Yale SCHOOL OF MANAGEMENT
Program on Financial Stability

Lessons Learned Oral History Project Interview

Interviewee Name and Crisis Position	Arthur Murton[1] Director, Division of Insurance and Research, FDIC
Interviewer Name	Sandra Ward (contractor) Yale Program on Financial Stability
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<u>Introduction</u>:

The Yale Program on Financial Stability (YPFS) contacted Arthur Murton by email to request an interview regarding Murton's time as Director, Division of Insurance and Research at the Federal Deposit Insurance Corp. during the financial crisis of 2007-09.[2]

The FDIC played a critical role in stabilizing financial conditions and establishing confidence in the financial markets by guaranteeing newly issued debt on a temporary basis for banks and thrifts as well as financial holding companies and eligible bank affiliates. The agency also fully guaranteed certain non-interest-bearing transaction deposit accounts.

Murton participated in key interagency discussions on Columbus Day weekend in 2008 that proved pivotal in stemming the crisis as programs critical to stabilizing the financial system were agreed upon. At the meetings, Murton presented a broad outline of how the FDIC's systemic risk exception authority might be used to guarantee bank debt. The Temporary Liquidity Guarantee Program and the Transaction Account Guarantee Program that resulted provided much needed ballast and steadied volatile financial markets.

An economist, Murton joined the FDIC in 1986. He became the first director of the newly formed Division of Insurance in 1995, which was combined with the Division of Research in 2002 to become the Division of Insurance and Research. In 2013, Murton was named Director of the Office of Complex Financial Institutions, a group formed within the FDIC under the Dodd-Frank Act to oversee bank-holding companies with assets over $100 billion and non-bank financial companies deemed systemically important. Since September 2018, Murton has served as Deputy to the Chairman for Financial Stability.

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[1] The opinions expressed during this interview are those of Mr. Murton, and not those any of the institutions for which the interview subject is affiliated.

[2] A stylized summary of the key observations and insights gleamed from this interview with Mr. Murton is available here in the Yale Program on Financial Stability's Journal of Financial Crises.

[*This transcript of a telephone interview has been edited for accuracy and clarity.*]

<u>Transcript:</u>

YPFS: **Let's start with what your role was during the financial crisis as Director of the Division of Insurance and Research.**

Murton: Let me start with the disclaimer that these remarks are my own and not those of the FDIC. There are a few areas of responsibility in that role. The Insurance part of the title refers to some of our responsibilities with respect to deposit insurance and, in particularly, how we maintain the Deposit Insurance Fund (DIF) and how banks pay for deposit insurance. We have a risk-based premium system, where banks pay into the Deposit Insurance Fund based on their perceived risk.

We report to our Board of Directors of the FDIC on the adequacy of the Deposit Insurance Fund and the outlook for the Deposit Insurance Fund. Another main area is a risk analysis group, based both in Washington and at our regional offices, that tries to identify emerging risks in the banking system and in the financial system. In that group, banking examiners identify risks in specific institutions.

We bring together the micro-perspective of risk that the bank-examination process produces and the macro perspective that economists and other financial analysts bring. There is also a statistics group which produces the Quarterly Banking Profile based on the Call Reports which banks file every quarter. In the Call Reports, they provide their financial information: their balance sheets and income statements, their earnings and credit quality and so on.

We also have a research group designed for academic work related to banking and finance and capital regulation and risk modeling. We also active with other countries on deposit insurance issues through a group called the International Association of Deposit Insurers.

YPFS: **You oversaw all those segments. Did you have a particular expertise in any one of those areas? Did you find yourself spending more time in one or the other? How did your role shift when the financial crisis unfolded?**

Murton: I've been with the FDIC since 1986. I am a PhD economist by training and I started in the research group. Early on I studied the causes and costs of bank failures. In addition to my research, I became actively involved in the process of resolving failed banks and learned much about the financial and legal aspects of that process. As the crisis subsided, I was active in the policy development of reforms to strengthen the deposit insurance system. Throughout its history the FDIC had very limited authority in terms of how to manage the Deposit Insurance Fund and how to charge banks for deposit insurance. That changed after the crisis of the late '80s and early '90s when Congress passed the FDIC Improvement Act, or FDICIA, and gave the FDIC the mandate to implement risk-based premiums and to maintain the fund at certain target levels.

