Federal Reserve Board Oral History Project

Interview with

Michael G. Martinson

Former Associate Director, Division of Banking Supervision and Regulation

Date: March 3, 2010

Location: Washington, D.C.

Interviewers: Cynthia Rotruck Carter, Adrienne Hurt, and David H. Small

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.

Contents

MS. CARTER. Today is March 3, 2010. I am Cynthia Rotruck Carter from the Federal Reserve Board's Division of Banking Supervision and Regulation (BS&R). I am joined by Adrienne Hurt from the Office of the Staff Director of Management, and Dave Small from the FOMC (Federal Open Market Committee) Secretariat in the Division of Monetary Affairs. We are interviewing Mike Martinson at the Board's offices in Washington, DC. Mike is a former associate director in BS&R. He worked at the Board from 1971 to 2006. Welcome, Mike.

MR. MARTINSON. Thank you, Cynthia.

Early Years at the Board

MS. CARTER. Let's begin with a brief discussion of what you did before coming to the Board, and what brought you to the Board.

MR. MARTINSON. I was born in a small town in Iowa. I went to Grinnell College. After that, I got a masters degree at Columbia in International Affairs. I got out of Columbia in the summer of 1970. I looked around for a job, but the job market wasn't too good. Eventually, I found a job back in Iowa.

About November of that year, I got a call from the Board. I'd sent out a lot of resumes. I think I even forgot I sent one there. I went to Washington for an interview. I was hired at a grade seven step three. In the interview, I spoke to Fred Dahl, who ran the Foreign Banking section. He was the person that hired me. I also spoke to Fred Solomon, the division director, and Brenton C. "Brett" Leavitt, the deputy director. That these officials were involved in this hire shows you how small of a place the Board was at that time.

In February 1971, I started working at the Board. I was in the Foreign Banking Section. That section was in charge of regulating and supervising the international activities of U.S. banks—in particular, Edge corporations and foreign branches.

Edge corporations are largely an anachronism now, although there are still two big ones. But they were in their heyday at that time. There were two types. The most important were the ones that the banks used to make their investments in foreign companies. Almost all of the foreign subsidiaries of U.S. banks are owned through Edge corporations. The Board not only has to approve all these investments, but is the statutory regulator of Edge corporations, including their foreign subsidiaries. The other type, which is largely irrelevant now, allowed banks to conduct international banking in the United States outside of their home state. In 1971, most of these were in New York City, and the biggest one was an Edge corporation owned by Bank of America [BofA]. Later on, there was a drive to open them up in a lot of other places—Miami, Chicago, Los Angeles, San Francisco—as a hopeful entrée into expanding the overall banking business of the major banks, but that never really panned out. This type of Edge Corporation mostly went away as interstate banking was permitted.

MS. HURT. Before you continue, what caused you to be interested in international affairs and then international banking?

MR. MARTINSON. In college, I started out as a chemistry major, but I couldn't see the electrons move, so I figured I'd better find something else. I gravitated to political science and economics. Then I went to Columbia's School for International Affairs and specialized in economic and political development. So the Board's position in foreign banking seemed like a good fit. It was in the field I was interested in.

MR. SMALL. You were talking about these Edge corporations. This was at a time when banks could not branch across state lines.

MR. MARTINSON. That's correct.

MR. SMALL. And an example might be Bank of America out in California setting up an Edge corporation in New York City to do transactions with foreign customers, or to invest in companies in France or Europe.

MR. MARTINSON. Yes, usually banks had more than one Edge corporation. They had one that did international banking and was located outside of the bank's home state, and one located at the bank's home office that did the foreign investments.

MR. SMALL. Someone might ask, why would the Board care about what our banks are doing abroad?

MR. MARTINSON. Historically, U.S. banks weren't allowed to buy stocks or establish foreign branches. In the Federal Reserve Act, the Congress authorized federally regulated banks to engage in international activities and gave the Board the regulatory authority in the foreign area. I think the main issue was safety and soundness because the bank's money is exposed.

MR. SMALL. So they could lose all kinds of money in capital in France and that would pull down the U.S. bank.

MR. MARTINSON. Right, that's correct. There were significant restrictions that the Congress established in return for giving banks the power to go abroad. Essentially, the Board had to give prior approval for foreign branches and investments, and the Board had authority to examine the foreign offices. The Congress gave the Board "carte blanche" to regulate foreign activities however it wanted. In addition, there was a statutory limit that banks could only invest up to 10 percent of their capital in Edge corporations. Due to the way that "invest" was interpreted, over time the actual percentage of a bank's capital in Edge corporations in some cases got to be very large, up to maybe 30-40 percent of capital. But the idea was that foreign banking was risky, and the Congress wanted the risk to be controlled.

MS. CARTER. If you look at the restrictions at that time, for example, U.S. banks couldn't even branch across state lines.

MR. MARTINSON. By now we're in the 1970s. U.S. companies are going abroad in greater numbers. They're becoming multinationals, and so you have this whole movement by not only the biggest banks, but also some of the regional banks wanting to go abroad with their customers in order to help serve their customers.

MS. CARTER. Was that relatively new in a sense?

MR. MARTINSON. It was really taking off when I came in. There had been a core group of institutions with some international offices, but in the 1970s this business was really in a major expansion phase. For example, in the 1970s, all kinds of regional banks opened branches in London because that was the place to be. Most of them never made any money and, probably by the end of the 1980s or the early 1990s, most of them were closed. But, in the 1970s, a bank had to be international to be somebody.

MS. HURT. You were about to tell us about your first job.

MR. MARTINSON. My first job was putting together a list of what U.S. banks owned abroad. There were various sources of information, but there wasn't really what you could call an "org chart" to know what we were supervising.

MS. CARTER. No big databases?

MR. MARTINSON. No big databases. The one I put together was on hand-typed colored cards that went into big binders.

Also, I soon got into working on applications. The Board had to approve all of the foreign acquisitions. I also became involved in supervision. So I did both. Back then, there was very little formal training in bank supervision. It was really an apprenticeship program, and I was very fortunate to work for the people I did, especially Fred Dahl, who was the assistant director in charge of the banking section. He was one of the smartest people that I've seen at the Board. Kathleen O'Day and I still think he was the best memo writer we've come across; he was really good. He always made you think things through and encouraged questioning thought. He would say, "Fuzzy writing reflects fuzzy thinking" and that is correct. When I see PowerPoint presentations, I always think that PowerPoint can hide a lot of fuzzy thinking because it's not written down so that it can be carefully analyzed.

The section had three other professionals. They were all in their 50s. One guy named Bob Hochstatter stood out. He had come to the Board from the Chicago Fed. His office was across from mine, and after lunch I would often go over and ask him questions about supervision. He would then launch into various stories, mostly about small Midwestern banks and bank supervision. But he always had a point to make. He not only had done examinations of small banks in the Midwest, he'd examined foreign offices of big New York banks and had been on IMF (International Monetary Fund) missions to Paraguay and various places. One of the stories I remember involved a large regional bank, Bank of the Commonwealth. He had examined the bank while he was at Chicago, before he came to the Board. This must've been about 1969–1970, somewhere in there. And, as you know, that bank eventually failed. It was run by a guy named Don Parsons. Bob was the head examiner, and he found all kinds of problems, mainly involving real estate lending, that he thought was risky. So he said he wanted to talk to Mr. Parsons at the end to go over the report. Parson's secretary said that he was too busy. So Bob told her he had to work on the exam report anyway and that he would just wait in the reception room of Parson's office until he could get in to see him. He sat there a couple days, and finally they gave up and Parsons met with him. Bob started criticizing the real estate lending as speculative. Parsons told him that he would take Bob up in a helicopter with a whole bunch of green balloons. He would let Bob kick those balloons out, and wherever they landed, the bank would go and make loans on that property. He said he would always make money because real estate prices would always go up. Bob said he replied, "Well, that may be fine with your money Mr. Parsons, but it's not fine with the bank's money." That story shows you how these bankers get in trouble by making loans that they don't really believe are risky.

MR. SMALL. Nowadays, there's this idea that examiners go into a bank with all these derivatives and swaps, and they can't really see what's going on because it's too complex. Back then, if an examiner walked into a bank, was it easier to see what was going on?

MR. MARTINSON. Banks then weren't as big, and they didn't have as many diverse products as they do now. But I'm skeptical of the assumption that examiners can't understand at least key features of the derivatives. They might not know all the math, but I think good examiners can identify the risks in individual derivatives and other complex structured products. Personally, I looked at a lot of trading operations and you could understand them. But, at the same time, banks weren't as big then or as complex; it takes more work now.

MS. CARTER. Bank of [the] Commonwealth was one of the first large bank failures where the FDIC provided assistance.

MR. MARTINSON. Right, it failed a few years later. I think Chase helped bail it out at the end. The point is, even though Bob spotted these problems, not enough corrective action was taken. It got worse, not better. Bob was responsible for part of my training in that he insisted, and Fred Dahl agreed, that I should go out to exams at least once a year. So I started by doing Bank of America International in New York City, an Edge corporation. After that, every year for the next 25 years or so, I went at least once overseas for two or three weeks to participate in an exam. Fred Dahl said, "It's fine to go on exams, but I don't want you just sitting in the exam room." He said he wanted me to pick a topic and go out and see other banks to learn more about it. That worked really well and I did it throughout my time in the international area.

On my first or second trip to London, ship lending was big. Everybody was into it. I went on an exam at this bank called something like International Marine Bank Limited. It was a subsidiary of Marine Midland Bank in New York. It was big in ship lending, and so I decided to look at that business. I was participating in the Inter-Marine exam. At the same time, I was going around and talking to the ship lending departments in all of these other banks in London. And you got a big, diverse view. I even went to Morgan Grenfell, a bank that was 30 percent owned by JP Morgan. I remember walking up to the bank's building and there were all these gold plaques on the wall going in. One of them went back to 1640 or something; the numerals were almost rubbed out from polishing. Anyway, I was looking at this one Marine Midland loan that was to an Israeli shipping company. The loan collateral consisted of third, fourth, fifth liens on all these ships, and the ships were on short-term charters. After getting all this information from various banks on shipping and ship loans, I thought, this loan was very risky. So I wrote the loan up as substandard. When I left to go back to Washington, I handed my loan write-up to the New York examiner in charge who would discuss the loan with the bank. I saw that the loan was not classified. What does this Board guy know? But within 12 months, there were marshals being sent all over the world to impound these ships because the market for these types of ships had fallen apart and the loans were in default. This experience convinced me about the need for specialization. When I took over the SNC (Shared National Credit) program many years later, I tried to create some specialty teams because I thought part of the problem was things were getting complex enough, that examiners needed to specialize more.

MS. CARTER. You're talking about examiners specializing in certain types of lending or whatever.

MR. MARTINSON. Right, we set up a healthcare team for a while when I had the SNC program, an energy team, and others.

MR. SMALL. So you go into a bank to do an exam. There's maybe someone from the District Reserve Bank. You send in a report, it gets fed up the line, if it doesn't pass—

MR. MARTINSON. The Reserve Banks did the exams. They were in charge of the exams. I was loaned out to them at this point. Part of my time there, I was working for the Reserve Bank. So like any examiner, when you read a loan, you fill out a line card, and you give your view of how the loan should be rated—pass, special mention, substandard, etc. Then you hand your evaluation into the senior examiner, the examiner in charge. He's the king. Whatever he says goes. I handed in my evaluations to him and I recommended substandard, but he decides at the end what to do.

MR. SMALL. What authority do you have, as an examiner from the Reserve Bank, when you walk into a bank? Could you ask for everything and it's carte blanche?

MR. MARTINSON. Right. And it still should be that way. You can see any piece of paper in there, and you can talk to anybody you choose. In some of the trading operations, examiners would talk to the top guys, then they would go down and talk to the clerks to see whether the confirmations are really separated from the traders.

