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STATEMENT ON

FAILURE OF THE PENN SQUARE BANK
OKLAHOMA CITY, OKLAHOMA

PRESENTED TO *the*

COMMERCE, CONSUMER, AND MONETARY AFFAIRS SUBCOMMITTEE *of the House*
COMMITTEE ON GOVERNMENT OPERATIONS
HOUSE OF REPRESENTATIVES

BY

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WILLIAM M. ISAAC
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

10:00 A.M.
FRIDAY, JULY 16, 1982

ROOM 2247 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, D.C.

Mr. Chairman:

I am pleased to have the opportunity to discuss the role of the FDIC as the Receiver for the failed Penn Square Bank of Oklahoma City. I thought it might be useful, in view of the complexity of this situation, to review the background of the matter and the options available to us. Then I will discuss generally the implications of this bank's failure.

I. BACKGROUND OF FDIC ACTIVITIES

On Wednesday morning, June 30, the Comptroller's staff called me to set up an urgent meeting at which they described the seriousness of the situation at the Penn Square Bank and indicated that the bank was in danger of failing. We immediately dispatched about 10 FDIC examination and liquidation personnel to the scene to gather information. They were instructed to operate out of our Oklahoma City field office, rather than the bank, to the extent possible.

On Thursday the American Banker ran a story on the bank, and on Friday both the American Banker and the Wall Street Journal ran articles. The story also received local media coverage in Oklahoma City.

In view of the increasing media attention and the possibility of widespread depositor concern, on Thursday we dispatched another 50 or so FDIC personnel to the scene.

They were to begin preparations for handling the possible failure of the bank through either a purchase and assumption transaction or a deposit payoff.

Deposit outflows were modest on Friday but on Saturday conditions deteriorated substantially. In fact, the bank did not have sufficient cash on hand to meet depositor demands and issued \$1.8 million in cashiers' checks. Local T.V. stations broadcast reports from the bank on Saturday. If the bank had opened for business as usual on the following Tuesday, we and bank officials anticipated extraordinary deposit withdrawals.

Approximately 30 FDIC personnel in Washington and 60 in Oklahoma City worked virtually nonstop through the holiday weekend to prepare for every contingency. We had essentially three alternatives to consider:

1. to arrange a purchase and assumption transaction,
2. to do a deposit payoff, or
3. to create a Deposit Insurance National Bank (DINB) to handle the funds of insured depositors.

P&A Transaction

Our preferred method of handling a bank failure is to merge it into another institution with FDIC assistance.

Very occasionally we are not able to do this either because we have no acceptable acquirers or because the bank has a potentially large amount of contingent or unknown claims which makes it impossible to estimate the cost of a merger.

We cannot, under our statute, enter into a merger or purchase and assumption transaction unless our Board can make a finding that the P&A will likely be no more costly than a deposit payoff. We estimated that our maximum cost under a deposit payoff could be as high as \$240 million but would likely be very substantially less depending on recoveries from the receivership.

In a purchase and assumption transaction, the Corporation indemnifies the acquiring bank against contingent liabilities or unknown losses caused by actions of the failed bank. In providing this indemnification, we must estimate the losses arising from the known contingent claims and satisfy ourselves that other contingencies that might lead to large losses do not exist.

In the case of Penn Square, we were aware of contingent claims -- including loan participations, loan commitments and standby letters of credit -- ranging between \$2.5 and \$2.9 billion. In addition, we had reason to believe there might be irregularities that could give rise to other claims. It was virtually impossible, particularly in view of the

time limitations, to estimate the potential losses that could stem from this vast source of contingent claims. Given our inability to accurately assess and quantify these potential losses, and our statutory limitations, we simply could not arrange a purchase and assumption transaction.

Deposit Payoff

Our second alternative was simply to pay off insured depositors up to the \$100,000 maximum. This process involves proof of deposit accounts, the determination of the amount held by each depositor in his or her separate right and capacity, and the preparation of checks. Uninsured depositors and general creditors would receive receiver's certificates with payments to follow as the assets of the bank were liquidated.

The process of paying off insured deposits is time consuming and disruptive. Our Division of Liquidation estimated that the payment of insured deposits could not have commenced until the week of July 12. Furthermore, if this alternative was selected, any checks drawn on deposit accounts in the Penn Square Bank would have been returned. Given the anticipated press coverage of the transaction, the size of the bank, and the possible adverse effect on public confidence, we were most anxious to reopen the bank's doors on Tuesday.

DINB

Our third option was to create a Deposit Insurance National Bank. All insured deposits would be transferred to the DINB, which would continue to honor checks drawn on the Penn Square Bank up to the insured limit and permit an orderly pay off of insured accounts. Uninsured depositors would be issued receiver's certificates for the excess of their accounts over \$100,000.

