Federal Reserve Board Oral History Project

Interview with

Stephen C. Schemering

Former Deputy Director, Division of Banking Supervision and Regulation

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Interviewers: Michael Martinson and Cynthia Rotruck Carter

Federal Reserve Board Oral History Project

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

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

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

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MR. MARTINSON. Today is Thursday, March 5, 2009. This interview is part of the Oral History Project of the Board of Governors of the Federal Reserve System. I'm Mike Martinson, a retired associate director in the Board's Division of Banking Supervision and Regulation. I'm joined by Cynthia Rotruck Carter from the same division. We're conducting an interview with Stephen Schemering, a former deputy director of the division. This interview is taking place at the Federal Reserve Board. Steve worked at the Board from 1974 to 2004. Let's start with how you came to the Board.

Early Years at the Board in the 1970s

MR. SCHEMERING. Well, when I first came to the Board, I had recently graduated from college. It was the summer of 1974. I already had a number of interviews, and I received a number of job offers. My last scheduled interview was with the World Bank. After the interview, I walked down 21st Street toward Constitution Avenue to catch a bus home. I passed the Federal Reserve Board building and, on a whim, I walked in off the street and inquired about the job opportunities at the Federal Reserve. The Human Resources staff showed me a number of job descriptions, and I was particularly interested in the job descriptions in bank supervision. After a number of interviews within the Division of Banking Supervision and Regulation, I was offered a position as an assistant financial analyst. I knew of the prestige of the Federal Reserve, so my initial intention was to accept the job, spend about five years there, and then find a job in the financial services private sector. That's how I came to be employed at the Federal Reserve Board.

MR. MARTINSON. What was your initial job and the career path?

MR. SCHEMERING. I recall most of the new financial analysts in the division were typically assigned to what I would describe as low-risk work. In particular, I started in the applications section and worked on what were called delegated application cases. These cases involved bank holding companies in good financial standing acquiring a bank in equally good standing. My job responsibilities included reviewing those applications and making sure they fit all the delegated guidelines that existed at the time for the Reserve Banks to approve the applications.

My first career challenge occurred in the applications section. I was reviewing a bank holding company formation over an existing bank that was in very good financial condition. The holding company financials were typical of a one-bank holding company. The parent company was highly leveraged, reflecting the application guidelines that permitted leverage up to three times the holding company's equity. These guidelines enabled individuals to buy and control banks. Without those guidelines, only wealthy individuals or an existing bank holding company with access to the capital markets could buy banks.

During the review, I noticed that the investors had investments in other one-bank holding companies. The investors owned or controlled 20 one-bank holding companies and were taking advantage of the more liberal guideline for small bank holding companies. They clearly warranted a denial recommendation even though the Reserve Bank's recommendation was approval. The application was removed from the delegated agenda and placed on the Board's agenda.

When I asked my manager what a Board case entails, he said you have to go to the Board table, make an oral presentation on the merits of the application, and explain why the division was recommending denial on an application that the Reserve Bank had recommended approval. I knew it was going to be a controversial case, and I was more than a little nervous because I had never even attended a Board meeting.

On the day of the Board meeting, I was extremely nervous given the circumstances, but I became somewhat relieved when I walked into the Board Room and noticed that Vice Chairman George W. Mitchell would be presiding over the meeting instead of Chairman Burns, who I heard could be a little rough with [the] staff. As I sat down at the Board table for the first time, my heart sank when the Vice Chairman started the meeting by saying, "This is the most important application I have ever seen come before the Board." He further stated that, given the importance of the application, he asked the Board members to immediately commence an "executive session." I had no idea what that meant, so I remained seated, looking straight ahead at the Governors. Finally, my assistant director pulled me by the arm and said, "You're not supposed to be sitting in on an executive session," and escorted me out of the Board Room.

The Board denied the application. That was my first real experience with the Board members and the Board Room, and I will never forget it.

MS. CARTER. Who was the division director then?

MR. SCHEMERING. Brenton Leavitt.

MR. MARTINSON. So when you started working at the Board, Arthur F. Burns was the Fed Chairman. And he was followed by Chairman G. William Miller.

MR. SCHEMERING. That was a short-lived chairmanship.

MR. MARTINSON. Paul Volcker became the Fed Chairman in August 1979. And that's when the problems started coming. Maybe you could skip to that time period.

MR. SCHEMERING. When Volcker came in—I'm trying to remember. At the time, I had been working in applications a couple [of] years. Maybe that was around 1977, 1978. At the time, the division had no bank holding company supervision section. Its focus was on state member bank supervision. There was serious debate about whether or not bank holding companies should be supervised at the Board. I think the position of the Board's research division was that it was unwarranted regulation. Nonetheless, the division decided to create a small bank holding company supervision section to monitor their financial condition and asked for volunteers. I volunteered. The section was comprised of four staff [members] for thousands of bank holding companies. That's how the division began its effort to supervise bank holding companies, and that's how I got started in supervision. Soon thereafter, the division reorganized, and the bank holding companies section and the state member banks section were merged. This function was managed by Jack Ryan.

MR. MARTINSON. At some point, John E. "Jack" Ryan brought William "Bill" Taylor into this group.

MR. SCHEMERING. Yes, early on. And this is getting back to Chairman Volcker. As you know, when Volcker came in, the first thing he did was significantly raise interest rates. At one point, the fed funds rate was somewhere around 20 percent. The immediate effect of the Chairman's monetary policy was that the S&Ls began to have earnings issues. There was a strong negative reaction to Chairman Volcker's actions not only from the S&L industry, but from the real estate and agricultural sectors. Jack Ryan brought in Bill Taylor to manage the supervision section. Bill had been a bank examiner at the Chicago Fed with Jack and had extensive real estate experience.

Penn Square and Continental Illinois Crises

MR. MARTINSON. One of the problems you worked on was Penn Square.

MR. SCHEMERING. About 1982. That was important because of the effect that failure had on individual banks as well as the oil and gas sector as a whole. Penn Square was an oil lender in Oklahoma. It had a one-office bank in a strip shopping center where it was making highly speculative oil and gas loans predicated on a price of $35 to $40 a barrel. At this time, in addition to farm commodities, oil and gas prices were increasing, so there was a high demand for oil and gas drilling. Because these wells in Texas and Oklahoma were old, they had to conduct what I think was referred to as deep-oil drilling to get further down into the basins and remove the oil. So oil exploration was expensive.

Penn Square began to participate out its oil and gas loans because it only had a balance sheet of about $400 million. The bank sold a lot of the loans that it originated to meet the demand for oil and gas loans that it made in that area, some of which, unfortunately, turned out to be fraudulent or extended on overly generous loan terms and conditions. Continental Illinois bought $1 billion of participations. Chase Manhattan, I think, bought about $200 million. How Penn Square, with assets of only $400 million, could sell $1.2 billion in loans into the market should have been questioned by bankers and bank supervisors earlier in the process.

Penn Square failed, and it caused Continental Illinois a lot of problems at that time. Continental's business strategy was to become the largest commercial industrial lender in the nation. It accomplished that goal through liberal underwriting standards that had a severe effect on its loan portfolio. Given its relationship with Penn Square, Continental suffered a market reaction both in stock price and funding issues, which continued to plague the bank in 1983 and into 1984 until Continental was the subject of a bank assistance program.

Continental's business strategy was to become the largest commercial lending bank in the United States. It clearly succeeded in doing that. If you look back at Continental's balance sheet and loans, it had tremendous loan growth year to year. Apparently it was after market share, and the way Continental got this market share was in pricing. Interest rates were very high at the time, so commercial lending rates were also extremely high. Continental was still experiencing significant loan growth by offering below-market-rate loans to its commercial customers.

After Penn Square failed, the market began to turn on Continental both in terms of stock price and fund suppliers because of Continental's relationship with Penn Square. Continental was a wholesale bank and, as such, was dependent on market-sensitive funds. Because of the limited branching laws in the state of Illinois, its core deposits never reached more than 30 percent of its total funding. Some of those fund suppliers started to move away in 1983 and into [the] beginning of 1984. At that time, three corporate bankruptcies that involved Continental lending became public. For the first time, I think, as a bank supervisor I experienced what was in the future to be referred to as a "silent run." It was all done electronically, and a lot of the fund suppliers canceled their lines and pulled out their funds. It continued into the beginning of 1984. And, if I remember correctly, one of its large suppliers announced that they were pulling away from Continental. That supplier turned out to be the Chicago Board of Trade.

