Part One

NO CALM BEFORE THE STORM

Chapter 1

Home Alone

I was home alone in Sarasota, Florida, enjoying the tranquil waters of the Gulf of Mexico lapping against the shore. Saturday, September 27, 2008, was a typical steamy day toward the end of an uneventful hurricane season. A storm of another sort was brewing, however, and I was jolted back into reality by the loud ring of my landline. It was the first of many urgent calls I would receive that day from Washington, D.C.

In contrast to the Gulf of Mexico, the worldwide financial system was anything but tranquil. It was, in fact, in the midst of a veritable tsunami in the wake of the government's decision to allow the venerable investment bank of Lehman Brothers to fail on September 15.

On Thursday, September 18, Secretary of the Treasury Henry Paulson and Federal Reserve chairman Ben Bernanke rushed to Capitol Hill to meet with leaders of Congress in House Speaker Nancy Pelosi's conference room.

Paulson and Bernanke presented an outline of a $700 billion financial bailout plan, called "TARP," as in Troubled Asset Relief Program. The idea was for taxpayers to purchase $700 billion of bad assets from financial institutions. Their presentation was, in a word, terrifying.

"If we don't do this," Bernanke was reported as saying, "we may not have an economy on Monday."

Paulson used inflammatory terms like "financial Armageddon" to stress the need for urgent action.

Having served as chairman of the Federal Deposit Insurance Corporation (FDIC) during the banking and S&L crises of the 1980s, I was disturbed, even angry, about the events that led up to the bailout plan and the plan itself. I was so upset that I wrote an opinion piece opposing the bailout plan that ran in the *Washington Post* of Saturday, September 27.

My op-ed suggested a four-step plan to alleviate the financial crisis:

1. The Securities and Exchange Commission immediately reimpose on short sellers the Depression-era regulations on speculative abuses the SEC had removed in 2007
2. The FDIC declare a financial emergency and proclaim that all depositors and other creditors of banks would be protected in bank failures during the period of emergency
3. The SEC immediately suspend the mark-to-market accounting rules adopted by the SEC and the Financial Accounting Standards Board during the preceding decade (rules that senselessly destroyed over $500 billion of capital in our financial system)
4. The FDIC use its emergency power to restore capital in banks along the lines of a program we used successfully in the 1980s

I believed then and continue to believe strongly that these actions would have been much more effective in dampening the financial crisis than Paulson's ill-conceived plan to purchase toxic assets, would have cost taxpayers little, if any, money, and would not have politicized the crisis and scared the public the way the Paulson plan did.

The *Washington Post* article triggered a series of Saturday phone calls from members of Congress, urging me to come to Washington immediately to discuss the crisis and the bailout legislation. The calls were from three Democrats (Marcy Kaptur of Ohio, Brad Sherman of California, and John Hall of New York) and two Republicans (Darrell Issa of California and Vern Buchanan of Florida).

Not only were they from different parties, they represented a pretty broad swath of the political spectrum. They had in common fears about the financial system, deep skepticism about Paulson's bailout plan, and frustration that the congressional leadership was rushing headlong into adopting the bailout plan without hearings, debate, or amendments.

I knew Marcy Kaptur, as she was on the House Banking Committee when I served as chairman of the FDIC, and she is from Toledo, Ohio, near my hometown of Bryan, Ohio. Vern Buchanan is my congressman in Sarasota. I had not met the others but would soon get to know them pretty well.

To this day, I do not know if their calls were coordinated or independent of one another, but my sense is that they were independent. I told each that I could see no point in coming.

"Congress is going to approve the bailout bill on Monday," I explained, "and my presence in Washington is not going to change anything. We are taking the kids to see the Buccaneers play the Packers tomorrow and that's a much better way for me to spend my weekend."

Several persisted. Brad Sherman offered to pay my expenses, but I declined. I teased John Hall, a former rock musician who founded the group Orleans, that my price for coming would be an invitation to watch his current group perform. He has yet to deliver, but I will remind him some day.

"Okay," I finally said. "When my wife gets home, I will ask her what she thinks."

When she returned, her response was immediate and unwavering, "You have to go. You feel so strongly about these things, you will always regret it if you don't."

She was right. The next day, my wife and kids went to the Bucs game without me and I took off for Washington. I went because I was convinced that our leaders had failed us for the last two decades, and because I hoped that I might be able to help prevent a bad situation from becoming even worse by tapping the lessons of the bank and savings and loan crises of the 1980s.

