



Every Crisis Begins with a Shock

Summary:

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Full article:

An interview with Robert F. Bruner, Dean, Darden Graduate School of Business Administration, University of Virginia

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The Panic of 1907 began in October of that year, when Augustus and Otto Heinze attempted and failed to corner the stock of United Copper Co. But, just as our current financial crisis took at least a year to bloom, you say the same was true in 1907?

It's a misconception to believe that financial panics and crises are due to just a panicky world of depositors and investors. A panic has to start with something. Every crisis has at its core a real economic shock — and the shock is unambiguous, costly, and surprising. The shock in the case of 1907 was the earthquake that devastated San Francisco in April 1906. That earthquake triggered insurance policies to be honored by companies around the world. It drew gold, which was the currency of the day, out of the major financial centers of the world to San Francisco, in order to pay for rebuilding the city.

The United States of the day was the equivalent of China or India today: it was the engine of growth for the world. When the earthquake hit, it merely amplified a demand for capital that had been growing for decades.

The flow of gold to the United States prompted European central banks to raise interest rates to draw gold back to their financial centers. The tug-of-war for capital was slowly being won by the Europeans. It created a liquidity crunch that by late 1906 was in full swing. In March 1907, the "silent crash" saw the market lose about 10 percent of its value in a couple of days. That was the turning point of

sentiment.

Other events presaged the actual panic.

Yes. One was the difficulty New York City had in refinancing its bonds. Essentially, the city borrowed on a short-term basis to fund some of its capital and operating expenditures. But it withdrew a bond issue in June when it couldn't sell bonds at what the city council believed were fair yields. The city sampled the market again in July, but again had no luck. By August, conditions were getting perilous. At that point J.P. Morgan stepped in as an adviser and underwriter. He convinced the city council to agree to some extra conditions and a slightly higher yield and was able to place the bond issue in Europe.

Morgan was lauded as the savior of the city. Thinking that the difficulty was behind the markets, he went off to Richmond, Virginia, to attend a triennial convention of the Episcopal Church, in which he was a warden. Thus Morgan was absent during the second proximate trigger of the crisis, which was the attempt at speculation in the shares of United Copper.

Now we come to the infamous Heinze brothers.

That's right. Augustus Heinze was a rough-and-tumble businessman from the copper fields of Montana. He had cobbled together a series of mining interests that represented a sizable portion of the copper industry. Heinze abruptly sold those interests to Amalgamated Copper, a company backed by the Rockefellers, and went to New York to make his mark as a financier. He bought an interest in a number of banks and trust companies but retained his stake in United Copper, one of the core companies on which he had built his fortune.

As the economy receded over 1907 Heinze grew more and more skeptical about the decline in the price of United Copper. He came to the conclusion that the company was the subject of a bear raid, where speculators were selling its shares short. So he attempted what is commonly called a bear squeeze. He began buying shares of his own company in volume, and the share price rose and rose. In those days settlement could occur the next day, or weeks or even months later. He allowed the positions to remain unsettled, and then on October 16 demanded that the shares he had bought be delivered.

His brother Otto played a key part in this maneuver.

Otto was a broker running Otto Heinze & Co., which was one of the two key brokerage firms through which the bear squeeze was implemented.

So on October 16 Augustus demands settlement. He thinks he already owns most of the shares of United Copper, and that short sellers will have to buy shares from him in order to settle their positions.

Yes, and the shares began rolling in. They get delivered and delivered and delivered, and to Augustus Heinze's astonishment, there were shares to back up all of the purchases he had made. By some fluke he had simply misestimated the volume of shares outstanding and was faced with an enormous cash outlay in settlement of these shares.

Your book paints vivid scenes of the beginning of the panic. Thousands of stock certificates arriving at Otto Heinze's offices. Curb traders in United Copper "shouting and fighting" outdoors on the street, as the stock began to crash.

You can imagine the intense role of rumor, literally passed by word of mouth. The sense that traders would get by watching the features and actions of other traders. The men and women on the street growing more fearful of the soundness of the institutions in which they had their life savings. And the rumor began to pass rapidly that Augustus Heinze's bear squeeze was failing. Indeed, his inability to deliver cash in settlement of the purchases triggered the collapse of his brother's brokerage firm and another brokerage firm he had relied on. And the rumors began to circulate that his purchases had been financed by the very banks in which he had an equity interest and some of which he had served as a director or executive. As rumors spread, depositors began to withdraw funds from those banks, and the runs began. The sharpest runs occurred on trust companies, which were not subject to the kinds of reserve regulations that banks had to observe; they were viewed as perhaps more speculative. Indeed, they paid higher rates of interest on deposits than banks did.