Continental's funding problems were exacerbated by that announcement. To stem the run, Continental went into the Eurodollar market later in 1984 until those fund suppliers started pulling out. Continental had to access the Fed's discount window for about $3.5 billion. Nothing seemed to stem the withdrawal of these more volatile funding sources, so the government had to intervene in the form of the FDIC buying a subordinated note in the bank and arranging for some U.S. banks to come forward with lines of credit to provide alternate funding sources for the bank other than the discount window.

The government's temporary assistance package lasted only two or three months when market confidence in the bank continued to erode. The temporary assistance became permanent assistance when the FDIC came in and bought convertible preferred stock of the holding company, the proceeds of which were downstreamed into Continental Bank. The FDIC also bought about $5 billion in loans from Continental and required Continental to take an immediate $1 billion loan loss provision on those loans that the FDIC purchased. As part of Continental's permanent assistance package, the senior management was removed from Continental's board of directors. It was ultimately sold to Bank of America.

Before Continental's problems became known, it had a sterling reputation in the markets. The bank had triple-A credit. I also recall that the chairman and CEO, Roger Anderson, was designated as the banker of the year in 1982 or 1983. The lesson I learn from Continental's demise was that if one started really looking hard behind the numbers at Continental, you could see the weaknesses emerging. But that has and always will be the challenge of bank supervisors, to intervene in an institution where the financial profile, at least from the market's perspective, is good and well received. It is one of the difficult decisions that bank supervisors have to make.

MR. MARTINSON. In Continental's case, the FDIC said it would guarantee all bank deposits, where heretofore, in a number of smaller banks, it had been making people take a loss.

MR. SCHEMERING. This is the "too big to fail" issue, which was clearly created by the Continental episode. There was a lot of criticism of the government assistance plan to Continental because, up until that time, the FDIC conducted purchase-and-assumption transactions in most of the failed banks, which meant all depositors were made whole. Later into the 1980s, it started doing some modified payouts. The FDIC would review the assets and make a calculation of what depositors would ultimately be reimbursed, given its analysis of what the loans could ultimately be sold for. Just prior to the Continental episode, Penn Square failed, and the FDIC conducted an insured deposit transfer, thus causing significant losses to uninsured depositors. The FDIC was concerned that the banks I mentioned previously that had bought participations would successfully sue the FDIC because of the fraud that Penn Square was perpetrating on those purchasers of the loan participations. These banks would not waive their legal claims, and the FDIC conducted an insured deposit transfer to extinguish these claims.

If I recall, Chairman Volcker was uncomfortable with the FDIC's decision because, as I mentioned, before Penn Square, in most of the resolutions, all the depositors were made whole. There were a few exceptions, but this was one of the first times the FDIC used an insured deposit transfer to resolve a failed institution. I think I read in the financial press that the Federal Reserve wanted the FDIC to cover all Penn Square depositors because of the Federal Reserve's concern about the effect on the markets and what that would have meant to Continental and other problem banks at that time.

That wasn't quite the Fed's position. I recall that Chairman Volcker's position was that the FDIC should announce, in advance, a change in its policy stance with respect to failed bank resolutions, and that the FDIC should indicate in this policy that, going forward, the FDIC would employ deposit transfers only covering insured deposits where the future losses in the failed bank justified such a resolution process. This is a very important distinction. Despite the Federal Reserve's concerns, the FDIC went ahead with its resolution strategy of only covering insured deposits. Unfortunately, Continental was immediately affected and experienced funding problems in late 1982 that continued into 1983.

MS. CARTER. I think, at the time, it was the costliest resolution. What was your thinking at the time? Was it "This is just a one-off thing"?

MR. SCHEMERING. Well, there is a lot of controversy, as I mentioned, surrounding the Continental rescue package. The argument against the too-big-to-fail policy was that there was a basic inequity in the policy, because uninsured depositors were being made whole in large bank resolutions while depositors in small bank resolutions were suffering losses because they weren't too big to fail. But, in the end, for good or bad, it may have been the lowest-cost resolution the FDIC ever conducted in a large bank.

MR. MARTINSON. Because, in the first round, the FDIC made money on their convertible stock conversions.

MR. SCHEMERING. In the second round, as part of the permanent assistance package, the FDIC bought a convertible preferred [equity stake] at the parent holding company level, which, in effect, gave the FDIC 80 percent control of Continental because of the convertibility features. The sale of the stock into the market as Continental recovered and the ultimate acquisition by Bank of America combined with the sale of steep discounted loans the FDIC received offset a large portion of the FDIC's losses.

MS. CARTER. One last question on Continental. When you were going through all this—and you said it evolved fairly quickly—do you remember any of your interactions with the Board or how the Board members were coming out? Was there a consensus on things?

MR. SCHEMERING. Well, I can give you some insight to that. Jack Ryan, Bill Taylor, and I were briefing the Chairman and the Board members a number of times on the Penn Square failure and the consequences of its failure, particularly on Continental. Jack and Bill were former bank examiners at the Chicago Fed, so they had a very good idea of Continental's asset and liability structure and the potential consequences for the banking sector if Continental were to fail. Around 1983, after the Penn Square failure and the subsequent funding problems at Continental, the Chicago Fed did an in-depth examination of Continental. The Chicago Fed identified some serious problems both in the credit risks in Continental's C&I (commercial and industrial) loans as well as the lack of an effective risk-management program.

It was a rather thick and lengthy report as I recall. After the staff reviewed and analyzed the report, Bill Taylor asked the staff to take the inspection report and redact any reference to Continental Illinois and any reference to its well-known corporate borrowers. The staff redacted the inspection report to the extent that the reader couldn't identify which financial institution was the focus of the inspection report. Unbeknownst to the staff, Bill took the report to the Office of the Comptroller of the Currency, which was the primary regulator of Continental Illinois National Bank, and went to the head of its large bank supervision program and said, "Listen, we just got this inspection report in. I'd like you to read it and tell me what you think." A week later, Bill told me that the individual that read the report at the Comptroller of the Currency called him up and said, "This banking organization is in clear difficulty. This report reads badly." He asked, "What bank is it?" And Bill said, "Oh, it's Continental Illinois. That's your bank."

Bill could make his point in a not-so-subtle way sometimes.

Hunt Silver Crisis

MR. SCHEMERING. You mentioned the Hunt silver crisis back in the early 1980s. The three Hunt brothers started making big bets on silver futures by going long. Their belief was that silver was undervalued vis-à-vis gold prices. Their theory was based on the Bible, where there was a reference that the value of gold to silver should be 20–1. At that time, commodity prices in general were increasing along with gold. Given the increase in gold prices, the Hunt brothers thought silver was extremely undervalued. The three Hunt brothers went about investing heavily in what they saw was a very strong possibility of silver increasing in value. They became a major market participant, so much so the market began to suspect that the Hunts were trying to capture most of, if not all of, the silver market. As the Hunts' position grew, the price of silver increased significantly. I think it reached an intraday high of about $50 an ounce, up from $5 an ounce before the Hunts began investing.

The Hunts' silver position began to cause major market concerns about the short sellers (which included some large investment banking firms) and other market participants. About this time, the exchanges began to increase margins on silver futures, which required the Hunts to go into their cash reserves to meet their margin calls. It was also reported in the financial press that the Hunts had approached Chairman Volcker about a possible discount window loan to meet their margin calls, which caused increased market concerns about a potential silver contract failure and its potential adverse effect on market participants as well as other commodity markets. There were also concerns about the commercial banking sector's exposure to these market participants. The Hunts eventually approached some large commercial banks about a syndicated loan to support their position. In hindsight, this is probably why Bill Taylor and I were asked to research the Hunt brothers' corporate and personal assets to determine if there were sufficient assets, along with their silver bullion they had taken delivery on under their silver contracts, to support a syndicated bank loan.

The Hunts were very private individuals, so our research was very difficult, but we ultimately found Placid Oil Company and Portal Boat Company (the Hunt brothers had a penchant for six-letter company names). Placid was an oil company that owned oil fields in Alaska, and Portal serviced oil rigs in the Gulf of Mexico. The precise ownership was difficult to determine, but we eventually determined that the companies were contained in trusts set up by their father, H.L. Hunt, the beneficiaries of which were the Hunt brothers and their sisters, who were enraged over their brothers' silver speculation. The commercial banks were faced with a potential problem when it was determined the Hunt brothers and sisters had to agree to "break the trusts," which created a large tax penalty for the beneficiaries before the banks could secure the assets of Placid and Portal. The Hunt sisters ultimately agreed to break the trusts after the Hunt brothers agreed to give up a significant portion of the beneficial interests in the trusts. The syndicated loan was eventually extended, and the Hunt brothers were ultimately able to orderly liquidate their silver position.

MS. CARTER. Was the Federal Reserve's entrée partially because of the financial institutions it supervised?