The FDIC created the Division of Insurance in 1995 to help carry out those responsibilities.

YPFS: **Did the risk-based premium model prove beneficial in the financial crisis?**

Murton: There was a quirk initially in the timeline of risk-based premiums. While we were given that authority in 1991 in FDICIA, and first implemented it in 1993, we hit the statutory target in the mid-1990s. Legislation was passed to prevent us from charging the vast majority of banks for deposit insurance if the fund was above the target. That restriction meant that the deposit insurance fund did not grow as much as it could have during good years when bank earnings were high. Conversely, during difficult times we were required to charge very high premiums at a time when banks could least afford it.

We spent a lot of time in the early 2000s trying to get Congress to change the law so that we could charge steady premiums throughout. For better or worse, we did not get the legislation passed until 2005. That was right before the crisis and we did not have much time for the new system to take effect before we were hit with the crisis

YPFS: **Did you see this crisis looming? Or did it take the FDIC by surprise?**

Murton: I wish we could say we saw it coming because that is part of our responsibility, to look ahead and try to do that. But we didn't see the extent of what was coming. We didn't appreciate the magnitude of the problems that we were going to have, and we didn't really have a good window into some of the interconnectedness in the banking system and financial system. We didn’t see how the risk was building up, not only in the banks themselves, but in their affiliates and other holdings.

We certainly had concerns about sub-prime lending prior to the crisis, but we didn't understand how that could play out through the system in the way that it did. We published a piece around 2005 about housing markets, an analysis that looked at boom-and-bust-markets over time, and we looked at the linkage in the 2000s between boom markets and the prevalence of sub-prime mortgages in those markets. We identified that connection as a potential problem but, again, we didn't really appreciate how damaging it would be to the financial and banking systems.

YPFS: **Did priorities shift for your agency in the financial crisis?**

Murton: Absolutely. In the fall of 2008, we faced a number of problems and took unprecedented steps to address them. Most of these required the use of a special authority, known as the Systemic Risk Exception (SRE), established by FDICIA.

YPFS: **When did the FDIC get drawn in? What was the event that said, "Whoa, this is way bigger than we imagined?"**

Murton: That would have been the fall of 2008. Now, I should note that IndyMac, a $30 billion thrift in California, failed in the summer of 2008 as a result of sub-prime mortgage lending. Perhaps we can come back to that.

IndyMac was the first shot across the bow. The fall of 2008 was when we became deeply involved and fully appreciated how severe the problems were.

YPFS: **How easily does the FDIC invoke the systemic risk exception? Is it a last resort measure? How many times has it been invoked in the past?**

Murton: It is a last resort. It was put in place after the crisis of the '80s and '90s, under the FDIC Improvement Act of 1991. Typically, in bank resolutions, it is difficult to protect anyone beyond insured depositors. The systemic risk exception is for emergency situations, or situations where we think that limiting protection would pose grave risk to the financial system. After FDICIA was passed, we did not invoke the SRE until the fall of 2008.

The first time we used it was when Wachovia was having severe funding problems in 2008. We spent a weekend sorting that out. We learned about it on a Friday and worked with other agencies to deal with it. We announced at the end of the weekend that Citicorp was going to acquire Wachovia with financial assistance from the FDIC.

It turned out a few days later that Wells Fargo decided to buy Wachovia without government assistance, which was obviously better for us. So even though we invoked the systemic exception for Wachovia, we didn't implement it.

Later in the fall, we invoked it again to provide assistance to Citicorp and Bank of America in order to guarantee some of their loans when they faced severe pressures. As it turned out, while we invoked it for Bank of America, we never implemented a guarantee.