Once we kind of got in trouble. Some people were worried about FX (foreign exchange) scandals/rogue traders. So we set up these exams in London where we went in early in the morning before the bank opened, say 7:30 a.m. Examiners would seize the mail bags, and look at the confirmations that were coming in to make sure that they'd been recorded by the trader on the way out. That was pretty aggressive. That one didn't fly very well. There was push back by the banks. That effort was a one shot deal, but it shows you what we could do.

At the time, international supervision was primitive. When I came to the Board, basically, the Call Report was domestic only.[1] It didn't include the business of the foreign offices. The only report that had the foreign operations consolidated into it was a one-page balance sheet that had to be published in the local newspaper. This report wasn't even sent to the Board. So every quarter we were scurrying around collecting these consolidated reports. Usually they were in the American Banker but sometimes you had to go to other newspapers. This lack of reporting had consequences because even back then, before I came to the Board, there was this big issue with capital. There was this debate between the ABC formula that John "Jack" Ryan (former Director of BS&R) talked about, and the Federal Reserve Bank of New York that had its own formula, the New York formula. Both were kind of liquidity-weighted capital ratios. But then they found out that all these capital ratios, which they thought [were] already low, were really a lot lower because they hadn't taken into account the foreign assets of the banks. So one of my early jobs was to redo the Call Report to make it fully consolidated—put in information on foreign operations. Large chunks of the changes made then are still in the Call Report. I don't know what that says about change over time. It would've been like the early to mid–1970s, I forget exactly when.

MS. HURT. You were in international banking supervision in BS&R. What was the relationship between that area and the Board's Division of International Finance (IF)?

MR. MARTINSON. We worked closely with people from IF when I was there, in particular, Bob Gemmill and Henry Terrell. They were involved in almost all of the supervisory

[1] Editor's note: Every FDIC-insured commercial bank files a Call Report each quarter with its federal supervisory agency. The Call Report provides a comprehensive balance sheet and income statement for each bank.

policy issues—for example, new activities and regulatory changes. Also, there was the Voluntary Foreign Credit Restraint Program. Technically, it was voluntary. Every bank and every company had a cap on what they could invest overseas. So whenever a bank would come in for an application, somebody had to check whether they were within the Voluntary Foreign Credit Restraint Program limits. Somebody from IF did that. For a while, they had a special guy on loan from the State Department that was in charge of that.

MS. CARTER. Did that reside exclusively at the Federal Reserve, or were other banking agencies doing the same thing?

MR. MARTINSON. The Board had control over bank investment overseas. We didn't have the state nonmember (FDIC) banks, but they didn't have significant international business. But international banking regulation was essentially here. I don't know the details of the Foreign Credit Restraint Program, but a lot of people said that it spawned the Eurodollar market originally.

We worked closely with IF on all of the significant international banking issues, including when we get to the LDC (less developed country) lending.

MS. CARTER. You mentioned that you worked on applications. Did many of those applications go to the Board for approval?

MR. MARTINSON. Oh yes, almost all of the applications went to the Board, although there were some minor ones that Andrew Brimmer—the Governor in charge of international supervision—could approve under delegated authority. But almost all of them went to the Board for approval. That was actually part of your education process because you went to the Board meeting, you went in at the start, and you left at the finish. It wasn't like it is now where you just come in for your item and then leave. You would sit in on the Board meeting and listen to all of the other things going on, and it sort of gave you an education.

MS. HURT. When you came to the Board in 1971, you were 25 years old. There was a social and cultural revolution going on in the United States. There was the anti-war movement, the rise of feminism, the civil rights movement, and so forth. How did all that affect the culture at the Board? How did it affect you being 25 years old?

MR. MARTINSON. Compared to when I went to Columbia University, things were kind of winding down at this point, and I don't remember any big effect at the Board. The Board was a pretty small place. People knew one another. It was a fun place to work, even though you weren't paid the greatest. You needed to do your work, but you weren't being harassed about your time. It was a very comfortable place to work. We didn't work in the main building. We were at the Watergate, which made things more relaxed.

Chairmanship of Arthur Burns

MR. MARTINSON. Even though, as a 25 year old, I thought Arthur Burns was really old, I was impressed by how smart he was. And I thought, "Boy, I'd hate to have seen him in his prime." But maybe he was in his prime. Also, like a lot of other people, I thought he was pretty mean. He was very intimidating. But from observing him, I learned some things that I still remember.

For example, we had a case that involved a U.S. bank setting up a trust company in the Caymans under an Edge corporation. An Edge corporation was only allowed to do international business. The sole purpose of this application was to help U.S. citizens avoid U.S. taxes. In those days, when you took such a matter to the Board, you wrote a memo with a section on arguments for approval, arguments for denial, and a recommendation. We were recommending approval, but in the arguments for denial, I made the argument that this really wasn't international business, it wasn't what the Edge Act was set up to do, it was purely domestic.

Six Governors were at the meeting. They took a vote. Before getting to Chairman Burns, who voted last, three voted to deny the bank's application. If the vote ended in a tie vote, the application would be denied. Chairman Burns voted for a denial, so it was a 4-2 denial. We had to write a denial letter, and that took a few days. Then one Governor changed his mind and asked for reconsideration at a new Board meeting. At that meeting, Burns said, "The only reason I voted against the application was because the Chairman should never be in the minority, unless it's a very important issue. I'm going to vote for approval too." Seven Governors were present this time. Another Governor, who hadn't been at the first meeting, also voted for approval. So the vote ended up 5-2 in favor of approval. Arthur Burns said, "Tax evasion is illegal; tax avoidance is good business." [Laughter]

The policy established then has been the guiding principle when we deal with these tax avoidance structures. And in the 1990s and early 2000s, there were a lot of them. We make the banks swear that the structures are legal, that it's avoidance not evasion, and then the Board approves them. So the case was very important.

MS. HURT. Was that unusual for a Governor to change his mind?

MR. MARTINSON. There might have been other instances, but that was the only one I recall. Afterwards, my boss said one of the Governors told him that I was confusing the Board members.

MS. CARTER. In what way?

MR. MARTINSON. Well, I don't know. [Laughter]

Another thing I remember about Burns is that, even though he started out not very much in favor of supervision and regulation, he later did quite a bit to strengthen it. There was a lot of expansion going on. Banks were buying domestic financial companies, and they were growing their overseas business. But no new capital was coming in, so the capital ratios were going down. As I said, at that time, there were always applications by the big banks wanting to do something overseas, and they went to the Board for approval. One day, a bunch of applications for small investments that we didn't even think were going to be discussed came back denied. The Board had instituted what it called the "Go Slow Policy." The Board said that banks should concentrate on managing what they've got, that they shouldn't expand. And the Board denied requests for even small new investments. Some of them were very small, and the banks were very big. That lasted for a while, then it'd go away, and I think it was reinstituted at least once.

MS. CARTER. Who was driving that?

MR. MARTINSON. Arthur Burns. I don't know whether it was just Burns or him and the other Governors, but all of a sudden it happened. I think it coincided with the Board tightening monetary policy for a little while.

One thing that came out of that episode involved banks and insurance underwriting. For a while, we'd had these applications lying around where a couple of banks wanted to do joint ventures abroad with insurance companies to underwrite property and casualty insurance. One was BofA with Allstate in Europe, and the other was Citibank with Chubb in Brazil. The applications had been lying around. We were pondering them. We weren't quite sure how the Board would react. As soon as the "Go Slow" policy was established, we made an all-out effort to get those applications to the Board with a recommendation for denial, and they were denied. They were denied not only on "Go Slow" grounds, but by the Board saying that it didn't think property and casualty insurance was a banking activity even overseas. That policy of not allowing U.S. banks into property casualty overseas lasted until the Gramm-Leach-Bliley Act was passed in 1999.

I should clarify that the Edge Act gives the Board a lot of flexibility in what investments and activities to allow Edge corporations to conduct overseas, and the Board allowed some things abroad that banking organizations were prohibited from doing domestically. There was always this debate about whether the policy should be to allow U.S. banks to do what they can do in the United States, plus a little bit more where it's clearly an integral part of banking overseas versus a sort of, when in Rome, do as the Romans do. If some country allows their banks into real estate development or to own drug stores or whatever, then U.S. banks should also be able to do so in that country. This came up over and over again, and the Board always sided with the "domestic plus" approach.

I have a personal story about Arthur Burns. I'm a messy person. My office always had papers piled around. For a while, I rode a motorcycle, so I had my motorcycle helmet in my office. And I was jogging, so I had my jogging stuff drying on the heating grate. On one very hot day around noon, when I wasn't in my office, Arthur Burns came over to BS&R. Later in the afternoon, Jack Ryan came by my office. He had a sheepish grin on his face, and he said, "It was too hot for Arthur to walk around the block today, so he came to BS&R, and walked around BS&R. He saw your office, and he said to get the damned thing cleaned up." [Laughter] So I may have been one of the few people ever to have a Chairman tell them to get their office cleaned up. I was just glad I wasn't there. There was a rumor going around for a while that Ryan had to hide me until Burns left. But I don't think that was true.

MS. CARTER. What lessons did you learn during the Burns chairmanship?

MR. MARTINSON. There was the point about the Chairman not being in the minority, unless it was really necessary. A lot of times I was chairman of ICERC (Interagency Country Exposure Review Committee). And sometimes I'd vote against the Federal Reserve's preferred outcome, if it was clear we were going to lose the vote anyway.

Another thing I remember involved Burns having to sign a letter during a Board meeting. Chet Feldberg was his assistant then. He brought the letter in. Arthur read it, and he found a typo. He said, "There's a typo. Take it back." So Feldberg took it out and brought it back. Burns started reading it again. Feldberg showed him where the typo had been corrected so Burns wouldn't have to re-read the whole letter. Burns said, "I never sign anything I don't read completely. How do I know you didn't change something else?" So every time I sign a document that I don't read, I think about that. [Laughter]

MR. SMALL. The international supervision and regulation game was very small when you came on board in 1971. There was a story that Burns was one of the first to catch on to the excessive lending by American banks to Latin American countries, and was concerned about that.

MR. MARTINSON. I don't know whether it was Burns who brought it up. It was bubbling up. When did Henry Wallich join the Board? He was one of the early people to worry about the LDC debt finance.

MS. HURT. Governor Wallich came on March 8, 1974.

MR. MARTINSON. Wallich played a big part in trying to rein in that lending. Throughout that whole time, until and after it blew up, he would give warnings about the dangers.

MR. SMALL. The Herstatt bank failure was in 1974. Did that stimulate the Basel Committee on Bank Supervision?

MR. MARTINSON. Fred Dahl was involved in putting together the Basel Committee with some of the people he knew from the Bank of England and elsewhere. Part of it was Herstatt, which involved the Germans closing Herstatt Bank while the New York market was open, so only one side of the foreign exchange contracts that day settled. Also, in 1978, the Board got the International Banking Act passed. That was Fred Dahl working mainly with Governors George Miller and Dewey Daane. That was the first time that the Congress asserted federal regulatory authority over U.S. branches of foreign banks. The Board's interest was driven, I think, mainly by the fact that branches were getting big enough that there were monetary policy implications. There was enough lending going on at the branches that they wanted them under Regulations D and Q. But I didn't work much on that Act.

I have another comment about Chairman Burns. I think that I mentally underestimated what Burns contributed to bank supervision until after we talked to Jack Ryan, former BS&R director. Burns started beefing it up and taking steps to improve things. He brought Jack in out of nowhere. Jack wasn't even an officer when I got there, and he was director within a few years. Then Jack brought in Bill Taylor, who then succeeded Jack and is viewed as one of the best BS&R directors ever. So I think there was a lot of strengthening of supervision going on under Burns.

MS. CARTER. Earlier you said something like Burns didn't care about supervision. What did you mean by that?

