THIRTY YEARS OF BANK FAILURES, BAILOUTS, AND REGULATORY BATTLES

INSIDE THE FDIC

JOHN F. BOVENZI

WILEY

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For Erica—the love of my life

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Any mistakes that remain are my own.

Introduction

We have heard little from the behind-the-scenes people who were on the front lines as the events of 2008 unfolded. Their actions can calm the storm and bring fair treatment to inherently unfair situations, or they can compound the problems. These often-maligned bureaucrats can either display courage, integrity, and fair play or contribute to an environment of fear, anger, and chaos.

This book doesn't focus on the arcane and mind-numbing details of capital, liquidity, and the other technical parts of a bank regulator's job. Instead, it puts human faces on the causes and effects of financial crises. These are personal stories of real people grappling with complicated issues while under enormous pressure, of individuals trying to ensure that they and others are treated fairly by our government, and of individuals misusing the system to serve their personal interests.

I spent 28 years as a bank regulator at the Federal Deposit Insurance Corporation (FDIC). During my career, I worked directly with ten FDIC chairmen and with many other senior government officials.

I was the highest-level FDIC career executive during the two biggest financial crises in the United States since the Great Depression. During the banking and S&L crisis of the 1980s and early 1990s, I assisted with the creation of the Resolution Trust Corporation (RTC) and personally had to explain to President George H. W. Bush that the FDIC's deposit insurance fund was running out of money. During the 2008 financial crisis, I helped develop the agency's policy and operational initiatives and served as chief executive officer at IndyMac Federal Savings Bank, the first large bank in over 20 years to be shut down and then reopened under government ownership.

Thus, I come to the topic with a perspective that's often absent from the financial-sector debates that play out on the airwaves and in the opinion pages. This book provides a different view of the FDIC and other bank regulators. Readers will see:

- How an agency that had become almost invisible would emerge as a major and highly independent force impacting U.S. financial markets.
- How 10 FDIC chairmen helped shape the FDIC and the U.S. financial regulatory system.
- How conflicts between the FDIC and other financial regulatory agencies unfolded amid the pressures and challenges associated with bank failures and financial crises.

I hope this book engages a different kind of discussion about the longer-term strategies needed to prevent repeating cycles of booms, busts, and bailouts. I also hope to encourage others to write about their experiences, so the historical perspective of long-term government employees can be added to policy debates in other regulatory arenas as well.

Chapter 1
IndyMac

I flew into Burbank, California, Thursday evening, July 10, 2008; drove a rental car the short distanc to Pasadena; and checked into the Hilton Pasadena on South Los Robles Avenue. Dozens of my colleagues from the Federal Deposit Insurance Corporation (FDIC) were also checking into hotels throughout the city. We used our personal credit cards rather than our government cards. Why? Because if anyone learned that the FDIC had descended on Pasadena, they might conclude (correctly that a bank was about to be closed.

Bank closings are carefully planned events, and they are usually handled quietly, smoothly, and uneventfully. The bank's depositors hardly know that anything has happened. For the vast majority, their money is safely protected by the FDIC's deposit insurance system. A bank is typically closed o a Friday afternoon and reopened under new ownership the following Saturday or Monday morning. Customers generally see the same bank employees at the same branch offices; only the name of the bank has changed. This well-rehearsed pattern is designed to maintain public confidence in the U.S. financial system and to prevent banks' depositors from trying to withdraw all of their funds at the same time.

But IndyMac was no ordinary bank, and this would be no ordinary closing.

IndyMac was a poster child for how home mortgage lending had spiraled out of control during the preceding boom years. The bank had been launched in 1985 as a division of Countrywide, a Californi mortgage lender that encountered its own troubles in 2007. IndyMac became independent of Countrywide in 1997, and it gradually came to specialize in something called Alt-A mortgages, whic were typically offered to borrowers whose credit profiles were better than subprime but not strong enough to qualify for prime loans. In the case of IndyMac, borrowers could obtain home mortgage loans without going through a formal credit review process—they simply stated to loan officers thei income, asset, and debt levels. After the crash, these arrangements became known as “liar loans” or “ninja loans” (no income, no job, and no assets).

IndyMac did not keep most of the mortgages it originated. They were packaged together, sold, and used as collateral for mortgage-backed securities. This originate-to-sell model also was not unique t IndyMac. Many banks found that they could increase their profits by selling mortgage loans soon aft they made them. The sales proceeds could then be used to make new loans, which could create a steady stream of income. As long as there was an appetite in the market for mortgage-backed securities, there would be a need to create new home mortgages. This would create additional pressu to further weaken lending standards in order to find new customers.

With housing prices rising throughout the United States, IndyMac found many willing borrowers. Th bank's profits tripled from 2001 to 2006, according to the *New York Times*. During 2006 alone, IndyMac originated $90 billion in new mortgages, and racked up $342.9 million in profits. The bank had established 182 loan production offices around the country to help it find new customers, and at its peak it was the nation's 10th-largest mortgage lender.

To help finance its mortgage lending, IndyMac had raised $20 billion in deposits through the Interne deposits placed at its 33 branches in Southern California, and from the brokered-deposit market. The bank offered higher interest rates than anyone else so it was easily able to attract rate-chasing deposits. The bank had also borrowed $10 billion in high-cost money from the Federal Home Loan Bank of San Francisco (FHLB-SF).

This toxic cocktail of high-cost funding, weak lending standards, and a constant churning of new loan originations left IndyMac highly vulnerable in the event of a downturn in the housing market. Predictably, problems for IndyMac started once housing prices began to fall in 2006 and 2007. Borrowers who never had the income or assets to support their mortgages began to understand how overextended they were and started defaulting on their monthly payments. As home values dropped below the amount owed on the mortgages, there were even some strategic defaulters who stopped making their mortgage payments even though they still could afford them. They simply didn't want t own a house that was worth less than their outstanding mortgage balance, known as “upside down” in the mortgage business.

IndyMac had not focused its lending activities on the subprime market. Most of its mortgage loans were made to middle- to high-income families, who were interested in the convenience, leverage, and favorable rates they could obtain from the bank. IndyMac's difficulties were a clear indication that th problems in the mortgage market had extended well beyond subprime loans.

IndyMac had also ramped up its lending to home builders, who were squeezed by the downturn in the housing market. At the end of the first quarter of 2008, IndyMac had $1.06 billion in loans outstandin to home builders—more than half of which had been categorized as “nonperforming.” By the spring 2008, IndyMac officials knew the bank was in serious trouble. It had lost nearly $615 million the yea before, and the company's share price had fallen to $6. Conditions worsened in the first quarter, with IndyMac reporting $184 million in losses. The bank's chief executive, Michael Perry, acknowledged that it would not return to profitability “until the current decline in homes prices decelerates.” Aroun this time, IndyMac was talking to private equity firms about acquiring the institution. When no buye could be found, the bank started planning to shutter its mortgage lending business.