MR. SCHEMERING. There was a lot of specific market concern, because the "shorts," as I call them, happened to be some large investment banks that had commercial bank relationships. There were also broader market concerns that a silver futures market collapse would adversely affect other commodity markets and their participants. That is why I believe the Federal Reserve got involved—to address these concerns and ensure that the Hunt brothers orderly liquidated their silver position.

MR. MARTINSON. That was an unusual involvement.

MR. SCHEMERING. It was, because, if I recall, we didn't have any exposure at the state member banks we supervised. A lot of the exposure was mostly in the investment banks and some market makers in Chicago. So it was very unusual that we got involved. It was a fascinating episode.

MS. CARTER. Because that was an unusual episode, I always wondered if the Fed's involvement was related to Bill's tenaciousness. Had Bill not been the director, would we have been involved?

MR. SCHEMERING. At that time, Jack Ryan was the division director and Bill was the deputy director. And, yes, he could be tenacious at times, but why the Fed became involved, I am not totally sure, because I was not part of those discussions.

I can give you an example of Bill's tenacity. During the Hunt silver episode, we spent four straight weeks and weekends in his office trying to put together some semblance of the Hunt corporate structure and their assets. We eventually found out that Placid and Portal had banking relationships with Morgan Guaranty, and that the trusts were located in a large Dallas bank. Bill sent me to Dallas to review the trusts, and he went to New York to go into Morgan Guaranty to see if he could find these assets and confirm their existence. He called the New York Fed to enlist help in his review at Morgan. He was informed that there was a transit strike in New York City, and that it would be very difficult for the New York examiners to get to Morgan Guaranty. When I returned, I asked Bill how he got into Morgan so quickly. He told me the first thing he did when he arrived at Morgan was to call the New York Fed to say that he had arrived, and that it was very easy to catch a cab when you waved down a cab with a $50 bill in your hand. Needless to say, the Fed examiners showed up immediately.

The Butcher Banks

MR. MARTINSON. I thought now we might turn to some of the other problems which started cascading at this time in the early 1980s—in particular, the Butcher banks.

MR. SCHEMERING. The Butcher brothers were quite an interesting pair. The two brothers were Jake Butcher, who had run unsuccessfully—I think, twice—for the Tennessee governorship, and his brother Cecil "C.H." Butcher. Jake Butcher wore Brooks Brothers suits and was very debonair and carried himself quite properly. His brother C.H. looked like a farm boy coming out of the field. But, as it turns out, C.H. was much brighter than his more famous brother, Jake.

They followed in their father's footsteps and accumulated—I don't remember the number, but I think there were some 10 to 15 banks that they owned in Kentucky and Tennessee. They also controlled some banks through what was referred to as management contracts, where they were allowed to manage these banks even though they didn't have a significant equity interest in the banks. In hindsight, I think their banking structure was designed to avoid scrutiny by the banking regulators. They had only one state member bank, which was United American Bank in Nashville. All their others were in state-chartered FDIC-insured banks. Their banks covered, I think, two or three FDIC jurisdictions. And then, being state-chartered banks, they had various state banking agencies involved. I got involved because, at the time, the financial analysts in the supervision section were typically assigned banks in a particular Federal Reserve District. I was assigned to Atlanta and Richmond. The Atlanta Reserve Bank was responsible for the state member bank in Nashville, Tennessee.

The previous examination report of United American Bank identified some serious management issues as well as some serious loan problems in the bank. Bill Taylor and I both thought that the issues with our state member bank might be indicative of the financial condition of the other banks that they owned or controlled. It was determined to immediately conduct another examination of United American Bank. After that examination, we knew we had a serious problem on our hands. We issued a formal corrective action against the bank that required the bank to file progress reports on the examination findings. The progress report reflected an unusual transaction involving a municipal revenue bond that was classified as "Doubtful." The progress report indicated that United American Bank had sold the municipal revenue bond at face value. That raised all kinds of red flags. I discussed this with the Reserve Bank, and we were both of the view that they had most likely sold that asset to another one of their banks to improve the condition of United American Bank.

I discussed the situation with Bill Taylor, and we further discussed it with senior members of the Atlanta supervision function. It was decided that the Federal Reserve would write a letter to the FDIC about this particular asset and our concerns that they might be shifting assets amongst their affiliated banks, as I said, to avoid scrutiny by the examiners. There was no real movement or traction by the FDIC. This was around 1982, if I recall. It got to the point where the bank in Nashville was having some serious loan problems and liquidity problems, and that there was a real possibility that the bank would fail. We were very much concerned about the effect the failure would have on the other banks.

Sometime toward the end of 1982 and into 1983, the FDIC finally conducted a coordinated examination of all the Butcher brothers' banks. The FDIC found evidence of fraud and asset sales among their affiliate banks, all designed to avoid the scrutiny that I previously described. The FDIC determined that at least 10 banks were in extremis. Even some unaffiliated banks that bought loan participations from the Butcher banks were having trouble because the loans were very weak and/or contained fraudulent elements.

About this time, Bill Taylor called the Butcher brothers to Washington. He told them in no uncertain terms that they had to provide immediate additional capital to their banks to avoid possible failures of those institutions. During the discussion, neither Jake nor C.H. were particularly forthcoming, so Bill said, "Look, you both have to be honest, and you have to be candid with me when we're discussing the problems that your banks are having." C.H., for the first time, finally spoke up. He said, "You mean, Mr. Taylor, we're supposed to fess up?" And Bill said, "That's exactly right, C.H., that's exactly what I mean."

The banks ultimately failed, and we confirmed that the Butcher brothers were shifting assets to avoid scrutiny by federal regulators. We also discovered that the Butchers owned an uninsured commercial industrial bank that turned out to be the main repository for most of the shifting assets.

After the banks failed, both Butcher brothers were prosecuted for fraud and other violations of federal law. Both were sent to federal prison for 20 years each. Many years later, I just happened to talk to staff at the Atlanta Fed, and I asked, "Whatever happened to the Butcher brothers?" This is God's honest truth. The Atlanta Fed told me that they both were out of prison on parole, and they were employed as used car salesmen.

MR. MARTINSON. Another issue was insider loans.

MR. SCHEMERING. Oh, yes, insider loans and fraudulent loans. Some of these loans were connected to the Knoxville World's Fair that Jake Butcher was in charge of organizing. A lot of these loans went to finance, in part, the infrastructure that was involved in organizing and building exhibits for this World's Fair. It did go off, but it was not very successful, which was reflected in the loans at their banks.

Southwest Commercial Banks in the 1980s and the Thrift Crisis

MR. MARTINSON. We've talked about some of the earlier problems that were, in some sense, more one-off. Now we're up to around 1984, 1985, when there were widespread failures. Let's talk about some specific examples—Texas and the Ohio and Maryland thrifts. Also, what general supervisory changes might have been taking place?

MR. SCHEMERING. I'll begin with Texas—or, more broadly, the Southwest commercial banks, and then I'll follow up with the federal S&Ls. At that time, there were three main drivers of the Southwest economy: oil and gas exploration; commercial real estate acquisitions and development loans; and, lastly, the farm agriculture sector. The Southwest economy wasn't well diversified. Given the problems in each one of those sectors, the commercial banks had a lot of asset quality earnings and liquidity problems that caused a considerable amount of failures. Nine out of the 10 largest bank holding companies in Texas failed. About 48 percent, almost half, of the banking assets in Texas were owned and controlled by commercial banks that failed. The numbers weren't as high in Oklahoma as Texas, but there were proportionally large numbers of bank failures.

I mentioned the economy. Now I'll briefly switch to what was going on in the federal S&Ls, which didn't help the plight of the commercial banks. In the early 1980s the federal S&Ls began to have problems, and a lot of legislation was enacted that, in hindsight, probably exacerbated the problems of the federal S&Ls. They were given new lending authority in an effort to return them to profitability. In the very early 1980s, interest rates increased rapidly, which caused losses in the federal thrifts, given their fixed-rate mortgage portfolios.

The business plan for thrifts was the "3-6-3" rule. Simply stated, the S&L executives would borrow money at 3 percent, lend it at 6 percent in the form of a home mortgage, and be on the golf course at 3:00 [p.m.]. It was quite a staid business. But when interest rates went up, a lot of them quickly became unprofitable. In an effort to assist the S&Ls to return to profitability, the Congress enacted a number of laws. The new legislation gave them authority to engage in commercial real estate acquisition and development loans. They were allowed to have operating subsidiaries that didn't have to conform to the thrift business. They also were permitted to issue stock certificates, which the FSLIC [Federal Savings and Loan Insurance Corporation] counted as regulatory capital.

MS. CARTER. Net worth certificates.

