

This Time It's Different (Or Is It?)

Those of you with several years of business experience in this part of the country may recognize that many of the things we are hearing today about the economy have counterparts in the past: Asset values are appreciating, farmland values are strong and we are all well-aware of what has occurred this year with the energy markets. In short, for many in this area of the country, times are good.

At the start of the 1980s, we were told that oil prices could only go higher, farmland was a solid investment because “they aren’t making any more of it,” and housing and stock markets would continue to climb.

Of course, if you were involved in business or banking 20 years ago, you will recall that several of the financial decisions made on those speculative forecasts created their own sets of problems, some reaching far beyond local banks.

Today, I am told that while there may be some similarities with current banking conditions and those of a quarter century ago, things are different this time. You may be hearing the same thing from investors and bankers, and, in fact, you may be saying to yourself: “This time, it’s different.”

Or is it?

Through the late ’70s and ’80s I had the opportunity of being an officer in banking supervision at the Federal Reserve Bank of Kansas City. I spent those years heavily involved in the banking crisis that enveloped the Tenth Federal Reserve District, a region that includes the central United States: Nebraska, Kansas, Oklahoma, Wyoming, Colorado, northern New Mexico and western Missouri.

Confidence abounded among borrowers, bankers and even supervisors during the early 1980s. And, as with any euphoric environment, potential pitfalls abound.

I realize this is not new information to many of you—maybe to none of you. But I believe that this is a particularly apt time to take a retrospective look at banking and finance.

We now have a new generation of bankers who haven’t experienced much in the way of a substantial banking downturn. Furthermore, many who can recall the 1980s will

soon be leaving the business, and we need to gain from their knowledge and experience before they leave. Lastly, it never hurts to be reminded of important lessons.

Let me share with you some statements that we actually heard from bankers and bank directors during the ’80s:

- “I am the CEO of this bank, and we’re doing it my way.”
- “Yes, we loaned a hundred percent on this project, but everyone knows that the collateral value can only go up during construction.”
- “If you understood this better, you wouldn’t have a problem with it.”
- “Although this is unconventional, our accountant says it is perfectly legal.”
- “The corporate plane will save money for the bank in the long run.”
- “We have put our problems behind us—our bank rating will be much improved at our next exam.”
- “If it weren’t for the examiners, this bank wouldn’t have failed.”





Commercial Real Estate

1970s

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Lessons from the 1980s

Before I go further, let me provide a brief background on the 1980s to remind us of the context of these stories—all of which happened in our Federal Reserve District. In the 1980s, community banks made up much of the District banking population, with a number of regional organizations filling out the total—a trend that continues today with additional entry by a number of large interstate organizations.

District banks played various roles in speculative booms in agriculture, energy and commercial real estate—all of which were significant for the District economy—and which all came to a precipitous end. The price of crude oil, for example, rose from \$2.75 a barrel in 1973 to a peak of nearly \$37 in 1981 before dropping to \$10 in 1986. Similarly, farmland values in Nebraska rose by more than fourfold in the 10-year period before 1982, but then dropped by 45 percent during the next five years. Inflation was around 13 percent at the beginning of the 1980s, and the prime rate reached 20.5 percent in 1981.

The sharp economic fluctuations had a severe impact on District banks. During the 1980s, 309 banks failed in District states, which was 11 percent of the 1980 District banking population. Now, let me recognize one very important point before I go on. Most banks in the 1980s, like banks today, were well-run, prudent and successful. But some managers couldn't resist the possibility of greater profit. These examples are designed to steer you away from similar mistakes.

For each of the statements I shared previously, there is a story around the events that eventually unfolded. I have three more statements for which I want to provide the story of the consequences. I hope these will serve as

examples of what you, as directors, need to be alert to when exercising oversight at your banks. Age-old behaviors, such as greed, shortsightedness, and arrogance, are at the center of these problems, and, I would caution, they are with us today just as they were in the 1980s.

The first comment stems from one of the most prominent examples of the '80s banking crisis:

"The examiners are dead wrong, they don't understand what we're doing—they don't have a clue about our business."

At the height of the agricultural, energy and commercial real estate booms of the late 1970s and early 1980s, competition among lenders was intense. When our examiners would ask about a loan with questionable characteristics during this period, they too often heard bankers say, "If I don't make the loan, the banker down the street will." In many cases, unfortunately, this turned out to be a race to the bottom.

