Federal Reserve Board Oral History Project

Interview with

John E. Ryan

Former Director, Division of Banking Supervision and Regulation

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Interviewers: Michael Martinson and Cynthia Rotruck Carter

Federal Reserve Board Oral History Project

In connection with the centennial anniversary of the Federal Reserve in 2013, the Board undertook an oral history project to collect personal recollections of a range of former Governors and senior staff members, including their background and education before working at the Board; important economic, monetary policy, and regulatory developments during their careers; and impressions of the institution's culture.

Following the interview, each participant was given the opportunity to edit and revise the transcript. In some cases, the Board staff also removed confidential FOMC and Board material in accordance with records retention and disposition schedules covering FOMC and Board records that were approved by the National Archives and Records Administration.

Note that the views of the participants and interviewers are their own and are not in any way approved or endorsed by the Board of Governors of the Federal Reserve System. Because the conversations are based on personal recollections, they may include misstatements and errors.

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MR. MARTINSON. Today is May 20, 2009. This interview is part of the Oral History Project of the Board of Governors of the Federal Reserve System. I am Michael "Mike" Martinson, a retired associate director in the Federal Reserve Board's Division of Banking Supervision and Regulation. I am joined by Cynthia Rotruck Carter, who currently works in the division. We're at the Federal Reserve Bank of Atlanta interviewing John E. "Jack" Ryan, who served as director of the Board's Division of Banking Supervision and Regulation from 1977 to 1985. Mr. Ryan worked at the Fed from 1969 to 1985.

Background and Working at the Chicago Fed

MR. MARTINSON. Let's begin with what you did before you came to the Federal Reserve and how you got into bank supervision. We're especially interested in your time at the Federal Reserve Bank of Chicago.

MR. RYAN. When I got out of college, I went into the army. And when I got out of the army, jobs were hard to find. That was in the late 1950s, early 1960s. I primarily wanted to be a writer. My ambition was to be a newspaper reporter, since I was the editor of our student newspaper and editor of the yearbook when I was in college. As I searched for a job as a reporter, I quickly learned that the salary offered was barely enough money to get by. It was like putting yourself through another four years of college, so I decided that was not for me.

For a number of years, my uncle had been a bank examiner for the State of Illinois. He was aware I was looking for a job, and he suggested I become a bank examiner. He knew somebody at the Federal Reserve Bank of Chicago that was hiring new examiners. He managed to arrange an interview for me in Chicago. Initially, the thought of becoming a bank examiner sounded terrible to me. I could see myself with a sleeve holder and green eye shades. But after my interview in Chicago, I had a different view, because I was so impressed with the chief

examiner at the Federal Reserve Bank, Charles J. "Charlie" Scanlon. Subsequently, he became the president of the Federal Reserve Bank of Chicago [1962–70]. He was charismatic and a knowledgeable guy. I thought, "Maybe this won't be so bad, after all."

So I took the job and struggled in it for a while. I've heard people say that when you learn a foreign language, you struggle with it, and then there's a click. All of a sudden things start to make sense. I had that "click" when I was an assistant examiner. Most of what we did until that point didn't make a whole lot of sense to me. But the fog began to lift, and I thought, "Now I understand what it is we're trying to accomplish here."

I worked at the Federal Reserve Bank of Chicago for about 10 years. I had the opportunity to work with some very good people. There was an excellent senior examiner, Charles Weiskopf, who used to be in charge of all the very large, complex institutions in Chicago and Detroit. I worked with him closely for a number of years. Some of his brilliance rubbed off, I hope. It was an interesting time.

My contemporaries at the Chicago Reserve Bank have done well. Some moved from the Reserve Bank to the Federal Reserve Board—for example, Bob Burton, who was an analyst in the applications area, and William "Bill" Taylor. I think it was in 1969 when my opportunity came. Brenton C. "Brent" Leavitt, the deputy director of what was then called the Division of Supervision and Regulation, called and asked if I would work at the Board. I enthusiastically said, "Yes." I moved as an analyst to the Federal Reserve Board after 10 years with the Chicago Reserve Bank.

Permissible Activities for Bank Holding Companies

When I started to work at the Board in 1969, it was struggling with the bank holding company (BHC) amendment. The Bank Holding Company Act of 1956 defined and regulated

bank holding companies. Under the act, a bank holding company was defined as a company that owns two or more banks. The 1960s was an era of conglomerates, when many of the major corporations were diversifying vertically. They were going into unrelated businesses. Many of them were engaged in commercial activities and were considering acquiring a commercial bank. At the time, the big issue was whether the United States ought to allow the mixing of banking and commerce, particularly among the largest banks.

The Fed was instrumental in getting new legislation that amended the Bank Holding Company Act to define a bank holding company as a company that owns one or more banks. The legislation provided that bank holding companies couldn't engage in any activity that was not closely related to banking and a proper incident thereto. This led to much controversy concerning which activities were closely related to banking and a proper incident thereto. The Congress, in the end, gave the Fed the task of deciding the issue. After a number of hearings and much controversy, the Fed set about compiling what was known as a "laundry list" of permissible activities.

There was little, if any, thought given to the regulatory side of what was being done. I remember Arthur Burns saying that we didn't need to establish a rigorous regulatory regime, because the new activities are closely related to what the bankers are already managing. The Board compiled the list of permissible activities in what started off to be an exercise in limiting the activities of bank holding companies. For some reason, the laundry list of permissible activities was perceived by the banking industry as something they ought to engage in. So most, using this as an excuse, set out on an expansion binge.

Bank holding companies were purchasing most of the larger mortgage banking companies, [accounts receivable] factoring, small loan companies, and so forth. There were

mixed views about whether it was preferable and more prudent to start these activities de novo and learn the nuances from the ground up or whether it was better to buy a large existing company that was already operating profitably. Almost all the holding companies opted for buying a large existing company. The acquired companies were well run and profitable and had been so for years. But after they became a subsidiary of a bank holding company, they had what I call the "rich uncle syndrome": These once-cautious companies began taking risks they wouldn't have taken if they remained on their own. Prior to their acquisition by a bank holding company, they had to satisfy their lenders, and now they didn't. They were being financed with the strength of the parent company. So they expanded exponentially and took risks that they wouldn't have ordinarily taken.

Amendments to the Bank Holding Company Act became law in 1970, and by 1975 a large number of these nonbank companies were causing serious problems for the bank holding companies. For the most part, the holding companies did not add additional capital to support these new activities. They borrowed and double leveraged with abandon because there were no consolidated capital requirements. In effect, all of these new activities were supported by the existing capital of the bank, since there was no equity capital in the consolidated entity other than the capital that was in the bank. Furthermore, the holding company was overburdened with acquisition debt.

It became clear that this was an unacceptable situation. I remember that Chairman Burns, out of frustration, quipped that the Bank Holding Company Act should be repealed. The Board acknowledged that we had a mess that had to be addressed. There were a number of meetings that were held with senior officers of bank holding companies, Wall Street representatives, and

academicians in an effort to fashion a responsible supervisory policy. In the end, a "go slow" policy was implemented, and consolidated capital requirements were established.

At about that time, staff prepared an internal problem-bank-and-bank-holding-company report and began to pressure the holding companies to improve their capital. One Sunday morning, I went to the front door to pick up the *Washington Post.* There was a banner headline on the front page that said: "Fed Report Says Bank Holding Companies"—and named several of the nation's largest institutions—"and Are in Dire Trouble." The *Post* reported liberally from the confidential report.

MS. CARTER. How did the *Post* get that report?

MR. RYAN. There was an investigation about how that report got leaked, but we never found out how it got into the hands of the *Washington Post.*

That episode fathered a new era of ensuring the confidentiality of such documents. At the time, there was a retired navy admiral on the staff of the Board.

MR. MARTINSON. Was it David Frost?

MR. RYAN. Yes, I believe it was. He was the chief of staff [staff director for management] at the Board. He devised a system that required a cover sheet on all confidential documents. I believe that approach was used in the military. The most sensitive document had a cover sheet that was labeled "Eyes only," and there were several other designations below that. The cover sheets, in my opinion, were eventually misused, because they morphed into a symbol of importance rather than a security designation. For example, a document with an "Eyes only" sheet took on an added degree of importance.