MR. SCHEMERING. Net worth certificates. And, as I said, the only game in town at that time in the Southwest was commercial real estate, given the decline in oil and other commodities prices. So when the S&Ls got this new authority, they went into commercial real estate development in a big way in order to return to profitability. But, in doing so, they took on huge risks. The S&Ls became such a competitive force that the commercial banks had to compete with the S&Ls in what I'd personally describe as a race to the bottom. There were not enough good loans to be made in Texas and the Southwest. The appetite of the S&Ls to book assets was quite strong and caused competitive pressures on the banks to continue to engage in real estate lending. As I said, it was a race to the bottom. There should have been more direct and strong action on the part of the Congress and the thrift regulators to deal with that federal S&L problem before 1989, with the establishment of the Resolution Trust Corporation (RTC) and the [RTC] Oversight Board that finally addressed these basically insolvent thrifts. [The] FSLIC was insolvent, and the thrift regulators could no longer impose the ultimate sanction against these thrifts by closing them.

The inability of the thrift regulators to close the insolvent thrifts caused a tremendous amount of moral hazard in the thrift industry. The senior management and the investors in these thrifts knew the regulators could not close them, so they continued to tap the brokered deposit market to secure the funds necessary to continue their risky lending activities. The issues kept building in these institutions, so the government finally decided to implement a conservatorship program for the largest and worst of these institutions. It was further decided that senior federal bank supervisors would take on the role as conservators in these institutions, replacing the senior management.

Senior federal supervisory personnel from the OCC, FDIC, and the Federal Reserve were appointed as conservators. For the first time in their examination career, they were basically running a financial institution. The conservatorship program was basically designed to address the larger thrifts with the highest risk profiles, because they had the highest prospects of causing the most losses when these institutions were finally resolved. The conservatorship program worked well and gave these examiners a lot of practical experience. Finally, in 1989, FIRREA (the Financial Institutions Reform, Recovery, and Enforcement Act) was passed. The Resolution Trust Corporation and the Oversight Board were established, and the Congress started to give funds to the RTC that were ultimately used to resolve these thrifts.

But if you look back, it was really a failure, I think, both from a political and regulator perspective. No one would directly address the problem, so the problem was deferred, and it only made matters worse. In the end, the cost to the American taxpayer was about $130 billion to resolve all these thrifts. The behavior of some of these thrift executives was appalling. I remember one in Texas—Vernon Savings and Loan—where, after the conservator was established, it was determined (and this is such a large number that it's hard to comprehend) that 90 percent of its loans were nonperforming or past due more than 90 days. If you put a barrel of money in a bank lobby and the bank's customers took what they needed but signed a simple promissory note, it would produce a better portfolio than Vernon's.

MS. CARTER. There was a lot of fraud, too.

MR. SCHEMERING. There was a considerable amount of fraud because of the moral hazard and the deferral of the problem. The S&L episode was a real shame, but we should not forget the lessons learned from that episode.

MS. CARTER. You mentioned the RTC [and the] Oversight Board. The Fed, you, and others were heavily involved with getting that up and running. Would you talk about that?

MR. SCHEMERING. Yes, but first let me get back to Michael's question concerning the Texas bank problems that reached their lowest point prior to the enactment of FIRREA in 1989.

As I previously mentioned, 9 of the top 10 banks in Texas eventually failed. The federal bank regulators collectively tried to deal with two of them in an effort to stabilize the situation: First Republic and Interfirst. It was thought that, if these financial institutions were combined, the merged institution could reduce its overhead and hope that the write-downs taken by these institutions up until their merger would produce book assets that came close to approximating the fair market value of these assets. The bank regulators knew there was a considerable amount of risk involved in the transaction, but we were trying to stabilize the banks in Texas and in the Southwest more broadly. For the first time that I can recall, the Federal Reserve conducted due diligence in both those institutions, although they were not institutions subject to our authority. We knew the two most critical factors in the transactions were the Texas economy and the market's validation of the merger.

The market validation came when the institution successfully sold close to $100 million in preferred stock to the market. The bank regulators eventually approved the merger, but the economic problems in the Southwest continued to decline, and the merged institutions ultimately failed. That failure was eventually followed by First City Bank Corporation and MCorp, among others. The only positive factor in our attempted merger was that the cost of the failure was probably less than their separate failures.

Ohio and Maryland Savings and Loan Crises

MR. SCHEMERING. As we were discussing, in 1989, the Congress finally passed FIRREA to address the problems in the federal S&L sector. We were aware of the escalating problems in that sector, and our findings were confirmed by the Ohio and Maryland S&L crises. These institutions were state chartered and state supervised, and both were supported by small state-sponsored insurance funds. In Ohio, most of these institutions were centered on Cincinnati, where they had long-standing customer relationships for 100 years or more.

The Federal Reserve Bank of Cleveland became aware of the problem when one of the largest institutions approached the Reserve Bank about a possible discount window loan. The Reserve Bank informed Board staff that it was sending examiners into that institution to review its loans for potential collateral. When Bill Taylor was informed of the problem, he sent me to Cincinnati to assist the Cleveland examiners with their review. Serious problems were found in the loan portfolio, and we were concerned that a similar situation might exist at other state-insured thrifts. The review also uncovered a disturbing presentation by thrift management to thrift employees on how to get the thrift depositors to convert their deposits in the S&L to debt instruments of the holding company. Given the results of the review, we knew the safety of customers' deposits was seriously compromised, but a debt instrument of the parent company would have more serious consequences for the purchaser, so we knew that management's veracity at that institution was highly questionable.

A retail deposit run eventually developed at that institution and spread to other S&Ls. We monitored the situation from the Cincinnati branch where, for the first time, I witnessed a retail deposit run. It was a very sobering experience for a bank supervisor. It was extremely sad to see elderly depositors sitting in lawn chairs and inching their chairs forward as the line progressed. The Cleveland Fed made numerous discount window loans and shipped cash to the affected institutions in an effort to stem the deposit run, but it continued to escalate.

At this time, Governor Richard "Dick" Celeste asked for assistance from the Federal Reserve to advise him of the breadth of the problem and possible options to deal with the crisis. It was determined that we would need 100 Fed examiners to conduct mini examinations of the S&Ls to meet the Governor's request. For each institution, we prepared examiner packages that consisted of the previous examination report, recent financial reports, and other relevant information.

When the examiners arrived, Bill Taylor addressed them and said, "We have divided you into teams and provided you with information to conduct a one-day examination of your assigned institution and provide me with your professional assessment of the financial condition of your institution. The rental cars are out front, so I suggest you leave immediately." The look on the examiners faces was, as the commercial goes, priceless.

The examiners were able to complete their assignment, except in one case where the examiners could not find their assigned S&L. The S&L was located in a rural area and was opened only one day a week when the directors would meet. If there was sufficient liquidity in the S&L, the directors would vote on which loan application would be approved. The cashier's check was placed in the mailbox, and the borrower was notified to pick it up.

After the review, E. Gerald "Jerry" Corrigan, Michael "Mike" Bradfield, and Bill Taylor met with Governor Celeste to advise him of the results and discuss possible options. At some point, the Governor asked the group which option he should pursue. Bill Taylor reportedly said, "We can't recommend a specific option. That's your decision. But, if I recall my civic lessons, depositors do vote." The Governor ultimately resolved the crisis by allocating state lottery funds so that the state thrifts could be sold, merged, or liquidated with no loss to depositors.

After our experience in Ohio, we looked for other state financial institutions that were examined and supervised by a state government and where the deposits were insured by a state-sponsored insurance program. That's when we found Maryland. From what little information was available to us, we determined that Maryland thrifts had the same financial profile as the Ohio thrifts, but three times larger.

We immediately became concerned, and Bill Taylor, through the Richmond Fed, arranged a meeting with the state to determine if our concerns were justified. At the meeting, the state supervisors and the deposit insurance executives informed us that our concerns were overblown because, although the Maryland thrifts had some asset quality problems, the state insurance fund had sufficient resources to handle any potential problems. When we asked if the Fed could have access to their financial records, we encountered significant resistance and pushback. It took the intervention of Governor Harry R. Hughes's office, and we were granted access to their information.

That is the first time I met Stephen R. "Steve" Malphrus. Bill Taylor sent me and Steve to Baltimore to retrieve the data, only to discover that the data had been stored in a computer using old technology. Within a few days, Steve and his programmers were able to produce the data contained on the disk.

Not surprisingly, the financial data on the Maryland thrifts showed a risk profile similar to their Ohio and federal thrift counterparts. We quickly arranged for another meeting with the state regulators. After outlining our analysis and concerns, the state regulators informed us that, the day before the meeting, they had issued their first enforcement action against one of the largest thrifts, presumably to demonstrate the effectiveness of their supervisory program. I cannot adequately describe the reaction by Bill Taylor and Welford Farmer (senior vice president, Richmond Fed) to the state's action, because we knew that the state's failure to notify us in advance of its supervisory action would significantly reduce our preparation time to respond to an adverse market reaction. After the meeting, it was decided to set up an operations center at the Baltimore Branch of the Richmond Fed to monitor what we thought would be the most likely outcome.