At the FDIC we had long been aware that IndyMac was dangerously exposed to the downturn in the real estate market. By the late spring, our concern was growing, so we set up a meeting with senior officials at the Office of Thrift Supervision (OTS), the federal regulator responsible for supervising IndyMac. FDIC Chairman Sheila Bair and I, and two senior officials from the Federal Reserve, met with John Reich, who was the Director of OTS, and Scott Polakoff, a former FDIC regional director who was now serving as the OTS deputy. Polakoff suggested that the OTS could supervise a gradual reduction in the size of the bank until its problems were more manageable. My colleagues and I from the FDIC didn't think it was a good idea to leave the people who had created the problems at the bank in charge of a gradual wind-down of its operations. I told the group that IndyMac was going to be the most expensive bank failure since the FDIC was created in 1934.

The FDIC had dodged a bullet earlier, in January 2008, when Bank of America purchased Countrywide, a troubled bank like IndyMac, except that it was much larger. If Countrywide had faile the public disruption could have been tremendous and the losses to the FDIC's deposit insurance func enormous. Bank of America was less fortunate, incurring over $40 billion in losses associated with it purchase of Countrywide and its subprime mortgage loans.

After our meeting at OTS, we anticipated an August closing, which would have given us time to quietly market the bank to prospective buyers. But our already-tight timeline was altered by an unexpected development.

On June 26, Senator Charles Schumer (D-NY) sent a letter to banking regulators highlighting the weakened condition of the bank. The letter stated: “There are clear indications that IndyMac…could face a failure if prescriptive measures are not taken quickly.” While the letter didn't say anything we ~~didn't already know, Senator Schumer took the unorthodox step of publicly disclosing his concern~~s to the *Wall Street Journal*, which published an article about the IndyMac letter the following day. One day after that, on June 28, the *Pasadena Star-News*, which served many of the communities in which IndyMac operated, published an article with the headline “IndyMac Appears Close to Collapse.”

Panic quickly set in. Customer withdrawals quickly reached $100 million per day, and there were extremely long lines of bank customers waiting to get their money—a scenario rarely seen since the bank failures of the Great Depression.

IndyMac's customers withdrew $1.3 billion in the 11 days following release of the Schumer letter, according to OTS. John Reich, the OTS head, said that Schumer's letter gave the bank a “heart attack and “undermined the public confidence essential for a financial institution.” Indeed, an OTS press release said that “the immediate cause of the closing was a deposit run that began and continued afte the public release of a June 26 letter to OTS and the FDIC from Senator Charles Schumer of New York.”[1]

Because of the accelerated timeline, there was no time to carefully prepare for the bank's closing. Within days of Senator Schumer's letter being released, IndyMac was on the verge of running out of money. The week after the Schumer letter, the bank announced plans to reduce its workforce from 7,200 to 3,400, and to close its wholesale and retail new loan divisions. But that didn't stop the hemorrhaging. The bank's stock price, which had been $50 in 2006, fell to just 28 cents on July 11.

We knew IndyMac had to be closed immediately. Without a ready buyer there were only two choices we could shut the bank down completely or we could take it over and run it ourselves. Both options were (in the polite terminology of economists) suboptimal.

IndyMac was the seventh-largest savings and loan in the country, with over $32 billion in assets. Mo importantly, it also managed a $184 billion mortgage-servicing operation. Closing the bank could mean disrupting service on all of the bank's mortgages. Customers might not be able to make their monthly payments or pay off their mortgages. Payments wouldn't be sent to the investors who had purchased securities backed by those mortgages. There would be great uncertainty and disruption in the market. The value of those loans would quickly dissipate, and the losses to the FDIC's deposit insurance fund would grow significantly.

There was only one real choice. IndyMac would have to be placed into a conservatorship, which mea closing the bank, then reopening it as a new bank under the ownership and control of the FDIC, until could be sold back into the private sector. IndyMac would, in other words, have to be nationalized.

I reflected on these developments the evening I arrived in Pasadena. IndyMac would be closed the following afternoon, on Friday, July 11, 2008. It would be the largest single bank the FDIC had ever closed. The following Monday morning it would be reopened as a new bank under FDIC ownership. I would be responsible for managing the newly constituted “bridge” bank.

Sheila Bair and I had discussed the possibility of my running the bank a few days earlier. While bankers with private-sector experience are typically recruited by the FDIC to manage failed banks, w didn't have enough time to find anyone. Moreover, we thought it would be beneficial to have someon running the bank who possessed an understanding of issues related to deposit insurance. There were thousands of uninsured depositors who would be angry when they found out that they were going to lose some of their money as a result of the closing; that anger could spill over into broader public concern about the safety of deposits at other banks; and there were important policy issues surrounding the creation and management of a government-owned bank.

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At 9 A.M. on Friday, July 11, about 60 FDIC employees and contractors gathered in a conference room at the Sheraton Pasadena on East Cordova Street, using a fictitious company name, to review ou final preparations for the bank closing. As the financial crisis unfolded in the months ahead, most of the people in that room would move from one bank closing to another, staying in one place just long enough to ensure a successful transition of a closed bank to its new owners. In this case, some of the people in the room would remain behind to help me run the bank.

Rick Hoffman was a bank-closing veteran. He had closed hundreds of banks over the course of his career. He reminded the assembled group that this would be a traumatic event for the people who live and worked in the local community. We had a job to do, but we had to be sensitive to what the bank's employees and their customers would be experiencing.

I told the group that we were at a critical point in time. The public had grown accustomed to a world where banks did not fail, particularly larger banks. This would be a wake-up call that the problems in the financial sector were getting worse. The world would be watching how we handled this situation. We knew the events of that day would be historic, but none of us could have predicted the extent of the financial crisis that would follow.

As I looked around the room, I saw many people whom I had worked with over the years. Most of them had been through the banking and savings-and-loan (S&L) crisis of the 1980s and early 1990s. could see the confidence in their eyes. Closing banks is an unusual profession, with unique challenge but they knew what they needed to do.