MS. CARTER. Now we have these series of classifications—restricted, restricted controlled, and so on. So, that was an earlier system of classification for information security?

MR. RYAN. Yes. It was a long time ago. Anyway, that's what it came from. When I arrived at the Board, Brent Leavitt was the deputy director of Supervision and Regulation at the time. Frederic "Fred" Solomon was the director.

I've got a little story to tell about Fred Solomon. He was the director when I started at the Board. When he retired, we had a retirement dinner for him. Fred had been at the Board since 1933 or something like that. He worked at the Board for about 45 years. At the retirement dinner, he said, "When I came here in 1933, there were two burning issues: One was how much capital the banks should be required to keep, and the other was whether the regulatory agencies should be combined." [Laughter] Nothing changes. We're still fighting that same battle.

Back to the bank holding company problems—Brent Leavitt was given the task of strengthening the capital ratios of these holding companies. That was a delicate task, although we seemed to ignore the delicacy of it. We were dealing with the parent companies of national banks. The Comptroller of the Currency was not at all pleased with us for trying to boost the capital of not only the bank, but the consolidated entity as well. The technique that was being used was a risk-based 9 percent ratio requirement.

I worked closely with Mr. Leavitt as we met with the senior management of virtually every major bank holding company. The senior management teams were told their banks had to achieve the 9 percent ratio; otherwise, the Fed would not approve any expansion plans of the bank holding company. That put pressure on the banks to boost their capital ratios, and they complied. The holding companies also boosted the consolidated ratio. We tightened our supervision, began examination of nonbank subsidiaries, and put in place a system to monitor the liquidity and cash flow of the holding companies. The examination and active supervision of bank holding companies had begun.

Bank Holding Companies Sponsoring and Advising Real Estate Investment Trusts

MR. RYAN. There was one piece of the list of permissible activities that always troubled me, and that involved the decision to permit the sponsoring and advising of REITs (Real Estate Investment Trusts). The argument for allowing this activity was much the same as the one used today with the SIVs (structured investment vehicles) and the SPEs (special purpose entities).

The presentations from the holding companies in support of the activity went as follows: The REIT is a separate company, not owned or consolidated with the bank holding company; the REIT will be separately capitalized with funds from the private sector; any loss in the REIT will not be recorded on the BHC's balance sheet. The BHC that sponsored and advised the REIT would be compensated with fees that would boost the capital of the BHC without having to take on additional risks. The BHCs sold the shares of the REITs to the best customers of their bank. To give the REIT more credibility, most bore the name of the sponsoring company—e.g., Chase Manhattan Realty Trust.

The activities of the REIT consisted primarily of financing construction of commercial projects. These loans were considered to be somewhat risk free, because the projects under construction were relatively short term—24 to 36 months—and they were supported by permanent takeout commitments from insurance companies who were making the permanent loan. Inasmuch as the loans were short term, the REITs were primarily financed with commercial paper. Initially, there were little, if any, commercial bank loans to the REITs. The major banks did, however, have backup lines of credit committed to the REITs.

As these REITs grew, there were persistent rumors of lax underwriting and heightened concern about them. I, along with two economists from the Federal Reserve Bank of New York,

was put in charge of preparing a white paper on the REIT experience. We personally interviewed the managements of 10 to 15 of the largest REITs that were sponsored and advised by BHCs. We heard similar responses from all we interviewed; they were: (1) The activities of the REITs are relatively risk free; (2) the BHCs were leveraging someone else's money, not their own; and (3) the BHCs were receiving sizable advisory fees, helping their earnings and strengthening their capital. Despite these assertions, our paper recommended that the REITs be considered BHC affiliates, and that they be subject to the transaction restrictions in section 23A of the Federal Reserve Act.[1]

Our group that had authored the white paper was in a Board meeting going over the report and making the recommendations when a senior Board staff member interrupted with news that there was a serious problem with a large REIT in the Midwest that was sponsored by a BHC. The Board tabled any action on the recommendations pending review of the current situation. It turned out that a major developer in the Midwest, with several large projects under construction that were financed by this large REIT and other REITs, had comingled the loan proceeds from one project to the other. Further, this developer was having serious financial problems, because the properties weren't being leased as expected and vacancy rates were soaring. The borrower defaulted on his sizable loans. The REITs with loans to this builder were unable to roll over their commercial paper. Overnight, this problem spread to all the REITs, and none were able to roll over their commercial paper.

[1] Editor's note: Section 23A was originally enacted as part of the Banking Act of 1933 (known as the Glass-Stegall Act). The Banking Affiliates Act of 1982 made major changes to section 23A intended to prevent the misuse of a bank's resources resulting from financial transactions between the bank and its affiliate companies. See John T. Rose and Samuel H. Talley (1982), "The Banking Affiliates Act of 1982: Amendments to Section 23A," *Federal Reserve Bulletin* (November), pp. 693–99.

In response, the REITs sought to draw on their backup lines of credit with the commercial banks. At first, the banks refused to honor the commitments, citing a condition in the contract that gave them an "out" if there had been a material change in the REITs' financial condition. After some considerable prodding, the banks did honor their backup commitments, and almost instantaneously, the financing for the REITs moved from the commercial paper market into the portfolios of the commercial banks. Despite the negative aspects of having these loans on the balance sheets of the major banks, the move did provide more time to work the problem out in an orderly manner.

It turned out that the default by the Midwest developer was just the tip of the iceberg. A number of similar problems began to surface, and it became clear that the commercial real estate market was in serious trouble, and that trouble was showing up in the portfolios of the REITs. Even though the REITs were not subsidiaries of BHCs, in most cases, they carried the name of the sponsoring company. Furthermore, they [the BHCs] were paid large fees to advise the REIT and didn't do a credible job. Many of these REITs were bankrupt, but the sponsor kept bailing them out with credit from their bank and the BHC, because they feared to do otherwise would result in irreparable harm to their reputation.

As an aside to the REIT problem, I had an interesting experience as a result of my work on this issue. I was bowled over when Chairman Burns asked me to join him at a Cabinet meeting at the White House to make a presentation to the Cabinet about the status of the REITs. I was very nervous but went with Chairman Burns and made the report to the Cabinet. The feedback was positive, but I will never know whether it was a good report or whether the Cabinet members were being courteous. That experience was one of the highlights of my time at the Board.

In reflecting on the problems of the REITs and the severe problems in the commercial real estate sector in the late 1970s, it seems that there was a cause-and-effect relationship. I have little doubt that the competition for commercial projects engendered by the vast sums of credit available from the REIT phenomenon resulted in overbuilding and caused the market to overheat and collapse. Of course, the underwriting was lax as a result of the need to deploy huge sums of credit. Much the same thing happened in the early 1980s, when the S&L (savings and loan) industry pumped huge amounts of credit into the commercial real estate sector.

Working at the Board in Contrast to the Reserve Bank

MS. CARTER. In coming from the Federal Reserve Bank of Chicago to the Federal Reserve Board in Washington, what were your first impressions?

MR. RYAN. I preferred the atmosphere at the Board. Federal Reserve Banks are rigid and steeped in tradition—which, of course, is not necessarily a bad thing, unless it is carried to an extreme. For example, when I was a review examiner at the Chicago Fed, I was placed in the former office of an assistant vice president because there wasn't any other office available for me. One day I noticed several senior Reserve Bank officers on the sidewalk looking up at my window. When they came back inside, I asked them what they were looking at, and they told me that my office had drapes, and my status as a review examiner didn't warrant drapes. Therefore, they were planning to remove the drapes. But first they wanted to see how it would look from the outside, if this was the only office on that side of the building that did not have drapes. I assume it must have looked acceptable, because the drapes came down. The same thing happened regarding a closet that was there for the senior officer. There was a small closet in the corner of the office. The closet was ripped out, which left a hole in the carpet where the closet

had been. The closet was replaced with a hall tree. After all, my status with the Reserve Bank didn't warrant a closet.

MR. MARTINSON. Yes, I think they were very hierarchical.

MR. RYAN. Oh, man, they really were.

Growth and Increased Responsibilities of the Supervision and Regulation Division

MS. CARTER. When you arrived, the Board was a lot smaller when compared to now. The size of the bank supervision section was larger when you left the Board. How many folks were you dealing with on a regular basis?

MR. RYAN. I don't remember, but it was fairly sizable.