But no doubt the most notable use of the SRE was the TLGP program developed during Columbus Day weekend of 2008.

YPFS: **That's when the FDIC management met with the Treasury and the Federal Reserve folks?**

Murton: That's right.

YPFS: **Can you walk us through that meeting?**

Murton: Probably a week or two before that, our chair Sheila Bair had had discussions with the other senior officials and they were starting to think about what measures could be used to shore up the system. It was suggested that we could possibly use our systemic risk exception authority to provide a guarantee of bank debt of some kind. Chairman Bair asked me to develop a broad outline of how that might work.

There was an urgency to it. We knew that whatever we announced would need to be in effect after that weekend. The FDIC program that was developed was the Temporary Liquidity Guarantee Program (TLGP), which comprised the Debt Guarantee Program (DGP) and the Transaction Account Guarantee Program (TAG).

YPFS: **Did you design the programs or just provide an outline?**

Murton: It was a group effort. We put together one or two pages describing how the plans could work, and who would issue the guaranteed debt. Would the guarantee be on new debt or existing debt? Would we charge fees or not for the guarantee. How long would the program last? There were many questions.

YPFS: **Anything more you can add about that Columbus Day meeting? There was a lot to do in a very short period of time, with a lot riding on the outcome and a lot of personalities. Can you talk about the feelings in the room?**

Murton: There were some disagreements on what should be done, but I'd say there was also a spirit of cooperation. Hank Paulson (former Treasury Secretary) led the group very effectively. People like Sheila Bair (FDIC) and Tim Geithner (Federal Reserve Bank of NY), and Ben Bernanke (Federal Reserve Board chairman) who are very smart, thoughtful and who understood the seriousness of this and were committed to doing whatever they could to try to address the problems that we were seeing. From each agency, there was staff accompanying the principals and everyone was committed to doing what they could to make this work. It was an intense weekend but, again, it was collaborative and, by and large, successful.

YPFS: **Was there a model for this program?**

Murton: The Europeans put in place their guarantee programs at the same time, but I have to say, here at the FDIC, we had very little contact with other jurisdictions at that time, and so we knew something of their programs but we were unable to draw on them as a model.

It was a time, before the financial crisis, that the FDIC didn't have a lot of engagement with other financial regulatory authorities in the other jurisdictions, which is completely different today. We now have very strong relationships with other jurisdictions, particularly the U.K. and the Bank of England, and the European Union through the Single Resolution Board, and so forth. We have a lot of engagement with them so it would be a very different situation today if something like this were to happen. We have a lot more dialogue about these things.

YPFS: **More global engagement is a positive outcome, right?**

Murton: Yes. We're in a better position to deal with future problems because we have this kind of engagement.

YPFS: **The procedures involved in the TLGP and TAGP, did those come together fairly quickly? Had they ever been implemented before?**

Murton: It came together fairly quickly. Had we done anything like this before? The answer is no. And I should spend a minute on the two parts of it: There's the debt guarantee program but also the transaction account guarantee program, which was something that Chairman Bair and the FDIC felt was important because the debt guarantee program was largely a benefit to the largest banks because community banks and smaller regional banks don't tend to issue much debt. Community banks and regional banks rely to a greater extent on deposit funding which could include business deposits that are over the deposit insurance limits. So, for example, a payroll account that a company has at a community bank might be exposed to loss and unavailable when the bank fails. Because of this risk, you could see those depositors getting nervous and possibly withdrawing their funds.

The Transaction Account Guarantee Program was designed to address possible funding problems at community and regional banks. It also benefited larger banks because larger banks also have transaction accounts. So it benefited the entire industry. We had never done anything like the TAGP program and it did take us time to sort out some technical issues.

We made the TLGP announcement after the Columbus Day weekend. We then had a series of conference calls where bankers and other interested parties could call in and ask questions about the program and raise issues. We would have several thousand people on the line and they would raise questions that we had to consider and figure out how to respond to them. That was very helpful. We put out initially what is known as an interim final rule to put the program in place. After receiving comments on that and through these phone calls, we came back after a month or two and made some changes to the program through another rule-making.

