Bob Litan was raising earlier?

Marked-to-market accounting, Bill had a rather sour comment about that; Bob had a rather favorable comment about it. Is your comment really sour? Does it really make any sense?

Just to express my own biases, I think, pushed to an extreme, it is nonsense for a bank. The idea that we have to be so precise about marked-to-market accounting for an institution that is supposed to take liquid funds and transform it into something longer, while we tolerate enormous uncertainties in accounting on other parts of the balance sheet and in industry generally, doesn't make sense to me. An accounting profession that will tolerate company after company taking large accounting losses for prospective events or to account for past losses that didn't appear on the balance sheet the day before, and doesn't blink an eyelash, shouldn't worry too much about marked-to-market accounting, in my opinion. Those were the three questions I had.

Golembe: I'll take the insurance one. What I said about insurance was that first of all, I think there is a role for private insurance. I am not at all convinced that you could not have as good, if not a better, insurance system, run privately. But, what I was talking about, Paul, is politically I think it is impossible. Since it is impossible politically, I just didn't want to waste much time on it.

One other point I made that I might elaborate on—not all deposit insurance systems in this country have relied on an insurance fund. The two most successful, in Indiana and Ohio—30 or 40 years in each case—before the Civil War were the most successful insurance we ever had. They did not rely on a deposit insurance fund. They relied on cross guarantee by the banks—Indiana, for example, did not have a bank failure in 35 years. The head of the Indiana insurance system became the first Comptroller of the Currency. We've never had since as successful a system as we had then in those two states.

Volcker: I suspect nobody in this room will challenge you on your historical analysis of Indiana before the Civil War.

Isaac: Subordinated debt—in 1982 we did a study called Deposit Insurance in a Changing Environment. We were concerned that interest rates were being deregulated and deposit insurance was not being dealt with. We were increasing the moral hazard by deregulating interest rates without modifying the deposit insurance system to bring some greater degree of deposit or discipline. We suggested, in a very nice book that Congress ignored, how you might change the deposit insurance system to deal with this growing moral hazard. One of the ideas that we thought made a lot of sense was the subordinated debt idea. We wouldn't necessarily increase capital requirements, but we would mandate that some portion of it be in subordinated debt so that you would have sophisticated creditors overseeing banks and deciding who could get subordinated debt at what price and who couldn't. I thought it made a lot of sense at the time. The reason why we thought it was an interesting idea was because we thought that other changes to the deposit insurance system were not in the political cards. It was unlikely that Congress, having increased the deposit insurance limit to $100,000 two years earlier, would reduce the deposit insurance limit below $100,000 again. So, why not go ahead and concede defeat on depositor discipline and try to impose it through sophisticated creditor discipline. I think it made sense at the time, and I think it still could make sense today. It is an admission of defeat that you can't change the deposit insurance system. It would be, in my opinion, far more desirable if we could find the political will to change the deposit insurance system by imposing discipline on depositors over $100,000. I believe you can do that without cratering the world. I also think you can probably make the $100,000 limit less of a problem by, for example, allowing a $100,000 limit per social security number. Right now a family can take the $100,000 limit and turn it into over a million dollar limit quite easily.

So, I think that the idea of subordinated debt makes sense. I would rather deal with deposit insurance limits and the way the system operates, but if we can't, then I think subordinated debt is an idea that we need to consider.

I think marked-to-market accounting is a very bad idea whose time should never come.

Medlin: I think it would be possible to design an insurance system that could work if you could get the laws passed that would enable you to enforce the conditions that would make it work, and that is probably not possible. Market value accounting—it has its virtues, but at the same time, it is a problem in times of stress when you have to market at the worst possible condition when if you could disguise it for awhile, things would be okay. As we have learned from our own banking system, if the thrifts who stuck in there and didn't sell their low rate mortgages when rates were high survived and the ones that bailed out went broke. So, subordinated debt is something that has its place as long as you recognize what it is and what it isn't.

Isaac: I just want to say one thing about marked-to-market. First of all, I think if you had marked the savings banks to market, clearly the FDIC would have been out tens of billions of dollars. But also let's take the LDC debt crisis, which was mentioned earlier. As you know, it was a massive problem. There was no market for LDC debt, so if you had tried to mark those loans to market, you would have driven almost every money-center bank into insolvency at the same time. I have trouble understanding how that would have been good for America.