MR. MARTINSON. The impression I had was that Burns originally was not a regulator. He was a free market person. Let the markets decide; they don't need the Board secondguessing them. But then, I think he saw that didn't really work. The big banks just started leveraging up.

Chairmanship of G. William Miller

G. William Miller wasn't Chairman very long (March 8, 1978 to August 6, 1979). When he came in, he was a non-smoker. He was ahead of his time. He took all of the ashtrays off the Board table. We had a lot of Governors that smoked then. Wallich puffed away on his cigars. Partee was a chain smoker. And I think there were some other Governors that smoked. So the ashtrays were all gone, and the Governors could no longer smoke at the Board table. This went on for a while. Then I remember going to a Board meeting one day—we went fairly often then—and in walked Henry Wallich carrying his own ashtray. It wasn't very long before other Governors had their ashtrays there too. And in my mind it wasn't much longer after that that Miller was gone. I always called it the "ashtray revolt." I think it was a way the Governors showed that they weren't accepting Miller as the leader. Maybe I'm reading too much into it, but that was my impression because I really felt that it was a revolt. That's my only G. William Miller specific story.

Less Developed Countries (LDCs)

The first oil shock was somewhere around 1973, 1974. There was a need to recycle the petrodollars, and the developed world's big banks—led by the U.S. banks—stepped up because they were looking for business. They started making loans to developing countries. This really hadn't been much of a part of their business before. As this lending grew, the big U.S. banks created the syndicated loan market in London. A lot of them set up "merchant banks" in London, and they syndicated the loans [they made] to foreign countries to other banks. They could pocket the syndication fees on term loans immediately, which bumped up the earnings.

The lead banks would take the biggest shares of the loan and most of the fees, but then would sell smaller parts of the loans to second-tier foreign banks and regional U.S. banks, et cetera. The biggest banks took the lion's share.

A few years later, you had the second oil price shock and the lending ratcheted up even more. Around 1975, concern at the Federal Reserve seemed to surface. The Board put out a special survey to get some better data on the exposures of the banks. I got involved probably in large part because I was considered to be good at designing reports to get international bank supervisory data. The only data the Board had until then were the Treasury international capital forms [TIC System], which recorded what the banks loaned out of their U.S. offices. And IF had set up this 502S report which gave the geographic breakdown of the assets of foreign branches of U.S. banks. That report wasn't very detailed, and it was only marginally useful. But there was enough information to indicate that bank exposures were building up. So we did the special survey, and we saw that some large exposures had already developed.

The other thing going on was that issues related to sovereign lending were starting to come out in the regular bank examination process. The treatment of these loans was very messy. Some individual examiners were starting to special mention or classify loans to countries because they could sense something was wrong. But they weren't very good at identifying the specifics. So you had this hodgepodge of classifications. I remember one examiner who had a pretty strong Libertarian bent. He classified a loan to one country as substandard and a loan to another country as special mention. When I asked about it, he indicated concern about what he viewed as the socialist policies of these governments and how that might affect their ability to roll over their debt.

The examiners would look at the cash flow of the country. Most countries, including the United States, need to refinance a lot of their debt every year. If you look at a country's cash flow basis, it looks kind of messy, even for good countries—the United States has to roll over how many hundreds of billions of dollars in a year. If you compared a loan to a country to what you would expect of a loan to a corporation, it was fairly easy to demonstrate concerns that would warrant at least a special mention rating. But, as I said, individual examiners weren't very good at evaluating country debt and it got to be pretty subjective. Although examiners weren't very good at evaluating country risk, they were sensing something was going wrong and were trying to identify problems through the regular examination process.

The same problems were occurring at the OCC [Office of the Comptroller of the Currency], and the OCC head office became interested in the topic too. The next year, 1976, the OCC did a special, even more detailed survey of the country risk exposures of national banks. The OCC had this form that people called the "horse blanket" because it was wide and about three feet long. It was very detailed but unwieldy. OCC staff called us over to show us the form and the results. We were also interested in getting better data. I went back with Henry Terrell [in the Division of International Finance], and we drafted what is now the Country Exposure Lending Survey. It has had a few changes since then, but it is fundamentally the same. The main thing it added was that it adjusted for guarantees—in and out. So if [a] Citibank loaned to the Brazilian branch of [a] Bank of America, that is initially viewed as a loan to a Brazilian entity because that is where the branch is located, but it was really U.S. risk because Bank of America had to stand behind it. Alternatively, if you had a loan to the New York branch of Banco Nacional de Argentina, it was a U.S. customer, but it was actually Argentine risk. So we set up a form that captured the information needed to make those types of adjustments.

We looked at the OCC's version—the horse blanket. We simplified it, but didn't really give up much information. Then we went back to the OCC, and we got agreement on the Country Exposure Lending Survey form. The FDIC also went along. In those days, in the international area, if the OCC and the Fed agreed, then the FDIC would just come along.

MS. CARTER. Because they didn't have much international exposure?

MR. MARTINSON. They didn't have much. They had a little. I think the form became final at the end of 1977. We put out a preliminary version around June 1977. After that, we had good data on the exposures, and they were already big. By this time, concerns are already on the horizon.

At some point in there, Henry Wallich used to go out and give speeches about the dangers of all this lending and especially the concentrations. Henry Wallich was, to me, the most impressive regular Governor of the Fed, maybe because he did a lot internationally and I had more dealings with him. He wrote some very good speeches. Unlike most Governors, he wrote them himself, and he sent them in draft to the staff for comment. You'd give him your comments—he wanted serious comments—and he would take them into consideration and revise accordingly. At some point he developed this lemming theory of banking, which said bankers are like the Alaskan rodents that go on these periodic mass migrations and end up running themselves into the ocean and drowning.

During the Burns Chairmanship, a lot of banks had set up London offices. They didn't have much business, so they went into the interbank lending market and used it to leverage up enough even at very small spreads to cover expenses and show a profit for the branch. There was a lot of churning that resulted in balance sheets building up as a result of lending to other banks and also borrowing from other banks. That was another piece of the leverage that was going on.

Going back to country risk, the LDC lending business was initially pretty attractive, but by around 1978 or 1979, the spreads were coming down substantially. Near the end, a lot of this LDC debt was done at very small spreads. At one time towards the end, term loans to Brazil got down to like 3/16 over LIBOR (London Interbank Offering Rate). Now, the accounting methodology for fee income was jacking up the total income for the largest banks, but still the business really only worked by increasing leverage. So the supervisory concerns were growing. The counterargument was that countries don't go bankrupt, there's no risk here. Regulators are crazy. Walter Wriston of Citi said that, among other people. Moreover, you couldn't point to any real problems early on.

As I said, the exam process was trying to deal with this lending, but in a very messy fashion. Two schools of thought started to develop. Around 1977, the Board and the New York Fed with Volcker up there was involved. The Fed wanted a new supervisory system that targeted concentrations. That's what we were going to be concerned about, not trying to guess which countries can or cannot repay their debt in full.

The OCC went the other way. It took the evaluation of county loans out of the hands of the individual examiners, and put it in this central committee in Washington composed of head office people and the top OCC international examiners. The OCC wasn't particularly interested in concentrations per se. It wanted to use the regular bank supervision loan categories to identify problem-country debt. Around 1978, the newly established OCC committee "special mentioned" Italy. All the exposures of national banks to Italy were designated special mention. That caused a diplomatic firestorm. Fortuitously, it was about this time that the Fed was ready with its approach targeting concentrations. John Heimann was the Comptroller (1977-1981). The OCC pretty much had to go along; the pressure was just too intense.

So in the end, with some limited compromise, the FRB approach was adopted by all three agencies. The ending compromise involved setting up three categories of countries: *strong*, where we weren't worried about your concentration level; *moderately strong*, where if you got to above 15 percent of capital, then you had to do more analysis about whether the risk was justified; and *weak,* when that analysis should occur if a bank's exposure exceeded 10 percent of capital. For evaluating country risk we did away with the special mention category, which was too fuzzy. While the substandard category (along with doubtful and loss) was retained, partly at the insistence of the OCC for country risk purposes, we said a loan is only substandard if the country has defaulted or default is imminent; imminent was eventually defined as meaning a virtual certainty within 90 days or something like that. So we really curtailed the standard definition of substandard.

In 1979, the agencies set up ICERC to make these decisions.[2] Countries were initially placed in their categories, using screens developed by IF, but then ICERC would review the countries in more detail and could move them. ICERC could also classify credits to countries that met the definitions established. The only ones I can remember being classified early on were a couple of countries, which were complete basket cases, and there wasn't much dispute about that.

[2] The OCC, the FDIC, and the Federal Reserve Board established the Interagency Country Exposure Review Committee (ICERC) to ensure consistent treatment of the transfer risk associated with banks' foreign exposures to both public- and private-sector entities. Transfer risk is the possibility that an asset cannot be serviced in the currency of payment because of a lack of, or restraints on the availability of, needed foreign exchange in the country of the obligor.

By this time, probably all the large banks had loans to Mexico that exceeded 15 percent of their capital; for the biggest banks, it was around 40-50 percent of capital. Most of them also had similar exposures to Brazil and many had more than 15 percent to Argentina. There was a lot of concern, but IF was still arguing that the countries were diversified, so they wouldn't all default at the same time. In other words, Brazil didn't have oil, Mexico did. If oil rose, Mexico would be fine. Brazil would be hurt, but they wouldn't both get into trouble at the same time.

Now, despite the new program, concentrations and concerns continued to grow. A few months before the collapse, which started in the second half of 1982, staff wrote a memo to the Board discussing the exposures. By this time, bank loan exposures to countries that eventually had debt servicing problems already averaged 200 percent of capital or so for the major money center banks. For example, Citi had a high exposure to Brazil alone. I reread that memo before I retired. While it laid out the potential for a major problem, it underplayed things quite a bit. The memo argued that the real danger was that countries won't pay the interest so bank earnings would take a hit. However, it was still the view that principal would eventually be repaid in full. Under the assumed scenario, no individual country would cause a solvency problem for banks. The memo did note that, if countries defaulted en masse, there would be a major problem. However, it was still thought it unlikely that the borrowing countries would all have problems at once.

Concentrations had risen even though we had been doing examinations since 1979 under the new policy and dutifully listing the concentrations in the exam report. It wasn't making any impact. I don't think the examiners, let alone the banks, really bought in. I remember somebody at the New York Fed telling me that some senior banker from Manny Hanny (Manufacturers Hanover Corporation) had called him up and said, "Your examiners are confusing our directors by calling attention in our exam report to all the concentrations we have to these countries." So this was a case where risks were highlighted in the examination report, but nobody had hard evidence of problems, so no serious actions were taken. The prevailing wisdom was still that countries don't go broke.

MR. SMALL. You mentioned a phone call from Manny Hanny to the New York Fed.

MR. MARTINSON. Yes, someone in bank supervision.

MR. SMALL. Was such a call proper protocol? Could one call their examiner whenever they wanted?

MR. MARTINSON. I said call, but it could've been when they presented the exam findings, but I don't think it was in front of the full board of Manny Hanny. When the exam report came out, if people had questions or comments, they would call.

MR. SMALL. But if the bank was really upset about what an examiner was doing, what was the venue for the bank?

MR. MARTINSON. They could talk to the head of the Reserve Bank. There is also a formal appeals process.

MR. SMALL. Or they could call the examiner.

MR. MARTINSON. Well, this was a head office person that supervised international exams at the New York Fed.

MR. SMALL. Have you ever heard of concerns of a bank saying that you were being too tough on the bank, that they would go to Capitol Hill or call their Senator?

MR. MARTINSON. I think that has happened. But I don't remember any cases where I was involved. Also, usually when there are complaints, they don't get much in the way of results. By that point, there is usually a lot of evidence indicating problems. But there can be pressure on examiners that comes down from the top, even maybe through the [Reserve Bank] presidents. It's something you have to live with.