Nowhere was this more evident than in the area of energy lending. Good loan underwriting standards were often swept away under an aura of optimism and the belief that oil prices could only go up. In this environment, repayment ability was not a concern, especially because rising oil prices would bail out any lender, and good loan documentation was something to be done later, provided the lending business slowed down at some point.

One notable or, in this case, notorious District energy lender was Penn Square Bank of Oklahoma City. If you've read books like "Funny Money" or "Belly Up," you know a lot of major banks courted Penn Square and competed with one another to participate in the bank's seemingly lucrative energy lending business. Energy lending was the hottest ticket in banking then, and in the race to stake out a

1980s

position, none of these major banks paid any real attention to Penn Square's loan underwriting and administration, or did much in the way of their own due diligence. In many cases, the loan participations were bought on blind faith and unlimited optimism.

For Penn Square, this provided an incentive to make loans to anyone who walked in the door, and Penn Square sold more than \$2.1 billion in loan participations to 88 banks, including eight of the top 50 banks in the country. Greed, thus, overwhelmed reason for all who were involved. This, in some ways, strikes me as similar to some "hedge funds" excesses of the recent past.

The outcome of these practices back then was the failure of Penn Square Bank during the Fourth of July weekend in 1982. At the Federal Reserve, we were faced with a decision on whether to continue lending to Penn Square through the Discount Window or to stop and let it fail that weekend.

With all the questionable energy loans on Penn Square's books, there was little to be salvaged, and a few colleagues and I found ourselves spending the holiday weekend working on what to do about it. After Penn Square's failure, FDIC Chairman William Isaac made clear where the blame lay when he stated, "The Penn Square debacle was caused by a gross dereliction of duty on the part of the bank's board of directors and management."

Penn Square's failure also led to a ripple effect within the banking industry. A staggering total of more than \$1.1 billion in Penn Square loans had been sold to the supposedly more sophisticated Continental Illinois National Bank. These loans received little, if any, review by Continental Illinois' management and served as the initial impetus toward that bank's eventual failure in 1984. Seattle First

National Bank was also a heavy buyer of Penn Square loans.

After Penn Square's failure, Sea-First quickly slipped from being a darling of stock market analysts to a bank shut out of funding markets and pushed to the brink of failure. The only thing that prevented it from becoming the largest U.S. bank failure at that time was its hurried acquisition by Bank of America under a special Washington state failing-bank law. Several other major banks also took significant losses on Penn Square loans and fell into a weakened condition.

The simple fact is there are times when it is wise not to jump on the bandwagon. In some instances, it is better to let the parade pass you by. As directors, you should be extremely cautious if your management can't fully and clearly explain the business lines they are about to enter or if there is too much of a rush to jump in.

"If you understood this better, you wouldn't have a problem with it."

There are a host of stories from the 1980s and early 1990s of individuals thinking they had a sure thing—something that would produce spectacular returns with little or no risk.

Unfortunately, bank directors have sometimes been caught up in this enthusiasm as well. One banker, for instance, became a loan originator, relying entirely on another organization to be the secondary market conduit.

It seemed like a foolproof strategy with far better returns than the bank's ag lending business in the 1980s—simply find willing loan customers funneled through from distant sources, make sure the loan paperwork is filled out properly, and then watch the conduit purchase the loans and place them in the secondary market.

For several years, this strategy



Energy

Commercial Real Estate

worked—great origination and servicing fees, virtually no credit risk with the quick sale of loans, and a big boost to local employment. Eventually, however, the market conduit canceled its contract with the bank, thus leaving the bank itself to fund and hold all the loans it was making. The bank's balance sheet ballooned with the influx of loans, and the bank soon found that many of these loans were of questionable quality—a fact that eventually led to the bank's failure.

Another bank from this period had a history of struggling along and was glad to finally pick up some new ownership, especially because this change brought in two fast-track partners from a securities firm. Soon the bank's investment portfolio was earning returns well above market rates—an outcome that pleased the directors and led to management bonuses.

No one seemed prepared to question how the bank could continue to earn above-market returns on U.S. government securities. The answer came out later. One of the partners in the securities firm was charged with fraud, through a Ponzi scheme, and with money laundering, and the bank became a defendant in a securities lawsuit. After losing the lawsuit, the bank was insolvent.