MS. CARTER. Did the Martin Building exist at that point?

MR. RYAN. Not when I started. I worked in the Eccles Building. When they started construction of the Martin Building, the supervision and regulation department was moved to the Watergate. That is why it was one of the Federal Reserve Board guards detailed to the Watergate that found the infamous taped door during the Watergate break-in. The guard dutifully reported the suspicious taped door to the police, and the Watergate burglars were caught in the office of the Democratic National Committee, thanks to the fact that the Federal Reserve guard was alert.

MS. CARTER. Was all of bank supervision at the Watergate?

MR. RYAN. Yes, we were all over there. A shuttle took us back and forth to the Board Building. When it was completed, we all moved to the Martin Building. I think we occupied most of a floor, as the size of the staff was increasing. As we encountered more and more bank problems, we needed a larger staff.

At the time, the entire legal staff was under the general counsel. The watchword of the day was “bank holding companies,” “competition,” “elimination of potential competition,” which, in retrospect, seems so insignificant now. The entire staff was focused on that, including the Legal [Division] staff. And when we needed to take enforcement action in the supervision area, we got stalled. The Legal staff would question the need for the action and were never satisfied with the support provided. As a result, the actions were unreasonably delayed or not taken at all. So I went to the Board and requested an enforcement staff in bank supervision. John D. “Jerry” Hawke fought the proposal, arguing that all lawyers should report to the general counsel. He was the general counsel at the time [1975–78]. We fought for some control over the enforcement process. We agreed to a dotted line to the general counsel so that a legal review of our actions could be made, but the determination of “unsafe and unsound” was reserved to the supervisory side. So the enforcement function was moved to the Division of Banking Supervision and Regulation (BS&R).

MS. CARTER. Since I have worked at the Board, there have always been folks in BS&R working on enforcement actions. So you started that?

MR. RYAN. Yes. It wasn’t there when I came to the Board.

MS. CARTER. At one point, there was some downsizing. But in BS&R, you had core people when the BSA (the Bank Secrecy Act of 1970) came in, with a whole other bunch of people to deal with.

MR. RYAN. Right.

The Expansion of U.S. Banks Overseas

MR. MARTINSON. During the Burns period, we had a lot of international applications, because U.S. banks were all expanding overseas. The Board would routinely approve them, and then, all of a sudden, they'd deny a whole batch, saying, "It's time to go slow."

MR. RYAN. Well, that's a whole other set of circumstances. We had that tremendous oil recycling of petrodollars issue. A tremendous transfer of wealth was taking place between the oil-producing nations and the oil-consuming nations. There was an international debate about how that ought to be dealt with. Some of the European banks proposed a consortium that would be owned by the major countries. It would be structured similar to the BIS (Bank of International Settlements) rather than leaving the decision to the private sector of how and when to lend. But the private sector won out. As a result, the London interbank market really took off.

All of the major banks borrowed heavily in that market and re-lent billions to other countries. The lending banks promoted infrastructure projects that many of the less developed countries (LDCs) couldn't afford. At the time, Walter Wriston [Citicorp CEO from 1967 to 1984], in defense of this lending, noted that countries can't go bankrupt. He was absolutely correct, because there are no international bankruptcy laws. All it means, however, is while they can't go bankrupt, they simply don't pay. The fallout from this activity was a tremendous buildup of country risk in the portfolios of the nation's major banks.

When this buildup of country risk first began, the supervisory staff worked with Paul Volcker—who was the president of the New York Fed at the time—trying to devise a supervisory strategy to address the problem. The proposal worked out with Mr. Volcker, and adopted by the Board, called for examiners to criticize banks that exceeded certain concentration limits. Since there were thought to be wide variations in the creditworthiness of countries, the

levels at which criticism was made had to take this into account. For example, it was believed that an oil-producing country, such as Mexico, and an oil-consuming country, such as Brazil, shouldn't have the same concentration limits. The concentration limit was established based on country studies that were done by the Board's Division of International Finance. The examiners criticized banks if they exceeded those limits in an attempt [to] cause them to manage their exposure to country risk. In the end, however, there seemed to be little difference in LDC creditworthiness, since most of the less developed countries—whether or not they were oil producing—became overextended and had difficulty repaying their debt.

MR. MARTINSON. It turned out that our limits were kind of guidelines to which nobody paid much attention.

MR. RYAN. In retrospect, the limits that we proposed were probably too high and, in some cases, ignored.

MS. CARTER. Was that the origin of ICERC—the Interagency Country Exposure Review Committee?

MR. RYAN. Yes.

MS. CARTER. Did ICERC come after that?

MR. MARTINSON. ICERC put them in the little buckets.

MS. CARTER. Put them in the buckets and did the country risk assessment?

MR. RYAN. Yes. That's when that started. The banks had loans to less developed countries in the billions. And these countries didn't have sufficient dollars in their current account. They couldn't generate enough foreign exchange to make the payments. So what do we do with them? What kind of strategy do you employ to fix that problem?

MR. MARTINSON. The one report we did afterwards said that 240 percent of capital of the average of the nine largest banks was loaned to countries that couldn't really pay.

MR. RYAN. They couldn't pay, yes. So how do you fix it? Well, Paul Volcker was Chairman of the Fed when the problem ripened [1979–87]. And if you look at how different agencies handled their calamitous problems, he was brilliant. The Home Loan Bank Board's solution to their problem was to grow out of it, which was a disaster. Look at the way Chairman Volcker dealt with the LDC crisis. He put the brakes on growth and required that banks boost their capital and build up their reserves over time while avoiding a blowup as this was being done. It took a number of years to build up the capital, but, as the other businesses that the banks were in provided an income stream, they were able to bolster their capital not only that way, but also by reducing their assets and obtaining external capital, in some cases. And it worked.

MR. MARTINSON. I think that was one of the great bailouts of all time.

MR. RYAN. I don't know if I would call it a bailout. In any event, the strategy worked, and it avoided what could have been an enormous problem. You hear the debate today about marked-to-market accounting and you wonder what would have happened if the banks would have been required to mark down their LDC credits at that time.

MR. MARTINSON. It would have been gone.

MR. RYAN. It would have been gone.

Bank of the Commonwealth: The First Cease and Desist Order

MR. MARTINSON. One of the early bank problems was Bank of the Commonwealth, which was an isolated event.

MR. RYAN. It was an isolated event.

MR. MARTINSON. I think the Chicago Reserve Bank had started dealing with it around the time you came to Washington.

MR. RYAN. Yes. I was put in charge of it when I came to Washington. This was the Parsons group (Donald Parsons).

MS. CARTER. Are you familiar with the 1986 book *Bailout,* written by Irvine H. Sprague, a former FDIC chairman?[2] The book is about the handling of over 300 bank failures.

MR. RYAN. Oh, yes.

MS. CARTER. It mentions that you attended a number of emergency meetings.

MR. RYAN. The Bank of the Commonwealth was headquartered in Detroit. It had about $1.5 billion in assets.

MS. CARTER. It was the first problem bank in the billion-dollar range.

MR. RYAN. Yes. The ownership group had maybe 15 to 20 banks throughout the State of Michigan. The Bank of the Commonwealth was the largest. It was the flagship bank. And it was primarily a commercial real estate lender. I remember the principal owner and the leader of the group saying you should fly over the State of Michigan, drop a football out of the window, and buy the property wherever the ball lands. You can't miss. He must have dropped a number of footballs, because there was a big portfolio of commercial real estate loans at Bank of the Commonwealth.

Bank of the Commonwealth also had a problem investment portfolio of municipal bonds. One of its principal analysts believed that the default rate on bonds rated AAA versus those rated A was insignificant and did not support the higher rates paid on the lesser-rated securities. Putting this theory to work, the bank made significant investments in the lower-rated securities.

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[2] Editor's note: Irvine H. Sprague (1986), *Bailout: An Insider's Account of Bank Failures and Rescues* (New York: Basic Books).

Subsequently, there was a flight to quality in the market, and the value of the lower-rated securities plummeted. Seems the market was unaware or did not accept the premise of the bank's research.

MS. CARTER. That was done through partnerships, because Michigan did not allow branching, is that correct?