Volcker: In a situation in which it wasn't at all clear that most of those loans could not be eventually be repaid, as they in fact were, marking to market in the middle of the crisis would have driven down the price even further, as subsequently happened.

Isaac: Right, so the question is—do you mark the balance sheet and the income sheet to market, or do you understand what the market values are and deal appropriately with those institutions that have a problem, like we did with the savings banks.

Volcker: Let me make your point in the way I would have made it, because I think it is the same thing. You've got items on both sides of the balance sheet that have readily ascertainable market values. It is a trading institution, a typical dealer, sure you want a marked-to-market. Dealers typically operate on very thin capital requirements and are permitted to do so by the market as well as by regulators, appropriately so. If everything is liquid, then mark-to-market.

A bank, by design, at least in the old days, was not supposed to be highly liquid in that same sense—100 percent of the balance sheet or even close to it on both sides liquid. It was supposed to take relatively liquid deposits and transform them into something longer. An extreme and an unreasonable case, in terms of prudent banking, was the LDC debt crisis. That was taking what banks are supposed to be doing to an extreme and until the crisis it would not have been reflected in marked-to-market accounting. That is why, in concept, the institution is supervised—so that you can make some appraisal of what they're doing. I think in those circumstances, you don't drive a doctrinaire view of marked-to-market accounting to the wall. I think we probably go too far in other financial institutions in that respect.

Be that as it may, what questions do you have out there.

Question: What is unique about North Carolina's banking laws or the atmosphere that produced three large regional banks when you don't see that sort of production in any other state in the union?

Medlin: The first thing is that we have had statewide branch banking since the Civil War—since the banking system got reestablished after the Civil War. There were communities that were poor and wanted banks, so banks were encouraged to expand across the state rather than being kept out. That is the first thing. So, we had statewide banking. We developed into a very healthy system of several banks which are statewide. Some are regional within the east or the west or the middle part of the state, and most communities of any size have one or two hometown community banks that don't have branches anywhere else. The larger banks are progressive and responsible and there is healthy competition. There is an occasional reckless renegade who ends up looking silly and paying for it. So, North Carolina is just a good, sound banking state. I don't know that our banking laws have been very different except for the branching laws.

Question: I'm Bob Miailovich. I would like to ask a question that really has to do specifically with capital, but it falls within the area of regulation versus supervision that Bill Isaac brought up. I think one of the major legacies of the time period we are talking about is the fact that for the first time in our history, we legislated capital requirements, that until the International Lending Supervision Act required and set a specific number, it was strictly supervisory, more of a discussion between examiners and bankers and so forth. We now have this very elaborate system of risk-based capital, and I read recently some voices at the Federal Reserve are already admitting that it is not covering everything and we need to go back and look at some finer tuning and maybe rely back on the bank's own justification for their capital levels for part of this business. Are we stuck with this, in your opinion? We have heard some good defenses today for PCA. First of all, I think most people who have been talking about it have been talking about the 2 percent closing. They have not been talking about the early intervention before then. But, it strikes me that is a major legacy that we are left with—are these laws and regulations trying to set capital numbers, and then the regulator is trying to know how to measure it. I would be interested in your comments about what do we do with that legacy and if we come back in 20 years, are we still going to have laws that mandate numbers?

Volcker: I was glad to hear you raise that question because it struck me there is relatively little talk here about capital and there has been, I think, a dramatic change between the beginning of the 80s and the second half of the 80s in capital requirements. Have we deliberately or otherwise stumbled upon a tool of banking regulation and supervision that indeed can go a long way toward preventing a recurrence of what happened in the 80s? Before the new requirements, there had been a long period of erosion of capital in the very informal way it was dealt with by the regulators at that time. Who wants to comment on that? It also has international dimensions, I might say. This is the first time we have this kind of international consistency.

Isaac: Actually, I think that one of the better things that has come out is that we have imposed capital standards of some sort throughout the world and I think part of the pressure on U.S. banks, particularly the major ones, was that they were facing competitors from around the world that had no capital, and therefore didn't much care about pricing, particularly those that were sponsored by their government. So, I think that imposing some capital minimums around the world wasn't a bad idea. I hate to see it in statutory form because you never know when you're going to need to get rid of it. I think prompt, corrective action is a huge mistake. Not the concept of prompt corrective action. Certainly regulators ought to be prompt in correcting problems they see and slowing institutions down. But I think doing everything by the numbers without discretion is a mistake. People keep on pushing for marked-to-market accounting, prompt corrective action and the like, and the next time we have an ag-bank crisis or a savings bank crisis or an LDC debt crisis, I think we are going to regret we have those laws on the books. I think it is going to tie the regulators' hands in a way that is going to precipitate a crisis, that could otherwise be avoided.

