



LESSONS *of a* FINANCIAL CRISIS

William Taylor played a central role in ensuring the nation's stability during the banking and financial crisis of the 1980s. During this time, Taylor was the Federal Reserve's head of banking supervision. Not unlike today, it was a time that presented the nation with challenges. The country saw widespread bank failures, the collapse of the savings and loans, and the introduction of the idea that a firm could be too big to fail.

Due in large part to his exceptional performance in handling these and other crises, Taylor was named head of the Federal Deposit

Insurance Corporation (FDIC) in 1991. His FDIC tenure, however, was cut short when Taylor died less than a year later.

Recently, the Federal Reserve Bank of Kansas City published "Integrity, Fairness and Resolve: Lessons from Bill Taylor and the Last Financial Crisis" to help Federal Reserve bank examiners understand the history and parallels to the recent financial turmoil.

Former FDIC Chairman William Issac said that if Taylor had not died after only 10 months in office, "he would have gone down in history as the best chairman the FDIC has ever had." It was a comment echoed by many

others, who noted that Taylor was also the greatest director of supervision in the Federal Reserve's century-long history.

Of course there is no way to know what Taylor would have thought about today's environment, or how his opinions on banking supervision and regulation would have evolved over time.

"If Bill were here today, he would probably share my disappointment that we learned so little from the crisis of the '80s," says Kansas City Fed President Tom Hoenig. "After that crisis, no 'rules of the road' were introduced that are fundamental to performance. Clear and enforceable rules work to contain excess risk during the booms and mitigate misery during the correction. Now, as we work to overhaul financial regulation in this country, implementation is key."

regulators: "I've always answered this question in a very straightforward fashion and the answer is 'no.' There should be one. It should be the Federal Reserve. Many people don't agree with that, but that's my opinion."

Examiners being "wrong": "You can't be single minded and say that all loans must have cash flow. But what we are teaching our examiners is this: If they are not going to criticize a loan for a project that does not have a prospect of fairly immediate revenue, they must have an exceptional story. ... I can recall examiners classifying real estate credits that didn't have sufficient cash flow based on existing market economics, and the bank arguing violently with them. Then the building would sell for twice the loan value. Bankers would turn to the examiner and say, 'See, you people were wrong about collateral values,' and

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Looking back, Taylor's comments then have a connection to today's crisis and ongoing recovery:

Complex mortgage products: "Some (adjustable rate mortgages) are more complicated than a VCR; you have to understand the arithmetic to be sure you are making the right payment. We find cases all the time where banks charge the wrong amount inadvertently. If the errors are in the bank's favor, they have to make restitution. But even though we watch out for you, you must also watch out for yourself."

Fed's supervision role: "The key role for the central bank in all this is to see that in the process of change, the stability of the banking system is maintained. As the lender of last resort, it is essential that the Federal Reserve be able to assess the risk of new powers and new geography. Maintaining a strong supervision function is essential in this regard."

Need for three federal banking

at the time, it looked that way, but sometimes worse than being wrong is being right too soon."

Deregulation / the then-proposed repeal of Glass-Steagall: "Bankers, and rightly so, argue that the reason they need more powers is because everyone else is in their business and yet (they) are kept out of everyone else's. To a degree, this is true. Big corporations no longer go to the banks for their loans. They generally access the public markets directly through the commercial paper mechanism. Every insurance man and broker, every department store, offers a kiosk that says, 'We'll invest your money, we offer a mutual fund, you can write checks, we take care of all of your financial services.' And so we've come to have a psyche of financial services industry. And so it goes. And some people think that these additional powers can lead to greater problems and potential conflicts of interest in the provision of financial services. But you'd have to say the course of the debate,



AFTER A LONG FED CAREER, BILL TAYLOR was sworn in as FDIC chairman on Oct. 31, 1991. His first and only year at the FDIC helm would be impactful, though it would be brief.

the tender of the debate, really seems headed for more powers for banks. Now one never knows. It's not over 'til it's over. But there seems to be an awful lot of conversation in this regard and ... (this) old examiner ... has these suspicions lurking in his heart. Suspicions that say the answer to world hunger is not eating someone else's lunch."

Another potential crisis similar to the savings and loan debacle: Bank supervision and regulation "...is a business of worrying and today we have to be in that mode when thinking about the real estate situation and the increasing corporate leverage that you see in these leveraged buyout deals. Combine these worries with a strong and growing economy with stable prices and low interest rates and one's sense of well-being appreciates. However, add a more negative scenario on these other factors and life gets tougher. Hopefully, another S&L-type crisis is not looming out there, but the fact that we have had such a crisis ought to make all of us in the business of banking supervision pay very close attention to our business."

Consolidation, deregulation and internationalization: "You come down to the end of the road and you say there's stress and

there are all these changes and what is the future of banking? ... It looks like pressure for more deregulation will continue. Banks getting into other businesses, more internationalization of banking markets, you'll be able to cash your check in Paris drawn on your Japanese bank in Chicago. The holding company structure will continue to grow, maybe at the margin, meaning less local control, maybe more services. Banking concentration measured on a national market basis will no doubt increase. Bigger banks will get bigger. There will be more big banks. Not to say that the small banks (will disappear) ... but the country is seemingly headed towards a higher level of concentration. ... The banking structure of the country will change, and has changed I think already. It's just now a matter of playing it out from a state and county type of banking arrangement to a nationwide banking arrangement. It may take a while to sort through, but I think that's where it's going. ... Although I have some hope for moderation, the increased competition brought about by all these changes, and in combination with the fascination of this country for debt and leverage, will continue to create stress that will require very close attention."



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The Federal Reserve Bank of Kansas City published "**Integrity, Fairness and Resolve: Lessons from Bill Taylor and the Last Financial Crisis**" to help Federal Reserve bank examiners understand the history and parallels to the recent financial turmoil. The book is free and available at KansasCityFed.org.

COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.