It was decided that this was the most desirable course of action. We decided to pay interest on interest-bearing accounts transferred to the DINB for 90 days as an assurance to depositors that there was no need to rush immediately to the bank to withdraw funds. However, it is hoped the 90 day limit will encourage an orderly transfer of funds to other banks within that time.

We were greatly handicapped in our preparations over the weekend due to the fact that the decision to close the bank was not made until 7:00 p.m. on Monday. Nevertheless, the DINB opened its doors at normal hours on Tuesday morning.

There were depositor lines throughout the day on Tuesday, but they were much shorter than anticipated for a bank of this size with nearly 28,000 customers. We announced that we would keep the bank open 24 hours a day if necessary to meet the demands of depositors.

People remained very calm and by 7:00 p.m. on Tuesday the depositor lines had disappeared and we closed the doors for the evening. Each day since, the bank has operated normally without lines of any note.

I would be remiss if I did not take this opportunity to salute the bank and FDIC employees who worked around the clock for days in order to provide uninterrupted service to the bank's depositors.

In addition to the activities at the DINB, we have a large number of FDIC personnel involved in the receivership activities relating to the bank. Their first priority is to assist credit-worthy borrowers in locating alternative funding sources.

They are also taking an inventory of all of the bank's assets and attempting to determine their value. We will endeavor to promptly dispose of the assets in an orderly fashion so that we may return funds to uninsured depositors and other creditors as soon as possible.

Our people are also conducting, in conjunction with the F.B.I., a thorough investigation of the events and activities which led to the bank's demise. Extensive legal proceedings are highly probable.

II. WHAT WENT WRONG?

Many people are asking: "How could this have happened? Why did this bank fail and how did so many other financial institutions get involved? Is this failure evidence of other problems in the financial system?"

The first point I should emphasize is that we do not yet know precisely what happened. The FDIC has only just begun to conduct its investigation.

However, we have at this stage a rough outline of the practices and problems which led to the bank's demise. The short answer is that, at best, this bank engaged in shoddy, speculative banking practices. Its problems were not due principally to the economy in general or even the decline in energy prices. Its problems were the result of loans which should never have been made at the values placed on them. The bank's growth rate was excessive, causing extensive reliance on volatile and expensive funds borrowed in national money markets. There was a complete lack of diversification in the loan portfolio.

In a word, the problems of this institution were unique and the bank's collapse is an aberration. Fortunately, the great majority of insured banks adhere to prudent and

rational lending and funding policies. With nearly 15,000 banks in the country, we will occasionally encounter situations like Penn Square. But they will be few and far between.

III. RIPPLE EFFECTS

Much has been said and written about the impact of the Penn Square failure on other financial institutions that either participated in loans originated by Penn Square Bank or provided funding to the bank in amounts in excess of the insurance limit.

Simply stated, a number of financial institutions regrettably have learned an expensive but important lesson. These financial institutions were attracted by the opportunity to obtain high yields on their investments but failed to take into account the degree of risk being undertaken. As a result, some institutions will sustain losses.

It is indeed fortunate that these institutions have the ability to withstand these losses. If one can identify a silver lining behind the dark cloud of the Penn Square affair, we should expect that all financial institutions will be more prudent in the future.

IV. LEGISLATIVE RESPONSE

We realize that there will be a great temptation to rush through legislation to address specific practices that led to the Penn Square failure. This, in our judgment, would be a mistake.

The regulatory agencies have sufficient supervisory and enforcement tools to carry out their responsibilities. As I stated earlier, the problems of the Penn Square Bank were unique, the failure was an aberration and similar pervasive problems within the financial industry simply do not exist.

Nevertheless, I think this experience should prompt us to reevaluate our financial institutions regulatory structure. In conducting a review of the regulatory structure, we should carefully consider the following questions:

1. Is there a need for five regulatory agencies to supervise the activities of the nation's depository institutions and does our current system function properly?
2. Is there a need for three separate deposit insurance funds?

3. Would it be appropriate to base deposit insurance premiums on the risk posed by the insured entity rather than to continue the present flat rate system for all institutions?
4. Can and should we revise our deposit insurance system and procedures to provide perhaps even greater protection for smaller depositors while at the same time introducing a greater degree of discipline with respect to larger creditors?
5. Is it possible and desirable to provide more public disclosure regarding the condition and business practices of insured depository institutions?

These are all matters that I have addressed in the past both before Congress and in other public forums. I firmly believe that significant reforms in our regulatory apparatus are needed. It is my sincere hope that the experiences of the last two weeks will provide the impetus to move forward on these issues.

The worst mistake we could make is to look for a "quick fix" or to enact punitive measures that would further

burden an entire industry to correct the abuses of a few.
We urge you to undertake a dispassionate review of the Penn
Square situation from a broadly-based, long-range perspective.

We appreciate this opportunity to appear today and
offer our complete cooperation in your future efforts in
this matter.