Volcker: You are objecting to the rigidity of it?

Isaac: The concept of prompt corrective action has been one of the hallmarks of the FDIC for a long time. So, the FDIC likes lots of capital, but the rigidity of the system I believe we are going to come to regret. But we're probably not politically astute enough or brave enough to get rid of it until it causes us a big problem.

Golembe: In answer to Bob's question that yes, we're stuck with it. Probably the greatest risk we face at the next crisis, whenever it will be, is that FDICIA will not have been repealed.

Question: As you well know, more and more loan categories are being structured for sale. As I understand it, commercial real estate loans are now marked-to-market. Do you believe that loans for which there is a market should be marked-to-market? I can understand why loans that you have to send teams of accountants in to evaluate what they might be worth under some set of circumstances shouldn't be marked-to-market, but what about loans that are traded?

Volcker: I am speaking for myself and I'm not going to get into enormous detail, but in general I would feel if you can value an asset reasonably, and even if you can't, it is incumbent to make some kind of an estimate of what that value might be in your annual or other report, which has been a practice for a long time. That is not quite the same as saying, I know the value so well, I'm going to actually adjust the balance sheet. But, if it is an important discrepancy, you ought to footnote it. At some point, maybe you ought to mark it to market if you are about to sell it or you have it for sale, which is a distinction the current rules make.

Isaac: You've got a lot of the balance sheet that can't be marked to market in any sort of a sensible way, and what are you going to do about the liability side. How are you going to mark it to market? It is really tough.

Volcker: It is really complicated.

Isaac: There are also a lot of assets in the bank that are not on the balance sheet at all. For example, Citicorp—what is their credit card operation worth that is not reflected on that balance sheet? So, if people want to mark things to market, you're going into a morass. I've got to tell you, when we were dealing with the savings bank problem, I was thinking seriously about how you could mark their balance sheets to market, so I was actually at one point sort of a proponent. I finally decided that it was a bad idea whose time should never come.

Question: Following up on the last discussion on rules versus discretion, if the Congress were to offer you a deal along the following lines—we will repeal all of the rules regarding capital and prompt corrective action, and restore supervisory and regulatory discretion, in return for a single consolidated regulatory agency outside the Treasury, outside the Fed, and outside the FDIC, is that a deal worth making?

Volcker: Everybody here has either been in the Treasury or the Federal Reserve or the FDIC, so they don't want to make the deal. You want a new agency outside all the present three?

Isaac: I have no qualms about the present system, except that I do think the FDIC ought to be focused on its insurance and liquidation responsibilities and not try to be a regulator. I must say, I believe the bank regulators—and I'm not saying that just because I'm in a room full of bank regulators—I believe the bank regulators did one terrific job in containing a massive set of problems in the 1980s. You weren't going to prevent a bunch of farm banks from going broke when we had an agricultural depression. There were going to be some farm banks going broke. When you have a massive collapse of the real estate industry like we had on the heels of the S&L crisis and the tax law changes and everything else, you're going to have some bank failures. You can't prevent that. All you can do is try to contain them and spot some of the trends before they get too far out. I also think it is a regulator's job to lean against whatever wind is blowing at the time. If everybody is doing really well and they are putting on a bunch of loans in real estate, that is the time to be saying, I wonder why they are putting on all those loans in real estate—maybe we ought to be taking a much closer look at it. That is very tough to do—to go into a major bank before it has obvious problems and say, you guys are making a lot of real estate loans and we are really worried about it and we think you ought to slow down. I've seen it. I was in Security Pacific on behalf of that board of directors, looking at what happened and why. The Comptroller of the Currency actually was calling the thing at Security Pacific five or six years before it happened, before it blew up. They kept on saying, you're doing this, you're doing that, and Security Pacific would write back and say—we appreciate your kind note, but frankly, we are Security Pacific—you don't seem to understand that—and please keep in touch. That was the end of that. What are you going to do about it?

