<u>Bailout: An Insider's Account of Bank Failures and Rescues</u> (1986), Irvine H. Sprague, FDIC Chairman and Director until 1986

Most people look at the FDIC sticker on a bank's door and assume that they are safe and that if there ever is any problem, the government will always bail them out. Few realize the increase in the size and scope of FDIC bailouts since the U.S. came off of the gold-exchange standard in 1971. Fewer still realize that it is completely up to the FDIC's discretion to decide which banks it will bail out and which deposits it will insure and which ones it will not. Large U.S. banks are considered too big (to be allowed) to fail. Will a day come when these same banks will be too big, with too many bad debts, to rescue?

As Chairman and Director of the FDIC, Irvine Sprague handled more bank failures than anyone else in U.S. history. What follows are his comments. Let's start first with the "guarantee" of FDIC bailouts:

"Many believe the FDIC should save all failing banks, a concept that is clearly beyond the law. Section 11(f) of the FDI Act provides that 'payment of the insured deposits shall be made by the Corporation as soon as possible.' This is the basic insurance law and FDIC is under no obligation to use any other procedure. It was very much at our discretion whether and when any person with more than $100,000 in a failed bank would receive any part of it. Particularly vehement were those newly educated the hard way – those people who had lost money in small-or medium-sized banks that we had handled without 100 percent protection for all depositors. Section 13(c)(4)(A) of the FDI Act gives the FDIC board sole discretion to prevent a bank from failing." [Pages 9, 23-24, *x-xi*, 27]

Banks most often failed for non-performing loans, taking other excessive risks, and making investments that moved against them (often bets on declining interest rates). Sprague worked on the three largest bank failures of his day, from 1972 through 1985. Commonwealth, the first billion dollar bailout, took place in 1972.

"Parsons, Commonwealth [bank's] chairman, set off on a rampage of acquisition and parlayed a small financial stake and a lot of borrowed money into a $3-billion banking empire. Commonwealth's pattern, which was repeated at other banks, was to sell off the safe securities in the bank's portfolio and load up on low-grade securities that bore high interest rates. Interest rates not only continued up – they began to soar. The securities' value in the marketplace plunged. The banks were losing money just holding onto them but the banks would go broke if they sold those securities and took the market losses. The banks were squeezed in, illiquid, inflexible, and capital deficient. Deposits and stable funding sources had not kept pace with its burgeoning loan volume. Loans continued to go bad. The bank continued in its errant way until collapse became inevitable." [Pages 56-66]

With $9 billion, First Pennsylvania experienced similar problems. Sprague writes,

“First Pennsylvania was carrying $328 million in questionable loans. That was $16 million more than the bank’s entire equity capital. Bunting [the bank CEO] sought to increase the bank’s loan volume at a more rapid pace than the growth in the bank’s core deposits would sustain. Loan quality was poor – problem loans rose from 10 percent of capital funds in 1967, to 32 percent in 1969, to 156 percent in 1976.” [Pages 83-85]

At roughly $520 million, Penn Square was a smaller bank, but it set afloat more than $2 billion in loans on other banks’ books, and the largest failure, the $41 billion dollar failure of Continental Illinois, was largely an outgrowth of this practice. As such, Penn Square reminds me of our banking system today, partly because of their loans on oil and gas, assets that were appreciating like real estate today, and partly because they sought to divest themselves of risky assets, similar to our current credit default swap (CDS) market today.

“Penn Square was plunging other banks’ money into the risky oil and gas exploration business. Its mode of operations was to make large, high-priced but chancy loans to drillers [think credit cards and auto loans] and then to sell the loans, in whole or in part, to other banks wile pocketing a fee for the service [just like CDSs]. Such loan sales are called ‘participations’ and are a common practice in banking. The bank used the proceeds of its participations to funds more oil and gas loans; it would then turn around and sell these as new participations to other banks to obtain proceeds to finance still more loans.