Within a few days, the situation began to deteriorate when a few of the state thrifts began to experience liquidity problems stemming from large deposit withdrawals. Bill Taylor, who had an insatiable appetite for information, kept calling us, asking, "What's going on? How many thrifts are experiencing deposit runs? What is the status of the larger thrifts?" He needed this information to advise Governor Hughes. So we came up with the concept of "windshield and sidewalk surveillance." In windshield surveillance, we rented cars and drove by the smaller thrifts to determine if they were experiencing deposit runs and some sense of its breadth. In sidewalk surveillance, we had bank examiners stand with customers in lines at some of the larger thrifts to gauge the level of depositor concerns. Soon thereafter, some of the larger thrifts began borrowing at the discount window, which we monitored at the Baltimore Branch.

Governor Hughes's chief of staff would visit the Branch each evening to review the level and trend of discount window borrowings, which were displayed on a large chalk board. One evening, as he looked at the board, he stated, "This is not as bad as I thought it was. I see borrowings of $23,000, $17,000, and $13,000." We told him the data was to the nearest $1,000, and that the numbers should be read as $23 million, $17 million, and $13 million. Later that evening we learned that he experienced a minor heart attack that required a few days in the hospital.

MR. MARTINSON. I remember Bill Taylor going around the third floor of the Martin Building looking for people to drive up to Bethesda to check out the lines.

MR. SCHEMERING. Yes, we sent some division staff [members] to the thrifts located in and around the Washington, D.C., area to determine the breadth of the deposit runs. Their findings were similar to ours in Baltimore. Bill Taylor and Mike Bradfield were advising Governor Hughes, and, based on our information, the Governor decided that the state government had to intervene in the developing crisis. He instituted a limited deposit withdrawal program and formally requested the assistance of federal bank examiners.

As I previously said, the problem at the Maryland thrifts were three times the size of the Ohio thrift problem, so it took over 300 federal examiners from the Federal Reserve, the Comptroller of the Currency, and the FDIC to conduct exercises similar to those conducted in Ohio. We conducted examinations and identified thrifts that could qualify for federal deposit insurance and thrifts that would need financial assistance in order to be merged or liquidated without losses to depositors.

MS. CARTER. If you look at that period relative to any time prior to that, it's my impression that it was quite unique for the Fed to send federal examiners to institutions that the Fed did not supervise.

MR. SCHEMERING. My sense at that time was that, if the thrift problems in Maryland and Ohio were not quickly resolved, it would cause deposit runs at the federal S&Ls. Given that [the] FSLIC had no funds to address its problems, the problems in Ohio and Maryland had to be addressed quickly to minimize the contagion effect these situations might have on the federal S&Ls. I assume that's why the decision was made to assist in those situations.

MR. MARTINSON. I remember you telling stories about how you got sent to Ohio on short notice.

MR. SCHEMERING. Sure. Bill came to my office and informed me that the largest state-insured thrift in Ohio, Home State, was having liquidity problems, so the Cleveland Fed was sending examiners to the Cincinnati Branch to monitor the problem and to begin a collateral review for a potential discount window loan. He said, "Just go up there for two days and participate in what's going on, and keep me briefed on what information you're finding." I brought a limited amount of clothing with me, because I was only going to be there two days and he wanted me to leave the office immediately. As things turned out, I was there for 30 consecutive days. Since I only had two sets of clothing, I had one set of clothes cleaned by the hotel laundry service each day. To make a long story short, when it was over, I had a substantial laundry bill from the hotel.

If you recall, at this time, Bill instituted a rotating deputy director program in the division where he would bring in a senior vice president from a Reserve Bank to serve as acting deputy director for a one-year rotation in order to give them firsthand knowledge of the problems and issues the division was dealing with. My request for full reimbursement of my laundry bill was denied by the Board's Controller's Office because the per diem policy only provided for a small percentage for laundry services. The deputy director at the time was Tom Cimeno from the Boston Fed. He and I went to the Controller's Office to plead my case. Tom argued that I did not know how long I would be in Cincinnati. Therefore, an exception to the per diem policy should be granted. The Controller's staff said, "Nothing in the policy would permit an exception to the rule." Tom responded by saying that their position was ridiculous under the circumstances. I responded by saying, "I guess this is not the right time to ask for reimbursement for 30 days in the short-term parking lot at National Airport." I parked my car in the short-term lot thinking I was only going to be gone two days. Tom was ultimately successful in getting me a substantial reimbursement of my expenses.

Resolution Trust Corporation

MR. MARTINSON. Would you talk about what you did at the Resolution Trust Corporation, how you got into the RTC, and what it was like?

MR. SCHEMERING. It was in August 1989 when the Congress finally decided to address the federal S&L problem, with $29 billion in initial funding. The Congress created the RTC, which was responsible for resolving the insolvent federal thrifts. The Congress also established the Oversight Board of the RTC, which was charged with monitoring the activities of the RTC to ensure its activities were consistent with the FIRREA legislation.

FIRREA did not fully address the staffing needs at the two new federal agencies. I think it was intended that the FDIC would staff the RTC, given the FDIC's experience with resolving insured commercial banks and selling distressed assets. The day after the legislation, Bill Taylor called me to his office and said, "We are going to the Oversight Board, so select five staffers and an administrative assistant and get to the Oversight Board immediately." We were to be temporary staff until such time the Oversight Board could hire permanent staff. A few days later we were joined by staff from the Comptroller of the Currency.

The physical condition of the Oversight Board office wasn't what I would call class A, B, or C office space. A former federal agency had vacated the premises six months earlier. The offices were in terrible condition. We only had one computer. And when a new temporary staffer arrived, Bill Taylor would tell them, “Take a desk from the pile in the corner and get to work.”

The reason I mention the early staffing situation is because resolving failed financial institutions is a labor-intensive process. You have to determine the fair market value of the assets, the amount of insured deposits plus accrued interest, the existence of any hidden or contingent liabilities, prepare bid packages, apply a “fitness and proper” test against the proposed bidders, and, finally, get signed confidentiality agreements from the approved bidders.

I was very surprised when a Treasury official pulled me aside and said, “We need you to spend $29 billion in 45 days, or by September 30,” because that was the end of the federal government’s budget cycle, and they wanted the funds expended before a new budget cycle began. We were faced with a problem. An officer from the Richmond Fed, who had been seconded to the RTC, and I came up with the idea of establishing a discount window facility at the RTC. We thought if we could make a temporary loan to the thrift at a rate below the thrift’s average cost of funds, it would lower the operating loss going forward and ultimately reduce the actual cost of the resolution.

So we used the discount window documents from the Federal Reserve Bank of Richmond and began the RTC’s lending facility. Management or the conservator at the insolvent thrifts would sign off on these documents, and the RTC would take a blanket lien against the thrifts’ assets and advance the funds. It was a prudent use of the funds that we otherwise couldn’t use, if we were only to employ them to resolve the thrifts because, as I mentioned, resolving a financial institution is a very labor-intensive exercise and difficult to accomplish, given the early staffing levels at the RTC and Oversight Board.

MS. CARTER. Was that other employee Arthur Zohab?

MR. SCHEMERING. Yes. Arthur Zohab. He managed the RTC funds that were approved by the Oversight Board. We worked late hours, so we would meet for dinner and reconcile the RTC's funding for that particular day. About two months into our operations, the GAO (Government Accountability Office) conducted an audit and concluded that the funding operation was too tightly controlled, but Arthur and I were okay with that.

MR. MARTINSON. That lasted for six months, and then you returned to the division.

MR. SCHEMERING. Yes. The Oversight Board began to increase staff, and the finance function at the Oversight Board was staffed by division staff. I became the acting vice president for finance and administration. The policy function was staffed by OCC senior personnel. Jonathan Fiechter became the acting vice president for policy, and he brought his staff over to assist him in that effort. The pace of thrift resolutions increased when permanent staff began arriving at the RTC and Oversight Board, and I returned to the division after seven months.

Real Estate Crisis and Large Money Center Banks

MR. MARTINSON. Well, that got you back to the Board about 1990, just in time for what I characterize as the final stage of the real estate crisis, when it started hitting the big money center banks and Citi, in particular.

MR. SCHEMERING. Yes. The commercial banking problems began with the agricultural banks in the Midwest and then moved to the oil and gas and real estate lenders in the Southwest. Banks in California and the Southeast began to have problems in their real estate portfolios, and regional banks in Ohio and Michigan were also affected.