I could not have guessed how much my life would change. I have devoted at least half of my time since September 28, 2008, to trying to help get us out of this crisis and make sure we do not ever experience another one.

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My flight from nearby Tampa landed at Reagan National in Washington at one o'clock in the afternoon on Sunday, September 28, and a waiting Lincoln Town Car whisked me directly to Capitol Hill. The next few days were a whirlwind.

Congressman Issa generously offered his office as a staging area. His staff put out the word to Republicans and Democrats alike that I was available to meet with any member of Congress who wanted to discuss the financial crisis or the bailout legislation.

There were plenty of takers. I had a series of meetings of various sizes with members of Congress that lasted until one o'clock Monday morning, when I finally checked into my hotel and crashed for a few hours. Most of the meetings were conducted in windowless rooms that I never knew existed in the basement of the Capitol Building.

All together, I met with some 200 members of Congress from both parties from the left, right, and middle of the political spectrum. Several of the meetings were joint meetings of Republicans and Democrats, which participants told me they had never witnessed previously.

I will never forget one meeting in particular. Congressman Jesse Jackson (D-Ill.) was on my left, Congressman Dennis Kucinich (D-Ohio) was on my right, and Congresswoman Maxine Waters (D-Calif.) was directly across the table with a number of conservative Republicans sprinkled around the rectangular table. I was thrilled to see them set aside partisanship and ideology for a moment and come together for the good of the country.

For the most part, the meetings were with the rank and file members of the two parties, not the leadership. The leaders of both parties had already made up their minds that the Paulson bill should be adopted immediately without hearings, debate, or significant changes. The leadership viewed the skeptics as an annoyance. As if to put an exclamation point on it, the floor vote in the House was scheduled for Monday morning, September 29.

As the day turned to evening on Sunday, the leadership began to realize that it had a rebellion on its hands. At the urging of the skeptics, the Republican leadership group in the House granted me a half-hour to present my views. I was honored to be there and appreciated their willingness to listen and engage on the issues.

The Democratic Caucus, again at the urging of the rank and file, agreed to meet with Professor James Galbraith of the University of Texas and me later that evening, a most unusual step. Unfortunately, by the time we were allowed into the meeting, nearly all of the Democratic leaders had departed.

I returned to the Hill Monday morning to be available to any members who wanted to talk before the vote on the bill. We could not get a reading on when the vote would take place. We were given a time and then we were told it had been pushed back. It seemed the leadership was in trouble on the bill and was trying to round up votes.

Finally, definitive word was received that the vote would begin early in the afternoon. We fought a good fight, but evidently the leadership had mustered the needed votes. Otherwise, why take a vote?

I camped out in Darrell Issa's office to watch the vote on C-SPAN. It was every bit as exciting as a football game. The vote seesawed back and forth, the yeas and nays never more than a few votes apart. As the end drew near, the nays took a decisive lead and the bill was defeated—228 opposed and 205 in favor.

Cheers erupted throughout Darrell's office. We turned up the volume on the news channels to see how the news was being received. The world was as flabbergasted as we were!

The Dow Jones Industrial Average had been off significantly (in the range of negative 500 or more) most of the morning before the vote was taken and ended the day down over 700. A lot was made of that by critics of the House rejection, but I thought it represented a pretty subdued reaction for the market to drop another 200 points or so after the vote. The market rallied nearly 500 points the next day.

Congressman Buchanan and his wife, Sandy, and I rushed to Dulles Airport right after the vote to fly back to Sarasota. We were thrilled with the vote but knew the leadership was not going to let the vote stand.

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Sure enough, the next day congressional leaders were working with the Bush Administration to sweeten the bill. A provision increasing the deposit insurance limit from $100,000 to $250,000 was added to buy support from smaller banks. Senator Chuck Schumer (D-N.Y.) called to ask if that amendment would move me to support the bill. I responded it would not.

About $150 billion of pork was added to buy more votes. Congressmen were threatened with the loss of committee memberships and support for their campaigns. Language was added requiring the SEC to provide a report on the effects of mark-to-market accounting. Moreover, the SEC announced a 30-day ban on short selling of financial stocks.

The Senate passed the bill by an overwhelming vote on Wednesday, October 1. I was particularly disappointed that Senator John McCain (R-Ariz.) came off the campaign trail to vote in favor of the bailout. I believe his vote was a nail in the coffin of his presidential campaign. If he had remained true to his core beliefs and voted against the horrendously bad Paulson bill, I believe he would have tapped into the very deep public anger toward Wall Street and Washington. One of my heroes was Senator Richard Shelby (R-Ala.), ranking member of the Senate Banking Committee. He railed against the Paulson bill on the White House lawn after a meeting in which President Bush asked for his support!