Oil and gas prices finally began to falter [think housing] and decline after rampaging through the 1970s. The prospectors began missing payments on their loans. Drilling rigs used to secure loans had been worth millions. Now their worth added up to only dollars.

Penn Square was in terminal trouble when we met. The large participating banks were exposed, embarrassed, and threatened. Buying loan participations in enormous amounts were some of the country’s leading, and supposedly, most sophisticated institutions. They seemed to have been ready, even eager, victims. They were buying risky oil and gas drilling projects secured with doubtful or, in some cases, no collateral at all. The acquiring banks neglected to undertake their own credit analysis. Now they were exposed to massive and potentially fatal losses.” [Pages 111-113]

Before it was over the larger banks suffered greatly: one was sold to avoid failure, one lost its management and had to fight a hostile takeover, one was bailed out, and one late-comer escaped with less damage. Remember, these were the brightest and the best. [Page 113]

With $41 billion dollars, Continental Illinois had all the appearances of a sound financial structure. Yet, an article in a banking periodical, Penn Square’s affect on its earnings, and other risks that Continental was taking caused the bank to suffer the loss of the public’s confidence.

The banking article stated that Continentals growth was less a matter of skill than being willing to lend to risky customers who would not qualify for other banks credit standards. An article in the *Wall Street Journal* corroborated the risk level of Continental’s loans. When Penn Square collapsed Continental, with $1 billion exposure to Penn Square’s

participations was hit hard. Its stock dove 25 percent in three months, its credit ratings were downgraded and its income plummeted two-thirds from the year prior – 1982. Continental also suffered from its exposure to another bank failure, corporate bankruptcies, and the Mexican and Argentinean debt crises. Outwardly, Continental still appeared strong and stable, and all remained quiet on the surface. [Pages 150-152]

"Until May. Then the run exploded." Concerns for Continental's stability began to flood the newswires. "Japanese money began leaving. As the sun rose in Europe, the European bankers also began to withdraw their funds. The run took hold domestically when a long-standing customer withdrew $50 million. Word of this defection moved promptly, and the panic was on. In the 10 days preceding FDIC assistance, the loss exceeded $6 billion. Inside the bank all was calm, the teller lines moved as always, and bank officials recall no visible sign of trouble – except the wire room. [Page 153]

Our planning had covered every contingency, except the failure of one of the small handful of multinational giants. The unthinkable had happened. All agreed that Continental could not be saved without 100 percent insurance by FDIC and unlimited liquidity support by the Federal Reserve. Regan and Volcker raised the *familiar concern about a national banking collapse, that is, a chain reaction if Continental should fail*. Volcker was *worried about an international crisis*." [Pages 163, 183, 255] (Emphasis mine) Needless to say Continental was bailed out.

More than five separate times throughout this book Sprague speaks to the fact that others and he "feared the domino effect that could be started by failure of [a] large bank with extensive commercial loan business and relationships with scores of other banks. The problem was there was no way to project how many other institutions would fail or how weakened the nation's entire banking system might become." [Pages 53, 155]

Sprague notes that the dollar amounts increased from $1.5 to $9.1 to $41 billion. He also notes the increase in the number of failures. "In 1968, there were three small failures all year. In 1983, we handled six failures in one day. In 1985, there were seven failures over a weekend. He also notes the increased speed at which banks can fail. "On occasion, the failure of a bank comes with lightning speed. In cases of fraud or runs, the failure can be dramatically fast. Continental succumbed in days." [Pages 4, 10, 30, 149]

Sprague concludes that a "disregard for loan quality" and loans made "without adequate investigation and documentation" were the surface reasons for most bank failures. As to the foundational reason, Sprague states, "The greed factor remains the major – often the only – reason for a bank's failure. Nothing much has changed, except now the numbers are quite a bit larger. There is no reason to think that the chain has been completed yet." [Pages 233, 245, *x*]

With our banking system's current exposure to low doc/no doc risky real estate loans, credit card, and auto loans, and with the credit default swap markets soaring, we would all do well to remember banks have not always been synonymous with safety.