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Q&A: RODGE COHEN REFLECTS ON BANKING CRISIS, CONSOLIDATION - PART 2

In the second part of a two-part interview, Sullivan & Cromwell's Rodge Cohen discusses bank consolidation, the 2008 financial crisis and this year's bank runs at SVB, Signature and First Republic.

BY DAVID MARCUS

This is the second part of a slightly edited interview with H. Rodgin Cohen, the senior chair of Sullivan & Cromwell LLP. Cohen has had a critical role in helping clients work through a series of financial crises, starting with the collapse of New York's Franklin National Bank in 1974 and including the New York City bailout of 1975; the savings and loan crisis in the 1980s; the stock market crash of 1987; and the near-collapse of the U.S. financial system in 2008.

In Part One of the interview, Cohen discussed the changes to bank regulation in the 1970s and the 1980s that allowed for the start of significant consolidation in the sector, the entrance of foreign players into the U.S. market in 1980s as well as how he came to the practice as a young associate.

In Part Two, which is below, he discusses run up to the near-collapse of the U.S. financial system in 2008, the much more vigorous regulatory environment that emerged after 2008 and the similarities between past crises and bank failures of early 2023 including the collapses of Silicon Valley Bank, Signature Bank and First Republic.

The Deal: As you have the S&L crisis in the late 1980s into the early 1990s, the consolidation among the commercial banks around the country is gathering speed. Talk about your work there.

Cohen: It was working with clients to try and help in the consolidation process. A lot of the S&Ls were bought by

Sullivan's H. Rodgin Cohen

banks out of receivership. There were also banks that collapsed. New England went through a terrible patch too. We worked on a number of transactions there as well to try to salvage whatever could be salvaged.

I should ask you about the 1998 crisis, which was relatively brief but certainly unnerving. That's the one speed bump between the early 1990s and 2008.

Because it was brief, it doesn't resonate with me even today. The 1998 crisis was over quickly, and maybe part of the problem was that people didn't learn a lot from it.

The one point I should mention because it comes back to the policy issue and shows that you would rather be lucky than smart relates to the 1987 stock market collapse that almost brought the country to its knees. It was the worst collapse since the 1930s in the stock market.

A number of people started to think about what could be done to try to alleviate the risk. One of the problems in 1987 was that the Federal Reserve Bank's ability to lend was quite limited by the type of collateral. When a number of people got together and thought about what could be done, it was to amend Section 13 of the Federal Reserve Act to permit the Fed to take pretty much whatever collateral it wanted to, so long as it was comfortable it would get repaid. That was originally designed when there was largely a separate broker-dealer industry because you still had the Glass-Steagall Act.

Although the amendment to the Federal Reserve Act was originally done for the broker-dealers, it ultimately proves critical in 2008, because without the special lending authority, almost none of the rescue programs could have been implemented. That again shows, and I keep coming back to this theme, the value of the public and private sectors working well together and in a coordinated way for the country's best interests.

With the exception of the 1998 crisis, between 1993 or so and 2008, there's a huge amount of consolidation.

It keeps going, and it gets exponentially larger.

And it seemed like there was relatively little strain on the financial system.

I think that's fair.

There has been an enormous amount written and said about the 2008 financial crisis, but if you were going to distill the experience into just a few minutes, how would you describe it? How did your previous experience affect how you looked at it? What did you learn from it? And were there moments where you were terrified at what might have happened?

There were certainly moments where I was terrified. I was frightened starting in the summer of 2007, and I'll never forget where I was when Countrywide was on the brink of collapse. That was the largest mortgage lender by far.

You're going to hear this multiple times. You got a cooperative effort in response to Countrywide's problems. This was largely the Federal Reserve Bank of New York, and the Bank of New York, which was a repo clearer, and Bank of America. That started about 11:30 pm one night, and by the next morning we had managed to get something cobbled together. If that's the biggest mortgage lender in the U.S. and it's in real trouble, you could see what was coming. Within a couple months, we start talking to one of the two government-sponsored entities, Fannie Mae, which is starting to experience challenges. Already some of the leaders at Bear Stearns understood the pressures they were under.

This was frightening from then on, but when it really became terrifying, and I was not at all confident we'd make it, was in September 2008 when the president of Lehman Brothers and I were called in and told that the government is not going to work out a deal for Lehman and Lehman is going to be forced to file for bankruptcy.

I also knew that AIG was in very deep trouble, and even though I was taken aside and told that AIG would not necessarily be treated the same way as Lehman, I was very concerned that with the government having failed to step up at Lehman, that they would also not step up at AIG, and I didn't know what would happen after that.