Even after we had the rules in place, we had to work through a number of implementation issues that were a challenge.

YPFS: What were some of the challenges?

Murton: The way deposit insurance works, when a bank fails it is placed in receivership, we usually transfer the liabilities to another bank and depositors have access to their money Monday morning. That was our experience and our conception of how things would work under the new program. Initially, we thought if a firm that had issued guaranteed debt failed, we would then do what we normally do which is put it through our receivership process and then start paying people who held the guaranteed debt.

What we learned was that the investors in this debt expected regular payments at regular times and wanted those payments to come at precisely the times they were supposed to. There's a specific term for it: "timely payment". We had to be prepared to make the payments that the debtor expected at precisely the time they were due. That was different from what we did in normal bank failures.

We had to work out operational issues as to how we would do this and come up with ways that we could be sure that we could make the payment if one of these banks that had issued this guaranteed debt defaulted. For example, if a commercial paper issuer were to default, the relevant parties would learn of it in the morning and we would need to be able to pay by the end of the afternoon. We had to work with the Treasury and the Federal Reserve and others to come up with a way that we could do that. Once we did that, the banks and the public got much more comfortable with the different programs.

YPFS: It seems the TLGP and TAGP programs were key to providing stabilization in the financial markets. Would you agree with that?

Murton: Yes, I think it's fair to say that was the consensus then and continues to be now.

YPFS: Let's backtrack and talk about IndyMac. That was the shot across the bow for the FDIC at the time of the last crisis.

Murton: Yes, we had one or two small failures maybe in 2008 before that but IndyMac was the first sizable failure, $30 billion or so, and it was a wake-up call. It was the first significant resolution of the crisis. It was a challenge because we didn't really have the time to do what we normally do.

That proved to be the most-costly bank failure in FDIC history, by quite a wide margin even though it was only a $30 billion bank. Because we didn't have time to find a buyer for it we had to establish a bridge bank where we, the FDIC, actually owned and operated IndyMac until we could find a buyer. Our then-Chief Operating Officer, John Bovenzi, went to IndyMac to be acting chief executive and run it until we could find a buyer, and I became the FDIC's acting COO while he was at IndyMac.

YPFS: Why wasn't there time with this one? Can you walk us through the events?

Murton: We knew there was problems there, but we didn't know how deep they were. We weren't the primary federal regulator of the bank, the Office of Thrift Supervision was.

YPFS: Does that agency still exist?

Murton: No, it doesn't exist. Congress judged that the OTS hadn't done a good job leading up to the crisis and abolished the OTS and merged its operations into the OCC, the Office of the Controller of the Currency.

YPFS: IndyMac's problems were all mortgage-related?

Murton: Yes, IndyMac's problems were due to subprime mortgages.

YPFS: For a bank it's size, its problems were outsized.

Murton: It was a $30 billion failure and it cost us probably on the order of $12 billion to resolve.

YPFS: Why was that? What's that a function of?

Murton: It was a function of how poor the loan quality was and how they had invested in mortgages and securities. They were underwriting loans to people who couldn't pay them back. It was the costliest failure in FDIC history. It was more than double the next most expensive failure.

YPFS: How did it compare to WAMU (Washington Mutual)?

Murton: WAMU came a few months later. We were more on top of that, but it happened rather quickly. Normally, we wait until Friday to close the bank so we have the weekend to turn over its operations and balance sheet to a new acquirer. But it suffered liquidity problems during the week and we had to close it on a Thursday evening. We arranged a bidding process and a sale of WAMU to JPMorganChase on a Thursday.

Fortunately for us, that resolution came at no cost to the FDIC for two reasons. One, there was more franchise value there, which is why JP Morgan Chase had been looking at it before we tried to try to sell it. They were considering whether to buy it without government assistance and had done some due diligence on it. They decided that the problems might be too severe to take on without assistance.