So then the crisis occurred, and countries started to fold—Argentina, Mexico. I think this was around 1982. Generally, they couldn't meet the principal payments on the debt coming due. They could pay the interest, but if a debt was coming due, they couldn't make the principal payments. They needed to roll over the debt or refinance. Initially, in Argentina's case, there was a short-term debt problem. A lot of it was centered in the New York branch, where an Argentine bank had borrowed short-term money. So it was a liquidity crisis. That was Volcker's position at the start, and that was his position throughout the whole process, at least as far as I know. His view was that we don't have a solvency problem, we have a liquidity problem, and we should deal with it as such. These countries will be able to pay, they just need time, and we shouldn't overreact.

In bank supervision terms, default occurs if you can't pay either interest or a maturing principal payment. If a bank is forced to roll [over] a matured customer loan, that is viewed as a default event. The [Reserve] Bank may give a waiver, but the non-payment would meet the definition for imposing a substandard classification under the supervision system the agencies had adopted.

MS. CARTER. Were these largely syndicated loans, where there were lots of banks exposed because they had pieces of these loans or debt?

MR. MARTINSON. They were syndicated. The regional banks had some but not much. The bulk of the exposure was in the world's largest banks. At this time (as we later documented in a congressional report) the nine largest U.S. banks, on average, had 250 percent of their capital exposed to countries that couldn't pay; so these banks were broke, if you marked the debt to market. In fact, there was no market, but the banks years later eventually settled at 60 to 70 cents on the dollar. At the start of the crisis, the debt was probably worth no more than 20 to 40 cents. But there was no market, so the issue of mark-to-market never gained traction.

From a Fed perspective, we had an immediate problem with the existing supervisory definitions because, technically, you could make a sound argument that these loans now met the definition of substandard and should be classified. Volcker did not want them classified because that would make it very hard for banks to extend new credit. So he was adamant that we not classify these loans. ICERC was composed of three people from each agency: one each from the head office, and two field examiners from each agency. There were nine votes; a majority won five to four. As I remember originally, there was some willingness of the ICERC members from all three agencies to give the countries the benefit of the doubt, but it quickly became apparent that we had to get the classifications changed. Jack Ryan asked me to come up with new definitions. So we came up with OTRP (Other Transfer Risk Problem), which was a new category, and some other changes. OTRP credits were not considered classified or criticized; OTRP was its own thing.

MS. CARTER. You changed the terminology.

MR. MARTINSON. Well, we had to go to the OCC and get its agreement. Substandard—we changed to make it almost impossible to use. So OTRP occurred if a country couldn’t pay principal but was working to get better. It was working with the banks, working with the IMF, and taking adjustment measures so that it would be able to resume full payment—that originally was substandard, now it’s OTRP. To be substandard, you had to be in default and not doing much about it. Substandard after that was very seldom used, and then only as a short-term way station to value-impaired. We got rid of “doubtful,” and we substituted a category called "value-impaired." That was the category a country moved to when it stopped paying interest on its debt. If a country went six months without paying interest, that was the reason to put the loans in "value-impaired." We kept the "loss" category at that point in time. So the OCC agreed with the changes, and then the FDIC went along too. I remember meeting with senior OCC officials. We'd originally proposed getting rid of substandard too, but they wouldn't stand for that. So this system got implemented, and all these countries initially went into OTRP in short order.

MS. CARTER. How often did this committee meet?

MR. MARTINSON. At that time, we met in Washington three times a year. The chairmanship rotated among agencies, I think, every year. But we had a rule that a rookie couldn't be chairman. A lot of the other agencies were moving their international people around, so I was chairman more than I should've been, but the chairman didn't have a lot of power. We had a lot of five to four votes on these countries. Generally, the Fed position prevailed and we kept the countries in OTRP for most of the time, at least until they stopped paying interest.

We used to joke at ICERC that we were a collection agency. The banks knew what countries were going to be on the agenda because we sent them a list of countries we wanted to talk to them about before our next meeting. We interviewed the banks to get their views on the countries and to get details on exposures of various banks (although at the beginning usually the country exposure data was better than the internal exposure data of the banks). Since the banks knew what countries were going to be on the agenda, the countries also knew. So just before a meeting, there'd be this whole flurry of rescheduling activity. Countries would all of a sudden take actions needed to get IMF agreements and the banks would come up with agreements to reschedule. An ICERC meeting was sort of a catalyst to prompt behavioral change because the banks and the countries knew, if nothing was going on, the loans would move into a classified category, and then it would be sort of the end of the story.

MR. SMALL. I think I understand from this OTRP how it would impact the Latin American country because it wasn't called a default. But what was the importance of that category for the domestic banks?

MR. MARTINSON. That was the beauty of it; it had no impact.

MR. SMALL. But if it hadn't come into effect—

MR. MARTINSON. Then the loans would have been substandard. They would have all been four- and five-rated banks.

MS. CARTER. I assume the other advantage of this was examiners had a guide.

MR. MARTINSON. They didn't have any choice. ICERC had sole responsibility for the rating applied to country risk exposure in the examination process.

MS. CARTER. But there were specific definitions—for example, categorizing exposure to Argentina—so there was consistency in it.

MR. MARTINSON. Right. We took it completely out of their hands. There was consistency. OTRP didn't go into the classified numbers. It didn't go into the numbers that rated asset quality; it was just separate.

MR. SMALL. So there was a concern not only about whether the old classification caused Latin American countries to go under, there was also concern about the stability of the U.S. domestic banking system, whether it would go under.

MR. MARTINSON. Right. They would have all been four- and five-rated banks, the nine largest, because they all had huge exposure. And if they had to write it down, they would've been broke.

MS. CARTER. Were they aware that they had a problem that needed to be dealt with?

MR. MARTINSON. The big banks knew they had a big work-out problem—that's why in these reschedulings there was a lot of pressure for people to go along. The big banks put pressure on the little banks to stay in there and reschedule and even put in new money. Reserve Bank presidents sometimes would call regional banks that were recalcitrant, urging for the better good that they go along with the process. For some of the banks with tiny exposures, sometimes a bigger bank would swap a bad domestic loan for some of the OTRP loans. But basically, there was a lot of pressure to stay. If you were in, you were in.

In these reschedulings, the banks would provide some new money that helped the country meet the interest payments. Generally, there also was an IMF program that put in some more money that would help the countries keep up the interest payments. Then the country had to dip a little bit into its own coffers to pay interest. The beauty of this system was that, over time, the exposures didn't really rise much. And to the extent they did increase, the exposures grew much less than bank capital. Bank capital was still growing because banks were still taking in the interest income from the LDC loans, and they had profits from their domestic operations. As I said earlier, the big banks at this point were really broke, but that didn't stop them from making domestic loans. They were all growing their domestic business in the hopes that they could grow out of the problem. The key was that problem-country exposures were growing less rapidly than bank capital, so that over time the exposures fell relative to capital. That's what made it succeed. And that's why, when forbearance became a four-letter word, for me it wasn't because, if done correctly, forbearance can work. But there has to be a plan that diminishes the exposure relative to capital over time.

In 1983, the Congress passed ILSA, the International Lending Supervision Act.[3] The Act didn't do a lot, but the law required that, when a country essentially got into value-impaired [status], the bank had to start writing down its loans to the country. ICERC would set the level of the write-down. The bank could either charge it off, or could set up a special reserve that was deducted from capital. So now, if something got into value-impaired, it started impacting regulatory capital. Also, for the first time, ILSA gave the regulatory agencies statutory authority to impose capital requirements. This was part of the effort to build capital using the primary capital standard and others. Even before the LDC debt problem, capital ratios had been eroding and people had been worried about it. Part of that was inflation. Governor Henry Wallich used to write some pieces that showed how bad an impact inflation had on bank capital because a bank's nominal assets and liabilities were expanding faster than its earnings. So capital ratios fell, even if a bank didn't grow in real terms.

Eventually, some of the countries did go into value-impaired. Generally, we managed the supervisory process through ICERC; there wasn't much political intervention. Chairman Volcker was reluctant to intervene. I remember only one case where he had to intervene. The country was in pretty sad shape, but Volcker didn't it want to go into value-impaired yet. We had a meeting in his office and I said, "We only have three votes, and I don't know whether the others will go along." Volcker replied, "You're the chairman of ICERC. You should be able to get the vote. But if you can't, we can find somebody else." [Laughter]

---

[3] The Act requires creation of special reserves against bank assets impaired by protracted inability of foreign public or private borrowers to meet their payments; amortization of fees received on restructured loans, to be spread over the loans lifetimes, instead of being taken into income immediately; collection and disclosure to the public of large concentrations of credit by country, for individual institutions; imposition of capital adequacy standards, based in part on country economic and currency risks; and evaluation of the economic feasibility of certain foreign resource loans.

We didn't get the vote. So the next morning, Ted Truman [Staff Director, Division of International Finance] came in to brief the ICERC people and make the case for not putting this country in value-impaired. This was not a good strategy because Ted was very authoritarian in a way. And most examiners, if they feel they're being pushed, they push back hard. That's just the reaction I see in most of them. Good examiners get pushed by the banks all the time and they react back; so it didn't work, and we lost the vote again. I was called into Volcker's office the night after the meeting. Then some calls were made to [the] Treasury, and [the] Treasury must've called the OCC. An agreement was made to have ICERC re-vote to defer implementing its decision for six months, or three months, or something like that.

MS. CARTER. At the time, there were a lot of press reports about Volcker either making speeches or, in one news account, meeting with creditors concerning the debt problems. Do you have any specific recollections?

MR. MARTINSON. There were two efforts. I was pretty much in the ICERC effort, and also in monitoring the size of the exposures. We used to run exposure levels all the time showing this is what happens if you start to require a 10 percent reserve, a 20 percent reserve, and send them over to Volcker. The numbers never looked very good, but we were always trying to push him to take some action on reserves. However, he was adamant—"No." Then there was a whole other aspect to resolving the crisis. IF and the New York Fed were trying to make sure the loan renegotiations went smoothly and that the countries were cooperating. Sam Cross was involved; Terry Checki, Ted Truman, and Charles Seigman handled that end, so I didn't see the gory details of what was going on. My goal was not to have to see Volcker because a decision went against us. [Laughter]

MS. HURT. It seems that a lot of those matters were taken directly to the Chairman, as opposed to going through a committee that usually has a Governor as chair.

MR. MARTINSON. All the LDC stuff went directly to Volcker. It didn't go to the Board unless he wanted something like a periodic update for the Board. At that time, although I was in BS&R, a lot of times I thought I was working for Michael Bradfield [the General Counsel] and Ted Truman.

MS. HURT. Who was the chair of the Banking and Supervision committee at the time?

MR. MARTINSON. I don't remember. Like I said, all the LDC stuff went through Volcker.

MS. HURT. Was this in the late 1970s?

MR. MARTINSON. This was early 1982, just before the crisis hit, where we talked about the big exposures. That went through [Governor] Partee's committee.

MS. CARTER. So it sounds like the committee probably was more focused on domestic issues?

MR. MARTINSON. Yes, the country debt problem got its own treatment. And, in a way, it didn't register with the domestic examiners. I was completely amazed that this big a problem didn't get much recognition outside of the people involved.

MS. CARTER. You were very specialized in international.

MR. MARTINSON. Years later, after the crisis was over, we still had ICERC meetings. At one meeting, one of the new members, a senior OCC examiner, said, "OTRP is really substandard." And I said, "Yes." [Laughter] I'm still amazed that Volcker pulled the banking system through the crises. I think it was because he had a view of how to proceed long term. He didn't deviate from that view and it worked. By 1987, the banks had enough money that they could start setting up big LDC debt reserves. Then a few years later, they did the Brady bonds and the crisis was over.