The runs began on the Knickerbocker Trust Co. [its president, Charles Barney, had ties to Augustus Heinze], and at this point the partners of J.P. Morgan wired him — they had been in touch about the bear squeeze — and cautioned him not to come back from Richmond yet, because his very appearance in the financial district would have led people to conclude that conditions were much worse than they might actually be. Then, on the night of October 19, Morgan received a cable asking him to return to New York. He took the equivalent of the red-eye — meaning he had his own Pullman car hitched to a single steam engine, which raced through the night to Manhattan. On the afternoon of Sunday the 20th, he convened a working group of senior financiers in the library of his home at

Madison Avenue and 36th Street.

Their first order of business was to figure out what was going on. They received delegations from the Knickerbocker Trust Co. and other organizations pleading for intervention. Morgan insisted he get the facts first. He chartered groups of young professionals to fan out and audit the assets in the vaults of these institutions, simply to test the solvency of them. The auditors came back in a couple of days, and by then the runs had grown in strength and magnitude. Morgan and his circle determined that the Knickerbocker Trust Co. was in fact insolvent and could not be saved. Much in the tough-love manner of central bankers today and European central bankers at the time, he acknowledged that lending good money after bad was a faulty strategy, and he refused to step in and save the Knickerbocker Trust Co.

The report also came back that the Trust Company of America probably was solvent, and in one of the most dramatic moments of the entire panic, Morgan concluded that the Trust Company should be saved. His famous statement, "This is the place to stop the trouble, then" — as he pounded his fist on the table in a moment of galvanic intensity — began the rescue process.

What ensued over the next four weeks was a series of dramatic rescues of one institution after another, fallen, thus impairing Moore & Schley's asset backing. Morgan determined that there was no demand or very little demand for these shares in the market. But he had been the architect of a combination that had produced United States Steel in 1902, and so he went to the directors of U.S. Steel and persuaded them to buy Tennessee Coal and Iron at a rather rich price, exchanging gold bonds in U.S. Steel for shares in Tennessee Coal and Iron.

Under the envisioned exchange Moore & Schley would have been solvent, but there was one barrier to this grand scheme: the antitrust policies of President Theodore Roosevelt, who was in a mood to bust up trusts rather than make them bigger. So Morgan sent a delegation of executives to obtain Roosevelt's support for the deal. They arrived in Washington early one morning while Roosevelt was at breakfast. The President refused to see them at breakfast and wasn't sure he wanted to talk to them at all. But his Secretary of State, Elihu Root, convinced him that market prices were beginning to fall sharply on the belief that Roosevelt would not issue an OK for the deal. The delegation finally got in to see Roosevelt, persuaded him to sign off on the deal, and telegraphed word back to the New York Stock Exchange, which by midmorning was nearing pandemonium. When word arrived that Roosevelt had approved the deal a cheer went up, and the

exchange and the brokerage firm and the markets were saved once again, including the New York Stock Exchange and brokerage firms. The ultimate rescue was the saving of a brokerage called Moore & Schley. The firm had in its vaults the shares of stock of Tennessee Coal and Iron, a marginal steel producer that had suffered greatly in the recession and whose share prices had

Let's switch from 1907 to the present. How is today's crisis different?

Today's crisis differs in complexity, speed, and scale. We have a vastly more complicated financial system now. It's intricately linked with markets and institutions around the world. The very instruments that became the focus of this crisis — subprime loans — are themselves extremely complicated to value. And the institutions themselves are much more complicated and difficult to understand. That's one of the core ideas of any crisis — that crises feed on rumor and the lack of transparency, [and] complexity creates a lack of transparency. The second big difference between today and 100 years ago is speed. Money moves at the speed of light, as does news. The possible response time of anyone who would seek to intervene is much shorter today than 100 years ago. Finally, the sheer scale of markets today dwarfs the magnitude of values of 100 years ago.

And yet similarities abound.