Second, the bank had some senior and subordinated debt that could absorb some of the losses and as a result the losses didn't extend to the depositor class. That's why the FDIC did not suffer any losses.

YPFS: **So 2008 was an eventful year for the FDIC, but there was more to come?**

Yes. What we have talked about thus far occupied much of our time in late 2008 and while the broader financial crisis was really acute in 2008, it started easing up in the first half of 2009.

However, as 2009 began we started seeing community banks and smaller regional banks failing on a regular basis. In a three-year period, the FDIC had to resolve on the order of 500 banks. We had banks closings almost every weekend.

Not to brag about our resolution group at that time, but they did a remarkable job during those years. In a typical failure, they would close the bank on a Friday night, transfer the assets and liabilities to an acquiring bank over the weekend, and the bank would open up Monday with business as usual. This is not a simple task, and they did it week in and week out for more than three years.

YPFS: **Let's talk about watching the Deposit Insurance Fund slip into negative territory. How scary was that.**

Murton: We entered the crisis with the Deposit Insurance Fund at $53 billion. The losses from all those bank failures caused the Deposit Insurance Fund to fall significantly and we had to find ways to try to address that.

The fund was being depleted and there were two aspects to that. The fund balance, which is essentially our net worth, was heading down and projections showed it going into negative territory. Another issue was liquidity, which is different than the fund balance. Liquidity is the cash we have available. As banks fail we have to provide cash to protect depositors. Cash reserves were going down as the fund balance was going negative. We had to address both of those problems.

On the fund balance going negative, we were concerned about how to communicate that. How would the public view it if they saw that the FDIC had a negative balance? We tried to communicate through our Quarterly Banking Profile press conferences that even if the fund balance were negative, we still had resources. We had lines of credit from Treasury that we could draw on to carry out our duties, and even if we were showing a negative balance we would be able still to conduct our responsibilities and protect insured depositors. We wanted to make that clear.

In terms of liquidity, we felt that if things continued on the path they were on we might run out out of cash and that would be a bigger challenge. Our solution was to come up with a way of having banks pre-pay their deposit insurance assessment. They paid into the Deposit Insurance Fund every quarter, and we had them pre-pay three years of deposit insurance premiums all at once. That was in late 2009 or early 2010.

We brought in close to $45 billion in cash through that mechanism and shored up our liquidity situation. That allowed us to get through the rest of the crisis without having to borrow from Treasury. Even though we would've been able to borrow through Treasury, our Chairman Sheila Bair and others were in general agreement that it would be better to use the industry's liquidity to get us through this rather than having to go to the taxpayers in the form of the Treasury and borrow from them.

From the industry's perspective, when they prepaid their assessments they were essentially lending us money and it didn't affect their earnings or their capital. It wasn't a hit to earnings or capital levels. Had we asked them to pay a large special assessment, which we could've done, it would've hit their earnings and capital. Our solution was a better solution.

YPFS: **Did industry help craft the solution or did the FDIC impose the solution on industry?**

Murton: It was through discussions within the FDIC and with some in the industry that we came to realize this might be an option. Again, it was a novel approach that proved to be effective.

YPFS: **Going through that process were you reminded of any other period? Did it remind you of the late '80s, or the savings and loan crisis?**

Murton: What happened in the fall of 2008 when credit markets seized up was unique. It really didn't happen that way in the '80s and '90s. Some things were similar. The 500 banks that failed were reminiscent of the problems we had in the late

'80s and early '90s. In the earlier period, problems were more office-related as opposed to residential, but they were still real estate mortgage problems. And in the '80s and early '90s we did have some large banks that got into trouble because of what was known as LDC, or lesser-developed-country, debt problems. Still, those problems were not as acute. Banks were able to work their way through it, in part because regulators gave them forbearance to allow them to work through their problems to a greater extent than would be possible today.

