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How to Destabilise the Financial System

Bank failures tend to come in waves. In the United States, there have been about 30 bank failures so far this year. The FDIC announces a few more every week.

As a result, there is renewed interest in systemic risk. Instead of looking at the risks for individual financial institutions, regulators are focussing on macro prudential regulation: looking at the financial system as a whole, measuring the aggregation of risks across the entire system, and allowing for linkages and interactions between individual financial institutions

Banking failures are not new – between 1982 and 1992, more than 1500 US banks failed. In this paper we look at the failure of just one bank – the Penn Square Bank in Oklahoma.

In 1976, this was a very small bank, with 35 employees and assets of about \$30 million. Within the next few years, it caused direct losses of more than \$1.5 billion in the US banking system. Penn Square was a major factor in the failure of two major banks – Continental Illinois (the 7th largest bank in the USA) and Seattle First National (the 19th largest). Literally hundreds of other financial institutions suffered losses as a result of their involvement with Penn Square.

Penn Square was the Lehman Brothers of the 1980s – an early failure which was the trigger for a widespread loss of confidence in the banking system.

By studying Penn Square, we can identify many of the same systemic problems which contributed to the current financial crisis.