After the one-hour meeting, several of us drove over to the bank's headquarters on Walnut Street. From the outside it didn't seem as if there were anything special about the bank's six-story building. Everything seemed pretty quiet. We went down to the basement of the building next door, which the bank also leased. Bank examiners from the OTS were already combing through IndyMac records, and doing so in the least desirable space in the building, something examiners are accustomed to when they go on bank examinations. In a couple of hours, we would begin a weekend of nonstop activity, but for now we just grabbed a few chairs, sat, and waited.

Just before 2 P.M., we walked over to the main building and took the elevator to the sixth floor boardroom. IndyMac's senior managers had gathered there to meet with us. The bank's chief executiv officer, Michael Perry, was seated at the head of the long board table that filled much of the room. H senior managers were on each side of him. The OTS examiners sat opposite us. Without much explanation they quickly told the assembled group that IndyMac was being closed and the FDIC was taking control. The bank's senior officials knew that this day was coming, but we still could see their stunned looks. It's one thing to know that something traumatic is going to happen; it's quite another when it actually does.

The OTS examiners turned the meeting over to us. We took a little more time and told the group that new bank, IndyMac Federal Bank, would be established under the FDIC's ownership to continue the bank's operations until it could be sold. We explained how this would impact the bank's operations, what our immediate needs were, and what our plans were going forward. We let them know that mos of them still had jobs and that we would need their help in contacting the bank's employees.

Following the one-hour meeting, Rick Hoffman and I walked down the hall with Michael Perry to his corner office. Wall-to-wall windows provided a spectacular view of the San Gabriel Mountains. The desk at one end of the room overlooked a large black conference table with six chairs around it at the other end. A large flat-screen TV covered most of the wall behind that table. Looking around, it was clear to see that Perry already had removed his belongings from the office.

We sat down at the conference table and confirmed to Perry that he would not have a job with the ne bank. This was standard practice. We never retained the CEO of a failed bank. Perry understood and offered to provide us help and answer any questions. He asked if he could send one final e-mail to th bank's employees. He read the seven sentences to us. “I gave everything I had to keep IndyMac Bank safe and sound, and preserve as many jobs as possible.” He asked that the employees “work as hard, smart, and courageously for the regulators as you did for me.” It was a very emotional moment for th youthful-looking Perry (described as “baby faced” by the *Washington Post*), and he had difficultly reading his message to us.

We let Perry send his e-mail to the bank's employees and told him that he would need to speak with the FDIC's investigative staff before he left the building. Having the bank's senior officials speak wit the FDIC's investigators also is a standard part of the bank-closing process. The investigation at IndyMac later would determine that there were more than adequate grounds to sue Perry and some o the other senior managers at IndyMac for damages due to their mismanagement. Perry eventually settled with the FDIC by paying $1 million from his own funds, agreeing to be banned from ever working again in the banking industry, and allowing the FDIC to pursue collections of up to $11 million from his liability insurance coverage.

IndyMac was officially closed at 5 P.M. Central Time. The closing set off a series of prearranged notifications and activity. The branch offices were contacted, as were other employees. A press relea announcing the closing was sent out from the FDIC's Washington, D.C., office. That press release wa sent to key senators and congressmen as well as every member of California's congressional delegation. The mayor of Pasadena also was notified. A few hours earlier, Sheila Bair had called Treasury Secretary Hank Paulson and Federal Reserve Chairman Ben Bernanke to alert them. That evening, Sheila held a press conference for local and national media to explain what had happened a to answer their questions.

Generally, banks are closed at the end of normal business hours on a Friday, usually at 5 P.M. This provides the FDIC with enough time to contact the bank's employees and explain to them what was happening, whether they still had jobs, and if we would need their help over the weekend. IndyMac had thousands of employees all across the country in multiple time zones and locations ranging from Pasadena, California, to Kalamazoo, Michigan, to Austin, Texas. And we did need their help. So the OTS closed the bank at 5 p.m. Central Time, which facilitated our being able to contact the bank's employees before they all went home for the weekend. However, the bank's deposit-taking branches were all in southern California, and it was only 3 p.m. there, which meant that some of the bank's customers who had planned to get into their local branch before their usual 5 p.m. closing time couldn't do so.

News cameras photographed these customers reading the closing notices that had been posted on the doors of the bank's branches. Some customers began banging on the doors to get in. Those photographs were in newspapers across the country the next morning. The closing of IndyMac becam a major national news story. The only story that drew more attention that weekend was the birth of twins to Angelina Jolie and Brad Pitt.

Some observers later would say it was a mistake to close the bank that early. Perhaps, but I think the real issue was that unlike most bank failures, this was a much larger bank, with a significant number of uninsured depositors who were going to be unhappy about losing some of their money.

With the bank closed we now had only two full days to get ready to reopen it on Monday. There was lot to do. Inside the bank, a couple hundred people began working around the clock.

There were a number of time-sensitive challenges. First and foremost, we needed to determine which deposits were insured and which were not, in order to sort out who was entitled to withdraw money when the bank reopened. The vast majority of bank deposits are insured, but determining which specific accounts are insured is not as simple as it may sound.

The deposit insurance coverage rules are complicated. Individual accounts, joint accounts, trust accounts, and retirement accounts all have separate insurance coverage. Trust accounts coverage depended on the relationship between the trust owner and his or her designated beneficiaries. Immediate family members were qualified beneficiaries who received insurance coverage, while mo distant relatives and nonrelatives were not. Given these complications, banks do not even attempt to keep track of which accounts are insured and which are not.

The bank's deposit records would have to be sorted by each account holder's name and address along with other identifying characteristics. Similar types of accounts with the same owner would have to b grouped together to see if they were within the insurance limits. Most of this work can be done relatively quickly through automated systems. Problems could arise, though, if the bank's electronic records didn't have all of the relevant information.

But even with automation, this was an enormous task, given that there were nearly 300,000 deposit accounts at IndyMac. The FDIC had never had to sort through this many accounts over a closing weekend. But we had to get it done on time. We did not want to delay the reopening of the bank. Public confidence was fragile enough. With hundreds of people facing a massive workload, and 48 hours to get through it, the environment was extraordinarily intense.

Another pressing challenge was finding and analyzing what are known under regulation as qualified financial contracts (QFCs) to determine which of them should remain in place and which should be cancelled. QFCs contain some of a bank's more complex contractual arrangements. They include contracts for transactions scheduled to take place at a future date and contingent contracts, such as credit default swaps, which are triggered only in the event of certain circumstances. QFCs also incluc other derivative contracts, such as interest rate swaps or currency swaps, which banks use to hedge or protect themselves against certain risks.

Finding and analyzing these contracts over a single weekend was a challenging, but critical, assignment. If we did not make a decision within one business day on what to do with each of IndyMac's QFC contracts, the bank's business counterparties would have the right to cancel those contracts, which could be very disruptive and very expensive.