You could feel these tremors from August of 2007, because the lending market shuts down within two weeks. You could see the pressures extending from that. At what point did you think there might be no ending point?

I was worried after, and my eyes were opened by, Countrywide. All these people who write the books say that they predicted everything. That's always easy to do after the fact, I didn't necessarily see that we would get to the point we did, but I knew this was a point of significant risk. It wasn't not foresight on my part. I have a lot of data points. I'm talking to one of the GSEs, and I've seen Countrywide up close and personal, we're talking to Bear, we're talking to some of the banks, and it's clear there's a lot of pressure.

There are all these immense forces, and you're sort of tossed and turned. You have very little capacity to control them. You do the best you can do, but at the end of the day, others make the decisions.

Was there a point at which you felt the system was going to survive?

I thought once you establish the precedent of the public and private sectors working together, then I think there's so much creativity in both sectors that when they work together, people can find a resolution. It happened with Bear. It didn't happen with Lehman, it didn't happen with Fannie or Freddie, although there were major efforts in those cases. Then, you come to the next set of institutions in serious trouble, including AIG, where the government is actively involved. The government is also helpful behind the scenes in the MUFG investment in Morgan Stanley, which is probably the transaction that has the highest ratio of criticality to publicity. Nobody seems to focus on it, but had that deal not gone through, it would have taken the system down with it.

It's a shame sometimes that things aren't written about because that means there are unsung heroes. Here, the two heroes are Treasury Secretary Henry Paulson, who overcame objections elsewhere that the Japanese would never move fast enough and said, "Let's give it a try." Paulson's written about, but the one who isn't is David McCormick, the Under Secretary for International Affairs at the Department of Treasury. There was a critical negotiation where Treasury had to be involved. They weren't providing assistance, but they had to take a certain action, and Paulson was not reachable that Sunday, and David did what he needed to do.

That occurs in September 2008.

Once MUFG invested in Morgan Stanley and Wells Fargo bought Wachovia and Berkshire Hathaway makes an investment in Goldman Sachs, the government starts to do certain other things. It's when the two sectors work collaboratively when things get done.

How did your practice change after 2008, because the kind of bank mergers that had occurred between between the early 1990s and 2007 stopped and have never come back.

There were mergers of some significance, for example Bank of Montreal buys Marshall & Ilsley Corp. in 2010, M&T Bank Corp. buys Hudson City in 2015. There are a few of these. It's nothing like the volume for sure in the 1980s, where every Monday it seemed there were three deals announced.

But now you have a much more vigorous enforcement approach by various governmental agencies against the banks whether it's for mortgage foreclosures or mortgage lending or anti-money laundering or sanctions violations. There's a lot of that, and it limits acquisitions. Plus there's a massive new regulatory scheme coming out of the Dodd-Frank Act, and that takes a lot of time.

So the bulk of your work as an adviser becomes managing that regulation.

A lot of it, yes.

That brings us to the last six months where you have a flurry of three bank seizures by the FDIC: Silicon Valley Bank, Signature Bank and First Republic. Discuss that episode and how your previous experiences in previous crises resonated as you were working on these situations.

The parallels you're drawing are exactly right. The players may change. The facts are not going to be identical, but there is so much similarity as to what happens, as well as differences. People have pointed out that more deposits left SVB in 24 hours than left Washington Mutual over weeks. Everything today, of course, is accelerated, and that was accelerated. But the basic issues of the need for government action, of the need to appreciate how quickly confidence can erode are the same. Looking for buyers, trying to shore up defenses, it's very similar.

What do you see as the most critical issues facing the banking sector now that we seem to be on the other side of the most recent crisis.

I still think there's a fair amount of dry tinder out there in at least the two areas. One Is the interest rate mismatch and potential velocity of deposit outflows. That still is there. You also may have some credit risks now. You look at the June 2 jobs report and you wonder, how could there be a risk in anything if we're adding 330,000 jobs and another 100,000, understated, in March and April? It's incredible, printing those numbers.

But there are obviously weak spots in the economy. The banking system as a whole is far far better capitalized than it was, and it's far more liquid, but a purpose of a bank is maturity transformation. You can't have exact matching of duration of assets and liabilities or the banks aren't going to be performing their essential service. It's finding what for a long time has been the sweet spot where you can engage in maturity transformation without creating undue risk.

I do also worry about the unchecked and non-transparent efforts of some short sellers to drive the price of bank stocks down, and then depositors take that as a sign of weakness and flee. It becomes a vicious downward spiral. ■

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