The last stage of problems in the banking industry in the late 1980s and 1990s occurred around the beginning of 1990 into 1991, when the money center banks began to show some serious signs of weakness. These banks were adversely affected by problems in both their real estate and LDC portfolios and by the devaluation of the Mexican peso. What the market was doing back then is what the financial market participants are doing today—that is, the market participants would look for money center banks that had similar risk profiles and asset liability mix. So the market began to short the stocks of the money center banks, and their fund suppliers began to require risk premiums on their advances. Security Pacific and Citicorp were particularly affected. These were the biggest banks in the United States at that time, and I became very concerned about the effect a potential failure of either institution would have on the banking system.

What relieved the situation—not in its entirety—was that Security Pacific was able to sell itself. It was a market transaction that didn't require any government assistance, and it had a calming effect on the banking industry. But I can't remember who purchased them.

MR. MARTINSON. Bank of America [BofA].

MR. SCHEMERING. That's right. When I was informed about the pending purchase, I could have kissed BofA's CEO for doing that transaction because it took a very large financial institution off the radar screen. That left Citicorp as an island, and its financial condition continued to deteriorate. So we began to have monthly meetings with Citicorp's senior management to discuss its problems and management's plans to alleviate those problems. During our initial meeting, it was clear that there was some amount of corporate denial on the significance and the depth of its problems, and management was not entirely candid about the magnitude and the severity of Citi's problems.

Bill Taylor became unusually quiet during the meeting, but I could see that he was becoming increasingly angry, so I prepared myself for a "Bill Taylor" moment. He finally had enough and stopped the meeting. He then proceeded to tell Citicorp senior management that unless they were going to be candid about Citi's problems and the actions [that] management was taking to address the problems, he was going to place 400 Federal Reserve bank examiners in front of Citi's main headquarters on Park Avenue at 9:00 a.m. Monday morning in a long single file if that's what was needed to get the information we needed. One of the senior managers said, "You don't mean that. If that ever got into the press, it could seriously affect us." And Bill said, "You have a choice." From that moment forward they were very candid and very open about Citi's problems, which continued to escalate nonetheless.

Citicorp had experienced a number of reserving episodes related to its LDC debt portfolio, but it set aside very few loan loss reserves for its domestic nonperforming. At one point, Citi's domestic loan reserves to domestic nonperforming loans was 21 percent at a time when the regional banking companies had over 100 percent coverage of loan loss reserves to nonperforming loans. So, obviously, Citicorp had a long way to go.

We ultimately decided to put an MOU (memorandum of understanding) in place, which was a difficult decision to make, given Citi's status as a money center bank and the potential adverse effects that would follow from the disclosure of an informal supervisory action. Bill asked me to attend an FDIC board meeting so I could inform the FDIC chairman and the Comptroller of the Currency, the primary federal regulator, of our planned supervisory action. I made my presentation to the FDIC board, and I was quite surprised that the board members did not ask any follow-up questions. My initial reaction was that the FDIC board didn't think much of our action or its potential consequences. But by the time I got back to Bill Taylor's office, I learned that the Comptroller of the Currency had already called Chairman Greenspan and asked him, "Was your representative at our Board meeting today serious?" And the Chairman said, "Yes, he was."

One of the provisions of the MOU was that Citi had to get the approval of the Federal Reserve to pay a common dividend. Citi had reduced its common dividend by 50 percent prior to issuance of the MOU. Over the next two quarters, it became apparent that Citi's earnings were not sufficient to cover the reduced dividend, so we called John Reed to Washington to inform him that Citi had to eliminate its common dividend. At that point John Reed became very upset, explaining that if Citi eliminated the dividend, there were certain markets which Citi would be shut out of, one of which was the CD market. He asked us if Citi could lower the common dividend to five cents so that the banking organization could continue to participate in all markets, but Bill Taylor responded with an emphatic "no."

The MOU also required Citi to submit a strategic plan wherein it was required to identify nonstrategic assets that could be sold for a gain to increase capital, which Citi did. Soon thereafter, Citi's capital was significantly increased through a private placement to a Saudi prince. Citi began to slowly recover and began to report earnings of $1 billion a quarter, which was considerable 20 years ago. With the acquisition of Security Pacific and Citi's return to financial health, the banking environment improved significantly. But at that time, I remember thinking, "We surely dodged a bullet."

Supervision under Chairmen Volcker and Greenspan

MR. MARTINSON. From my perspective, by the mid-1990s, the crisis period was over. We had a few one-off problems, but it was generally a different environment. Comments on the views of supervision under Chairman Volcker and under Chairman Greenspan?

MR. SCHEMERING. Both Chairmen Volcker and Greenspan were highly supportive of the supervision function during my tenure. Chairman Greenspan, being more of a free market thinker, probably took a little more convincing. During the 1980s and 1990s, the division's staff and budget nearly doubled commensurate with the banking environment and our new responsibilities. That would not have happened without their support. Both were extremely intelligent and highly respected individuals, and working with them was a professional privilege.

I did not know until my retirement reception that Chairman Volcker had nominated me for the Federal Employee of the Year Award back in the 1980s for my work on Penn Square and Continental. When Richard "Rich" Spillenkothen told me about it, I thought, "That's not too bad for a guy who literally walked in off the street for a job at the Federal Reserve." I did not receive the award, but to know that Chairman Volcker nominated me was very special.

I'll tell you a quick story about Chairman Greenspan. A lot of people say he lacks a sense of humor, but I saw his sense of humor on more than one occasion. One in particular stands out in my mind. It was the holiday season. His assistant called to tell me the Chairman wanted to be briefed on a banking matter. When I arrived in his office, she said, "The Chairman is on the phone, so just have a seat. Would you like a piece of holiday candy?" I took a piece and put it in my mouth, and about 10 seconds later the Chairman buzzed his assistant. She said, "The Chairman is ready for you now." So I went into his office, sat in one of the three chairs in front of his desk, and started my briefing. I was about 30 seconds into the briefing when the Chairman leaned forward with a very perplexed look on his face. I started thinking to myself, "Oh, my God, I must not be giving a very coherent presentation or I have the wrong subject matter," because about once every 10 seconds he would lean even further forward until he was halfway across his desk. I thought to myself, "This is serious. I'm in real trouble." I started to perspire a little bit. He finally said, "Steve, can you answer me a question?" I thought, "Here it comes." And he said, like a teacher to a student, "Do you have something in your mouth?" I swallowed the candy whole and said, "No, not now." He leaned back in his chair and started laughing and said, "Gotcha." So he very much had a sense of humor. I can't imagine working with two finer individuals, and three of the division's directors I worked with: Jack Ryan, Bill Taylor, and Rich Spillenkothen. I had a lot of respect for all of them.

Changes in Supervision

MR. MARTINSON. While you were at the Board, there were a lot of changes in supervision. One was the technical support that the bank supervisors got, as far as modern equipment.

MR. SCHEMERING. The technical support the division received from the time I arrived in 1974 until I retired was the difference between night and day. In 1974, construction on the Martin Building wasn't completely finished, and I was assigned an office in the division's off-site offices at the Watergate office and condominium complex.

When I walked into my assigned office, I was flabbergasted. I looked out the window and saw the Potomac River and Roosevelt Island. It was very beautiful, and I said to myself, "I made the right career choice." But what I found to be a little disconcerting was that the division had only one vintage hand-cranked calculator for [the] staff, and staff [members] had to make an appointment days in advance to use the calculator for a one-hour period. I thought, "This was not sufficient technical support to effectively operate the supervision function at the central bank of the United States." Some months later, when we moved to the Martin Building, we finally were issued some very basic handheld electronic calculators.

So, in the beginning, we had to provide our own tech support, in essence. Later in my career, computer terminals were installed not only in my office, but also in my home where I could remotely access the Board's databases. I was also issued a cell phone and given access to the federal government's emergency phone network. The advanced technical support made our jobs a lot easier.

MR. MARTINSON. During your Board tenure, we also saw a giant change in the industry, with the large consolidations into fewer and fewer big banking organizations. Then, finally, there was expansion of the activities conducted by banks, and supervision changed with it—for better, for worse. Does anything stand out about the differences from when you came in versus when you left?

MR. SCHEMERING. When I first started, there were basically three types of banks: money center banks, regional banks, and small retail banks. As consolidation grew, money center banks grew through mergers and absorption of the regional banks.

On the one hand, these consolidations were positive, in that these organizations became much more efficient in the delivery of financial products and the use of improved technology. On the other hand, with fewer large and more complex banking organizations, it reduces your supervisory options if something should go wrong, which I suspect is what bank supervisors are experiencing today. It also makes the too-big-to-fail issues much more relevant. It also became apparent that we had to change our supervisory approach for these larger and more complex banking organizations.