The importance of these types of decisions would become clear in September 2008 when Lehman Brothers declared bankruptcy. Unlike the FDIC's authority when a commercial bank or S&L fails, the bankruptcy process, which handled the failure of investment banks like Lehman Brothers, has no authority to preserve such contracts. As a result, Lehman's counterparties rushed to cancel their contracts and sell the collateral that they held on those contracts. As this collateral flooded an already weak market, values plummeted, and the losses to Lehman's creditors and business counterparties grew enormously.

We were more fortunate at IndyMac. The bank had relatively few QFCs, and once we explained to th bank's management what we were looking for, they showed us the key contracts that needed to be analyzed. IndyMac had a number of contracts that allowed it to sell its newly created mortgages to ~~third-party buyers for a fixed price at a future date. If these contracts had not been identified,~~ analyzed, and transferred from the failed bank to the bridge bank over that initial weekend, the counterparties to those contractual commitments would have canceled them. This would have left us with a large volume of additional mortgage loans. Given the decline in the mortgage market, these mortgages would have been sold at a later date for far less than the price stated in the contract alread in place. Because we were able to identify these contracts, analyze IndyMac's exposure, and take the necessary steps to keep them in place, we saved the FDIC's deposit insurance fund millions of dollar

In addition to our progress on QFCs, we also managed to complete the automated calculations that segregated insured from uninsured deposits by late Sunday night—an achievement that would enable us to reopen the bank the next morning knowing the insurance status of most of the bank's deposit accounts. We had identified about $17 billion that was insured and $400 million that was uninsured.

But we hadn't determined everyone's deposit insurance status. There was about $1.7 billion in deposi accounts where the bank's records did not have the information we needed to determine whether the accounts qualified for deposit insurance coverage. We would have to talk directly to the owners of those accounts, and that could take weeks. We were about to reopen the bank the next morning knowing that there still were 48,000 accounts that held over $2 billion that was either uninsured or might not be insured. We would not be able to make this money available to as many as 30,000 of the bank's customers. This was going to cause problems. There had never been a bank failure with this many uninsured or potentially uninsured depositors.

Given the bank run that had occurred at IndyMac prior to its closing, the seemingly round-the-clock media coverage during the closing weekend, and the large number of uninsured and potentially uninsured deposits, it was more important than ever for the FDIC to provide a clear and reassuring public message. We decided an important part of getting the message out would be for me to hold a press conference before the bank reopened.

The press conference was held Sunday evening in the bank's boardroom, the only room at the bank that was large enough to hold the audience we anticipated. When I entered, there were cameras spanning the entire length of the boardroom. I moved to a seat at the middle of the long board table o the opposite side from the cameras. A dozen or so microphones had been set up in front of my seat. I read a statement that explained what had happened to the bank and what our plans were going forwar I said that the bank would be reopened as a “strong and safe institution” and that it would be “busines as usual for all insured customers.” I ended the statement with an assurance to everyone that no FDIC insured depositor had ever lost any money in a bank failure.

The assembled reporters immediately began peppering me with questions. Why did the bank fail? What was going to happen to the bank's stockholders? Would they get any of their money back? Wha would happen to the bank's senior managers? How would uninsured depositors fare? How much of their deposits should they eventually expect to get back? I answered all of the questions as best as I could. As the questions slowed, I ended the press conference about 45 minutes after it had begun.

I then moved to an office down the hall that CNN had set up for me to be interviewed long distance b Rick Sanchez. He had heard the press conference and asked me a series of follow-up questions. He wanted to know if IndyMac had been on the FDIC's official problem bank list. I told him that it wasn on the list. What I didn't add was that there had been a difference of opinion between the FDIC and th OTS as to when the bank should be added to the list, with the OTS only recently agreeing with the FDIC that it should be classified as a problem bank. When the press conference and the interview ended, I felt that they had gone well and hopefully had provided some measure of reassurance to the bank's customers and to insured bank depositors across the country.

There wasn't much more left to do before reopening the bank the next morning. We had set up an entirely new governance structure for IndyMac over the weekend, starting with a board of directors. Five senior FDIC officials with different areas of expertise were selected to comprise the new board. would serve as the board's chairman, and Rick Hoffman would be vice chairman and also the chief operating officer and president of the new bank. Our new board of directors already had met for several hours over the weekend to address a variety of issues. Interest rates were set for new deposits at a lower level than what the bank had previously paid. Existing delegations of authority had been ratified so the bank's employees would have the authority to continue to do their jobs.

We also had ensured that the bank's call center was ready for the onslaught of phone calls that would begin Monday morning. Question-and-answer forms had been prepared to help the bank's employees respond to the most likely questions. By the time I went to bed Sunday night, following very little sleep the previous two nights, I felt that we had done everything we could to get ready for the bank's reopening. But we hadn't.

Early the next morning, lines of people started to form at each of the bank's 33 branches. Television cameras were there to capture it all. The camera crews' trucks extended far down the street outside of the bank's headquarters. Local, national, and international-based reporters began interviewing the people waiting in line at the branch office located on the first floor of the headquarters building.

I went outside to talk with some of the people who were waiting in line. A few of them were angry, b most were not. Each person I talked with wanted to have a chance to explain his or her situation. I listened to as many people as I could and then tried to explain to them that they did not need to wait i line but, for the most part, to no avail. They wanted to get their money back. Reporters came over to interview me throughout the day. I also walked up and down the street with David Barr from the FDIC's press office so we could talk with each waiting reporter. As soon as one round of interviews was complete, another round started. This was fine with us because we wanted to take every opportunity to reassure the bank's customers and the general public that there was nothing to worry about.

We also wanted to help everyone get into the bank's branches as quickly as possible, but that wasn't easy. The branches were fairly small and could accommodate only a few people at one time. We brought in some local FDIC bank examiners to help work inside the branches. Volunteers from the bank's staff also came to help as well.

As the day went on, it became much hotter outside. A few of the people waiting in line had anticipate the summer heat and brought lawn chairs with them. Others stood. One woman standing near me whi I was being interviewed fainted and fell to the ground. I didn't see her fall; I only heard her head hit the cement. (The reporter and I promptly ended our interview, assisted the woman, and called 911). Some of the camera crews started to film the woman as she was lying on the ground. Other people waiting in line came over to shield her from the cameras. Soon an ambulance arrived and took her to local hospital, where she was treated and released the same day.