MR. RYAN. Yes, there were a number of states that had different rules. That's one of the reasons why, if you read today's Bank Holding Company Act, it requires partnerships that own banks to register as bank holding companies. If you reexamine the Fed's experience with REITs, you'll see language in the Bank Holding Company Act that treats any trust or company that is sponsored and advised by a bank in a holding company to be considered an affiliate subject to Regulation W.

The experience with this ownership group is important for another reason. The regulators had this new enforcement tool contained in the Financial Institutions Supervisory Act of 1966 that created the cease-and-desist order, the written agreement authority, and authorized removal and prohibition action. This authority had never been used, and there was debate about whether it would be a useful tool. As it turned out, the first cease-and-desist order under the new law was issued in July 1970 against the Bank of the Commonwealth.

MS. CARTER. According to the book *Bailout,* this wasn't in the public eye. People weren't aware that there were any problems.

MR. RYAN. Yes. The original statute did not require public disclosure of enforcement actions; the public disclosure requirement came along later. But the problems eventually surfaced, and the public realized the bank was in serious trouble. Eventually, it was purchased by a Middle Eastern investor.

MS. CARTER. Right. There was a Comerica connection.

MR. RYAN. Yes, I think that is correct. Eventually, Bank of the Commonwealth was resold.

MS. CARTER. Chase was heavily involved. I think Chase had been funding a lot of the partnerships.

MR. RYAN. I think it was.

MS. CARTER. And then they pulled the plug.

MR. RYAN. Pulled the plug, and everything came apart.

The International Banking Act of 1978: Expansion of Foreign Banks in the United States and U.S. Banks Overseas

MR. MARTINSON. Do you remember anything about the short-lived chairmanship of G. William Miller from March 1978 to August 1979?

MR. RYAN. G. William Miller was the former CEO (chief executive officer) of Textron. He was the first Chairman that I worked for who was a businessman from the private sector. He brought an entirely different style to the Board. For example, he was a firm believer in the eight-hour day. He used to say, "If you can't get your work done in eight hours, you are not using your time wisely." This was so much different than the collegial atmosphere, with discussions of issues going into the evening, as was the case with other Board Chairmen. He was also very knowledgeable about securities laws and SEC (Securities Exchange Commission) matters.

He was very helpful, particularly when the foreign banks were coming to the United States through the International Banking Act of 1978 (IBA).[3] The foreign banks were branching

[3] The International Banking Act of 1978 placed U.S. branches and agencies of foreign banks under the supervision of the U.S. banking regulators. Foreign banks were eligible for federal deposit insurance, were required to maintain

into the United States at the time. Chairman Miller was a stickler for having the same disclosure requirements for banks doing business in the United States as the U.S. banks had to meet. The Swiss, in particular, were opposed to any such requirement and pointed to the fact that they had been in the United States for years and had not been subject to such requirements. They believed that the United States was changing the rules in the middle of the game. Further, they argued that their banks had less exposure to LDCs and had adequately provisioned for any losses, while the U.S. banks were overburdened with LDC loans and were not adequately provisioned. The argument was that the U.S. banks were hiding the true nature of their problems, so they should come clean if the Swiss were going to be subject to disclosure requirements.

In any event, we had a number of discussions with the Swiss and finally reached a compromise. They set up a reading room at one of the law firms and disclosed their hidden reserves—but only to me, as I remember. I could review the data at the firm in order to inform the Board that the institutions had met the capital requirements for bank holding companies. This was a compromise that I doubt would be acceptable today, but it did meet our safety and soundness concerns at the time.

MR. MARTINSON. We used to get that. Finally, we got this one special report that only a few people could see that listed the hidden reserves while they lasted.

MR. RYAN. Yes, I think they've gone through their hidden reserves by now. That was a byproduct of World War II. There were a lot of German refugees who put their money in Swiss banks who didn't make it through the war. A lot of that money went unclaimed in the Swiss banks. Although they have since made reparations, they did have a large amount of capital from that source. At least that was my observation.

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noninterest earning reserve account balances and submit to periodic bank examinations, and were subject to the same branching limitations as domestic banks.

MR. MARTINSON. Yes, that was the case, especially back then. It has become a little more homogenous over time.

MR. RYAN. Yes. With the introduction of international accounting standards and the like, it has. But, boy, back then, there were no international accounting standards.

MS. CARTER. Because it was really the first. No one had come together before to do any of this stuff.

MR. RYAN. No, they had not. With the International Banking Act of 1978 and the expansion of U.S. banks overseas and foreign banks in the United States, it was time to have some forum to deal with these international issues. So the central banks from the developed countries decided to set up an international committee on bank regulatory and supervisory issues in Basel at the BIS (Bank for International Settlements). I think [Sir George] Blunden was the first committee chairman. I worked with Peter Cooke from the Bank of England.

It was a rocky road to begin with. There were divergent interests. The first issue I can remember dealing with involved the committee adopting a requirement that banks consolidate their subsidiaries and publish consolidated balance sheets and income statements. This was a very sticky issue, because many banks were taking major lending and investing risks in their subsidiaries, which, in many cases, had slim capital ratios. To consolidate the company would reveal how thin the capital protection really was. Finally, after protracted discussions, the proposal was adopted. This was only the beginning.

MS. CARTER. On the flip side, I remember analyzing balance sheets of foreign companies and their hidden reserve accounts. It was very different from analyzing a balance sheet for a U.S. company.

MR. RYAN. Absolutely.

MS. CARTER. I assume that, since that time, there is a lot more transparency. It sounds like you were at the beginning of bringing that together.

MR. RYAN. Yes. I believe we are well on our way toward international accounting standards.

MR. MARTINSON. The Italians used to reappraise them every five years or so. And since they were having 50 percent, 100 percent, or some very high inflation number, they got these huge—

MR. RYAN. —bumps. Yes.

Banking Crisis: Penn Square and Continental Illinois (Too Big To Fail)

MR. MARTINSON. Soon after Paul Volcker became the Fed Chairman in 1979 and started raising interest rates, we had a number of bank problems. Was Penn Square one of the first, followed by Continental Illinois?

MR. RYAN. In my recollection, Penn Square preceded the increase in interest rates. It involved oil speculation, plain and simple. There was an oil and gas find in the Anadarko Basin in Oklahoma. The deposits of oil and gas were deep and required extra-large derricks and drilling equipment to reach them. That oil exploration was very expensive. Although it doesn't seem high in light of present conditions, oil prices had to be around $30 or $35 a barrel to make exploration economically feasible.

There was a small bank located in a strip shopping center in Oklahoma with less than $1 billion in assets. The bank was making huge amounts of oil derrick loans and loans to explore the Anadarko Basin. The bank was selling participations in those loans to a number of very large banks, including Continental Illinois. Continental was the largest purchaser of those loan participations, with $2 billion in participations with Penn Square.

MS. CARTER. Two billion [in] loan participations.

MR. RYAN. Chase had $1 billion. And there were a number of others. Seafirst, in Seattle, had a big chunk of participations. I've forgotten the numbers, but it was a large amount at the time.

MS. CARTER. Right. And Continental had half of that $2 billion.

MR. RYAN. In order for the expensive oil exploration in the Anadarko Basin to be economically feasible, oil prices needed to rise considerably above current levels. Oil prices instead went down. It was on the Fourth of July weekend when we heard that these loans were in deep trouble and that Penn Square would probably fail.

MS. CARTER. There was an emergency meeting during the Fourth of July weekend.

MR. RYAN. At the time, Bill Taylor was my deputy. He had been at the Chicago Fed [from 1961 to 1968] and subsequently worked in various firms in Chicago. [From 1972 to 1976,] Bill worked for James W. Rouse and Company, a real estate development and mortgage banking firm. Rouse developed Baltimore's Inner Harbor, Faneuil Hall in Boston, and I think he did the Underground here in Atlanta. Bill and I had worked together for a number of years, and I was able to persuade him to come to Washington and be my deputy.

MS. CARTER. That was in early 1980s?

MR. RYAN. Yes, I am not sure, but I think Bill came in the late 1970s.[4] Anyway, Bill and I were working on Penn Square. We went to Chairman Volcker's office, and the Comptroller of the Currency was there since Penn Square was a national bank. We saw the enormous size of those participations and were more worried about the large participating banks

[4] In 1977, Bill Taylor was an assistant director in the Division of Banking Supervision and Regulation. He then became an associate director. In February 1983, he became deputy director. From 1985 to 1991, he was division director.

than we were about Penn Square. This small bank in a shopping center had sold $6 billion or so in participations to large banks, and it was becoming insolvent. The Office of the Comptroller of the Currency (OCC) was going to have to do something to resolve the problem at Penn Square. We were concerned that if this bank was put in receivership, losses on those participations would skyrocket.