Early on, we took the traditional supervisory approach to large banking organizations. That is to say, we examined these organizations once a year to get a "snapshot" of the banking organizations' financial condition and compliance with banking laws and regulations. As these organizations grew, however, the examinations took six months or more to conduct. By the time we presented our examination findings to the board of directors and senior management, the financial data was stale, and our recommendations may or may not have been particularly relevant. So Rich and I and the 12 SVPs (senior vice presidents) in charge of supervision at the Reserve Banks decided to look at our supervisory processes at both large and small banks with the goal of making our examinations more efficient and effective. Two committees were established for that purpose: the Large Complex Banking Organizations (LCBO) committee and the Regional and Community Banking Organizations (RCBO) committee.

In the LCBO committee, we came up with the concept of risk-focused, segmented examinations that would look at the riskier banking products and activities such as trading and securitization. Four or five segmented examinations would be conducted each year, and the results were immediately provided to senior management and the audit committee. At the end of the year, our findings and recommendations of the consolidated organization, based on the segmented exams, were presented to the board of directors.

We also established a budget and training committee that reviewed the expertise and training requirements of our examination staff at the Federal Reserve Banks. We changed the curriculum of the Federal Reserve's training function based on that review. We established procedures for examiners to cross District lines to assist other Reserve Banks with their specialized expertise. That committee developed a unified supervision budget that reflected the changes in our supervisory approach and the efficiencies we gained. We also engaged the first vice presidents at the Reserve Banks in that budget process, which was a first, to gain support and approval of our unified supervisory budget. These efforts, I believe, resulted in a much more efficient and effective supervisory process and fostered a high degree of cooperation among the Reserve Banks and Board staff.

MR. MARTINSON. Are there other topics that you wanted to discuss?

MR. SCHEMERING. Yes. Some personal things that affected me during my tenure with the division deserve special mention. In 1982, I identified a particular Florida bank that, in my view, was rapidly becoming a problem bank, although that hadn't been reflected in examination reports. You could see it in analyzing the quarterly financial statements and reading the previous examination reports that showed a high concentration of real estate loans that appeared to have been extended on liberal terms. Bill Taylor sent me to Atlanta to talk with the senior staff of the Atlanta Fed about the problems that I saw in that particular bank. To their credit, the Atlanta Fed said it would conduct an immediate examination of that bank, and that its best examiner would be the examiner-in-charge—a gentleman by the name of Arland Williams. Bill asked the Federal Reserve Bank of Atlanta if I could participate in that examination, and the Bank agreed. I was immediately impressed with the professionalism and competency of Arland Williams. He had previously been an examiner with the Atlanta Fed but left to take a job at a Florida bank. He eventually became president at that bank but returned to the Atlanta Fed when his bank was merged out of existence.

I worked with Arland for a period of two weeks, and over that two-week period we discovered a lot of problems in the bank's real estate portfolio. There was one borrower in particular that raised a lot of concerns. He had a large number of loans that were extended on generous terms and appeared to be weakening. Arland and I both thought he was misrepresenting his financial position in order to garner this amount of loans and concluded that this was a problem bank. Arland asked me to write the liquidity portion of the examination towards the end of the exam.

There was very little office space in this bank where I could work on the examination report, so I asked the president's secretary if there was space available in the bank where I could work. She said, “Sure. The president is not going to be in today, so you can use his office.” I brought my legal pad in and all my materials and started writing up the liquidity section. I happened to look down and noticed that there was a single piece of paper that was hanging out of his desk drawer. I didn’t want the secretary to think I was going through the president’s desk, so I attempted to push the paper back into the drawer, but I had to lift the top edge of the paper to push it in. That is when I noticed that it was a photocopy of 12 U.S.C. 1001, entitled “Lying to a Bank Examiner.” Enough said.

When I returned to the Board, the division’s enforcement attorneys and the Legal Division’s attorneys began drafting a notice of charges and cease and desist order against the bank. We brought Arland to Washington to review the documents to ensure that the examination and the work papers fully supported the notice of charges and cease and desist order. It was a cold winter day in January, and we were working in my office. Arland originally scheduled an early afternoon flight back to the bank in Florida but decided to change his reservation so he could complete his work. It was Air Florida Flight 90. I think everyone remembers the details. There was a lot of speculation about the hero who passed the lifeline so others could be saved, and it was eventually determined that it was Arland. This had a profound effect on me, and I often think about that fateful day. Several months later, President Reagan mentioned Arland’s heroism at a commencement speech at the Citadel, Arland’s alma mater.

The borrower I mentioned that we thought was misleading the bank sued Bill Taylor and me in federal court in Florida for violating his constitutional rights to bank credit. He was ultimately found guilty of defrauding the bank and was sent to federal prison. Some years later, Herb Biern, who was in charge of the division’s enforcement section, walked into my office and said, “Our friend is at it again.” Then he showed me a news article from Denver, Colorado, where the same borrower was arrested for penny stock fraud in Denver and sentenced to another 10 years in federal prison.

Terrorist Attacks on the United States on September 11, 2001 (9/11)

MR. MARTINSON. On 9/11, as the person in charge of supervision, what did you do after the attacks occurred?

MR. SCHEMERING. That event also had a profound effect on me. It was a beautiful day—one of those few clear days that you have in Washington. I was preparing myself to conduct a meeting of the LCBO subcommittee. It was a Tuesday, and we were scheduled to start at 9:00 a.m. Chairman Greenspan and Rich Spillenkothen, the division director, were in Basel for Basel committee meetings. As the deputy director, I was in charge of the division during Rich's absence. About 9:00 a.m., I was sitting down to start the meeting when Rich's secretary came in and said, "Steve, I think you better see this." She had heard a radio report that a plane had hit one of the Twin Towers in New York City, so we turned on the television in Rich's office. We saw that one of the towers had smoke billowing out of a huge hole. At the time, the television commentators were speculating that it was an accident involving a plane out of Kennedy, LaGuardia, or Newark. Within a few minutes, we saw the second plane hit the other tower. It was immediately clear to me that this was not an accident.

Immediately, I asked the six SVPs to come into Rich's office, including Bill Rutledge from the New York Fed, to see what was going on. After a few minutes, we all agreed to cancel the meeting so that the SVPs could return to their Reserve Banks. As it turned out, all planes were grounded, and the SVPs had to rent cars for their return trips.

About an hour later, after the initial attacks, the Pentagon was hit by an American Airlines flight out of Dulles. By now, many of the division's staff had become visibly shaken and upset. As acting director, I was being asked by [the] staff, “Can we go home?” Back then, the Office of Management and Budget made the decision for early dismissal of the federal government, and we had not received any notification. When staff members saw the State Department evacuating, they asked me, “Do we need to evacuate?” There was a report of a fourth aircraft hijacked by terrorists, and there was a lot of speculation about the plane’s destination. Was it going to hit the White House? Was the target the Capitol Building or the Treasury Building? So I made the decision to release the staff except for some senior level staff. I went to the elevators as they were exiting. I told them to be extremely careful driving home because there might be some panicky drivers as well as gridlock when the government decided to close.

Sometime later, the Vice Chairman called me to his office to begin thinking about the ramifications of the attacks on the banking system and other markets. He then asked me the most difficult question I was ever asked in my life: “Should we keep the banking system open tomorrow?” We learned that many banks internally decided to close while others had been required to close because of evacuation orders, so there was a lot of confusion about the status of the banking system. I told him that my greatest concern going forward was that banks might offset one financial contract against another, not knowing the effect of the attack on their bank counterparties, which would seriously affect the interbank market. The decision was eventually made to keep the banking system open, which proved to be the right decision despite some bumps along the way.

We set up an operations center in the division’s conference room so that we could communicate with the Reserve Banks and other bank regulators. I recall that the Vice Chairman said something to the effect that this was going to be the crisis of deputies, because “You are the deputy director and I'm, in effect, the deputy Chairman, so we're going to have to get through this together." We then discussed various announcements about the discount window being made available to institutions that may require it and the release of supervisory forbearance documents that we had used in prior hurricanes and floods that affected financial institutions.

Later in the day, we received word that the Bank of New York's operations center was affected by collateral damage that occurred from the collapse of the Twin Towers. To the New York Fed staff's credit, they retained staff [members] in the main building despite its proximity to the Twin Towers, an official order to evacuate, and the serious air quality and power issues in the immediate vicinity.