After that unfortunate event, we set up canopies over the people in line to provide them with some protection from the midday sun. We also brought out food and water. The media remained, continuin to interview the bank's customers and me, sometimes at the same time. CNN aired new interviews every half-hour.

Late in the afternoon, we put a numbering system in place for the people still in line. Everyone was told ~~when they could get into the bank, depending on their number. This made a real difference.~~ The people in line left once they knew they had a designated time when they could get into the bank, even if that time was sometime the next day.

In retrospect, I wish we had thought of the numbering system earlier or that we had made separate arrangements for the uninsured depositors. If we had rented conference rooms for the uninsured depositors at hotels (away from the bank's branches), we would have been able to better address thei questions and might have avoided the long lines that formed outside of the bank's branches that day.

A few hours after the bank's branches closed for the day, I went to the hotel to get some sleep. I had a live interview scheduled with *CBS Morning News* for their 6 A.M. show, which was 3 A.M. on the West Coast. I had my wake-up call set for 2 a.m.

I arrived outside the bank a little before the scheduled interview time. The person interviewing me was in New York, so I would be hearing his questions through earphones. It was pitch black outside, and bright camera lights were shining on me, so I couldn't see the camera lens. The cameraman put a piece of light-colored masking tape on the bottom of the lens. That worked. I could see where I was supposed to be looking. But all I remember about that interview was that I did my best to have an intelligent conversation with a piece of masking tape.

Two FDIC employees, David Barr and Rickey McCullough, were with me that morning. Both had been talking with the press the day before from morning through nightfall. Now what we really want was some coffee. But before walking off the bank's premises, we saw someone waiting alone in front of the branch door. It wasn't even 4 a.m. Rickey went over to talk with him to let him know that he didn't need to be there. He thanked Rickey and said that he understood, but he couldn't sleep, so he w going to stay.

We hoped that the numbering system we had put in place would mean there would be no lines of people that morning. We did not need another day of news stories featuring a run on the bank. The public already was on edge. Their concerns extended well beyond IndyMac. Many weren't sure if the money was safe in other banks as well. It was important that we calmed the situation as soon as possible.

Federal deposit insurance was designed to prevent this type of panic. But the more people I had talke with, the more I realized how little many people understood deposit insurance. Many of the people waiting in the lines had total deposits that were far less than the $100,000 deposit insurance coverage limit, yet they were worried. I realized we needed to do a far better job of educating everyone about deposit insurance.

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The media didn't help. We wanted them to educate their audiences that if you had $100,000 or less in any bank, then your money was completely safe. While some in the media were helpful in that regard a majority seemed to prefer emphasizing the more sensational scenes that only added fuel to the fire.

When we opened for business Tuesday morning, I was pleased to see that no one was waiting in line front of the branch door at the bank's main building. I stood in front of that branch door for a televise interview so everyone could see how quiet it was at the bank. I felt we had turned the corner.

My pleasure was short-lived. After the interview, the reporter told me that no other reporters were there because they were at one branch in Encino where a small riot was under way (the bank's 32 othe branches were peaceful). Apparently, two sets of numbers had been handed out the day before. A thir set was given out that morning. As a result, there were three groups of people trying to get into the branch, leading to some fairly heated arguments.

One of the bank's managers visited that branch to restore order. Despite taking more than a slight amount of abuse, he settled the crowd within half an hour. There were no more lines after that. Nevertheless, we now had one more day of worldwide news coverage that showed agitated depositors waiting to withdraw their money.

Even though the lines were gone, people kept withdrawing money—totaling about $3 billion in the two weeks following IndyMac's closure. In one sense, the withdrawals were not a big concern, as we were not going to run out of money. The FDIC owned the bank and was ready to provide it with whatever amount of money was needed. Our broader concern was that these withdrawals probably indicated that people across the country were worried about the safety of their money.

Whenever I had the chance, I explained to the bank's customers and to broader audiences that as a government-owned bank, IndyMac Federal Bank was as safe as any bank in the country. But even tha raised some questions. One woman who passed by me on the street stopped to ask me if I could guarantee that the federal government would never fail. Clearly, she was concerned. I was taken abac by her question. I told her that there was nothing safer, but her question was one more indication of diminished public confidence in the financial sector and the federal government.

One unexpected problem arose in the days following IndyMac's closure: many of the bank's custome started to complain that other banks were placing excessively long holds on their checks or, in some cases, were not accepting them at all.

When IndyMac's depositors withdrew their money, they were given an official government check. There should have been no concern about the safety of those checks, but apparently there was. I had t call several major bank CEOs to complain about what was happening at many of their branches. And the FDIC issued a notice to all of the banks stating that they were expected to accept IndyMac's government-issued checks, which they ultimately did.

A more legitimate concern was that some IndyMac depositors might want to get all of their uninsure money back and might try to write personal checks for amounts above what was insured. To alleviate this concern, we set up a private hotline that bankers could call if they had any worries about the validity of personal checks brought to them by IndyMac's customers. When they called the hotline, w told them if the customer had enough money to cover the check. After taking these and a few other steps, the problem was fixed.

After the first couple of weeks, the volume of deposit withdrawals died down. The FDIC stepped up i educational campaign on the safety of deposit insurance and made some changes to simplify how tru accounts were insured.

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I felt that our initial set of challenges had been addressed. The first priority in any bank failure is to maintain public confidence. It had been a rough start, but now the situation had stabilized.

This didn't mean that everyone was satisfied. The owners of the $400 million in uninsured deposits received only half of their money, based on our projection of how much we expected to recover once we sold the bank. Also, there still were many people who owned accounts where we needed more information to determine if their money was insured. This was a slow process since we needed to wo with these depositors on an individual basis. Their frustration grew as we set appointments for them over a period of several weeks.

Most of the depositors with unclear insurance status would later find out that they were protected aga~~inst any losses. But the initial determination of $400 million in uninsured deposits had grown~~ to nearly $600 million. After we paid these depositors 50 percent of their uninsured amount, as a group they still stood to lose nearly $300 million.

Three months after we took over IndyMac, the deposit insurance limit was temporarily raised to $250,000. This helped others, but not the IndyMac depositors, since the limit was raised on a going-forward basis. However, Congress eventually made the $250,000 limit permanent and applied the limit retroactively to IndyMac's depositors, helping to substantially reduce their losses.

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From the moment my colleagues and I took control of IndyMac, one of our main objectives was to return the bank to the private sector as soon as possible. To help us negotiate a sale we hired a group of advisers. But in a painful irony, they were from Lehman Brothers, which caused us a few anxious moments when the firm went bankrupt. Those advisers quickly joined another firm, though, and stayed focused on helping us sell the bank, working closely with the FDIC's Jim Wigand.