We explored different approaches and decided to propose that the banks that had purchased the participations form a consortium to purchase and recapitalize Penn Square before it failed. That way, the banks could manage the loans in a more orderly way if they had control rather than if the bank were turned over to the FDIC. Bill Taylor and I set about trying to arrange such a transaction. We had 100 percent agreement on the approach, except that Continental refused to join because it believed the bank had an actionable claim under its blanket bond against some of the officers that made those loans, and Continental could recover under the bond. It believed that if it joined the consortium, it might compromise the insurance claim. FDIC Chairman Bill Isaac, who attended a later meeting, said that the takeover by the participating banks was not going to work, and the FDIC was going to take over the bank.

MS. CARTER. In the book *Bailout,* it says that there was an emergency meeting over the weekend at the Federal Reserve offices. Chairman Volcker, Vice Chair Preston Martin, and others at the Federal Reserve were concerned that a payoff of depositors would have a ripple effect on financial markets.

MR. RYAN. Yes. The argument was between the FDIC chairman, Bill Isaac, and Fed Chairman Volcker. Bill Isaac thought that we ought to do something other than put Penn Square into receivership and liquidate it. He was adamant, noting that it was about time that banks got a little market discipline. So they had to summon a referee to make the decision. The Secretary of

the Treasury came over to Chairman Volcker's office. The Chairman sent Bill Taylor and me out of his office. It was just Volcker and Bill Isaac in the Chairman's office. Donald "Don" Regan, who was the Secretary of the Treasury, came to be the arbiter.

I digress here to tell you a story about Don Regan. I used to go over to the Treasury Department and talk to the deputy secretary of the Treasury, R. Tim McNamar. I'd take a Board car to the Treasury building and was taken to the Secretary's entrance, because that's where the driver took Chairman Volcker. The entrance had security guards and consisted of a small room. I went into the room, took the elevator up, and had the meeting. When I came back down in the elevator, the Board car hadn't arrived yet. All of a sudden, lights came on, and sirens began going off—blue lights, red lights, and a little siren. The guard told me that I had to go back into a small anteroom and stand in the closet. He said that the Secretary doesn't like people looking at him when he comes in. So I dutifully went around the back and stood in the closet while Secretary Regan came in and went up in the elevator. Then the guard came to the closet and said that I could come out.

In any event, the meeting with Chairman Volcker, Chairman Isaac, and Secretary Regan lasted all of five minutes. Regan came out of the meeting and joined his entourage. They get in their cars and sped off. I walked into Chairman Volcker's office, and he said that the decision had been made to close the bank. The FDIC took over Penn Square.

Shortly thereafter, I started getting frantic calls from bankers that had purchased participations from Penn Square. They complained that the FDIC was offsetting borrower's deposit accounts against their loans. The deposit accounts represented the working capital of the borrowers, and, without access to their funds, they were being forced into bankruptcy. This action rendered many of the participations purchased from Penn Square a total loss.

After Penn Square, Continental Illinois continued to take big losses and began to lose its credibility in the market. The problem was that Continental's problems weren't limited to Penn Square; it had a number of other losses in its commercial loan portfolio.

I think it is most interesting to explore why Continental Illinois, with one office in downtown Chicago and a long history of sound operations, became so troubled. Prior to Penn Square, Continental Illinois hired McKinsey and Company to help it devise goals and objectives and set an operating strategy. The McKinsey report looked at the strengths of Continental. It noted the strong credit culture and a large correspondent banking business. The goal set after this study was for Continental to become the largest domestic commercial lender in the United States. Continental aligned its compensation system to achieve that goal. Management made all of the appropriate gestures to maintaining safety and soundness standards, but in the end they proved to be only gestures. As we all have learned, goals and objectives have to be measurable. Unfortunately, it is much easier to measure volume than to measure intangibles, such as safety and soundness, which has to be measured over a longer time period than is optimal for achieving the goals.

The correspondent bankers were purchasing loans and building volume, apparently gaining big bonuses in view of their contribution to the goals. This phenomenon was not only in the correspondent department but was being followed throughout the entire lending function. It is interesting to note that prior to its failure, Continental's senior management team graced the cover of *Businessweek* magazine because Continental Bank had been selected as the best managed corporation that year. The losses from this poorly executed strategy continued to mount, and in the wake of the Penn Square debacle, Continental's reputation suffered and worsened over time.

I also discussed the problems with the CEO of Seafirst that had also purchased participations from Penn Square. I asked him how a bank headquartered in Seattle had decided to purchase $1 billion in participations from a small strip mall bank in Oklahoma. He responded that his office in the Seafirst tower overlooked the Seattle harbor where he witnessed the movement of drilling and other equipment. There was tremendous economic activity in the harbor as men and equipment were moved to the North Slope of Alaska. The CEO said that they looked at all of that economic activity and just had to participate in it. They were introduced to Penn Square from other oil men coming through the Seattle harbor. The rest is history.

Richard Cooley, who came from Wells Fargo, took over as the new CEO of Seafirst. Some of his initial action was based on his concern that Seafirst was vulnerable to a liquidity strain as a result of its credit problems. His solution was to arrange for a backup line of credit of $1 billion with the New York banks that he believed would give him enough cash in case the liquidity problem developed. The line with the New York banks was secured with pledged collateral. Seafirst put out a press release trumpeting the backup facility in hopes the action would help maintain customer confidence in the company. It turned out that the strategy worked, and they did not have a calamitous liquidity problem.

The then CEO of Continental witnessed what Seafirst had done and decided Continental should take similar action. The CEO arranged for a $2 billion line of credit for Continental. And, of course, the line of credit was secured. The difference between the two was that Seafirst was funded with a core base of deposits; Continental was not. Continental was getting one-half of its funding from the Eurodollar market. When the participants in the Eurodollar market learned that Continental had a collateralized line of credit with the New York banks, they reacted negatively. The other participants were not going to lend unsecured in the Euro[dollar] market while the

New York banks were secured. As Continental's Euro[dollar] takings matured, it could not roll them over and was losing roughly $1 billion a day in funding.

MS. CARTER. The book *Bailout* states that there was a run on electronic depositors.

MR. RYAN. There was a run on other deposits through electronic withdrawals. However, the major problem was in the Euro[dollar] market. As its Eurodollar takings matured, the Fed was lending to Continental through the discount window, and the line kept building up.

Chairman Volcker said that something had to be done to stabilize the situation. He arranged for a meeting in New York with all of the major banks and the regulators, including the FDIC. I attended that meeting. The focus was on how the situation with Continental could be managed. A number of options were discussed, and it was clear that the other major banks were somewhat torn by the problem. They had little sympathy for Continental that had so vigorously competed with them for national credits. At the same time, they did not want to see a major default in the Euro[dollar] market, because they were themselves so dependent on that market.

Eventually, a decision was made: The large banks that set up the secured line would cancel the line and replace it with a subordinated loan. After much debate and wrangling, it was worked out that the banks would buy $1 billion of subordinated debt to be issued by Continental. Chairman Isaac and the FDIC played a critical role in devising and implementing the strategy. The subordination loan [subordinated debt], together with actions taken by the FDIC, stabilized the situation, avoided a major default in the Euro[dollar] market, and prevented a number of smaller community banks with correspondent business at Continental from taking huge losses. In return for its action, the FDIC took all of the shares of the bank that could be immediately issued. This resulted in the FDIC acquiring control-ownership of Continental.

MS. CARTER. Yes. Eventually, it was 15 banks involved in the package, and the story came out that there was $1.5 billion, and the banks put in $500 million. But what really happened was, the FDIC put in $2 billion, and the banks later bought a quarter of it—something like that.