I returned to Washington the day of the Senate vote to be available to members of Congress prior to the House vote. The House voted narrowly in favor of the amended bill on Friday, October 3. The leadership prevailed, but at least some of what the skeptics had argued for had gotten into the legislation.

The Administration and congressional leaders made a huge deal about their belief that the markets were counting on passage of the TARP legislation, predicting that the Dow would drop at least 1,000 points if the bill were not passed. Once the bill did pass, the markets sobered up to the recognition that Congress just spent over $850 billion (counting the pork added to the TARP money) the Treasury did not have so it could pay for a bill that would do no good. The Dow dropped from 10,831 on October 1, 2008, to 8,175 on October 27, 2008. It continued its downward spiral to 6,547 on March 9, 2009. It is difficult to imagine how rejection of the bill could have produced worse results.

Each of the four actions I urged in the September 27 *Washington Post* op-ed piece was put into place after the TARP bill became law. The SEC adopted a temporary ban on short sales of financial stocks. The SEC also proposed to reinstitute a version of the short-sale regulations it had seen fit to abolish in 2007. Better late than never, unless, of course, you have already lost your house or your job, or your bank has failed and you cannot get a line of credit!

The SEC and FASB finally made significant reforms to mark-to-market accounting in early April 2009, but only after Congress held a scathing hearing in March 2009 (at which I testified) and threatened to legislate repeal of mark-to-market accounting if the SEC and FASB did not act immediately to correct its most egregious problems. The April action by the SEC and FASB was an improvement and was well received in the markets. But we really needed retroactive repeal of virtually all vestiges of mark-to-market accounting to restore much of the $500 billion of capital in our financial system that mark-to-market accounting had senselessly destroyed.

On October 14, less than two weeks after the TARP was enacted, Secretary Paulson announced that he was triggering the systemic risk exception to allow the FDIC to guarantee checking accounts and the debt of banks and bank holding companies. It was not the simple and reassuring blanket proclamation I had urged, but it had a similar effect.

Even more striking, Paulson aborted his plan to buy toxic loans under the Troubled Asset Relief Program in favor of using the money to recapitalize banks! I hate the way he got there and the way he implemented it, but he deep-sixed the Troubled Asset Relief Plan and decided to focus the money on recapitalizing the banks, as I had urged in the *Washington Post* article.

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Twelve months later, when we observed the one-year anniversary of TARP, a fair number of political leaders credited TARP with calming the financial crisis—a lame defense at best. What else would we expect of people who gave $700 billion of our money to the Treasury secretary to distribute as he saw fit?

The irony is that while TARP was being considered, Barney Frank (D-Mass.), chairman of the House Financial Services Committee, when confronted by the skeptics about the plan I advocated in the *Washington Post* article, reportedly responded, "Isaac did a good job running the FDIC in the 1980s, but this crisis is much more complex due to all of the derivatives and other off-balance sheet exposures and requires different solutions. Isaac's experience is outdated."

Frank went on to draw an analogy to Joe Gibbs, who took the Washington Redskins to the Super Bowl several times during the 1980s and early 1990s but was unable to repeat when he coached the team more than a decade later. I was flattered to be compared to Joe Gibbs, but was not sure what to make of Barney's suggestion that I was over the hill, except to note that Barney is nearly four years older than I.

In fact, TARP accomplished nothing that could not have been done without legislation. The SEC could have suspended mark-to-market accounting and reinstituted regulations on short sellers without legislation. The FDIC could have guaranteed depositors and other creditors of banks without legislation. Moreover, the FDIC did not need legislation to develop a capital infusion program for banks under the systemic risk exception—had it done so, the program would have been administered far better and more fairly than the TARP program run by Treasury.

If we had gone down this path using the SEC's and FDIC's existing authority, we would not have forced Congress to appropriate taxpayer money with all of the harsh political consequences for both politicians and financial institutions. We would not have endured the political spectacle of our leaders using such inflammatory language as "financial Armageddon," "worst crisis since the Great Depression," and "not sure if we will even have a financial system on Monday."

The rhetoric used by political leaders to sell the TARP legislation seriously eroded public confidence in the government and the financial system and panicked the public. The economy flatlined during the month of October.

I will come back to all of this later, but first I will take you on a journey through the banking crisis of the 1980s through my eyes. I believe that understanding how we addressed the severe crisis of the 1980s is critical to understanding how we mishandled the problems of 2008.