We realized that there was little interest in IndyMac from traditional banks, given the poor quality of IndyMac's assets and its high-cost, less stable source of funds compared to other banks. There was interest, however, from private equity firms. For them, this was a chance to enter the banking business, and such opportunities were few and far between.

We soon had a large number of interested bidders. We let each of them spend time analyzing the ban and talking with the bank's senior management. After a preliminary round of bidding, we narrowed th field to a smaller number of firms that were willing to spend the time and money on more extensive due diligence. We offered the bank as a whole or in parts. We took final bids in December 2008. A consortium of private equity firms led by Steven Mnuchin purchased IndyMac for $13.9 billion, and the deal closed in March 2009.

Notwithstanding all of the work carried out by the FDIC, IndyMac was the agency's most expensive bank failure ever, costing an estimated $13 billion. That cost was paid by the banking industry, which is responsible for maintaining the deposit insurance fund. Higher costs for the banking industry affec the cost of bank services, so bank customers paid indirectly as well. IndyMac signaled the start of a new round of bank failures in the United States. Over 400 banks would fail over the following four years, costing the FDIC over $90 billion.

The failure of IndyMac resulted in a rare use of the FDIC's “bridge bank” authority. A bridge bank is established when the government temporarily takes over a failed bank, reopens it under FDIC ownership, and manages it until it can be dismantled or sold back into the private sector.

Bridge bank authority is becoming more and more important. As financial institutions have grown larger and the industry more concentrated, it has become less feasible to merge a large failed bank into a large healthy bank. As a result, it has grown increasingly likely that in order to end “too big to fail,” the FDIC will have to temporarily manage bridge banks in order to resolve future insolvencies of large financial firms in a manner that does not put taxpayers at risk and does not create even larger firms going forward. In that regard, the FDIC's experience in running a bridge bank at IndyMac provided many useful lessons.

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After my first couple of weeks at IndyMac, I moved from a hotel room to a one-bedroom apartment i Pasadena. It was a charming area with plenty of restaurants and shops. The weather always seemed perfect. Some of the people in town recognized me and thanked the FDIC for being there to help deal with a difficult situation.

When my wife, Erica, made her first weekend visit to Pasadena, we took a much-needed break and went to a beach in Malibu. As usual, the weather was perfect. We found a comfortable peninsula of sand and set down our towels. The ocean was on one side of us, with surfers riding the waves. A wildlife preserve was on the other side, with pelicans and other birds scattered all around. Later, we walked over to a nearby beachfront restaurant to sit on the balcony overlooking the ocean and sip on cool drink. Despite our East Coast orientation, we thought that perhaps we could even live here for a while under the right set of circumstances.

That was before the earthquake. At 11:00 the next morning, I was back at my IndyMac office (which was the former CEO's office). Generally, it was a very comfortable place. But now the 10-foot tall windows and the ceiling were shaking, at first a little, then a lot. The building was swaying far more than what I thought was safe. Not knowing that earthquake protocol was to hide under your desk, I ju stood there. I thought the building might collapse.

Erica was several stories up in a nearby building. She was on a conference call with several FDIC colleagues (she was an FDIC deputy general counsel at the time). Someone in Washington said they heard that there was a large earthquake in southern California. Ron Bieker, who ran the FDIC's Dalla office, asked Erica if that was true. There was no response. She was gone, having scrambled down fou flights of shaking staircase and out the door. We agreed that we belonged on the East Coast.

In retrospect, IndyMac's closing was like that earthquake. It shook people out of their comfort zone. I was traumatic. Suddenly, we saw that events don't always work out smoothly. Long periods of tranquility can precede an unexpected and sudden turn of events.

Federal deposit insurance was created to protect the smaller, and presumably less sophisticated, bank customers who would not be able to distinguish well-run banks from poorly run banks. After IndyMac's failure, many of these less sophisticated depositors all across the country were on the verg of panic, but the vast majority of them remained calm. The initial earthquake effects from IndyMac soon died down.

But earthquakes have aftershocks. Those aftershocks can be more or less severe than the original earthquake. There is no way to know in advance. IndyMac's aftershocks soon followed. They were much larger and much more severe. By September, the so-called “sophisticated” financial market participants began to panic. They could not tell which financial institutions were safe, so they stoppe lending money. We were about to experience our worst financial crisis since the Great Depression.

[1] The Treasury Department's inspector general later reviewed the circumstances surrounding the closing of IndyMac. It confirmed that while the deposit run was a contributing factor in the timing of the closing, the underlying cause of the failure was the unsafe and unsound manner in which th bank operated. Indeed, the public disclosure of the letter did not cause IndyMac's problems. The bank was deeply insolvent and was going to be closed.

Chapter 2

The 1980s: Booms, Busts, and Bailouts

Financial crises often are described as something akin to a "perfect storm," in which the simultaneou occurrence of so many unforeseen and unpredictable events can only happen once every 100 years.

But that is far from the truth. Booms, busts, and financial crises have occurred throughout U.S. history, for the most part every 20 years or so. However, only during the last two financial crises—th banking and savings-and-loan (S&L) crisis of the 1980s and early 1990s, and the financial crisis of 2008—have we experienced the additional phenomena of "too big to fail" and the widespread use of taxpayer bailouts.

Perhaps the 100-year flood explanation is a way to justify unpopular taxpayer bailouts, with the follow-on statement, "Don't worry, it won't happen again, at least anytime soon." But financial markets are becoming progressively more integrated, which means that financial volatility spreads much faster. Unless we learn from history and better prepare ourselves for new challenges, in the years ahead we risk facing larger, more sudden, and more frequent storms, more taxpayer bailouts, continued economic hardship, and social unrest.

The history that remains critically important to understand is the boom-and-bust period encompassin the 1920s and the Great Depression that followed. From 1921 to 1929, the stock market experienced sixfold increase. Almost everyone wanted to share in the gains, and an article in the *Ladies Home Journal* headlined "Everyone Ought to Be Rich" captured the spirit of the era. People borrowed more so they could invest more. Debt levels steadily rose. Bank lending standards steadily eroded.

Then the bubble burst. The Dow Jones Industrial Average fell 39 percent from October 23 to November 13, 1929. There was a small recovery over the next few months, but then the decline resumed. When the market bottomed out in July 1932, stock prices were 85 to 90 percent lower than their peak in 1929.