MR. RYAN. I don't remember all of the details, but something like that was worked out. And the FDIC ended up with the stock. Now, why would you do it? Even today, when I talk to Bill Isaac, he still expresses reservations about what was done to aid Continental. The reason it was done was simple: Continental was taking half of its funding out of the Euro[dollar] market. That would not be a lot of money now, but it was a lot of money at the time. Every other major bank in the United States was getting a like percentage of their funding out of that market. What would happen if there had been a default by an American bank of the amount in that market? What would happen to that market? How would it destabilize the funding of all of our nation's banks? That was the problem.

MS. CARTER. So you saw the potential systemic effect.

MR. RYAN. Yes, absolutely. This got less press, and there was a lot of talk about the deposits that these smaller banks had with Continental because they had a big correspondent relationship and they were uninsured and so forth. That really wasn't the main focus at the Fed. The main focus was the Eurodollar market and the potential disruption that could have occurred in that market. The FDIC eventually sold out their ownership interest in the bank and recouped some of its losses.

MS. CARTER. According to the book *Bailout,* even though the depositors had been guaranteed before in those situations, this one really caught the attention of the media and public—where all depositors had been guaranteed.

MR. RYAN. It wasn't just deposits. It didn't work, anyway. The point is that that was done, and the chairman of the FDIC sent a letter guaranteeing all of their deposits. It was a valiant and courageous effort on their part. However, it didn't stop the run in the Eurodollar market, because the banks had questions about how the guarantee would work and whether it was legal and binding. It was clear to me that the subordinated loan [debt] and the other actions taken by the FDIC are what stabilized the situation.

MR. MARTINSON. People didn't realize how much money the big U.S. banks were taking from the Euro[dollar] market, and by this time the LDC debt crisis had come along, so everybody knew—

MR. RYAN. Yes, most analysts knew Continental was weak and was overconcentrated in one funding source.

Banking Crisis: The Hunt Brothers and the Silver Crisis

MR. MARTINSON. Would you talk about the Hunt Brothers silver crisis?

MR. RYAN. The first we knew about the Hunt Brothers silver crisis was when I got to work one day, and early in the morning I got a call from Chairman Volcker's secretary, who always said, "He wants you." I went to the Chairman's office, and there were a group of people in his office already. Mike Bradfield, the Board's general counsel, had been called too, and we sat with the group. It turned out that the people we were meeting with were the Commodity Futures Trading Commission (CFTC) senior staff, their lawyer, and Engelhard Minerals and Chemicals Corp., which was a big commodities broker. The CFTC representative explained that the Hunt brothers had millions of dollars in futures contracts on silver outstanding. There had been a huge margin call, and the Hunts couldn't meet it.

The CFTC was concerned that a default of that magnitude could disrupt the entire commodities market. They asked for help and suggested that the Fed should get involved and work to solve the problem. We discussed the problems among ourselves when the others left. It was decided that Bill Taylor and I [would] call several of the large Texas banks that had relationships with the Hunts. We called them all and had discussions about what can be done to resolve this matter and prevent a potential crisis.

MS. CARTER. Was it in the billions?

MR. RYAN. I don't remember the exact amount, but it was very large. The Hunts were cooperating, and we contacted their accountant who gave us a list of all of their assets. They had a large amount of assets that included pizza parlors, oil reserves, and real estate. The list was shared with the large Texas banks who were working together to secure a loan large enough to cover the margin calls.

With the guidance of Chairman Volcker, we worked for several days trying to put this deal together, and, finally, it did come together. Through loans, the Hunts got enough money to meet the margin call after pledging virtually everything they owned. In the end, they did all right and were able to come back.

The haunting question is, why would these oilmen speculate in silver? The answer is, they were hedging their position. As oilmen, they were pumping oil and selling it for dollars at a time when the inflation rate was 12 percent. By the time they got the dollars, their oil was worth a lot more than the dollars. So, to protect themselves from the declining value of the dollar due to inflation, they needed a hedge. They explored several options and settled on silver because it was a precious metal that also had an industrial use. As they invested heavily in silver, they

drove the price up from less than $10 an ounce to $50 [to] $60 an ounce. It had become so valuable that people were hiding their silverware in the attic.

MS. CARTER. There were many robberies.

Inflation Fighting under Chairman Volcker and the Effect of High Interest Rates on Savings and Loans

MR. RYAN. My personal belief is that the experience with the Hunt silver crisis heightened Chairman Volcker's concern about the present rate of inflation and its effect on the value of the dollar. I believe he was thinking that, when our businesses lose faith in our currency, it will have dire consequences for our economy. I believe that the Hunt silver crisis was a catalyst that led to the sky-high interest rates that eventually broke the back of inflation and restored confidence in U.S. currency.

Again, this is my interpretation of one of the reasons why the Fed raised the interest rates to such high levels. I'm sure others might have a different take on this. The high interest rates had a devastating effect on the savings and loan industry, on real estate, and the building industry. Builders from all over the country used to send 2x4s to Chairman Volcker, and they'd have something scrawled on them complaining about the high rates. Volcker had these 2x4s all piled up in the corner of his office so he could eventually use them as fuel in his fireplace. At one point, the National Association of Home Builders pulled up in a hearse in front of the Board building and had a mock funeral with a casket. It was marked "Building Industry," implying that the Fed was killing the building industry.

The high interest rate fix was not without pain. The effect on the S&Ls was instructive. The savings and loans were highly regulated—at the time, the rate they could pay on deposits was covered by regulations. They could only pay 3 percent, and I think there was a differential of ¼ point over what banks could pay in order to give them a bit of an edge over the banks.

Furthermore, they were prohibited from making adjustable-rate home loans. So they ran a business that was described as "3-6-3." They paid 3 percent interest on their savings, they got 6 percent on the loans, and they were on the golf course at 3 in the afternoon. That was the business. That business had to change.

The Congress was being forced to deregulate interest rates, because the inflation had already started raising some of the rates. And, on their own, people were disintermediating out of those thrifts—that is, people were finding other places to put their money that paid higher rates, so the funding sources were decreasing. When interest rates moved up to 17 and 18 percent, the plan to use the Depository Institutions Deregulation Committee to slowly ratchet up the interest rates became unworkable, and all ceilings were taken off immediately.[5] The problem now was solvency. The thrifts were stuck with 30-year, 6 percent fixed-rate loans that had to be funded with deposits costing in the double-digit range. The S&Ls were operating at huge losses, and it was relatively easy to determine how many months were left before insolvency.

MS. CARTER. Net worth certificates were being issued by FSLIC [Federal Savings and Loan Insurance Corporation] when it resolved failing thrifts in the late 1980s because the insurance fund was insolvent. Rather than putting in money capital, they put in net worth certificates—a form of capital on the balance sheet that was used as part of the resolution process.

[5] The five-member committee was set up under the Depository Institutions Deregulation and Monetary Control Act of 1980 to gradually phase out interest rate ceilings on deposit accounts over a six-year period. The committee's authority expired in 1986, when Regulation Q abolished interest rate ceilings on passbook savings accounts. Voting members of the committee were the Treasury Secretary, the National Credit Union Association administrator, the Fed Chair, the FDIC chairman, and the Federal Home Loan Bank Board chair. The Comptroller of the Currency was a nonvoting member.

MR. RYAN. Yes. Net worth certificates and the Bank Board (Federal Home Loan Bank Board) let the S&Ls count any goodwill as capital and propped them up with gimmicks.

MS. CARTER. That was the period leading up to what then became the RTC (Resolution Trust Corporation) and all of the S&L failures. I remember analyzing capital levels for S&Ls when I came to Washington in the mid-1980s. Bill Taylor was the BS&R director. When we ran the capital numbers for institutions in some states—for example, Texas—we thought, "That can't be right, because three-quarters of the ones in Texas are all insolvent." We thought we'd done the numbers wrong, but, in fact, there were large numbers of insolvent institutions—institutions with negative equity—which indicated the large looming problem on the horizon.

MR. RYAN. There were some S&Ls that survived, but not many. FSLIC (the Federal Savings and Loan Insurance Corporation) was desperate and entered into questionable transactions that did nothing but make the situation worse. For example, they sold failing thrifts to developers and allowed them to count the goodwill as capital. Even though the regulator counted the intangibles as capital, it was not capital. About the only strategy the new owners could follow was to grow and take on additional risks to make a profit, thereby making the problem worse.

MS. CARTER. During that time, FSLIC was broke.