MS. CARTER. Did they set those reserves up because they were told to do so?

MR. MARTINSON. No, they did it on their own. They were healthy, and they started competing. One of the healthiest banks at this point would say, "I can reserve against my LDC debt. I'll put up 20 percent." So the next bank would say, "I'll one up you. I can go to 30 percent." And the reserves just started to build. With inflation falling, the banks were making all kinds of money because they make money in falling-rate environments.

MR. SMALL. Did a lot of this go under the term "forbearance?"

MR. MARTINSON. No, it wasn't called that at the time, but it would fit the definition now.

MR. SMALL. People criticized that from the perspective of moral hazard saying that the IMF or whoever came in and bailed out the banks. To what extent did banks take hits on this?

MR. MARTINSON. The banks didn't take any hit until 1987, when they started putting up the reserves, and then later they did the Brady bonds. They rescheduled at a discount, and I think they took around a 30–40 percent haircut in real terms.

MS. CARTER. What are the Brady bonds?

MR. MARTINSON. Treasury thought up this program. You could switch the LDC debt that you had to a country into a long-term bond. The principal of the bond was backed by zero-coupon U.S. Treasuries. For accounting purposes, your principal was assured, so now it was a good loan. In return for doing that, there were a couple of different options. You could reschedule at par with a below-market interest rate or reschedule with a lower principal. By this time, banks had sufficient reserves so they were in good shape.

I don't think the term "forbearance" was used at the time. That term seemed to come in a little later in reference to the savings and loan problem.

The other crisis I worked on a little bit was the agricultural (Ag) lending crisis. There the Congress mandated forbearance. That worked because, like the LDC debt problem, you got the banks to reschedule. Plus the borrowers got help—in the international case, from the IMF and, in the farmer's case, the farm payments from the government went up. Even though these little Ag banks had huge amounts of problem loans, when you looked at their income statements, except for the provisions, which were a one-time earnings hit, they were still cash-flow positive. Their interest income still exceeded the interest they had to pay out on deposits and their operating expenses. So the problem got smaller over time. So, while there were some failures, it mostly worked out.

During the Ag crisis, Hawkeye Bancorp was a holding company that was buying up a bunch of small Iowa banks. Just prior to the problem, it made the statement in its annual report that said something like, "In 20 years we have never lost a dollar lending to Iowa farmers." A few years later the holding company failed. I have often used that example over the years when someone said certain lending wasn't risky.

The Ag problem was around 1982, 1983. During the winter, I took this Administration-sponsored trip to soothe the farmers in North Platte, Ogallala, and Lincoln, Nebraska; Creston and Des Moines, Iowa; and St. Joseph, Missouri. On our way to St. Joe, I remember fish-tailing in a snowstorm in a light plane down the Des Moines runway. [Laughter]

MS. HURT. Why were you there?

MR. MARTINSON. Because John Ryan had put me in charge of the Fed's supervisory effort on the Ag lending problem. And maybe in part, because I was from the Midwest, and I owned a small farm in Missouri. And maybe he knew I was experienced with forbearance.

MS. CARTER. Were you listening to speeches? Were you part of a panel? Were these town hall meetings?

MR. MARTINSON. Yes, they were like town hall meetings. I think there was a panel, but I don't remember much about it.

When Alan Greenspan became the Fed Chairman in 1987, the LDC debt problems wasn't over, but it was in its mop-up phase. Greenspan did not appear as interested in it as Volcker, maybe because the crisis had passed. But Greenspan was very effective when he needed to be. When Greenspan first came in, we were about to have an ICERC meeting. Bill Taylor said, "We have to go over and brief the Chairman." So we went to Greenspan's office, and he was getting ready to go play tennis. We get started, and Greenspan said, "I've got to go change." He walked into the bathroom, and Taylor said to me, "Keep talking, he's listening." So I kept talking while Greenspan was in the bathroom changing, but it became apparent to me that he wasn't interested in this.

Shortly thereafter, we had another vote at ICERC that went against us. I think the OCC wanted to make it value-impaired, and we wanted to keep it at OTRP. The OCC won the vote so I called back and told Truman or whomever. They talked to Greenspan, but we didn't have a meeting, we didn't have a crisis thing. However, the next morning, the OCC members came into the ICERC meeting and said, "We have to break at 10 o'clock because we're having a meeting with the Acting Comptroller." They went to the meeting, and when they came back, they changed their votes. Greenspan had taken care of it. He didn't seem interested, but when he needed to be he was effective. I'm sure Ted Truman and Mike Bradfield talked to him and he agreed it was important. So he called, and he got results. There wasn't a lot of hand wringing. I didn't have to go over and sit in a meeting. He just took care of it.

In 1994, there was the Mexican peso crisis or the Tequila crisis, and, in 1997, there was the Asian crisis, but they didn't really pose a solvency danger to U.S. banks. They weren't big events for U.S. banks from a safety and soundness perspective. By this time, the Latin American exposures were way down, and they didn't have much Asian exposure. All that happened in the Asia crisis was that some of them had earnings hits, in particular from trading activities. The 1997 Asian crisis wiped out a quarter's earnings or impaired earnings for a quarter or two at a couple of big banks. To me, it was a wakeup call to see how narrow the business at these big New York banks had become, that the hit to the trading income could really almost do away with their earnings.

MR. SMALL. Going back a moment—the Bush Task Group on the Regulation of Financial Services was formed in 1982 to make recommendations to simplify the regulatory structures of the financial services industry. The task group consisted of the heads of the federal regulatory agencies, the SEC, the Attorney General, the director of OMB, and others. Were you much involved with the Vice President's task group?

MR. MARTINSON. I was involved in most of those proposals. One of the arguments was that the Board needed supervision over banks with international business, so I always used to go run the numbers to show which banks had significant international business. It didn't take a lot to say they were really in international.

Wells Fargo had virtually no international business, but it was a big bank, and they wanted it included in the banks that the Fed should supervise. Bill Taylor said, "Why can't you give me Wells Fargo?" [Laughter] I said, "They don't have any international business." And he said, "Well, I'll get somebody else." And I said, "Go ahead, the numbers aren't going to change." [Laughter]. Fortunately, he then called Virgil Mattingly, the Board's general counsel, who said, "Wells Fargo is big in the payment system, so we'll use that as another criteria." That pacified Bill Taylor.

I went to all of those meetings where people agonized. International was always a big reason why the Board needed to keep the big banking organizations.

Chairman Alan Greenspan

MR. MARTINSON. By the Greenspan era, the mega life-threatening crises for the banking system were pretty much resolved. There were no events that almost brought the banking system down, like during the Volcker period. We were pretty much in the repair stage, although we had the scare of the real estate problem with the big banks.

MS. CARTER. In the 1980s, you had all the major—

MR. MARTINSON. Right. We had that scare.

MS. CARTER. But not in the international area.

MR. MARTINSON. Not international, and some of those other problems maybe weren't as bad as they seemed at the time, in my view. We did have a lot of little problems.

MS. CARTER. Do you think they were not as bad at the time because of what had been put in place, like ICERC?

MR. MARTINSON. The timing worked out because the LDC debt problem was resolved by the time the largest banks got into the real estate problem. The international earnings were clicking back in, and I think that helped some of the biggest banks take care of the real estate problems, although they were pretty weak. But then we also started doing those big in-market mergers, which is what really saved Manny Hanny and Chemical [Bank].

MS. CARTER. When you say in-market, you mean big banks that were in the same market?

MR. MARTINSON. In the same market. Manufacturers Hanover and Chemical Bank merged; they took out all kinds of costs, and it was a huge benefit.

Banca Nazionale del Lavoro

So we had a lot of little problems, rogue bankers. The first one was BNL Atlanta, the Atlanta branch of Banca Nazionale del Lavoro, an Italian banking firm. In late summer 1989, we got a call from the Atlanta Fed. This wasn't public for a long time, but now it is. Two female employees of the branch had come in. They ran the funding. They said the branch had loaned about $1 billion to Iraq off-the-books and funded it in the interbank market. We thought that this couldn't be right; they must have misplaced some decimals.

It became apparent we had to deal with it. Somebody had to go to Italy to tell the Italians about the problem and make sure they provided the liquidity to Lavoro, or make sure Lavoro had liquidity. And somebody had to go to Atlanta to go in on the exam/raid. William "Bill" Ryback was in charge. Ryback went to Rome with someone from the New York Fed, Jerry Corrigan, I think. And in August, I went to Atlanta.

On a Friday evening, right about closing time, two FBI women knocked on the branch door to get in and, once in, they immediately secured the doors and told the employees the FBI was coming. I think there were 13 FBI agents, maybe 11 Atlanta supervisors, and me.

The branch offices were a floor or two part way up in some office building. I think there were only 11 people at the branch. The two top people we knew were off some place. The branch manager, Christopher Drogoul, I think was in Europe. Von Weidel, the other main lending officer, wasn't there either.

My job was to interview the operations person who was the senior branch officer present, a woman that everybody described as a real terror. This 6'2" FBI agent and I go into her office. He sits down and crosses his legs. And I'm sitting there. The woman is about the size of my 4'11" mother, and probably around 60 years old. She starts out denying everything, but we had plenty of information from the informants. So I kept pressing and said, "The auditors from Italy are coming over here and they will want cooperation. They're going to find out the real answer, and it would be better than not if you cooperate." Finally, she agreed to cooperate. She had the employees print out all the real records. There were two sets of accounts. One was the official books that the branch reported to us and the head office. Another was a shadow set of books that had all the Iraq lending along with the associated borrowings. So she got everybody running reports. It seemed to take hours but, by the end, we had a complete record of all of the shadow books and the operations.

We already knew about the funding. The funding came from the interbank market because all the world's banks were willing to lend money in the interbank market to Lavoro, which was owned by the Italian Treasury. The woman who ran funding would use blue ink, if it was for the regular books, and red ink for the shadow books. Anyway, we ran reports of all this data. Meanwhile, the examiners were interviewing everybody else and going through Drogoul's office.

The next day, Saturday, we started reading through the documentation to find out what we could about the loans. We thought it was about $1 billion; $1.1 billion is what Iraq owed. Bill Estes and I kept reading various telexes. We kept seeing these references to something called MTL4, which is Medium Term Loan 4. We eventually found some scrap of paper that showed Drogoul had committed to lend another $1 billion to Iraq. So now it was up to $2 billion.

The FBI agents were very calm. I don't think the agent in my meeting said anything when I was interviewing the woman. The only time Estes and I saw them get worked up was Saturday morning. They were taking all of the documents to Kinkos to copy them. It's amazing how much paperwork a bank generates. The copying at Kinkos was going very slowly, and people were starting to get upset, so Estes agreed to truck a lot of the records down to the Reserve Bank and have all the massive documents copied there.

These branch officials were documenting every single loan because they believed, at least when it started out, that Iraq was a good credit. At the end of the day, Iraq would pay off, the bank will see how stupid it would have been not to let the Atlanta branch make loans to Iraq, and the branch officials would be rewarded.

By Sunday afternoon, auditors from Banca Nazionale de Lavoro, Italy were there. We'd also gone into the New York branch, which wasn't involved. We told them that, by Monday morning, this is going to get out, and the New York branch would need to have a lot of liquidity. The head office in Italy put a ton of liquidity into the New York branch, and so, by Monday morning, the next business day, the branch was a huge seller of federal funds. They weren't buying. They didn't have to go into the market. The idea was to show strength, to show that they had money, that they didn't have to buy money, they wanted to be selling. So there was never any real run on Lavoro, I think, in part, because it was owned by the state of Italy.