Once the selling started, it turned into a vicious downward cycle. Panic ensued and there were bank runs. But the banks didn't have enough cash on hand to meet the demand. They had to sell good asset at fire-sale prices, further exacerbating the downward cycle. Half of all U.S. banks either closed or merged with other institutions. There were no taxpayer bailouts. Instead, there were suicides, bankruptcies, and massive levels of poverty and unemployment.

The experience was forever etched into the memories of all who were touched by it, and it was something no one ever wants to repeat. It took decades for the country to recover. The most significa financial reform legislation in the history of the United States was enacted during the early to mid-1930s, calling for the creation of the Social Security System, unemployment compensation, and a number of new government agencies, including the Federal Deposit Insurance Corporation (FDIC).

The FDIC was created to help maintain public confidence in the banking system and reduce the likelihood of bank runs. Individuals could be assured that their money was safe, up to the deposit insurance limit of $2,500, regardless of which bank was holding the deposits. In the decades that followed, the pendulum swung full circle from the "anything goes" days prior to the 1930s. The banking system was heavily regulated and tightly controlled. There was little risk in the system. Few banks failed, but this stability was offset by a dearth of competition or innovation.

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As memories of the Great Depression dimmed, the financial markets gradually evolved. Inflation accelerated during the 1970s, as did market interest rates. But there were strict limits on the interest rates that banks and S&Ls were allowed to pay for deposits. Bank customers began to look for better places to invest their money. Money started to move out of the heavily regulated banking system into far less regulated money market mutual funds, part of what later became known as the "shadow banking system."

Businesses and consumers found that loans were harder to obtain and more expensive. Economic growth slowed. The interest rate caps at banks and S&Ls had to be eliminated in order to encourage people to deposit money back into the banking system.

In 1980, President Carter signed legislation that would begin the deregulation of interest rates. Over the next several years, interest rate controls at banks and thrifts were gradually removed. That law als raised the deposit insurance coverage limit from $40,000 to $100,000.

I joined the FDIC in 1981 thinking that I would be there for only a couple of years to experience wha it was like to work in Washington, D.C. But by the early 1980s financial markets were starting to operate very differently than they had for the prior few decades. The FDIC was about to find itself right in the middle of the developing turmoil. From a quiet little agency with somewhat of an inferiority complex, the FDIC would be transformed into an independent-minded organization operating in a challenging and fast-paced environment.

During the 1980s, the rapid evolution of the financial environment, coupled with reckless lending, reckless borrowing, weak oversight, careless policies, and boom-to-bust markets, led to the failure of over 2,000 banks and S&Ls. In the first half of the 1990s, another 900 became insolvent. These failures were more than enough to render the S&L deposit insurance fund insolvent, while also costin the FDIC's deposit insurance fund over $30 billion. The total cost to taxpayers was $125 billion.

But none of that was easy to see in 1981. I was 28 years old, newly arrived from Massachusetts, and impressed with my new world. The solid structure that housed the FDIC headquarters was just one block away from the White House. The photographs on the inside walls showed lines of depositors waiting to take their money out of banks during the Great Depression. They were a constant reminder of the importance of the FDIC's mission.

But not everyone in Washington was impressed with the FDIC. The Federal Reserve, which also had regulatory authority over banks, looked at the FDIC as a younger sibling that mostly could be ignored but occasionally had to be told what to do.

At the FDIC, we looked upon the Federal Reserve with a combination of respect and suspicion. It wa the top dog in the financial regulatory community, and staffers there liked having the rest of us know they were the top dogs. They supervised big banks, while the FDIC supervised small banks. They wer the bank regulatory equivalent of Wall Street, while we were more Main Street. Their male bank examiners wore starched shirts with ties and suits. The FDIC's bank examiners wore ties, too, althoug occasionally one might detect the slightest hint of food stains. The short-sleeved shirts were easier to notice.

My early impression was that the Federal Reserve staff was arrogant. When I went to a meeting with couple of their economists and introduced myself as being from the FDIC, one of them said: "Oh yes you supervise small banks, don't you?"

The Federal Reserve also appeared to be ready to bail out any big bank regardless of the situation. ~~"Regulatory capture" is the phrase that came to mind. At the FDIC, we sometimes referred to the~~ Fed as the "Evil Empire," a *Star Wars* analogy bestowed upon them by Roger Watson, then the FDIC's deputy director of research.

In 1981, Paul Volcker was the chairman of the Federal Reserve. Despite being the leader of the Evil Empire, Volcker was no Darth Vader, even if many people probably thought of him that way. Volcke was determined to bring inflation under control. To do this, the Federal Reserve drastically reduced the supply of money in the economy, which had the intended effect of dramatically increasing interes rates. They peaked at over 20 percent. Needless to say, this greatly depressed economic activity, sinc neither businesses nor consumers could afford to borrow money at those rates of interest.

Volcker was not a very popular person, but he persisted and achieved his objective. By bringing inflation under control, he set the stage for many years of economic prosperity. He had the courage to take a position that was in the best long-term interest of the country despite the personal attacks that he endured from those with a much shorter-term point of view.

This is not to say that some of Volcker's critics didn't have legitimate concerns. The Federal Reserve monetary policy had some nasty side effects. Many people had made financial decisions based on a certain view on where the economy was headed. Volcker changed those expectations so dramatically that it was hard to adjust. Many small businesses no longer could afford the loans they needed to stay in business. Events didn't turn out as they had planned, and no one was going to bail them out of their problems. Countless individuals and institutions no doubt felt there was some unfairness in the size and speed of the Fed's interest rate pivot, and their concerns were legitimate.

Some of the businesses that were overwhelmed by the changing economy were more fortunate than others. Many savings-and-loan institutions also had trouble adjusting to the new economic environment, but they were bailed out. The increase in interest rates had left them in a hopeless financial position. Their customers were demanding much higher interest rates on their deposits. Tha would have been fine if these S&Ls could have lent that money out at higher interest rates, but their ability to do so was limited.

Because savings-and-loan institutions primarily lent to home buyers, in the early 1980s that meant their loans were 30-year fixed-rate mortgages. S&Ls already had plenty of 30-year mortgages that they had made when interest rates were much lower. Those low interest rates were locked in place fo up to 30 more years. So while S&Ls had to pay depositors higher and higher interest rates, their income from mortgage holders did not change much. They were steadily losing money. The reality was that they had no way to save themselves.

The Federal Home Loan Bank Board (FHLBB) regulated the savings-and-loan industry, but it didn't have enough money to close insolvent S&Ls. Instead, it decided to prop them up, creating zombie S&Ls.