MR. RYAN. Yes, FSLIC was insolvent and had been declared as insolvent by the Government Accountability Office (GAO). This was the beginning of the end of the Federal Home Loan Bank Board (Bank Board) as a regulator. When the Congress saw that the Bank Board had entered into transactions that obligated an insolvent insurance fund for billions of dollars, that was the end of FSLIC and the Bank Board as a regulator. The Congress enacted

FIRREA (the Financial Institutions Reform, Recovery, and Enforcement Act of 1989) and created the Office of Thrift Supervision as a bureau of the Treasury.

Increased Supervision of Bank Holding Companies in the 1970s

MR. MARTINSON. When you came to the Board, there was this debate over how much holding companies should be supervised and even whether they should have capital rules. I think it was during your tenure that we ramped up the supervision of the companies.

MR. RYAN. We did. And, as I mentioned earlier, it was in the early period of expansion that this debate really took place—after the 1970 amendment to [the] Bank Holding Company Act to cover [the] one-bank holding company. The thought among the Governors was that the market would discipline the holding companies and that there shouldn't be any problems, because the bankers were not getting into businesses they didn't understand since they could only engage in activities that were closely related to banking.

It wasn't until it became clear that many of the major banks formed holding companies and, without increasing their equity capital, purchased the largest independent firms whose activities qualified under the BHC Act. And they made these purchases with the proceeds of debt issued at the holding company level. Then, when the nonbank activities began to experience serious problems, the regulation of holding companies was ramped up materially. This mainly occurred in the mid-1970s.

Commercial Real Estate Problems in the Late 1970s and Early 1980s

In my opinion, a factor that led to the commercial real estate problems flowed from the thrifts attempting to manage their interest rate risk exposure. For years, the thrifts were prohibited from making adjustable-rate loans to consumers. Since the thrifts were primarily a consumer-driven model, they had a real problem. This prohibition was eventually removed, but

thrifts—except for those in California—had a difficult time convincing homebuyers to take an adjustable-rate mortgage. Therefore, they turned to commercial real estate, where there were no such prohibitions. With many developers owning thrifts at the time, the industry pumped substantial sums into this sector. The thrifts weren't alone; the commercial banks were also making commercial loans directly and through their REITs. When too much money was pumped into a particular sector, the inevitable happened, and commercial real estate prices fell. The portfolios of the banks and thrifts resulted in material losses.

MS. CARTER. And not in home mortgage lending.

MR. RYAN. For the reasons I stated, commercial real estate was an opportunity for thrifts to make adjustable-rate loans. Still another tack taken by the Federal Home Loan Bank Board exacerbated the situation. The Bank Board permitted thrifts to sell their 30-year fixed-rate loans and amortize the loss over the expected life of the loan. The theory was that the thrifts could take the proceeds from the sale and invest them in adjustable-rate loans bearing much the [same] higher rates in the market at the time. The truth was that the discount they had to take on the sale reflected the rates prevailing in the market, thus the reinvestment of the reduced cash from the sale did little, if anything, to improve earnings. In that regard, it was a zero-sum gain. What it did do, however, is provide substantial additional funds that were invested in commercial real estate.

I'm going to digress about the REITs, because I think this is an interesting story. It's like the SIVs (structured investment vehicles) and the special purpose entities (SPEs) today. In the final analysis, these types of entities are not really separated from the banking institution. They are formed and managed by the bank, and too often they are not well managed because of this fiction of separation.

The following is a true anecdote about how this fictional separation affects management decisions. A builder told me he approached one of the banks that ran the REIT out of its mortgage loan department of the bank. The bank didn't set up a separate company. When the builder indicated that he was requesting a large loan, the lending officer asked him if he was there to make an application with the bank or the REIT. When the builder responded that he was there to apply for a loan from the REIT, the lending officer responded that he was pleased, because that meant they could have a martini for lunch. The difference in behavior didn't stop at lunch but crept into whether the loan was going on the bank or REIT portfolio. This is but one reason why the REIT portfolios were replete with problems.

We also heard about the cavalier behavior of some of the REIT lending officers, such as closing large loans at an airport between flights. The money being pumped into the commercial real estate sector by the REITs built hotels, resort property, strip malls in remote locations, et cetera.

There certainly is a cause-and-effect relationship of all of these poor lending practices. In the case of the REITs, too much money was pumped into the commercial real estate sector, and it overheated and collapsed. Much the same phenomena occurred in the early and mid-1980s when the savings and loan industry, in an effort to grow and place adjustable-rate loans on their books, pumped vast sums into the commercial real estate sector. Many of the loans were questionably underwritten. Some of the projects financed by the S&Ls defy description. I've seen videos of projects in Texas where, instead of phasing the projects, all the phases were built before the earlier phases had any indication of sustainable sales. In the end, the whole project had to be bulldozed.

MS. CARTER. Right, the I-30 corridor.

MR. RYAN. Yes.

MS. CARTER. Bill Taylor had us go down and look at the real estate properties—to determine if they were occupied, how well there were maintained, et cetera, for collateral evaluation purposes—posing as SMU [Southern Methodist University] students. You know Bill.

MR. RYAN. He always liked the intrigue.

MS. CARTER. We were always doing contingency planning like that.

Banking Crisis: The Butcher Banks

MR. MARTINSON. Do you remember anything much about Jake and C.H. Butcher and the Butcher bank scandal?

MR. RYAN. Yes, I do.

MS. CARTER. In 1982, 180 federal bank regulators from the FDIC raided the Butcher brothers' 29 bank branches and offices in Tennessee. Bank records led investigators on a paper trail of illegal loans, forged documents, and various other forms of fraud. Jake Butcher's flagship institution, the United American Bank of Knoxville, collapsed on February 14, 1983. At the time, it was the fourth largest commercial bank failure in the United States since the 1930s.

MR. RYAN. Jake Butcher ran for governor of Tennessee, and he had been instrumental in getting the World's Fair in Knoxville.

C.H. Butcher owned an industrial loan company along with his part-ownership with his brother in various Tennessee banks. They would move some of the bad loans out of the banks into the industrial loan company to hide them from the examiners. Eventually, all of the banks were in deep trouble because of speculative lending practices. Several of the banks were on the brink of failure.

The governor of Tennessee called a meeting of the regulators and the major Tennessee bankers to discuss the situation. I attended that meeting. We explored various options for dealing with the crisis, and some of the Tennessee bankers indicated they might buy some of the banks from the FDIC. Not long after that, the FDIC took them all over and was able to sell most of them.

MS. CARTER. Did you ever meet the Butcher brothers?

MR. RYAN. Oh, hundreds of times. Jake Butcher was a real politician, a glad-hander. He was always "on." C.H. Butcher was more a behind-the-scenes kind of guy. He was quiet. He never said much, but he was probably the brains behind the whole thing. At least that was my take on them.

MS. CARTER. Jake and C.H. Butcher were convicted of bank fraud, and they served jail time. Sixteen banks in Tennessee failed either as members of the Butcher chain or because of loans purchased from Butcher banks.

MR. RYAN. I talked to C.H. when he got out of jail. He looked me up when I was in Florida. I asked him what he was doing, and he responded that he was working on high-stake bingo games on Indian reservations.

BCCI (Bank of Credit and Commerce International)

MS. CARTER. You were dealing with some pretty contentious situations. Did you ever have somebody come back for you?

MR. RYAN. You remember BCCI. It purchased First American Bancorp, an early multiple-bank holding company that owned several banks, including one or two in New York, one in Florida, and one in Georgia. A Saudi prince, who was a major BCCI investor, had entered into a letter of intent to buy American Bancorp. He needed Federal Reserve approval to

consummate the transaction. The Saudi Prince was represented by Clark Clifford, a former Secretary of Defense and power broker lawyer in Washington. Mr. Clifford and his partner Robert Altman visited me on several occasions to discuss the transaction. The main issue that surfaced was, the Saudi Prince was being advised by Agha Hasan Abedi, a Pakistani financier who managed BCCI. BCCI was a Pakistani bank registered in Luxembourg with offices in several European countries. BCCI had a checkered reputation across Europe.

As we moved to process the application, it was protested by the New York Banking Department. Under Board procedures, such a protest required that the Board hold a hearing on the issues. Clark Clifford called me and requested a meeting at the Board. At that meeting he asked to see the hearing room. While he was in the room, he asked several questions about where the various parties would be seated, whether the window blinds would be open, et cetera. He was staging the hearing.