A common theme in these various trading scandals was that it always appeared that the perpetrators should've been caught at some point early on, but they weren't. Chris Drogoul didn't have much other business, so he pretended that he made some non-Iraqi loans to justify the branch's continued existence. He pretended that he had bought parts of SNC credits because he knew examiners never looked at SNC credits (because they had already been reviewed through the Shared National Credit Program). To show a profit, so that Italy wouldn't close the branch, he would take some of the money he was getting from Iraq and show it on his books as income from these fictitious loans. They were threatening to close him down because he didn't have enough business. Drogoul made one of these fictitious loans to some Swiss bank. The branch's auditors sent out a confirmation request on the loan to the Swiss bank indicating that the Swiss bank has a loan with BNL Atlanta and the amount. Instead of notifying the auditors that the loan didn't exist, the Swiss bank employee sent it directly back to Drogoul, who he knew, asking him in a little note what the confirmation request was about. So the auditors did the right thing. Drogoul should have been caught, but he didn't get caught because the confirmation didn't go back to the auditors like it was supposed to.

After the raid, we set up a system so that all the incoming mail for BNL Atlanta had to be sent to a mailbox controlled by the Atlanta Fed. The Atlanta Fed reviewed everything before passing it on to the branch.

MR. SMALL. So this was just the Atlanta branch of this Italian bank going rogue. It wasn't in concert with the home bank?

MR. MARTINSON. Right. As far as I know, the home bank did not know about it. In fact, when the head auditor for the bank came in for the meeting on Sunday, Walter Zunick from the New York Fed had also come down to attend the meeting. Walter speaks Italian, as well as a lot of other languages. While we were describing all the lending, he heard the BNL auditor say in Italian something about a piece of Drogoul's anatomy should be cut off. [Laughter] That guy was not happy.

MR. SMALL. What happened to Drogoul?

MR. MARTINSON. Drogoul went to federal prison for about three years. When he got out, he went back to France or maybe Algeria, but he didn't live very long. I think he only lived another two or three years; he wasn't that old.

There was always a lot of mystery around this scandal about whether there was more than appeared. A lot of the lending was letter credit stuff, in addition to the term loans. There was a lot of documentation showing the trade items being financed. I thought a lot of the stuff being financed could've been what you might call, dual-use equipment. One transaction I remember was for three-inch steel plates, and there was another letter of credit for exporting a lot of centrifuges. And there were ones for the big Mack truck bodies that the long cement mixers sit on but not for the mixers. So maybe those things could've been used to haul scuds. Henry Gonzalez's [Chairman of the House Banking Committee] staff did start nosing around into how all of this could have been going on without triggering other warning bells, but nothing ever came of that.

MS. CARTER. Back then, were there sanctions against Iraq?

MR. MARTINSON. No. There were no sanctions. You could lend to Iraq. In fact, a lot of the early credits were partially guaranteed by the U.S. Department of Agriculture's Commodity Credit Corporation program. There were a number of loans made with that guarantee. They were like 97 percent guaranteed. They were not particularly risky. But BNL had a policy against lending to Iraq. Drogoul did not have authority to lend to Iraq, so he had to do it all off the books.

MS. CARTER. So it was a corporate restriction.

MR. MARTINSON. Some people thought maybe this was a vehicle where people were helping to build up Saddam at that time because of the war with Iran.

MS. CARTER. There were charges directed toward the Bush Administration.

MR. MARTINSON. That's what Henry Gonzalez's people were wondering about, but they never got anywhere with that. There was a lot of stuff that made you wonder how nobody could have known about the equipment being financed. After the raid, about a year or so, Gonzalez had a hearing. Drogoul was brought in from federal prison to testify in Washington.

MS. HURT. Henry Gonzalez was the chair of the House Banking Committee at the time.

MR. MARTINSON. I don't remember much about the hearing except for one thing. It was probably tongue in cheek, but Gonzales went on, "Oh, Mr. Drogoul, it's so nice to see you here. We're glad you could take the time to come testify." [Laughter] It went on for quite a while. Later that afternoon, I went to another committee meeting. I don't remember what the topic was, but Governor LaWare was there to testify and he was treated like he was a criminal. It wasn't Gonzalez, it was some other congressman and a totally different subject, but I thought about the disparity in treatment. The congressman just lit into Governor LaWare. LaWare really did a lot of yeoman work for the Board because he was sent up there to testify on a lot of issues, and to take a lot of heat.

MS. HURT. Governor LaWare chaired the Board's Banking Supervision Oversight Committee.

MS. CARTER. And, I think at the time, he was one of a few Governors that had a banking background.

MR. MARTINSON. Yes. He'd been the chairman of Shawmut [Bank], so he had a banking background.

MS. CARTER. So there had been a lot of bank problems.

BCCI (The Bank of Credit and Commerce International)

MR. MARTINSON. BCCI had a spectacular failure in 1991. Bill Ryback dealt with BCCI more than I did.[4] During the summer of 1988, Bill called me into his office. He said he'd gotten notice that there was going to be a sting operation against BCCI in Florida. He was going to be gone over the weekend, but he wanted me to come in [on] Sunday to call his contact and see if it actually took place. So I did. It had taken place and it soon got a lot of press.

We started looking at BCCI's U.S. operations. It had branches in New York, Florida, and maybe California and Chicago. We saw that the U.S. offices were in a net due from position vis-à-vis BCCI—that means BCCI had raised deposits here and sent the money to other BCCI offices overseas. So to repay the depositors, they had to get the money back. It was about $600 million, as I recall. We were worried about the impact of the sting on BCCI's liquidity, and the repercussions for its U.S. branches. We looked at BCCI's published balance sheet. BCCI seemed to be gurgling with liquidity, all kinds of interbank deposits, Treasuries, but for some reason, we weren't satisfied with that. So between us, Bill and I made phone calls to the bank supervisory authorities in three places—Hong Kong, the Caymans, and London—because that's where BCCI's biggest operations were. We asked whether BCCI was liquid in their jurisdictions. The answer was always, "No, all the liquidity is in Central Treasury in Abu

[4] BCCI was a major international bank founded in 1972 by Agha Hasan Abedi, a Pakistani financier. The bank was registered in Luxembourg with head offices in Karachi and London. Within a decade it became the seventh largest private bank in the world by assets, with assets in excess of $20 billion; it operated in over 70 countries and had over 400 branches. Subsequent investigations revealed that BCCI was involved in massive money laundering and other financial crimes. In 1991, bank regulators liquidated the bank and forced it to close.

Dhabi." Bill Ryback and I didn't like that. We talked to Bill Taylor. He didn't care much for BCCI anyway.

We called BCCI in for a meeting. In the room, there were two BCCI people, Bill Ryback, Bill Taylor, and me. Bill Ryback and I said that BCCI couldn't operate its U.S. branches in a net due from position, we couldn't rely on money in Abu Dhabi, and we wanted BCCI to get to at least neutral and repay what it owed the branches here. We said that we were going to put their U.S. operations under weekly reporting, and we wanted to see this due from position come right down. Taylor sat there looking mean, and he nodded. So they agreed to do that. There were no lawyers, no supervisory letters, no nothing. We just told them and they did it.

We put BCCI under reporting, and the exposure came down to pretty much zero almost immediately. We kept that reporting on until they failed. Even though, I must admit, after a while, I never looked at it much anymore. Periodically, I'd get calls from the New York Fed asking whether we really needed to get these reports, and I'd say, "Let me think about it." Luckily we never took it off. Because of those actions, and because BCCI eventually was run out of Florida—it closed the Florida offices where most of the deposits were—U.S. branches were in a net due to position by the time BCCI failed in 1991. In other words, our branches had about $300 million of BCCI's money. That gave a huge cushion to pay U.S. depositors who never lost a dime.

Regarding the failure, the main thing was that the authorities in Luxemburg were supposed to wait until the end of the business day in New York to close BCCI in Luxemburg. That would have been about 9:00 at night local time, but the Luxemburg judge wouldn't do that so they closed BCCI while New York was still open.

The main holding company for BCCI was in Luxemburg. It owned most of the bank subsidiaries with offices all over the world. So when Luxembourg acted, we sent our examiners, who were poised already, into all the U.S. correspondent banks of BCCI, as well as to the branch of BCCI in New York. We captured a lot of money in transit. Money had come into New York from BCCI to pay out later in the day to other BCCI offices in Canada, or Asia, or wherever. Under New York law, these were seized. The United States got about another $300 million that way. So at the end of the day, while depositors all over the world lost money, all the U.S. depositors got paid. We fined BCCI a huge amount, and ultimately we repatriated other money back to the central liquidation. I think that was all made possible because of that call back in 1988, when we said we didn't trust BCCI, and it shouldn't be exporting money from its U.S. offices.

The BNL and BCCI scandals later led to the enactment of FBSEA, the Foreign Bank Supervision Enhancement Act of 1991, which beefed up the Board's supervision authority over foreign banks. When that law passed, the Fed developed the SOSA (Source of Strength Assessment) rating as part of the basic supervisory program for U.S. branches of foreign banks. We said that unless we were sure a bank is sound, its branches should not be sending money abroad. Initially, we rated foreign banks A, B, C, or D. If we weren't certain a bank was strong (rated A or B), it couldn't be in a net due from position—it had to be at least neutral. That was one reason we didn't have a problem when the Asian crisis occurred.

If we had specific doubts about a bank, we wanted it under asset maintenance, which means it had to have a positive net due to position here. In other words, the branch effectively had to have capital. But if a bank was say, [a] Barclays or somebody equivalent, and we trusted the bank, then it could do whatever it wanted. So, in the case of BCCI, we were fortunate due to a sort of one-off action that we later built into the supervisory system.

MS. HURT. When you said that Bill Taylor didn't like BCCI, you meant that back in 1988, he had concerns about its operations.

MR. MARTINSON. BCCI was always a question mark in a lot of people's minds about what it was and how reliable it was. When BCCI first started, Bank of America had a 25 percent interest in the Luxemburg holding company. Fred Dahl, who never seemed to dislike any bank, didn't like BCCI, and eventually Bank of America got rid of that ownership piece. But some people just had a gut feeling about BCCI.

MS. CARTER. Wasn't there some BCCI ownership questions connected to an application involving First American Bank?

MR. MARTINSON. A lot of people thought that BCCI was behind the First American acquisition, but they couldn't prove it. They were not all that happy about Clark Clifford—then chairman of First American and a well-known attorney and famous adviser to Presidents—coming in and getting the application rammed through. But that was a period where there was a lot of interest in attracting Arab money, Middle Eastern money. There were also some joint ventures set up in New York. There was a whole panoply of things like that.

I don't remember much about the BCCI closure other than that Taylor set up his war room. We all had phones and we had these charts to report information, but you really couldn't do much at that point. The chips were going to fall where they fell, and if we hadn't done something earlier, we'd have been holding the bag like everybody else.

I remember some U.S. corporation calling. It had money in BCCI in Nigeria. The guy said, "We have money in these U.S. banks that the FDIC closes all the time, but all that means is we get an account in a new bank on Monday morning. I take it that it's not going to be like this." I said, "No, it's not." [Laughter]

I also remember an incident concerning Visa traveler's checks. Various banks were VISA members. They issued the checks and they had the issuing bank's logo on them, Riggs [Bank] or whoever. If you looked closely, there was a payee bank named on the traveler's check—payable by whoever—because when, for example, Riggs collected the money and issued the traveler's check, it sent the money to the payee bank who was then responsible for funding the payments when the traveler's check was redeemed. BCCI was the paying agent for all the Visa traveler's checks issued in the Middle East, and they were payable through Bank of New York, using an account that BCCI had there, which of course got wiped out. We had copies of all these traveler's checks issued by Middle East banks, like Bank of Egypt, payable by BCCI, payable through Bank of New York, but there was no money. Visa hemmed and hawed for a while, but then it decided eventually that it had to make good to save its reputation. I think it cost VISA something like $80 million. That's one of the things you would never expect.

