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SOME STRAIGHT TALK ABOUT PENN SQUARE

An address by

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Washington, D.C.

before the

Uninsured Depositors of Penn Square Bank

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I am pleased that your Senators and Congressmen have provided this forum for me and FDIC staff members to meet with those of you who have been affected by the failure of Penn Square Bank. In a moment, we will open the meeting and try to respond to all of your questions and concerns. But let me begin with some general comments.

When Penn Square failed on July 5, 1982, the Oklahoma City area was reminded of an unpleasant fact of life: there is no such thing as a painless bank failure. People and businesses get hurt. The entire community experiences stress and uncertainty.

Due to its size, the volume of uninsured deposits at risk and the vast amount of loan participations sold to other banks, the Penn Square failure was more disruptive than most. Its effects are still being felt not only in Oklahoma, but throughout the nation.

We at the FDIC are keenly aware of the trauma accompanying bank failures. We try in every way possible to minimize the impact on innocent victims.

It would be easy to get the impression from some of the local media coverage that the FDIC is something other than the "good guy" in this sordid affair. Some people seem to have lost sight of one central fact: the FDIC is not even remotely responsible for the demise of Penn Square or any of the pain and suffering the failure has caused.

The FDIC first learned of the seriousness of the Penn Square problem a few days before the bank failed. Our people worked around the clock for the next two weeks in a highly successful, even heroic, effort to avoid the slightest delay in making funds available to insured depositors. For the next several months our people worked 16-hour days, seven days a week, issuing receivership certificates to uninsured depositors, trying to get a handle on the loan portfolio, balancing the bank's books and investigating potential civil and criminal claims. The bank's records and books of account were in complete disarray.

The working conditions were almost insufferable. The hours were long. Office space was dingy and cramped. The pressures were intense. Scores of people were forced to leave family and friends behind in distant cities while they lived out of suitcases for months on end. Some of our employees were literally driven to the point of exhaustion.

I have never been more proud of our people. It was one of the FDIC's finest hours.

I have often wondered why our employees are willing to make these kinds of sacrifices. I have not been able to come up with any satisfactory explanation other than that they believe in the importance of what they do. They are true public servants.

No, the people of the FDIC are not the source of your problems. Let me be blunt about who is. The Penn Square debacle was caused by a gross dereliction of duty on the part of the bank's board of directors and management. They were able to perpetrate their abusive practices by obtaining funds -- normally through money brokers -- from banks, credit unions and S&Ls around the nation. These financial institutions, which held 80 percent of the uninsured funds at Penn Square, were motivated solely by a desire to make a fast buck.

Many of you have asked why the FDIC chose to handle the Penn Square failure through a payoff of insured depositors rather than a merger, as we typically do. The answer is simple: we had no choice.

When a merger of a failed bank is arranged, the FDIC must provide protection to the purchaser against any contingent or off-balance sheet claims. Penn Square had sold more than \$2 billion in loan participations to other banks and had outstanding nearly \$1 billion in letters of credit. The potential exposure to loss on the \$3 billion of off-balance sheet claims was staggering. The FDIC is prohibited by law from arranging a merger unless it determines that the cost of the merger will likely be less than a payoff of insured depositors. The existence of the tremendous volume of potential off-balance sheet claims made that finding impossible.

We were under a great deal of pressure that fateful July 4th weekend to arrange a merger. The financial institutions that had purchased loan participations and had uninsured funds at Penn Square urged the FDIC to help bail them out of their problems. If we had done so -- if we had tried to bail out these institutions in a situation as egregious as Penn Square -- the long-range consequences to our free-enterprise banking system would have been devastating.

Others have asked why the FDIC does not absorb all of the expenses of the liquidation of Penn Square rather than charging them against the receivership's collections. The answer is again quite simple: we have no choice.

It would be completely inappropriate for the FDIC to divert the resources of the deposit insurance fund, which is maintained solely for the benefit of insured depositors, to grant a subsidy to uninsured depositors and other general creditors of a receivership. The FDIC's policies at Penn Square are the same as those followed in more than 730 bank failures handled throughout our 51-year history; we simply cannot alter them for the benefit of the creditors of a single bank. Moreover, the National Bank Act expressly provides that the expenses of a national bank receivership shall be deducted before any distributions are made to creditors and stockholders.

It is important to bear in mind a couple of important facts. First, the FDIC, because it has paid off the insured depositors, is the major creditor of the Penn Square receivership. This means that for every dollar of expense charged to the receivership, the FDIC absorbs over 50 cents of the cost. Second, holders of the vast majority of the remaining receivership claims are not the completely innocent victims of Penn Square that some would have you believe. They are the financial institutions that helped make the Penn Square fiasco possible by supplying the funding for its reckless lending activities.

Finally, some have questioned whether our liquidation expenses are too high. While the size and complexity of the Penn Square loan portfolio and litigation have resulted in higher than normal liquidation costs, the FDIC has kept those expenses to an absolute minimum. Liquidation expenses at Penn Square represent less than 4 percent of total collections. By comparison, collection costs in the typical corporate bankruptcy often run in the 20 percent range. Moreover, in reporting on the Penn Square expenses, some people conveniently overlook the fact that the receivership's interest income of \$73.6 million far exceeds its expenses, which total only \$21.8 million. To be completely candid, though, I should note, as we have from the beginning, that as the liquidation progresses and the quality of remaining assets declines, our ratio of expenses to collections will increase significantly.

In sum, I have not the slightest reservations about the performance of our people at Penn Square. Have we made any mistakes or errors? Yes, we have. But they have been minor and readily understandable in view of the circumstances under which we have been forced to operate. Have some innocent people been hurt at Penn Square? Unfortunately they have, and nobody regrets that more than I. I have met with some of those people, I share their pain and we are doing everything possible to alleviate their hardship. But I take great comfort from the knowledge that the FDIC is not the source of their problems but part of the solution.

Now let's turn to your questions.

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