The FHLBB engaged in policies that were designed to buy time. Capital requirements (the amount of money required to be put into a financial institution by its owners) were reduced, accounting rules were weakened, and other regulatory requirements were relaxed. The FHLBB hoped that these types "forbearance" policies would buy enough time to allow the interest rate environment to improve so the weakened S&L industry could regain its financial strength.

This regulatory strategy might have worked out if there were stronger supervisory controls on weak and insolvent S&Ls. As their capital became depleted, the owners of these S&Ls saw that they had nothing left to lose by taking extravagant risks. If those risks worked out, they might get all of their ~~money back, perhaps even more. If those bets did not work out, their S&Ls would be that much~~ more insolvent. But so what? They had already lost all of the money they had invested. It was worth the gamble. Heads, they'd win; tails, the federal government would lose.

The incentives were all wrong. Insolvent S&Ls tried to grow their way out of their problems. By paying extremely high interest rates for deposits, they could attract as much money as they wanted. They invested that money in speculative new real estate development projects. When the real estate market crashed in the mid-1980s, the losses at these now much larger institutions had grown enormously.

These S&Ls had been given a second chance, but many wound up failing anyway. The Federal Savin and Loan Insurance Corporation (FSLIC), the industry's deposit insurance fund, now was broke. It wa the responsibility of the S&L industry to replenish the FSLIC, but the amount needed far exceeded what the industry had the capacity to pay. Most of the cost would have to be borne by taxpayers, and that cost was much higher than it would have been if these S&Ls had been closed earlier or if their activities had been placed under tighter supervisory controls.

At the time, my focus was on what was happening within the FDIC. The FDIC did not supervise S&L but it did supervise commercial banks and mutual savings banks. The term *mutual* means that there are no shareholders, this type of bank is “owned” by its depositors and other creditors. Mutual saving banks were a lot like S&Ls. They also lent money to home buyers for 30 years at fixed rates of interest. This meant that they were experiencing the same type of financial problems as S&Ls, but there were significant differences in how the FDIC and the FHLBB handled their otherwise very similar problems.

The financial problems affecting savings banks in the early 1980s were the most serious problem the FDIC had ever faced. Because of the significant rise in interest rates, the market value of the assets owned by FDIC-supervised savings banks was far below what they in turn owed to their depositors ar other customers. If all of the weak savings banks were closed, the cost could have been over $10 billion—an amount that far exceeded what was in the FDIC's deposit insurance fund.

These problems had their first financial impact on the FDIC in November 1981, when the FDIC arranged for a healthier institution to purchase the $2.5 billion, 148-year-old Greenwich Savings Ban This was an “Open Bank Assistance Transaction,” which meant that the failing institution was not closed before it was sold, and that the buyer received financial assistance from the FDIC. That assistance cost the FDIC $465 million, an amount higher than the combined cost of all previous bank failures in the FDIC's history.

The FDIC offered to provide financial assistance to other buyers of insolvent mutual savings banks through a voluntary merger program. Under this program, the FDIC offered to cover the cost being incurred by failing savings banks (the difference came from what they had to pay in interest on their deposits compared to the interest they were receiving on their loans and other assets). Thus, buyers were protected against any further losses due to fluctuations in interest rates. By structuring its financial assistance in this manner, the FDIC was taking a calculated risk that interest rates would decline from their historically high levels rather than increase even further.

In 1982, Congress further encouraged the FDIC to provide financial assistance to weak or insolvent banks by giving the agency broader open bank assistance authority. The FDIC was also given the authority to create a program that would allow weak savings banks to remain open even if they did no have the minimum amounts of capital generally required by bank regulators.

Importantly, the FDIC closely monitored and controlled the activities of banks that were allowed to stay ~~open despite their lack of capital. They were not allowed to try to grow their way out of thei~~r problems. This helped ensure that if some of these banks still failed, the government's costs wouldn't be any higher because the FDIC had deferred their closings. This oversight was a clear difference fro what the FHLBB was doing at that time. Twenty-nine savings banks were allowed into this new program, six of which ultimately failed.

Altogether, the FDIC also arranged 17 open bank assistance transactions under its voluntary merger program. The healthy savings banks that merged with weak or insolvent banks received a combined amount of financial assistance from the FDIC of just over $2 billion. This was a very positive financial result for the FDIC, given what the cost could have been if these banks had been handled in different manner.

The voluntary merger program helped ensure that there was no run on these or other banks, and there was no public panic. Everyone was protected against any losses. Deposit insurance was there to protect insured depositors, and the structure of the transactions meant that no other creditors were exposed to losses either. Since these were mutual savings banks that were “owned” by their depositor and other creditors, there were no shareholders to absorb losses either.

The FDIC viewed these open bank assistance transactions as being much better than the alternatives. There wasn't that much uninsured money in these banks, so protecting uninsured depositors didn't co the FDIC very much, and that expense was far outweighed by how much less these transactions cost compared to the alternatives. Nor was there any need to dictate changes in management in most of these situations, since the problems facing these savings banks stemmed from the dramatic change in interest rates that had affected the entire industry. For the most part, they had been conservatively managed and had made high-quality loans.

However, the next problem the FDIC faced was very different. The Oklahoma City–based Penn Squa National Bank was terribly mismanaged. It had very loose lending policies, which were used to attrac borrowers who could not obtain loans from other more conservative lenders. Nevertheless, these borrowers generally were given very favorable interest rates and loan terms.

Penn Square's business was based on lending money to oil and gas producers. The high rates it paid t attract deposits and its relaxed lending policies allowed it to grow very rapidly. However, much of th growth came just as oil prices were peaking. Prices had risen from under $3 a barrel in the early 1970 to $36 a barrel in 1981. Then they started their descent. The forecasts for a continued upward growth in future oil prices that Penn Square had based its loans on were no longer valid.

Oil prices dropped sharply in 1986, affecting most oil and gas producers at that time. But Penn Square's borrowers were among the first to run into financial difficulty, and Penn Square National Bank was one of the first energy banks that became insolvent.

The FDIC did not want to bail out the uninsured creditors in Penn Square. A bailout in this situation would have been enormously expensive and would have sent a message that no one in the private sector needed to worry about the risks they took in supporting a poorly managed bank.

The Federal Reserve and the Office of the Comptroller of the Currency (OCC), the federal bank regulatory agency that was responsible for supervising Penn Square and other nationally chartered banks, felt differently. Senior officials at these two agencies wanted to see Penn Square get bailed ou despite its obvious mismanagement and the far higher cost to the FDIC associated with a bailout. The argued that Penn Square was too connected to other banks to allow its uninsured creditors to suffer sample content of Inside the FDIC: Thirty Years of Bank Failures, Bailouts, and Regulatory Battles