The S&L crisis was similar to the most recent crisis in at least one important way. That was a crisis in which thousands of savings and loans failed. A now-defunct agency, the Federal Savings and Loan Insurance Corp, FSLIC, became insolvent and couldn't act on its guarantee. Taxpayers had to step in and cover more than $100 billion of losses, which was a lot of money then. There was taxpayer outrage over that as there was in the 2007-09 crisis with the TARP and other programs.

YPFS: **How did you come to your current position, and how did your experience handling the crisis of 2007-09 inform the role you're now in?**

Murton: Throughout the course of my career, even though I wasn't directly responsible for the group that resolved failed banks, I came to learn how they did what they did, particularly from a policy point of view and the financial and legal framework around it.

During the more recent crisis, I was involved in trying to shore up the largest banks and so I was acquainted with the issues that arose when a large bank or financial firm was in trouble and might need some kind of intervention to correct it, either a failure or some other kind of arrangement. When Congress passed the Dodd-Frank Act, it gave policymakers another alternative for how to deal with large failing financial institutions and it gave those new authorities to the FDIC.

I'd like to think we've made a lot of progress in implementing the resolution reforms of the Dodd-Frank Act. You may be familiar with "resolution plans" that firms have to file under Title 1 of the Dodd-Frank Act, section 165D, requiring the largest banks to submit plans to the FDIC and the Federal Reserve, which share joint authority, that show how they could be resolved under bankruptcy without damaging the financial system.

YPFS: **These are the living wills?**

Murton: Yes, the living wills. It took us and the Federal Reserve a few years to figure out what to do with this new authority and how to implement the rules. By 2014-17, we and the firms made a lot of progress. We identified actions and made changes to the way they operate that would make them more resolvable.

Congress gave us the authority to impose sanctions if these plans were not credible and the banks couldn't be resolved without damaging the financial system. We could impose higher capital and liquidity levels or restrictions on operations. If after two years those measures didn't correct the issues, then we had the authority to require them to divest of operations and assets, and essentially break them up. Congress gave us a fairly strong tools to use if we found that firms were not meeting the standards that Congress set.

And so, the firms started making changes that would make them more resolvable under bankruptcy. All the steps they take under the living will process to make them more resolvable under bankruptcy also make them more resolvable in the event we would have to use our Orderly Liquidation Authority.

In addition, we have worked very closely in the last seven or eight years with foreign authorities, especially in the U.K. and the European Union, that have powers similar to ours in terms of resolution, to better understand one another's frameworks and what our issues would be if we had to resolve one, and how we could cooperate across borders in the event that a global firm was in trouble and had to be dealt with. We've established relationships and understandings and tests that didn't exist prior to the last crisis.

YPFS: **What for you are the most important lessons of the last crisis?**

Murton: On the resolution front, in 2008-09 when big banks were in trouble, policymakers had two bad choices: One was to let them go through the normal bankruptcy process and possibly create a lot of disruption in the financial system and the broader economy, or we could bail them out and face the political backlash. What Dodd-Frank did and what we've been working on over the years is to have in place another option for policy makers so that we could do an orderly resolution of one of these firms, whether under bankruptcy or under our liquidation authority. We have to be ready to use our new authorities and be prepared to use them so that we can avoid bailouts or disruptive failures. That's very important.

We've done a lot of work, but until it's tested, you don't know. We won't know until we actually face a new crisis. We have much better tools. We've done much more thinking and planning about how we would approach this. We have deeper relationships with the authorities and other jurisdictions.

We as a regulatory community need to do a better job of understanding the risks that are out there, digging deeper into where the vulnerabilities might be, where the risks are building so that we're better prepared and better able to address those risks. We need to do a better job before the problems arise. We need to be ready to exercise the authority we've been given. Having relationships with other jurisdictions in other countries and understanding their systems and their concerns is important.

In the last crisis, we thought a lot of risk was outside the banking system and banks' balance sheets, but it all came back to the banks' balance sheets. So, we can't be lulled into a false sense of security when problems arise outside the banking system or in ways that differ from the past.

YPFS: **Thanks, Art.**

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