Hedge Funds

MR. MARTINSON. My first involvement with hedge funds was in 1994. In the first half of 1994, the Board took some actions which caused short-term interest rates to spike.[5] That caused some fallout in the markets because there was a lot of what they called the carry trade going on—borrowing short and lending long. It was the first time I remember where a money market fund or two threatened to "break the buck" and had to be supported by the sponsor of the fund. We saw that again recently. That event, along with other things, convinced me that, if a

[5] Editor's note: The FOMC began increasing short-term interest rates in February 1994; over the first half of that year, the FOMC increased its target for the federal funds rate 125 basis points.

bank has its name on the door, whether legally obligated or not, it has to support the entity. In my view, these money market funds always should've been consolidated.

The interest rate spike also caused a hedge fund or two to go bust. One was the Askin funds.[6] I don't think there were any big losses by banks, but there were some securities settlement issues, where for a while, State Street was threatened with some big losses. Anyway, shortly after the hedge fund problem, I got a call from the Board's Division of Research and Statistics (R&S) asking me to come to a meeting in the director's office. At that meeting was the first time I heard about hedge funds. R&S said the Board has been asked to testify on this hedge fund issue—this hedge fund going broke and the exposure of banks. R&S said that BS&R should take the lead. That was a warning sign right there because I've never known R&S to be shy about taking the limelight.

I started a crash course on hedge funds and how banks interacted with hedge funds. With the help of Mike O'Connor, a staff member, we managed to draft testimony on the issue. Research did some little piece. I don't remember much about it, except that Governor LaWare was going to give the testimony. We had a briefing for him in the Board's Special Library. During the briefing, Chairman Greenspan came in. He sat through the whole briefing and made some comments. That was really unusual. Chairman Greenspan undoubtedly thought the testimony was important, but I don't know why. Sometime after the testimony, the New York Fed started a review of how banks interacted with hedge funds. Christine Cumming was then in supervision at the New York Fed. I went with her to a bunch of banks talking about how they managed their hedge fund exposure. We weren't particularly impressed. It all seemed very

[6] Askin Capital Management owned three hedge funds that sustained significant losses in 1994: Granite Partners, Granite Corporation, and Quartz Hedge Fund.

subjective and driven by the reputation of the hedge fund managers and by how much business the bank might be able to do with them.

MS. CARTER. Were there any kind of restrictions on how much you could—

MR. MARTINSON. No, it was all just like any bank trading activity. The bank set its own limits as to how much it dealt with them and what it thought its exposures were, but it seemed very touchy-feely and marketing driven. There was no real hard data on a fund's risks, and it wasn't clear how the banks gave lower limits to some funds and higher limits to others, other than reputation. But there weren't any losses to which you could point. The exposures didn't seem overly large and there wasn't much impetus to do anything on the supervisory front. The New York Fed did issue its own guidance letter, but Board supervision declined to participate in it. I can't remember why, but I don't really think the New York guidance had much effect.

Long-Term Capital Management (LCTM)

MR. MARTINSON. The LTCM crisis came to my attention after William J. McDonough, president of the New York Fed (1993–2003), had a meeting with creditors to bail out LTCM.[7] We started looking at LTCM then. The New York Fed had gotten a fair amount of information on the LTCM portfolio.

I was sent to New York to talk to the big banks to see how they managed their exposure with LTCM, and how much they might have lost if LTCM hadn't been resolved the way it was.

[7] LTCM was a hedge fund structured to avoid regulation by limiting its clientele to a small number of highly sophisticated, very wealthy individuals, and that sought high rates of return by investing and trading in a variety of financial instruments. Since its founding in 1994, LTCM had a prominent position in the community of hedge funds, in part because of its assemblage of talent in pricing and trading financial instruments, as well as its large initial capital stake. In its first few years of business, it earned an enviable reputation by racking up a string of above-normal returns for its investors. The firm failed in the late 1990s, leading to a bailout by other financial institutions. The Federal Reserve brought the market participants together and facilitated the refinancing.

I talked to three banks, but I only remember two of them. The first bank I went into had a compliance officer that I had dealt with because we were monitoring some of its trading activities pretty closely. He set up a morning meeting. He brought in some credit people from the bank, not the marketeers, or the traders. They told us outright that LTCM didn't give much information to anybody; LTCM wouldn't let the bank see any of the details on its trading book. The exposure limits this bank had with LTCM were quite high and were still based on what we found a few years earlier—the name and reputation of the participants and how much business they were giving to the bank. This bank did a lot of modeling of risk exposure including potential future exposure. I asked how much the bank would have lost if LTCM hadn't been rescued. The bankers said their estimate was around $300 million, which was big but not life threatening.

Then I went to the second bank. That meeting, which was set up by the head of the trading operations, included the LTCM account manager, a big cast of other people from the bank, and a lot of people from the New York Fed. Some officer from Legal in New York attended, as well as some people high up in Examinations and regular examiners. It was a pretty big group. The account manager started talking about how much due diligence the bank did, and how it checked things. Finally I said, "Did you get any information on LTCM's positions?" The response was "no." Finally it came out that this bank wasn't getting any more than the first bank, which wasn't much. They were dealing with LTCM based on reputation and the amount of business it generated. Eventually I asked, "How much would you have lost?" The head of trading said, "You don't need to know that. Why would I tell you that?" I reminded him that we were the bank's regulator, we were interested in how much money it could lose, and he ought to tell me. He finally did.

The atmosphere was entirely different between the two banks. The amount of potential loss exposure at each bank was about $300 million. We got a similar figure from one or two other large banks that were major counterparties of LTCM. Based on that, my conclusion was that the "bailout" really wasn't necessary to protect the solvency of U.S. banks. It had to be motivated primarily by other reasons, for example, concerns about broader markets. But it really wasn't a bank supervisory safety and soundness issue. These banks could have absorbed the losses. Three hundred million dollars was one quarter's earnings.

One thing that impressed me about the LTCM bailout was how much liquidity can affect the mark-to-market price. After the fact, we received some LTCM position data that I looked through. One set of trades that stood out to me was the big positions LTCM had in the Royal Dutch Shell Group stock. That group traded under two ticker symbols, two companies in the United States: one is Royal Dutch Petroleum; the other one is Shell Transport. They have the same identical risk. One owns so much stock, and the other one owns the rest of the stock of the operating oil company. And the price of each reflects how much stock of the operating company they own, and how many shares they have outstanding. There should be a set ratio between the prices of the two because they're the same economically. So the modus of LTCM would be to go short the stock of the more liquid one, and go long an equivalent amount of the less liquid one. They were long Shell Transport and short Royal Dutch Shell. Because they would buy Transport when it traded at a tiny discount, and then they would expect convergence, the stocks would get back to parity and LTCM would make a profit. When LTCM got into trouble, the difference between these two identical things spiked to a 7 percent differential just because everybody went to the more liquid one, and probably because everybody knew what LTCM's position was and they were squeezing them. That shows the things that can happen with mark-to-market [accounting] when liquidity evaporates. Recently, we saw again that this was a major problem. LTCM was a vivid example to me of how much liquidity can affect short-term price even when there's no substantive difference or reason.

Other Trading Problems

In addition to the hedge fund problems, during the Greenspan Chairmanship there were a number of trading problems, scandals, and rogue traders. Some didn't involve U.S. banks directly, some did. We started studying the rogue trader problem to see if there were some themes one could identify. We looked at Barings Bank. The Fed wasn't involved in that, but I did read the report.[8] And there were trading scandals involving Sumitomo and the New York branch of Daiwa Bank.

The key to these scandals, in my view, was the ability of the rogue trader to fund losses. Any trader can probably find a way to book unauthorized trades. But then how is he going to fund his losses and build them up to a point where they are big enough to affect the solvency of the bank?

I remember talking to a compliance officer at a large bank who was in charge of its international traders at the time. I said something like, "We saw that your trader in France did unauthorized business and lost $11 million." She said, "I supervise hundreds of traders. One's always going to be able to cheat me for a while, but so what, if it's only $11 million."

What caused the big losses was the ability of the rogue trader to get the funding needed to pay off his losses. We kept seeing new ways that traders did this. At Barings, the trader just called the bank's treasury, asked for money, and got it. The trader persuaded the bank that he

[8] Barings Bank was the oldest merchant bank in London until its collapse in 1995 due to unauthorized trading by its head derivatives trader in Singapore, resulting in a loss of over $1 billion.

had to pay out on certain instruments he traded, but he was really making a profit on the other side of the trade through instruments that he had to hold and couldn't turn into cash right away. The bank thought that, even though he was currently cash flow negative, he was really making tons of money for the bank. So the bank's treasury kept sending him money until things fell apart and broke the bank.

In the Daiwa branch in New York, the trader controlled the custody operations, which is a no-no. Traders should never control any money. The rogue trader funded his losses by selling securities out of a custody account.

Sumitomo Copper lost over $1 billion from the actions of a rogue trader in unauthorized copper dealings. Yasuo Hamanaka, Sumitomo's trader, was known as the world's biggest copper trader. He got the cash to fund his losses through the derivatives market. He also sold put options to raise cash, and he entered into prepaid swaps. A prepaid swap is a loan that's done under swap documentation. The one U.S. bank that did these with him reported them on its own books as loans, but they did it under swap documentation because Hamanaka had authority from Sumitomo to trade, but he didn't have the authority to borrow money. He couldn't go to the bank and ask for a loan, so he had to raise money using derivatives. At another big bank, he did a whole series of options and forwards with them. Since he was Mr. Copper, and was supposed to know everything about the copper market, the bank actually analyzed the whole set of trades it did with him. They concluded that the overall result of the trades was that Hamanaka was borrowing from them at something like LIBOR plus 1 [percentage point] or LIBOR plus ½. They knew that Sumitomo Copper could fund itself at LIBID (London Interbank Bid Rate). So they were kind of puzzling their heads as to why he was paying up to use the complex trades to borrow money, but they never said anything that I know of to Sumitomo Copper. We see this use of options and pre-paid swaps later on as ways rogue traders or corporations could fund themselves without reporting borrowings.

One bank that did the pre-paid swaps with Hamanaka later did them with Enron. These transactions allowed Enron to show cash flow from operations even though functionally Enron was just borrowing money. The bank thought it had protected itself against Enron default risk. It had gotten an insurance company to guarantee the swaps. But when the insurance company saw that the swaps really were loans, they sued and the bank had to settle for about $0.50 on the dollar with the insurance company. The bank lost about $0.50 on the dollar on these prepaid swaps.

As that process was unfolding, after the suit was filed, I knew the bank would have to write the value of the swap down because it was booked in the trading account at par, and no one would pay full value for it now. I was looking for the trading loss to be reflected in the bank's income report, and I couldn't find it in trading income. I looked through the rest of the income statement, and I couldn't find the loss—it would have been big enough to notice. So I had the New York Fed look into it, and New York said that the bank was still carrying the swaps at 100 cents on the dollar in the trading account. I thought, "The borrower's in default. The guarantor is contesting its obligation in litigation. This is really a doubtful loan. I don't know what it's worth, but it's not worth 100 cents." Finally, I called the guy at the bank who was responsible for that piece of the trading book. He had his accountant on the line with him—an accountant from the outside accounting firm. I had Charlie on the line with me. I said, "You're carrying this at 100 cents. How can it be worth 100 cents? You're in litigation." The trader said, "It's in the trading account. It's not traded, so I can value it at whatever I want to." I said, "It's not worth 100 cents, and if you don't do something, I'm going to send an examiner there and have him classify it [as] doubtful." My recollection is that first they moved it out of the trading account to some other account where the bank didn't have to mark-to-market and then eventually wrote it down. This was around 2002. It showed me the lack of discipline that had crept into the trading account. The guy just flat out said that it was not traded so he could value it at whatever he wanted to, and his accountant didn't say a peep.