The points in common are numerous, and indeed these commonalities have appeared in all the major crises since 1907. First, there's been an economic shock of some kind.

The collapsing of the housing bubble?

Specifically, I would point to the discovery in late 2006 of much higher rates of default on subprime debt than anyone had expected. The discovery was enabled by the invention of the ABX index, an index of subprime collateralized debt obligations. As the realization spread through the capital markets, institutions and bond markets began to react. This was a major change in expectations, a major piece of news.

Every crisis follows a period of exceptional expansion. In our case it was the real estate boom. There were other, lesser booms synchronous with this one: oil peaked at \$147 last summer, and commodities, metals, and foodstuffs, which have all subsided dramatically from their peaks, were also the focus of investor bubbles.

The absence of financial slack in the economy is another key feature of every crisis. In 1907, the American economy had been booming with short interruptions

since the end of the Civil War; from 1893 to 1907 real GNP growth averaged 7 percent per year. We don't have aggregate debt data for the first decade of the century in as granular detail as we do today, but the evidence is clear that the industrial sector of the United States was expanding rapidly, and this expansion drew down cash and unused debt capacity. Today everyone is talking about the global economy facing an extended period of deleveraging. Cases in point would be the bulge-bracket investment firms that, following permission from the SEC, began to leverage up dramatically. Hedge funds are known to be highly leveraged, and consumer debt was reaching an all-time high. The very nature of the real estate bubble was fueled by extending mortgage loans to consumers who should not have been extended that kind of credit.

Another common feature is optimism, the belief that this time it's different — that this time, there's a paradigm shift that will prevent a change in direction in the market. In 1905 and '06 rapid growth stimulated a burst of investment activity in subways and railroads; in the telephone; in basic industries, such as U.S. Steel; and in many other fields. This buoyant investment is a telltale sign of expectations of rapid growth believed to extend many years in the future. We saw that in the technology bubble of 1999–2000, and certainly in the real estate bubble. Every period of excessive optimism is, of course, followed by excessive pessimism. As we see the Dow fall into the 7,000s, it's a reminder that emotion goes both ways.

A final factor I would highlight is the role of adverse leadership. In 1907, Teddy Roosevelt surely had a role in alarming investors. He had created an atmosphere hostile to industrialists and wealthy investors; he spoke of "malefactors of great wealth." In the modern day, Alan Greenspan recently went before Congress to say yes, he did make some errors. The leaders of financial institutions who permitted them to jump heavily into investments in subprime loans would certainly be in the pool of leaders who weren't taking the long view.

When we look back at the subprime crisis, will we use words like "panic" and "crash" to describe it?

They are entirely appropriate. Although we haven't seen long lines of anguished depositors in front of banks in the New York financial district, the footprints of a panic are all over this current crisis. We've actually seen panics at IndyMac in California and Northern Rock in the United Kingdom, lines of anguished depositors. More important, we've seen the panic evident in the withdrawal of funds from banks by major investors and individual depositors, and we've seen the reluctance to lend to banks in the overnight interbank lending market. We've seen the panic evident in the large default-risk premiums in credit default swaps.

The volatility in the stock market is unquestionably evidence of a crash, as well as the fact that the market is off now [in October] since its peak in October 2007 by more than 40 percent.

When do you think this panic will end?

I don't have a crystal ball, but the aftershock will carry on for some time. In 1907, there was a two-year trough and recovery. The practical person would be well advised to assume that something approaching a year will be what it will take — at the least — to crawl out of this.

The big unknowns are, first, the potential amplifying impact of emerging economies. Will they be able to weather the crisis as well as the developed economies? Second, what will be the role of technology in all this? Information technology is an accelerator in all ways: it could accelerate the contagion, the spread of bad news, but it could equally well accelerate a recovery. For instance, supply chains are much shorter and much more efficiently managed than ever thanks to IT. Another unknown is the extent to which we need to bleed off excess leverage in the global economy. The insertion of governments very aggressively is an attempt to hasten the deleveraging process. This should accelerate the recovery as well.

We're at the height of uncertainty. At the core of every crisis is an information problem. Economists love to talk about information asymmetries, the fact that some players in the market know things that other players don't. The way to quell a panic is to create much more transparency, to flood the market with information about the soundness of institutions and individuals, to flood the market with liquidity. That seems to be happening.