At the hearing, the focus was largely on the role that Abedi was to play if the application was approved. Was this really BCCI buying the banks? The hearing lasted for three or four hours, as I recall. I remember Clark Clifford pointing to the Saudi prince. He kept saying, “His Excellency” has an unblemished record and is a respected member of the Royal family of Saudi Arabia. The Prince was acquainted with Abedi and trusted his judgment. It was stressed that he was only using Abedi as a consultant on the purchase, and he would have no role after the acquisition.

Because there was no hard evidence that the Prince was fronting for Abedi, the application was approved, and the holding company was purchased. As was indicated in the application, Clark Clifford was elected chairman, and he and his partner Robert Altman

essentially oversaw the operation of the company. This continued for several years without any serious problems or concerns.

My first clue that something was amiss came from a call I received from a reporter. The reporter had obtained a copy of the transcript of the Fed hearing under the Freedom of Information Act. He said that "Abedi and BCCI were behind this acquisition; it was not the Saudi Prince that you thought made the acquisition." I asked him how he knew that and what information it was based on. He had some information that came from a London deposition of sources at BCCI. The deposition stated that Clifford went to London to meet with Abedi quarterly to report on the earnings of the bank, what the bank was doing, and to get approval for salaries, bonuses, and other matters. This was several years after the application was approved, and it seemed to indicate that, indeed, Abedi was making the key decisions at First American.

It wasn't long after that the New York District Attorney Robert Morgenthau decided to bring the case against Clifford and Altman, alleging that they lied to the state commissioner when they said that Abedi was not behind the purchase of First American, the holding company that owned the New York bank. And, further, they lied about Abedi being just a consultant and that BCCI had nothing to do with the transaction, when BCCI was the actual purchaser.

There was a trial, and I was summoned as a witness even though I was no longer with the Fed. This demonstrates that you can't get away from your past. I was on the stand testifying for several days. The questions I had asked Clark Clifford and the Prince at the Board hearing dealt specifically with the role of Abedi post acquisition: "Do you have to report back or do you have to furnish any information about the bank to BCCI or Abedi? At what point does Abedi's connection with the bank end if he's a consultant?" Those are the kinds of questions I asked at the hearing.

I was a witness because I was the regulator at the time. I spent the better part of a week at the trial. Clifford was so ill that he wasn't at the trial. But Altman and his wife, Linda Carter, who played Wonder Woman on television, were at the trial. Neither Altman nor Clifford were convicted. I always believed the reason was—and counsel for the two asked me this directly at the trial—that there weren't any victims of this alleged lie. Nobody that we could identify took losses because of their doing business with First American. There weren't any failed banks. In fact, the banks had been capably managed.

MR. MARTINSON. None of the U.S. banking offices lost any money.

MS. CARTER. Interesting point. They circumvented the law.

MR. RYAN. The jury on the case didn't seem to have much, if any, banking knowledge. The lawyer representing Clifford and Altman would throw so much dirt in the air that I know the jurors were confused. He had all these files and papers. One piece of paper contained the instructions on the preparation of [FR] Y-3 (Application for Prior Approval to Become a Bank Holding Company). The lawyer said, "Mr. Ryan, would you read that paragraph to the jury?" And the expressions of the faces of the jurors were: What in the hell is this?

MR. MARTINSON. Those instructions were impermeable to most people.

MR. RYAN. By the time their lawyer finished presenting the case, I'm sure the jurors were confused. They had no idea what was going on.

MR. MARTINSON. That's what good lawyers do.

MR. RYAN. He was a good one, because he just obscured things. It was amazing.

Perspective on Members of the Board

MS. CARTER. What is your perspective on your time at the Fed—how the Board was run, your interaction with the Board and with the staff?

MR. RYAN. I was fortunate that I was at the Board when people like Paul Volcker were there—people who understood the necessity of bank supervision and didn't subscribe to the notion that market discipline will substitute for supervision. If you get someone from academia—an economist with a capital "E"—they seem to think that the market will take care of everything, but it won't. I think that it is important to maintain balance on the Board. Arthur Burns saw the need for regulation from his experience with the one-bank holding companies. Hopefully, someone who fails to recognize the need for both supervision and good monetary policy doesn't become the Fed Chairman.

MR. MARTINSON. Did any of the Governors who were not Chairmen stand out to you?

MR. RYAN. Yes. I've always had a high degree of respect for Governor Charles "Chuck" Partee. He was formerly head of the Board's Research Division. He was one of my favorites. I thought he was a brilliant guy. He understood things. He cut to the chase, to the meat of things.

I always liked and admired Henry Wallich, the Governor who focused on international matters. He was smart and well informed.

To give you another example of my high regard for the Federal Reserve Board and the Governors that served on it, I need to go back to 1993 when I served as CEO of the Resolution Trust Company. When the Congress passed the RTC Completion Act of 1993, the Congress had to appropriate more money to pay off the insured depositors and wind up the affairs of hundreds of failed thrifts.

Anytime the Congress gives more money, it puts strings on it. There was concern that large commercial banks were buying up failed thrifts for pennies on the dollar. And these banks were closing branches in low- and moderate-income areas because the branches weren't

profitable enough. The Congress was concerned about this and wrote a provision in the RTC Completion Act requiring that the RTC give preference in the bidding process to minority buyers that bid to purchase branches located in minority areas or whole banks that were located in a predominately minority area. This was a Democrat-backed effort. At the last minute, the Republicans added an amendment to the act that provided that the RTC may give a preference to minority buyers, but the preference couldn't increase the cost of the resolution. So we went through this process at the RTC of trying to decide how we could put these facilities out for competitive bid and give somebody a preference without incurring a cost.

The Congressional Black Caucus—mostly House Democrats—got involved in this. The Caucus's first proposal was that when the RTC put the minority branches or institution out for bid, it would take the highest bid and then allow the potential minority buyer to match it. In our analysis, this wouldn't work, because it would chill the bid. That practice would reduce the number of willing bidders, because they would incur the cost of due diligence and preparation of a bid only to be acting as a stalking horse for somebody else to be the purchaser.

I was getting all kinds of grief from the Congressional Black Caucus, the Congress generally, and others urging me to fix the problem. In the end, I hired former Federal Reserve Governor Andrew Brimmer as a consultant to give the RTC a report on his thoughts about how the RTC should implement this requirement. At his recommendation, we did the following: The minority bidder could win the bid if the minority bid was within 10 percent of the highest bid. This would help level the playing field by forcing the minority bidder to have sufficient information to prepare a reasonable bid. This seemed to satisfy the Congressional Black Caucus as well as the Congress as a whole and helped solve this difficult problem. The bottom line is that I used my connection with the former Governor to help me out at the RTC, and he sure did.

Working with Reserve Banks

MS. CARTER. Do you have any comments about working with the Reserve Banks during the period you were at the Fed?

MR. RYAN. I remember specifically that William "Bill" Wiles was in the division, running the applications process. Then he became Secretary of the Board. He was also in a unit in the research department that was preoccupied with competition. Anyway, he was in charge of applications in the division when I was at the Board.

We had a big project to delegate more authority to the Reserve Banks. The document made the appropriate references to delegation, but, in reality, it increased oversight by the Board staff. Les Gable, the vice president of the Reserve Bank in Minneapolis, said after the discussion that "If I keep getting more delegated authority, pretty soon I won't have any at all."

MS. CARTER. Did you deal with the Reserve Bank officers in charge of supervision? Was it kind of a one-off thing?

MR. RYAN. Yes. We had meetings periodically.

MR. MARTINSON. I don't think it's like now, where every decision is pushed around.

MR. RYAN. No, we tried to leave real authority to the regions. I didn't believe it was good management to leave the responsibility in the Reserve Bank and then make all of the decisions in Washington.

MS. CARTER. My sense is that maybe it was a lot more autonomous.

MR. RYAN. It was deliberate. Now, when there was a major problem, we got involved. There wasn't any question about that. If there wasn't a major problem and things were going on along all right, we had staff that reviewed the reports and other matters. But, by and large, I

think we had good people in the Reserve Banks that had good judgment and could operate their department without our interfering with every decision they made.

MR. MARTINSON. Well, that concludes the interview. Thank you.