Over the next several hours, it became obvious that the Bank of New York had some serious operating problems. It was a major clearing bank and one of only two banks that cleared U.S. government transactions. The New York Fed sent an examiner to the Bank of New York—a courageous decision—to determine the extent of the problem. The examiner confirmed that the Bank of New York's operations center had suffered collateral damage that seriously disrupted its payment system. Apparently, it could receive funds but could not send funds out.

Over the next few days, the bank accumulated over $9 billion that was owed to banks and other market participants, which resulted in a lot of discount window borrowings. We received many calls from other bank regulators who were hearing from their supervised banks about the Bank of New York's problems. We informed them what the nature of the problem was and what we were doing about it. We were also informed that some commercial banks were considering making a formal demand for payment. That would have serious consequences for the Bank of New York, because if it was unable to meet such a demand, it could have been considered a default event and could have triggered cross-default provisions in its debt obligations.

Ultimately, staff at the New York Fed and Board staff, particularly the Division of Reserve Bank Operations, were able to convince FEMA (the Federal Emergency Management Agency) and Verizon of the Bank of New York's urgent need for new cable installation. The installation took about 24 hours, and once it was installed, the Bank of New York's payment system became operational again. The Bank of New York was ultimately able to settle transactions that had been outstanding for three or four days.

MS. CARTER. Weren't all the officers in charge of supervision here for a meeting?

MR. SCHEMERING. I previously mentioned that six of them were at the Board in my office. Bill Rutledge (New York), Jim Nelson (Chicago), Terry Schwakopf (San Francisco), Bob Hankins (Dallas), Bill Estes (Atlanta), and Jack Wixted (Cleveland) were attending the meeting and had to rent cars to return to their Reserve Banks.

MS. CARTER. There were stories of examiners driving cross-country and all over the place.

MR. SCHEMERING. Yes, because of the grounding of the airlines. It was a miracle that none of our supervision staff was physically affected by the attack, because the Twin Towers had many banking offices, especially FBOs (foreign banking organizations) that we supervised. The towers also housed several specialty firms such as Cantor Fitzgerald, which lost its entire staff.

MR. MARTINSON. One of our examiners was on the 90th-something floor of the second tower when he heard the explosion in the first tower. He did not hesitate and started down the stairs.

MR. SCHEMERING. Good for him. Some Fed staff had emotional issues to deal with as a consequence of what they saw that day. It was such a frightening experience that you will always remember where you were on 9/11, just like the John F. Kennedy and Martin Luther King assassinations.

MS. CARTER. Also, it spurred a number of initiatives that we had to take on at the Fed.

MR. SCHEMERING. Yes. In consultation with the other agencies, we decided that these operational centers shouldn't be housed in close proximity to the main banking facility and congregated in a small geographic area within Wall Street. So we came out with a policy that the ops center should be no closer than 50, 70 miles, or some distance that we thought reasonable.

Despite what happened, we got a lot of pushback from the banks: "Oh, no, you know how expensive that's going to be. It's going to disrupt our activities, our internal operations. And it's going to be very expensive space, because if all the banks are required to find alternative sites, there's going to be a lot of demand for these sites, and, therefore, the expenses for the purchase or the lease of those properties are going up."

There was a lot of pushback. But, finally, the banks complied. Today, if you look from Manhattan out over the harbor across the water to Jersey City, you can see these centers. A new skyline for Jersey City emerged, because a lot of those are now operational facilities for the banks located in Wall Street.

Promotion to Deputy Director

MR. MARTINSON. We've talked about a lot of things today. Are there any other topics that come to mind you want to talk about?

MR. SCHEMERING. I think this is the last thing I'll mention. In 1991, Mike, you indicated things were beginning to settle down, except that some of the money center banks had not resolved their financial problems. It was around October, and I went on my first vacation in a number of years. I went on a four-day golf vacation. I was returning on a Friday, so I thought I'd call my secretary and ask her what was going on, what my calendar looked like the following week, and if anybody had called me concerning some problems. And she said, "Yes, yes, yes." I said, "Why don't you describe what happened?" And she said, "The first thing I should tell you is that I should have answered the phone, 'The deputy director's office.' " I said, "What?" She said, "You've been promoted to deputy director. And Rich has been promoted to director."

I had no inkling that this was happening. We knew that Bill Taylor was scheduled to take over the chairmanship of the FDIC and that he would be leaving, but I didn't realize it was going to happen so fast. There was some speculation about who was going to replace Bill. At the time, Rich and I were on the same officer level, and at the time, there were two officers in the division that were senior to us. I always had the presumption that those individuals would most likely take over those positions. So I was shocked to find out I was made deputy director. She said, "When you get home, call Bill Taylor."

I said, "Okay." I got home late in the afternoon, early evening, I can't remember. I called Bill, and he said, "Congratulations, Steve. Rich and you will make a great team. I talked to the Board about this, and they have a lot of confidence in you two. Good luck." I asked, "When is this effective?" And he said, "Immediately." I said, "I guess we can talk next week and transition for your departure and our taking on these new positions. He said, "No, Monday morning I'm going to be appointed as the FDIC director, so I won't be there." I thought to myself, "So much for the transition period." Bill told me to call Governor John LaWare. I called Governor LaWare, and he congratulated me. He was confident in our abilities.

Finally, I got in touch with Rich, and I said, "Rich, I'm shocked." Rich was very surprised, too. I said, "I think what's really bothersome is that Bill is not going to be there, and we have to hit the ground running on Monday morning." He said, "Yes, I know. Why don't we meet early tomorrow morning?" This was Saturday morning. We agreed upon a time. I drove into the Board. I was early, because I wanted to make sure we could start as fast as we can. But you know Rich. You never beat him into the office. He was there before I was, well before our meeting time. I remember looking into Bill's office, and Rich was standing there looking around like, "Is this really happening?" He was like a deer caught in headlights. Then I walked in the office, and I could see why he had this wide stare. Bill had these bookcases where he had all the manuals of all the crises we talked about today—what we did, how we did it, what the magnitude of the problem was, and what institutions were involved. They were all gone. Bill had taken those over with him to the FDIC. Then it hit me, and I said, "Rich, I can see why you look concerned."

Soon thereafter, one of the biggest applications, if not the biggest, state member bank merger application came in, in the late fall, early winter of that year—the merger of Chemical Bank and Chase. It had a lot of issues. And I think that was our first difficult decision to make, because the staff's analysis and our analysis fully identified the need for this merged institution to have more capital, which was always a sore subject for the bankers involved.

But we knew that this bank probably needed incremental capital and needed to supplement its application by a commitment to raise capital. I remember the first time we called the attorneys representing the banks about where we were with the application and the issue that we identified. The first words out of the senior attorney in New York was, "You new guys on the block"—he very well knew that we were just new to our positions—"I guess you guys are like little kids. You have a long Christmas wish list." He said something to that effect. We were nearing the holidays, and they were surprised and upset that we thought that this application needed incremental capital. And the New York Fed expressed its concern. They were concerned about our position and our ability to follow through and get the merger completed.

To make a long story short, a lot of tense meetings later, Chemical agreed to raise additional capital. The Board approved the application. That afternoon we got a call from Jerry Corrigan, president of the New York Fed. He congratulated us on both. He said, “You guys did a great job in getting this application through.” But having to confront that and being in a new position, I’ll tell you, was a stressful time.

William “Bill” Taylor and John E. “Jack” Ryan

MS. CARTER. Do you have any specific comment about Bill Taylor? He was a bigger-than-life figure and then left to go to the FDIC.

MR. SCHEMERING. Bill Taylor and Jack Ryan were both extremely bright and smart and were extremely good bank supervisors. They were very much alike in that regard—the difference being that Bill could be a lot more vociferous than Jack. Jack was always pretty quiet. But you always respected his judgment and opinion, same as you did with Bill’s. Although they had different personalities, they worked well together. They were both examiners for the Chicago Federal Reserve Bank. And they both respected each other.

When the real estate problems started and when we went through that division reorganization where holding company supervision was moved down to Jack’s state member bank supervision, he could see quite clearly that the real estate bubble was evident in a number of geographic areas. At the time, Bill had left the Reserve Bank and worked for Rouse and Company, a large, well-known commercial real estate developer. Jack knew that we needed Bill’s expertise, so he convinced Bill to come to the Board. Jack was the assistant director of supervision at that time, and Bill became the manager. Then, ultimately, they were promoted.

Jack became the director, and Bill became the deputy director of the division. They were very smart and effective bank supervisors.

But Bill left no doubt where you stood with him, whether or not he was pleased or displeased with your performance. There's no doubt about the way he felt about it, and he was very direct in telling you about your performance. I learned a lot from both of them. I learned a lot of which I was able to use when I became deputy director. I learned a lot of useful lessons from them.

MR. MARTINSON. That wraps up our interview. Thank you.