Volcker: I don't like the way you posed the question—as a trade for discretion. Whatever you think about independent banking agencies, I wouldn't tie the issue to discretion. I always thought the strength of the Federal Reserve as a regulator and a supervisor—not everybody may think it had strength, but I thought it was fairly well borne out in the 1980s—rests on the fact it can better resist the industry pressure, precisely because regulation and supervision are not its sole responsibility. I think a single-purpose agency, combined with the discretion, makes it even more vulnerable to the kind of pressure that Bill was talking about, that will be true on capital requirements or anything else. It is just harder when so much of your existence, in some sense, depends upon your relationships with the regulated.

Golembe: I always preferred the Hunt Commission approach, which was not a single agency but two agencies, rather than three. So, you would still have the two, but then you would have the FDIC focus simply on insurance, which I think is what Bill was talking about. I thought that was a good recommendation.

Question: I want to ask one final question because in his recent piece in the *American Banker* Bill Isaac called for abolishing the too big to fail concept. So, I would like to zero in on Continental. If you had it to do all over again, do you believe it was a mistake for the FDIC to assist in keeping Continental open, and I would like the other panelists to comment on Bill's comments.

Isaac: Actually, I was just talking about that the other day with a banker who asked that very question. Before I get into this answer, let me thank you for putting on this wonderful conference. You really stimulated me, and I'm going to write a paper that I will submit to the conference officials. It occurred to me that I never put down on paper what happened in the 80s from my perspective, and I'm going to do that now. But, anyway, the way I feel about Continental is this—if you gave me the same set of facts today that I had then, and the same knowledge of what was going on and what was likely to go on, I would do the same thing all over again. I think we did effect a good solution. We maintained stability in the system. It was a very low-cost solution to a massive problem.

What I was looking at is that we had a bunch of small banks that would have failed, but what I was really concerned about—and I know Paul was—is that Manny Hanny goes down, B of A goes down, First Chicago goes down, all the Texas banks go down, the entire S&L industry collapses all at once. So you have all this massive hemorrhaging throughout the country's financial system—everything comes down at once and what do we do about it. That was what the fear was. I think it was a fear that was legitimate. I think there was a substantial chance that a lot of that would have occurred.

What I never counted on, though, was that all those things would happen anyway—or a lot of those things would happen anyway—and that the S&L problem would be allowed to grow from a $15 billion problem at that time to a $150 billion problem. I look back now and I say, wait a minute, what if we had allowed Continental to go down and all these bad things started happening—what could possibly have occurred that would have cost more than $150 billion to fix. I can't think of anything we could have done that would have cost more than $150 billion to fix.

Volcker: Let me give you a little perspective on this that I think is going to the heart of the whole discussion today. I agree with Bill's decision, obviously, and the Federal Reserve decision which were combined. That came at a particularly critical point. It was in the middle of the debt crisis and there was worry about other banks and the economy was in deep recession and so forth and so on. I think it was necessary. But, in fact, it had a big effect—that was the precursor of a lot of protection that happened afterwards. I can remember looking at television when I was out of office in 1990 and 1991 and 1992—and it would be in the press every day—that so-and-so bank or savings and loan was close to insolvent and failing, and nobody seemed to care. Even when you had headlines about the weakness of an institution no depositors moved their money because they had been convinced that the government was going to take care of everything, so you had no market discipline. It drives the lesson that has been described here over and over again. How do you get some balance between the rescue and retaining some discipline? I don't know whether we yet have the right answer.

Isaac: The other thing that I would make clear is that the way we handled Continental was determined way back in 1982 when Penn Square failed. We thought then that Continental might happen and we said to ourselves, if Penn Square causes some of these larger banks like SeaFirst and Continental to go down, we will stop it there. We are not going to stop it here at Penn Square—we are going to make some people pay the price for Penn Square. But, we will deal with the ripple effects on these much larger banks if and when they do occur. So when Paul called me and asked me to come over to talk about the $10 billion overnight run on Continental, we didn't have any debate—we knew exactly what we were going to do. There was no discussion of should we do it, wringing of hands or anything else—we knew we were going to stop it there.

Volcker: We have reached the magic hour. I had another comment I was going to make. You won't be able to resolve it for me but I'll raise it anyway. It strikes me that when one looks at the banking system, never before in our lifetime has the industry been under so much competitive pressure with declining market share in many areas and a feeling of intense strain, yet at the same time, the industry never has been so profitable with so much apparent strength. How do I reconcile those two observations?

It has been a pleasure to be here.