Similar stories can be found in other banks. A particularly common story concerns structured notes. How many banks bought such notes through bond salesmen with the idea that they carried high returns but were safe because they were backed by the Federal Home Loan Bank System and the federal government? One banker even told us he didn't have to worry about his securities because his broker "controlled" the risk for him. In many cases, bankers never gave a second thought to the significant risks structured notes presented to their banks.

"Didn't you learn from corporate finance that leverage can be powerful?"

Franklin Savings was a Kansas thrift institution that made a name for itself through its complex arbitrage operations, expert staff and ability to "outsmart" major securities firms on trades. Franklin Savings started out as a small traditional thrift institution in a small Kansas town.

Like many thrifts in the early 1980s, Franklin Savings faced substantial losses from interest rate mismatches in its mortgage portfolio. In response, Franklin changed its business model to an arbitrage and hedging strategy, using brokered deposits to fund its positions in mortgage-backed securities, junk bonds and the futures market.

The thrift brought in an impressive staff of Wall Street and capital markets hotshots to carry out its strategies, and in just a few years, Franklin grew from virtually nothing to one of the largest and most profitable thrifts in the country with more than \$11 billion in assets.

While Franklin Savings had impressive returns for a number of years, its rapid growth—along with tighter thrift capital standards under FIRREA (Financial Institutions Reform, Recovery and Enforcement Act of 1989)—turned its leverage into a regulatory issue. Also, unexpected movements in interest rates led to sizable losses at Franklin in 1989, and to further declines in its capital ratio and net interest margins.

In a dispute over accounting practices, the Office of Thrift Supervision seized Franklin in 1990. What followed was a series of articles and court cases in which a number of well-known arbitrage experts took turns defending and criticizing Franklin's reporting of hedging gains and losses and the length of time it could take in recognizing some notable losses. There



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was no consensus on whether Franklin was a viable institution or was truly insolvent. In the end, the courts largely deferred to the OTS.

Among the lessons we can learn from Franklin Savings is that an institution's management should be able to explain fully its strategy and risk exposure to directors, current and prospective investors, and bank supervisors. Franklin also could be regarded as forerunner to today's hedge funds, except that it was relying on insured depositors and its thrift charter for funding advantages and didn't have large, sophisticated investors as its target clientele. As a result, it had a great responsibility to be transparent in its strategies and to maintain its capital at prudent levels and in compliance with minimum supervisory standards.

Some might quibble about whether the thrift examiners were knowledgeable enough to judge Franklin's activities. But they had enough experience by then to be skeptical when managers at problem institutions would tell them: "We're too sophisticated to get into trouble," "You don't understand, we know what we are doing," and "We have a tax—or an accounting—angle that will make this pay off."

Conclusion

My purpose in reviewing these stories with you today is not that I think a return to a 1980s-style crisis is imminent. Certainly, banking conditions today are good: strong earnings, good asset quality, no bank failures in more than two years. However, those who, in the early 1980s, predicted an endless rise in energy markets and real estate values were as confident in their outlook as we are today. And, certainly, the same rules and lessons continue to apply in banking and finance.

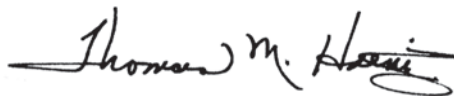
Although the world has changed during the last quarter of a century, at least one thing

has not: human nature. As I mentioned earlier, greed, pride, arrogance and other human frailties are often at the root of bad banking decisions, and those qualities remain with us today. They still motivate behavior as they have in the past, and, in many cases, these frailties keep us from acting on the lessons we should have learned from previous generations.

In addition, no matter how sophisticated we think current analytical tools, management information systems and financial instruments are, the most critical element in banking is still individual experience and judgment. In the end, bank employees, and, I would stress to this audience, bank directors, are still making the important decisions. The quality of those decisions will always depend on human characteristics and our ability to learn from the past.

One banking scholar said, "There is really nothing new in banking and finance, each generation just thinks there is."

So, are we in a different situation than 20 years ago? I would suggest that one way we can ensure a different outcome is if you, in your oversight capacity as bank directors, are willing to be skeptical, willing to ask the difficult questions and unwilling to accept the answer "This time, it's different."



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TOM HOENIG delivered this speech October 29 at the Western States Bank Directors Education Foundation's annual symposium. To learn more about bank director training programs from the Federal Reserve Bank of Kansas City, turn to page 30