Earlier in my career, the Board had allowed U.S. banks to do some securities activities abroad before they could do them here. Fred Dahl got that approved before I came to the Board, I think around 1970. So some U.S. banks had small trading operations that traded eurobonds. I talked to a banker who was running the eurobond trading operations. He said, "The trader can always cheat me; he can go out and buy 10,000 bonds at, say, 96. Then that's his mark-to-market position. He can always find somebody to take 5 or 10 bonds from him at 98. Then the trader gets to mark his whole position up, and he says, 'Look at all the money I made.' I'm not going to accept that. The trader needs to sell all of them to prove he made a profit. If he can't get rid of it within a certain time period, I'm going to start putting liquidity haircuts on him." So if that position is still there 30 days from now, he would take 10 percent off the guy's valuation. And if it's six months, he would make him sell it all. So a lesson I learned was that the discipline in the trading account really comes from having liquid instruments that have to be bought and sold all the time. When they get all these swaps in there that never trade, that discipline goes away. So unless you've got something else to replace it, you get the situation where traders have a lot of leeway to overstate profits and understate losses.

The modern equity derivatives market started mainly with Banker's Trust in London. There were two guys there—one in New York and one in London. The one in London eventually went to Credit Suisse in Japan. Primarily, they would buy NIKKEI puts very cheaply from Japanese insurance companies and then sell them to people who wanted to hedge or bet against the NIKKEI, which at this point was on a straight upward spike. This was the 1980s. This worked in part because there was an accounting arbitrage opportunity. The Japanese insurance companies could recognize the premium they got from selling the puts as current income because they didn't have to show any liability for their obligations under the put. If the put went into the money, and they owed Banker's Trust, that didn't show up anywhere on their records. So for these Japanese insurance companies, this seemed like free money. Plus they thought, "We've got to invest our future premiums in stock anyway, so what?" Then Banker's Trust would in turn sell the puts to others at a substantial markup. It made a lot of money on this business, and took no position risk. They could almost completely hedge the book. It was a big money maker for them when the LDC debt problem was still going on.

We'd gone to London to investigate this because they were doing it under this Regulation K provision that was a loophole. We could've closed it if we wanted to, but the Board didn't. I was talking to a senior official at another U.S. bank in London and I said, "I've seen this equity derivatives business. All this money is being made and there's no risk." The banker looked at me and said, "If there's no risk, there's no profit."

It wasn't until years later that I discovered what the risk was. One night I got a call from Banker's Trust indicating that it was going to be sued by Proctor and Gamble (P&G) over options contracts purchased from the bank. Later, Gibson Greeting Cards did the same. I knew something about the way Banker's Trust did this type of business. When they booked these deals, it hedged it all out, at least mathematically, against its books and determined the cost of buying hedges to eliminate all of the market risk. The difference between what Banker's Trust sold it for, and what it cost Banker's Trust to hedge it out was the first-day profit. My first question was, "What was the first-day profit on these?" The Banker's Trust official gave me the number, I can't remember it exactly but it was large, I think in a range of $12 to $25 million. I thought, "Whoa." The problem was that P&G needed periodically to mark its obligation to market because it had a liability for the puts it sold to Banker's Trust. So when P&G calls Banker's Trust to get the value, Banker's Trust can't say, "You lost $12 million on the first day. You sold us the puts at a big loss to you." But that's what Banker's Trust was doing with its customers. It would book these first-day profits, but then the customer would call in and Banker's Trust couldn't tell him. [Laughter] That was the risk in the business. It was a reputational/legal risk.

Real Estate Problems

The real estate problem in the money center banks occurred in the late 1980s, early 1990s. I was in the international supervision group. I didn't move to the domestic area until 1997. The real estate problem was mostly domestic, but there was an international aspect. U.S. banks had big operations in Australia. In 1987, for the first time, we went there to exam[ine] the operations on site. The biggest Australian operations were subsidiaries of two U.S. banks that owned them through their Edge Corporations, which were located in Delaware. The Philadelphia Federal Reserve Bank was in charge of supervising those Edges and all their overseas subs. We didn't find many problems in those examinations. About a year later, I get this call from Steve Hoffman, who was in charge of Edge exams in Philly. He was back in Australia doing another round of examinations. He said something like, "We are finding big losses here. It could be in the billion dollar range." That was big in those days. I laid into him. I said, "We were just down there. Why didn't we find all these things earlier?" He said, "A lot of these are new loans."

There had been a big building boom in Australia leading up to a big bicentennial event and a World's Fair in 1988. So there had been a lot going on down there and the banks were lending willy nilly. A lot of the loans were substandard or doubtful the day they were made. One of them, I remember, Steve Hoffman said was called "octopus." The bank had loaned money secured by a bunch of second and third liens, but the loan officers couldn't get it to fit within the bank's underwriting criteria. It had all these parts, tentacles; that's why the Philly Fed called it octopus. The final capping piece used to qualify the loan was that the borrower gave the bank a lien on an option on the air space over the Sydney train station, which was then valued high enough for the loan to pass the underwriting criteria. Of course, when the real estate bubble burst, the loan soon went bad.

This experience set Steve Hoffman off and not too long later, he found much the same thing in Canada. Canada had had a real estate boom that was starting to crack a little earlier than ours. The real defining piece occurred when Steve went over to Germany to exam the bank's operations there. Germany hadn't allowed much commercial building for a long time; it had all these building restrictions. He found the bank was using its interpretation of a Regulation K provision to allow it to do real estate development where it took an ownership 40 percent piece in real estate development projects.

MS. CARTER. Because it was overseas?

MR. MARTINSON. Well, under Regulation K, you could make a passive investment up to 20 percent of voting in any kind of foreign company and another 20 percent non-voting, but it wasn't intended to allow real estate development. We called the bank's reps and told them that. I told them that we would take the matter to the Board, if the bank wanted to get a formal no. So the bank quit. That's all it took in those days. But there were two existing projects; one was for this big office building in Frankfurt, which hadn't seen a new office building in a long time. The other one, I think, was in Hamburg. Both were going to be profitable business. These projects were going to make big money. This was done under the principle that a bank shouldn't be lending 100 percent of value on real estate. The loan should always have a haircut; without it, this was not sound underwriting even though we knew they were going to make money on this particular loan—it wasn't prudent banking.

The report went in, and the bank threw a fit. It complained to the New York Fed, and New York complained to Philly. Steve Hoffman called the Board asking whether we were going to back him. So one afternoon, Steve, some other Philly people, some OCC examiners, and I went to the bank in New York. This must be around 1990. We met with a woman who was the head of credit, and she laid into us. "Stupid examiners, don't you know that I can lend 100 percent on real estate and make money? I do it all the time in New York. I might even lend 110 percent of value. There is no risk. You people are idiots." She went on and on. We just came out of that meeting shaking our heads. [Laughter]

MS. CARTER. Was New York aligned with you on this?

MR. MARTINSON. New York didn't say a peep. Once the real estate market turned, you saw the effects of this type of lending. Like the LDC debt, when the banks were making the loans, they didn't view them as high risk; the banks thought the loans were a no-brainer profit opportunity. That's one of the reasons I always disagreed with the theory behind Basel II, which assumed that the real danger is that banks go out and make knowingly risky loans because they don't have to put up any more capital against risky loans than other loans. Banks have always had procedures that, if they think a loan is risky, the total of such loans is capped at a pretty small amount. Where banks have losses that are big enough to affect the overall condition is when they don't think there's any risk, and so they make a whole bunch of these loans. That's my parting view of the lessons I learned.

MS. CARTER. What about a case that was before the Board involving Goldman Sachs and Chairman Volcker?

MR. MARTINSON. I was impressed how good Volcker was in cutting to the essence of things and managing to get people around to his view. I don't remember exactly when it was, but I think it was still when Goldman Sachs was a partnership. It had come up with this deal where Sumitomo Bank in Japan was going to buy a 24.9 percent passive interest in Goldman. Sumitomo Bank, because it had Sumitomo Bank of California, was subject to the Bank Holding Company Act. So Sumitomo Bank couldn't make the deal unless it was passive under the Holding Company Act. The Board had to sign off on that. There was a lot of concern among individual Board members that, A, it was a foreign bank and might be getting an advantage over U.S. banks and, B, it seemed contrary to Glass-Steagall. Goldman and Sumi had agreed to a bunch of passivity commitments to begin with, but these weren't satisfying all the Governors. Volcker asked the Governors what would make it passive. The Board members started adding more passivity commitments, and pretty soon there was a whole bunch of them. At the end, Chairman Volcker said, "We're going to go back to Sumitomo and say this is our view. If it agrees then we have to be willing to say okay." They wrote down all of the new requirements, went back to Sumitomo, and sure enough Sumitomo agreed. Goldman Sachs got its money, and the rest is history.

I was amazed how Volcker managed that whole discussion and got agreement. It was a very passive investment. Sumitomo couldn't do things with Goldman that everybody else could do with them. I talked to one Japanese banker later and he said, "A lot of people think

Sumitomo didn't get a very good deal out of this." I think part of the original idea was for Sumi to build its expertise and reputation in investment banking. Eventually, however, it sold its interest at a huge profit.

That's one of the few individual cases that I remember from the Volcker era. But there were a number of times over my years at the Board when issues arose about the right policy toward foreign banks—the U.S. policy is national treatment. National treatment says foreign banks can do in the United States what our banks can do. There was always a push among some people who felt that we should have reciprocity; that foreign banks can do here what our banks can do in their country. And while there have been a few doubts here and there among individual Governors, to its credit, the Board as a whole has always strongly supported national treatment, real national treatment, which means comparable treatment, not identical treatment. If you insist on identical treatment, there's always some little quirk to your system that the others can't match.

Changes in Banking Supervision

MS. CARTER. During your 30-plus years at the Board, you served under many different BS&R directors, and over that time, there were a lot of changes in the division.

MR. MARTINSON. The first two directors were Fred Solomon and Brent Leavitt. Fred Solomon retired not too long after I came. My impression was that things had been pretty quiet for a long time. Things started to get a little worse under Leavitt. The directors didn't deal much with the international group. That was mostly Fred Dahl. When I came, he reported to Governor Brimmer. Then with enactment of the International Bank[ing] Act [of 1978], he reported to Governor George Mitchell primarily, and also J. Dewey Daane. It was really when Jack Ryan came that things changed; Ryan was a very good director.

MS. CARTER. Did organizational change also reflect momentum in the banking environment?

MR. MARTINSON. Yes. Problems were coming and, to his credit, Chairman Burns plucked Ryan out of the staff as the most capable person to deal with the deteriorating situation. Jack came from the Chicago Fed to BS&R at the Board, and he rose quickly.

MS. HURT. What do you mean when you say the deteriorating situation?

MR. MARTINSON. The U.S. banks were starting to show some financial problems. They had the REIT [real estate investment trust] crisis around 1977-78, where you saw some real estate problems bubble up and the trend about the declining capital ratios also kicked in. Jack Ryan brought Bill Taylor to the Board and Bill rose along with Ryan. Bill became the deputy director, and the rest is history.

BS&R was much more bureaucratic by the time I left. As I progressed, I did things as a GS-11, or 13, or 15 that I don't think most people would experience now.

Also when I started, the Board had Board meetings in which they went through many cases. I thought that was productive. Not only did staff learn from attending the meetings and hearing the Governors reactions, but Board members who might not have known or cared much about supervision got force-fed these things. I remember when Governor Henry Wallich came in. He'd been a columnist for Newsweek among other things. He was very conservative, a free market person. I don't think he initially believed much in supervision, but I think when he saw the way banks were behaving, the declining capital ratios, and the problems building, he became a strong supporter of proactive supervision. In my view, that change occurred in part because he was seeing the issues, even if initially he didn't want to.

MS. CARTER. Thank you for taking the time to talk about your experiences and express your views.